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Closure of Subsidiary/JV - Possibility to claim Business Loss

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MARK Zuckerberg rightly said that ***"The only strategy that is guaranteed to fail is not taking risks"***
. But, sometimes the risk may not result into reward and we may run ourselves into a roadblock.

A wise man keeps himself ready today for tomorrow, and does not put all his eggs in one basket. In the modern era, with a view to enhance business objectives through forward and backward integrations and for augmenting diversification, corporates either set up or invest in new companies in the form of joint ventures (JVs) or subsidiaries. However, subsequently, if due to any reason, such ventures are unable to perform well and are required to be wound up, it leaves a huge dent on the financial position of the company.

In such a case the question from an Income tax perspective is whether such a loss arising on write-off of the investment from the books of accounts of the parent company, be claimed as deduction in the computation of income? Related questions that follow are whether it will be considered as capital loss or whether it can be allowed as a revenue deduction. As an assessee, one would like to claim such loss as a business loss and reduce company's profits. Likewise, the Revenue may take a stand that such loss is a capital loss and should be disallowed. In such a case, if the view of the department is accepted, the company will be unable to claim benefit of set-off such losses in the adjacent years of loss, unless it generates similar quantum of capital gains to set off such losses.

Reasons for treating loss on write-off of investment on liquidation as capital loss

The claim of the department "that such losses are in the nature of capital loss" is supported by the provisions of section 46 of the Income Tax Act, 1961 ('the Act'), wherein it is provided that in case a shareholder receives any money or other assets on liquidation of a company, then such receipt shall be chargeable to tax under the head 'Capital Gains'. Following the principle of
"Lex specialis derogat legi generali - a specific provision will always override the general rule"
that gains/losses should be held chargeable under the head capital gains.

Also, the following judgements have held that if any amount is received on liquidation of a company, it should be charged to tax under capital gains:

- R.M. Amin - **2002-TIOL-2670-SC-IT** and

- Vijay Kumar Budhia [1993] 204 ITR 355 (SC)

Earlier some decisions have also held that section 46 is a special provision enacted only to charge gains arising on liquidation and therefore in cases where the assessee does not receive any amount on liquidation, the resultant loss emanating from liquidation, if any, does not fall under the charging provision and the charge of section 46 fails to provide the benefit of claiming loss to the assessee. If this is followed the assessee will not be able to claim the actual loss incurred by it wherein gains, if any, would be liable to tax on a similar transaction.

With a view to clear the air over such unjust rulings, the Hon'ble Gujarat High Court in the case of
CIT v. Jaykrishna Harivallabhdas [1998] 231 ITR 108 (GUJ.)
held that even in such case, where the shareholder does not receive any amount on liquidation of a company, the cost of investment can be claimed as a capital loss as per provisions of section 46 of the Act, as extinguishment of rights in shares.

Further, as per common parlance, the activity of making investment in a subsidiary for furtherance of own business is generally regarded as capital in nature and is not undertaken in the ordinary course of business of the companies, barring those involved in investment business (like banks and insurance companies).

Additionally, subsidiaries are usually reported as Non-Trade Investments in the financial statements of the parent company, and therefore, loss on closure of a subsidiary would generally be characterized as a loss under the head capital gains.

Possibility to claim loss on write-off of investment on liquidation as business loss

The vexed question remains as to how claim of loss on investment made in a subsidiary as a business loss can be justified. If a nexus can be established that the investment made in a subsidiary is for the enhancement of business objectives of the parent company, then the loss emanating from such investment can be considered as loss arising from business and the same can be claimed under the head 'Profits and Gains from Business/Profession'.

The genesis of this rationale has its roots emerging from the landmark decision of the Hon'ble Supreme Court of India in the case of Brooke Bond & Co Ltd - ***2002-TIOL-1091-SC-IT***. The Honorable Apex Court in its decision laid down the cardinal principle of income tax law that ***"income- tax is a single charge on the total income of an assessee and only for the purpose of computation, the statute recognizes different classes of income which it classifies under different heads of income."***

The Court explained that the nature of income must be determined from the fact that whether having regard to the true nature and character of the income it could be described as an income from business or not. If it can be shown that said investment intended to bring or has brought some advantage or benefit to the business carried on by the assessee, then it could be categorized as business income. Likewise, if there is loss which arises from an investment which was initially made in order to enhance the business objectives of the company, the said loss can be characterized as business loss.

Recently the Karnataka High Court in the case of ACE Designers Ltd - **2020-TIOL-1615-HC-KAR-IT** has affirmed that where assessee-company made investment in its wholly owned subsidiary outside India for business purpose i.e., ***for enhancement of its business activity in the global market,*** however, the said subsidiary could not perform up to the company's expectations and was wound up, loss arising from investment made in the subsidiary was to be allowed as business loss.

The court observed that ***"The investment was made for the purpose of extension of business activity and not with a view to creating capital asset in the form of holding shares. It is also pertinent to note that the assessee never acquired any capital asset or expenditure of enduring benefits to WOS and there is no relinquishment or transfer of capital asset to any third party."***

Various other decisions are also in assessee's favour based on the aforesaid rationale:

- ***Sahara Global Vision Pvt. Ltd [ITA No. 2514/DEL/2014]: -***
In this case the assessee had entered into a JV by way of participating in a company in USA for distribution of petroleum and chemical products after obtaining approval from the RBI. Subsequently, the JV company in USA was liquidated. The assessee had invested USD 3 million and on liquidation of the JV company, a sum of US$ 24,82,746 could only be recovered and the balance amount was written off in the accounts of the relevant year. The claim of the assessee that the write off represents business loss was upheld by the ITAT as there was no dispute that the assessee made investment in furtherance of its objects.

- Bombay High Court in the case of Colgate Palmolive (India) Ltd - - **2014-TIOL-2344-HC-MUM-IT**
- The fully owned subsidiary Camelot was engaged in the manufacturing of toothbrushes exclusively for the sole client, namely, the assessee. The High Court agreed with the Commissioner's conclusion that the main reason for setting up Camelot was to manufacture toothbrushes exclusively for the assessee. Since the assessee was relying on Camelot for manufacturing of toothbrushes to be traded by the assessee, the investment was nothing but a measure of commercial expediency to further business objectives and primarily related to the business operations of the assessee. At no point of time the investment in Camelot was made with an intention to realize any enhancement value thereof or to earn dividend income. The investment was made to separately house the integral part of the business activity.

- Cochin Tribunal in the case of Apollo Tyres Limited - **2017-TIOL-264-ITAT-DEL**
-In this case the Tribunal held that there was nothing on record to show that the subsidiary company was doing any activity

completely independent and unrelated to the activities carried out by the assessee-company. Thus, assessee's claim that the investment was made for commercial purposes and not for purpose of accretion of investment was to be accepted.

Based on the above decisions, it can be inferred that if a strong nexus can be established between the investment objective and with business of the parent company and if one can establish that the investment was made as measure of ***commercial expediency,*** then the parent company may possibly claim the loss arising on sale or closure of such subsidiary as a business loss.

However, litigation on this issue cannot be ruled out as the department would more likely than not dispute such position taken by the company and the matter may have to be litigated before higher appellate authorities. Another aspect which raises caution is that what if in line with the above judgments, the department begins to opine that correspondingly the gains arising on sale/liquidation of shares, which can be inextricably linked to the business of the assessee should be held as chargeable to tax under the head 'Income from Business/Profession' instead of 'Capital Gains'.

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