

Losses

Summary				
Head of Income	Possibility of loss	Treatment of loss for the year	Whether loss can be carried forward	Whether losses for the year of other heads can be adjusted
salary	No	N/A	N/A	Loss under any other head of income cannot be adjusted against salary.
Income from Business	Yes	<ul style="list-style-type: none"> Business loss can be adjusted against any other Head of income except salary and income from property. Unabsorbed depreciation can be adjusted against 50% of the persons balance income chargeable under the head "income from business" after setting off business loss and so on until completely Set off. 	Business loss (i). Loss can be carried forward for six years and adjusted only against future business profits. Unabsorbed Dep (ii). Unabsorbed depreciation can be carried forward until fully set-off subject to adjustment of 50% of total income.	Loss under following heads can be adjusted against business profit: Income from property Income from other source
Income from Business-speculation	Yes	Loss can be adjusted only against any other speculation business profit earned during the year. It cannot be adjusted against income of any other head.	Loss can be carried forward for six years and adjusted only against speculation business profits.	Loss under following heads can be adjusted against speculation business profit: Income from property Income from other source Income from non Speculation business
Foreign Source of income	Yes	Foreign loss under particular head including speculation loss shall be treated as separate head. Foreign loss cannot be adjusted against Pakistan source income. Loss under any other foreign head of income cannot be adjusted against foreign income under a particular head.	Any foreign loss under a head of income can be carried forward for six years and adjusted only against foreign income earned under that head.	Any Pakistan source loss can be adjusted against foreign source income.

Set-off of losses

Where the total deduction admissible to a person exceeds the income of a person then the said person suffers loss under the said head of income. The income tax law includes comprehensive provisions which stipulate the mechanism for adjustment of these losses against other heads of income and against the income for the ensuing years. Sections 56 to 58 of the Ordinance deal with this issue and the said sections stipulate that:

Set-off of losses (Sec-56)

Where the net result of computation of income for any tax year under any head of income is a loss, the same can be set-off against the income from any other head of income except for "income under the head salary or income from property". For example a business loss can be set-off against income under the head "Income from other source" or any other head of income. However the following are exception to the said rule:

- (i). Loss in speculation business cannot be set-off against any other income.
- (ii). Capital loss
- (iii). Loss from any head of income falling under presumptive tax regime
- (iv). exempt income e.g. loss of agriculture income cannot be set-off against any taxable income

No loss except loss under the head "Income from Business" (including income from speculation business) and "Capital gain" shall be carried forward.

If a person sustains loss under the head "Income from Business" in addition to loss under any other head, the loss under the head "Income from Business" shall be set-off last

Carry forward of business losses (Sec-57)

If business loss (other than speculation loss) sustained in a tax year cannot be fully set-off in the same year with income under any other head, it can be carried forward to subsequent years.

In subsequent years, this loss can only be set-off against the person's income chargeable under the head "Income from Business".

No loss shall be carried forward to more than six tax years immediately succeeding the tax year in which the loss was first computed.

Where a person has a loss carried forward for more than one tax year, the loss of earliest tax year shall be set-off first.

If the loss, which is carried forward, includes depreciation, initial depreciation, first year allowance and amortization allowed u/s 22, 23, 23A, 23B & 24, such loss shall be set off against fifty percent of the person's income chargeable under the head "income from business" for the following year (after adjustment of brought forward business losses) or if there is no income from business for that year be set off against 50% of the person's income chargeable under the head "Income from Business" for the next following year and so on for the succeeding years.

However, loss shall be set off against hundred percent of the said balance income if taxable income for the year is less than ten (10) million Rupees.

While computing person's taxable income, the deductions available u/s 22, 23, 23A, 23B & 24 shall be taken into account last.

Carry forward of speculation business losses (Sec-58)

Where a person sustains a loss in a tax year from any speculation business, he can set off such loss only against profits of another speculation business carried on by him during the same tax year.

If any loss cannot be so set-off, either wholly or partly, such portion of loss shall be carried forward upto six tax years immediately succeeding the tax year in which the loss was sustained.

In the subsequent years this loss can only be set-off only against income of any speculation business. It means that loss from speculation business cannot be adjusted against any other head.

Where a person has a loss carried forward for more than one tax years, the loss of earliest tax year shall be set-off first.

Carry forward of capital losses (Sec-59)

A capital loss sustained by a person during a tax year shall not be set-off against income of same person under any other head of income, for the same tax year.

The amount of capital loss which cannot be set-off shall be carried forward upto six tax years immediately succeeding the tax year in which the loss was sustained.

In the subsequent years this loss can only be set-off only against capital gain for this year.

Where a person has a loss carried forward for more than one tax year, the loss of earliest tax year shall be set-off first

Limitations on set off and carry forward of losses (Sec-59A)

Losses sustained by AOP and their adjustment by members

An AOP whose profits are chargeable to tax under Income Tax Ordinance, 2001 shall be entitled to a set off or carry forward and set-off any loss of AOP against the income of AOP.

Any members of an AOP shall not be entitled to set off or carried forward and set off loss of AOP against his income.

In case company is member of an AOP, then any loss incurred by AOP shall not be added in the income of company.

Other limitations

Any person who has succeeded, in such capacity, any other person carrying on any business or profession, otherwise than by inheritance, shall not be entitled to set off or carry forward loss of predecessor.

If the loss includes depreciation, initial depreciation and amortization allowed under section 22, 23, 23A, 23B and 24 or 25, and full effect of such amounts cannot be given either due to their being no profit or profits are less than deduction stated above, such amounts shall be added to the amount of such deductions for the following years and shall be carried forward in the following tax years till they are completely set-off.

Business loss, speculation loss and capital loss shall not be carried forward and set off unless it is assessed or determined by an order treated as made under section 120-Assessments, 121-Best Judgment assessment or 122-Amendment of assessments of the Income Tax Ordinance, 2001.

Change in control of AOP/Company (Sec-98)

Where there is a change of fifty per cent or more in the underlying ownership (Share in a company or the interest of the member in association) of an entity, any loss incurred for a tax year before the change shall not be allowed as a deduction in a tax year after the change, unless the entity:

- (a) continues to conduct the same business after the change as it conducted before the change until the loss has been fully set off; and
- (b) does not, until the loss has been fully set off, engage in any new business or investment after the change where the principal purpose of the entity or the beneficial owners of the entity is to utilise the loss so as to reduce the income tax payable on the income arising from the new business or investment.

Group taxation (Sec-59AA, Rule 231D)

Holding companies and 100% owned subsidiaries may opt to be taxed as a single fiscal unit for which consolidated group accounts shall be required for the computation of income and tax liability.

Under this option profit and loss of all group companies is pooled together. In this way, a tax loss sustained by one Group Company is set off against taxable income of another group company. The benefit of set-off is however not permissible for losses incurred by a group company prior to exercise of the option.

Such option exercised by the group companies shall be irrevocable.

The group taxation shall be restricted to companies locally incorporated under the Companies Ordinance, 1984

The option of group taxation shall be available to those group companies which comply with such Corporate Governance requirements as may be specified by the Securities and Exchange Commission of Pakistan from time to time and are designated as companies entitled to avail group taxation.

Groups taxation may be regulated through rules as may be made by the Board.

Exemption under Second Schedule in case of group taxation:

- (i). Any income derived from inter-corporate dividend within the group companies entitled to group taxation is exempt from tax subject to the condition that return of the group has been filed for the last complete tax year. In view of the said provision tax shall not be deducted at source while paying dividend. (Ref: Clause 103A Part I and Clause 11B Part IV of the Second Schedule).
- (ii). Further tax shall not be deducted at source in respect of inter-corporate profit on debt within the group companies entitled for group taxation subject to the condition that return of the group has been filed for the latest completed tax year. (Ref: Clause 11C Part IV of the Second Schedule).

Note: Under section 97 of the ITO, 2001 where a resident company disposes off all the assets of a business to another resident company, no gain or loss on disposal is to be accounted for when both companies belong to a wholly owned group (100% ownership) of resident companies at the time of disposal. It must be remembered that whether companies have opted for group taxation or not, no gain or loss will be booked.

Rule 231D. Procedure for group taxation under section 59AA

100% owned company shall be a subsidiary company where holding company owns all equity shares of such company except those held by nominees to meet the statutory requirements of Companies Ordinance, 1984.

Holding and subsidiary companies entitled for group taxation under section 59AA shall make separate application duly signed by their respective Chief Executives containing declaration of irrevocable option for group taxation as one fiscal unit to the commissioner in the prescribed form within first quarter of the tax year for which group taxation is opted for.

Holding and subsidiary company shall also furnish a certificate issued by Securities and Exchange Commission of Pakistan (SECP) verifying that company has been complying with Code of Corporate Governance.

Return for the tax year following the option for group taxation shall be prepared as one fiscal unit under the name of the holding company and tax liability shall be discharged or refund claimed as if the business of the subsidiaries companies were the business of the holding company.

No effect shall be taken for losses including unabsorbed depreciation of subsidiary company for the tax year prior to the exercise of option for group taxation.

Along with group return, copies of audited accounts of every company in the group shall be attached.

In case there is divestment of subsidiary company and provisions of group taxation become inapplicable, no effect shall be taken for group taxation during the year of disposal.

Holding and subsidiary company shall continue to be independent withholding agent and file monthly withholding statements when the group is taxed as one fiscal unit.

All companies opting for group taxation shall have similar accounting period for computation of income.

Transaction by any company within the group and its associated companies shall be carried out and recorded on arm's length basis.

Group Relief (Sec-59B)

A subsidiary company may surrender its tax loss (excluding brought forward loss and capital loss) in favor of its holding company or its subsidiary or in favor of any subsidiary of its holding company. The holding company should directly hold share capital of the subsidiary company as under

If one of the company in group is public listed	55% or more
If none of the company in group is public listed	75% or more

The loss to be surrendered shall be allowed as per following formula, namely:-

$$(A/100) \times B$$

Where

A is the percentage share capital held by the holding company of its subsidiary company; and

B is the assessed loss of the subsidiary company

The other loss surrendered by the subsidiary company may be claimed by the holding or any subsidiary company under the head income from business in the tax year in which the loss has been surrendered and in the following 2 tax years subject to the following conditions:

- (i). There is a continued ownership for 5 years of the share capital of the subsidiary company as mentioned above (reversal of availed relief shall take place if the equity interest falls below the minimum required in such 5 years)
- (ii). A trading company within the group shall not be entitled to avail group relief
- (iii). If a holding company is a private company, it shall get itself listed within 3 years from the year in which the loss is claimed
- (iv). Approval of Board of Directors of both the companies (loss surrendering & loss claiming) is necessary
- (v). Subsidiary company shall continue the same business during the specified period of 3 years
- (vi). All the companies in the group comply with corporate governance requirements.
- (vii). The subsidiary company cannot surrender its assessed losses for more than 3 tax years. Any unadjusted loss of subsidiary company after the specified period shall be carried forward by the subsidiary in the normal manner.

Unlike group taxation, Inter-corporate dividend income within the group companies is chargeable to tax in group relief. Further concept of withholding tax while making payment for dividend and profit on debt is also applicable.

Loss claiming company shall, with the approval of the Board of Directors, to transfer cash to the loss surrendering company equal to the amount of tax payable on the profits to be set off against the acquired loss at the applicable tax rate. The transfer of cash would not be taken as a taxable event in the case of either of the two companies.

Transfer of shares between companies and shareholders in one direction, would not be taxable capital gain provided the transfer is to acquire share capital for the formation of a group and approval of SECP or SBP has been obtained in this respect.

Set off of business loss consequent to amalgamation (Sec-57A)

Amalgamation means merger of entities where

- (i). One of the merger entities is:
 - A banking company
 - A non-banking financial institution

- An insurance company
- Company owning and managing industrial undertakings
- Companies engaged in providing services and not being a trading company

(ii). One of the merger entity carries the legal status of:

- A public company or
- A company incorporated under any law in force in Pakistan, other than Companies Ordinance, 1984

(iii). All the assets of dissolving company (referred as amalgamating company) as immediately before merger becomes the assets of the amalgamated company (company formed as a result of merger).

(iv). The liabilities of amalgamating company immediately before the merger becomes liabilities of amalgamated company.

With reference to merger of specified entities as discussed above any integration cost incurred by amalgamated company are tax deductible in so far as these relate to following:

- (i). Legal services
- (ii). Financial advisory services
- (iii). Administration costs

Note 1: *Given that law has identified specific costs as tax deductible, expenditure incurred by amalgamated company on other accounts such as technical due diligence, financing cost, retrenchment cost etc. will not be tax deductible.*

Note 2: *In case of merger of entities other than those defined above, no integration cost will be allowed as expense.*

In the case of amalgamation of company owning industrial undertaking or company providing services, assessed loss (excluding capital loss) for the tax year, other than brought forward and capital loss, of the amalgamating company shall be set off against business profits or gains of the amalgamated company in the year of amalgamation subject to the condition that amalgamated companies continues the business of amalgamating company for a minimum period of five years.

However in the case of amalgamation of banking company, Non- banking finance company, modaraba or an insurance company, the accumulated losses under the head income from business (other than speculation business loss) of amalgamating company shall be set off or carried forward against the business profits and gains of amalgamated company upto a period of six years immediately succeeding the tax year in which the loss was first computed. Any unadjusted loss can be carried forward up to a maximum period of 6 years succeeding the year of amalgamation.

Unabsorbed depreciation can be carried forward in the normal manner with no time limits.

Non-compliance with any of the conditions laid down by SBP, SECP or any court shall render the allowed adjusted loss be treated as the income of the amalgamated company in the year which the non-compliance occurred.

Exercise:

- (a)** Lahore Textile Limited (LTL), which was incorporated over 20 years ago, is listed on the Pakistan Stock Exchange. It manufactures textile products and sells them in Pakistan. LTL is one of the largest textile companies in the country and has steadily accumulated a significant cash balance, but has been losing market share for several years. Growth in the industry has also slowed, leading to declining revenue, to the extent that LTL is in a breakeven situation. Some major shareholders in LTL have been critical of management, demanding that they formulate a strategy to restore growth.

The board of LTL is now considering two options to achieve this growth, both of which could be financed from cash reserves:

- (i). Launch an aggressive marketing campaign to grow organically. This would be underpinned by a new, more efficient production process as LTL will replace its existing machines, some of which are outdated, with modern, innovative machines purchased from Germany. These can be operated by fewer staff which will allow for reductions in cost, and lower, more competitive pricing.
- (ii). Acquire an established competitor, Multan Fabrics, which is also based in Pakistan.

The board members believe that they must choose between these options as they do not have the management capability or financial resources to undertake both of these.

Required:

In the light of the provisions of Income Tax Ordinance, 2001 examine the taxation implications of the two options followed by a brief conclusion.

- (b) Abu Bakar (Pvt.) Limited holds 65% of share capital of Sameel (Pvt.) Ltd. Remaining 35% share of Sameel (Pvt.) Ltd are held by one individual Mr. Farhan. Sameel (Pvt.) Ltd is suffering tax losses due to heavy expenditures and it is expected that company will continue to suffer losses in future. CFO of Abu Bakar (Pvt.) Ltd seeks your opinion about steps to be taken to avail maximum benefit under the Income Tax Ordinance, 2001.

Answer:

(a) Option 1: Tax implication under Marketing Campaign

Marketing expenses

Cost of marketing campaign can be treated in either of the following ways by the tax authorities:

- (a). Allowed as an expense in the year of incurrence. LTL would obviously like this but the taxation authorities may not agree. The aggressive nature of the campaign implies that the cost will be significant and if accepted by the tax authorities, LTL would incur tax losses initially which may be carried forward and offset against future profits generated by LTL once its operations become profitable. However, the maximum carried forward period allowed for tax losses is 6 years.
- (b). As per section 24(11) of the Income Tax Ordinance, 2001, marketing expenses may be treated as intangible assets as its benefits are spread over more than one year. For tax purposes, the maximum amortization period of the intangible assets is 10 years, though LTL may be able to have it amortized in 3–5 years. It is quite evident that the cash flows under the two alternatives would be significantly different.

Purchase of plant and machinery from Germany

Any depreciable asset put into service for the first time in Pakistan during a tax year will be entitled to an initial allowance of 25% of the cost of the asset. LTL is also allowed to claim depreciation at the rate of 15% annually on reducing balance method. Further, LTL would also be entitled for BMR tax credit @ 10% of cost under section 65B-Tax credit for investment of the Income Tax Ordinance, 2001. In case of taxable losses, LTL is allowed to carry forward the tax depreciation for indefinite period. Tax credit allowed @ 10% of the investment under section 65B can also be carried forward for two years.

Option 2: Tax implication of acquiring Multan Fabrics

It appears that LTL is currently a standalone company without any subsidiaries. The acquisition of Multan Fabrics, given its size, is likely to result in a group with LTL as a holding company. This gives rise to a number of options with regards to its tax affairs, as under:

LTL is able to acquire 100% shareholdings of Multan Fabric (Group taxation)

By default, both companies would be taxed separately but it is possible to make an irrevocable election to tax the group as a single entity. In such a case, any losses made by either entity would be

automatically offset against the profit made by other entity. However, the option of group taxation shall be available to those group companies which comply with such corporate governance requirements and group regulations as may be specified by SECP from time to time. Any income derived by LTL on account of dividend from Multan Fabrics will be exempt from tax subject to the condition that return of the group has been filed for the tax year.

Subsequently if LTL decides to acquire the assets of Multan Fabrics, no gain or loss shall arise in case of such acquisition subject to meeting the conditions specified in section 97 of the ITO-2001.

LTL is able to acquire less than 100% shareholdings in Multan Fabrics (Group relief) In case LTL acquires at least 55% of the share capital in Multan Fabrics it may be able to surrender its tax losses (excluding capital losses) in favour of LTL, to the extent of LTL's percentage of holding in Multan Fabrics.

Inter-company dividend would not be exempt from tax and hence any profits transferred from Multan Fabrics to LTL by way of dividend would be taxed again.

On the basis of above information, it is obvious that LTL would be able to obtain tax benefit under this option only if it is able to acquire 100% shareholding in Multan Fabrics. However, this rule has no practical advantage for LTL as Multan fabrics has significant profits whereas LTL is at breakeven.

Conclusion:

The tax benefit of acquisition is quite limited because it is only limited to adjustment of losses whereas none of the company is expected to incur a significant loss. On the other hand, at least in the case of a favourable stance of the tax authorities with regard to marketing expenses LTL would make a significant tax savings in the initial years. Even if all the marketing expenses are spread over more than one year, the marketing option would still be better from a tax point of view because of the initial depreciation on imported machinery and tax credit @ 10%.

(b) Abu Bakar Limited

Group Taxation

35% Shares held by Mr. Farhan may be transferred to Abu Bakar (Pvt.) Ltd. In this case Sameel (Pvt.) Ltd will become 100% subsidiary of Abu Bakar and group may opt to be taxed as single fiscal unit in which case losses of current year and future years would be adjustable against profits of Abu Bakar (Pvt.) Ltd, intercorporate dividend would be exempt and losses prior to formation would lapse. However Mr. Farhan would be subject to tax on capital gain on transfer of his shares to Abu Bakar (Pvt.) Ltd.

Group Relief

Atleast 10% shares may be transferred to Abu Bakar (Pvt.) Ltd by Farhan. In this way, Sameel (Pvt.) Ltd may surrender its proportionate (75%) tax losses (other than b/f and capital loss) of not more than 3 years in favour of Abu Bakar (Pvt.) Limited, intercorporate dividend would not be exempt from tax. However, if approval is obtained from SECP/State bank for formation of group, capital gain would not be taxable in the hands of Farhan on sale of 10% shares.