

## **SET OFF AND CARRY FORWARD OF LOSSES**

### **Background:-**

The public finance domain of Economics deals with principles/cannons of taxations. There are various models of Taxation but in the developing economies progressive system of taxation has been advocated which means a person having larger income should contribute more to the public exchequer in comparison to the person having lesser income.

While dealing with the subject, it has been envisaged that if a person has profits/income he should pay taxes if he has profit and losses simultaneously he should pay tax on net profit after deducting the losses and if he has resultant loss or only loss he is not required to pay taxes. However, due to the complexity and need it has been thought of to incorporate the provisions relating to set off and carry forward of losses. Additional complexity has been created and the losses have been restricted to be set off due to greediness of the legislators and tax administrators.

The set off and carry forward of losses can be sub divided into two broad categories:-

1. Set off of losses.
2. Carry forward and Set off of losses.

### **SET OFF OF LOSSES:-**

The set off of losses are further sub divided in two categories:-

1. Set off within the same head of income or inter head set off.
2. Set off against other heads of income or intra head set off.

### **Set off within the same head of income or inter head set off (section 70)**

According to section 70, if there is a net result of loss from any source of income during any assessment year the loss can be set off against the income of any other source within same head of income.

### **Exceptions:-**

1. Loss from speculation business.
2. Long term capital loss w.e.f AY 2004.
3. Loss from activity of owning and maintaining race horses.
4. No loss can be set off against gains from winning from lotteries, crosswords, puzzles, card games or other gambling.

➔ **This implies**

- Loss from one house property can be set off against the income of other house property.
- Loss from non speculative business can be set off against income of speculative or non speculative business.
- Short term capital loss can be set off any capital gain (LT/ST).
- Loss under the head income from other sources can be set off against other incomes except owning and maintaining of race horses and gains from winning from lotteries, crosswords, puzzles, card games or other gambling.

**Set off against other heads of income or intra head set off (section 71).**

According to section 71, if there is a net result of loss in respect of any head of income during any assessment year the loss can be set off against the income of any other head of income.

**Exceptions:-**

1. Loss from speculation business.
2. Losses under head capital gains.
3. Losses from the business of owning and maintaining of race horses.
4. Loss from business/profession cannot be set off against income under head salaries (2005-06).
5. Loss from exempt income (loss of profit must be loss of taxable profit).
6. No loss can be set off against gains from winning from lotteries, crosswords, puzzles, card games or other gambling (section 58(4)).

**CARRY FORWARD AND SET OFF OF LOSSES.**

If a loss cannot be set off either under the same head or under the different heads due to absence/adequacy of the income during the same year, such loss may be carried forward to the next year to be set off against the income of that year.

In the present context the losses can be carried forward to be set off against the income of other subsequent year is possible in the following heads of income:-

1. Loss from house property.
2. Loss from business and profession:-
  - a) Loss from non speculation business.
  - b) Loss from speculation business.
  - c) Loss on account of depreciation, Capital Expenditure on Scientific Research and Family Planning.

3. Loss on account of capital gain:-
  - a) Loss on account of short term capital gain.
  - b) Loss on account of long term capital gain.
  
4. Loss from other sources:-
  - a) Only from the activity of owning and maintaining race horses.

### **Carry forward and set off of losses from HOUSE PROPERTY:-**

In terms of section 71B inserted w.e.f. 1999-2000, it provides that if the loss from the house property cannot be set off in the year in which it has occurred will be carried forward to be set off against the income of 8 assessment years subsequent to the assessment year in which the loss was first computed.

#### **Key points**

- The loss can be carried forward and set off only prior to assessment year 1999-2000.
- No necessity to file return in time.
- No need to hold the house property in the year of set off

### **Carry forward and set off of losses of BUSINESS AND PROFESSION:-**

#### **Non speculation business:**

The business loss other than speculation loss to the extent of not set off u/s 71 can be carried forward to the subsequent years unless it is set off but not exceeding 8 assessment years immediately succeeding the assessment year in which the loss was first computed.

#### **Key points**

- It is not necessary that the business should be continued (w. e. f. 2000-01)
- Business profit also includes business activity assessable under other head. (sec2 (22) (e)).
- The assessee must be same (exceptions are there).
- Loss must be determined in terms of the return filed by the assessee.
- The delay in filing loss return may be condoned in terms of Circular No. 8/2001 dated 16/5/2001.

**Priority of set off**

- (a) Current year depreciation, Capital Expenditure on Scientific Research & Family Planning.
- (b) Brought forward Business loss.
- (c) Brought forward depreciation, Capital Expenditure on Scientific Research & Family Planning.

**Key Points:**

- Loss and depreciation of the proprietary business merged into firm, the firm is not entitled to carry forward loss and depreciation. However, the proprietor can be entitled to carry forward.
- In case of inheritance, the legal heir is entitled to carry forward the loss for balance numbers of years. Section 78(2) does not permit carry forward the depreciation.
- Legal heirs can form the partnership firm to carry out the proprietary business of the deceased. The partnership firm can carry forward the losses of the proprietary business of the deceased. [CIT vs. Madhukant M. Mehta (2001 247 ITR 805 SC)]
- Loss from non taxable source cannot be carried forward [Harprasad & Pvt Co. Ltd.(SC)].

**Speculation business**

In terms of explanation 2 to the section 28 it is stated that where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business (hereinafter referred to as “speculation business”) shall be deemed to be distinct and separate from any other business.

In terms of section 43(5) a “speculative transactions” means a transaction in which a contract for purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips:

**Provided** that for the purposes of this clause-

- (a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him; or
- (b) a contract in respect of stocks and shares entered into by dealer or investor therein to guard against loss in his holding of stocks and shares through price fluctuations; or

- (c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member, [or]
- (d) an eligible transaction in respect of trading in derivatives referred to in clause [(ac)] of section 2 of the securities contracts (regulation) Act, 1956 (42 of 1956) carried out in a recognized stock exchange;]

Shall not be deemed to be a speculative transaction.

Analysis of amendment made by Finance Act, 2005

The explanatory Memorandum to the Finance Bill, 2005 explains the rationale of introduction of the provisions as follows:

“Under the existing provisions [clause (5) of section 43], a transaction for the purchase and the sale of any commodity including stock and shares is deemed to be a ‘speculative transaction’, if it settled otherwise than by actual delivery. However, certain categories of transaction are excluded from the purview of the said provision. Further, the unabsorbed speculation losses are allowed to be carried forward for 8 years for set off against speculation profit in subsequent years. The screen based computerized trading provides for an excellent audit trail. Therefore, the present distinction between speculative and non speculative transactions particularly relating to derivatives is no more required.

The proposed amendment, therefore, seeks to provide an eligible transaction carried out in respect of trading in derivatives in a recognized stock exchange shall not be deemed to be a speculative transaction.”

A transaction shall be regarded as eligible transaction in derivatives and thus not being considered as speculative transaction only if following conditions are satisfied:

- (a) It is carried electronically on screen based system.
- (b) It is carried out through a duly registered stock-broker, sub-broker or other intermediary.
- (c) It is carried out in accordance with the SEBI act the SCRA, the Depositories Act and rules framed under these acts.
- (d) It is carried on a recognized stock exchange.
- (e) It is supported by a duly stamped contract note issued by such stock broker or sub-broker or other intermediary to its client.
- (f) The contract note indicates the unique client identity number.
- (g) The contract note indicates the PAN.

Once a derivative transaction is regarded as part of non speculative business income, it will form part profit and gains of business or profession. Some of the consequences of this are:

- a. Interest on margin money will be allowable as a deduction for computation of business income.
- b. Business loss on derivatives transactions can be set off against other business profit (but not against Salary income).

Note: it may be noted that the losses on derivatives trading were treated as speculation losses upto a/y 2005-06. The profit/losses on derivative trading are treated as normal business income/losses from a/y 2006-07. Therefore the losses on derivative incurred upto a/y 2005-06 can not be setoff against the profit form derivative trading in a/y 2006-07 and future assessment years speculation losses can't be set=off against non-speculative income.

### **Section 73:**

- (a) The loss of a speculation business shall be set off only against the profits and gains of another speculation business.
- (b) The loss to the extent not set off shall be carried forward to the next assessment year and set-off against the profits from speculation business of the next assessment year.
- (c) The loss form speculation business can be carried forward for **four** assessment years.

In respect of allowance on account of depreciation or capital expenditure on scientific research, the provisions of sub-section (2) of section 72 shall apply in relation to speculation business as they in relation to any other business.

### **Explanation to Section 73:**

Where any part of the business of a company consists of sale and purchase of shares, such company for the purposes of section 73, be deemed to be carrying on a speculation business to the extent to which the business consists of sale and purchase of shares.

This shall not apply to the following companies:-

- i. Investment company i.e. the company whose total income mainly consists of income from house property, capital gain and income from other sources.
- ii. Company whose principal business is of banking or of granting loan & advances.

**Key Notes:-**

1. Penalty for non performance of a contract can not be treated as speculative loss.
2. The purchase and sales of shares against delivery will also constitute speculative business.
3. The shares are different from units of mutual fund/uti.
4. The loss on sale of units will be treated as normal loss.

**Brought forward depreciation, Capital Expenditure on Scientific Research & Family Planning.**

Set off & carry forward of losses under above heads are governed by sec 32(2) of the income tax act, 1961. Accordingly these can be carried forward indefinitely.

Note:- The depreciation can be carried forward even if return is not filled in time.  
{ Haryana hotels, Punjab & Haryana H.C.}

**Carry forward and set off of losses of Capital Gains:-**

If the net result of computation under the head capital gain is a loss, such loss can be carried forward & set off as under:-

1. Upto asstt. Year 2002-03 Long term capital loss can be set off against any capital gain whether long term or short term.
2. From asstt. Year 2003-04, long term capital loss can be set off against long term capital gains only.
3. Short term capital loss can be set off against long term & short term capital gains.
4. The losses under the head capital gain can't be set off from other heads of income. It can be carried forward for 8 next asstt. years for set off.
5. The return is required to be filled with in time prescribed under sec 139 of the income tax act, 1961.

**Carry forward and set off of losses & depreciation in case of Amalgamation, Conversion, Merger & Demerger, (Sec 72A, 72AA, 72AB):-**

As a matter of general principle the carry forward & set off is permitted to a person who has incurred these losses. However, there are exceptions to this rule as under:-

1. **Amalgamation of companies**
2. **Demerger**

- 3. Conversion of proprietary concern/ firm into a company**
- 4. Amalgamation of a banking company with banking institution.**
- 5. Merger/Demerger of cooperative banks**

Conditions to be satisfied:-

**1. Amalgamation:-**

- a. Eligible assessee:- 1. company owing industrial undertaking (see note below) or a ship or a hotel, 2. Banking company under banking regulation act, 1949 with a specified bank, 3. Public sector airlines with other public sector airlines.
- b. The amalgamating company has been engaged in the business in which the accumulated loss occurred or depreciation remains unabsorbed for 3 years or more years.
- c. The amalgamating company has held continuously as on the date of amalgamation at least three-fourths of the book value of fixed assets held by it two years prior to the date of amalgamation.
- d. The amalgamated company continues to hold at least three-fourths of the book value of fixed assets of the amalgamating company which it has acquired as a result of amalgamation for five years from the effective date of amalgamation.
- e. The amalgamated company continues the business of the amalgamated company for a minimum period of 5 years.
- f. Any other condition as may be prescribed.

If the above specified conditions are not fulfilled, then that part of brought forward loss and unabsorbed depreciation which has been set off by the amalgamated company shall be treated as the income of the amalgamated company.

**Note:- Additional conditions under Rule 9C for industrial undertaking:-**

- a. The amalgamated company, owning an industrial undertaking of the amalgamating company by way of amalgamation, shall achieve the level of production of at least 50% of the installed capacity within 4 years from the date of amalgamation and continue it till the end of 5 years from the date of amalgamation. However, the C.G. may relax the condition of minimum level of production or time period in suitable cases having regard to genuine efforts made by the amalgamated company to attain the prescribed level of production and the circumstances preventing such conditions.
- b. The amalgamated company shall furnish to the A.O. a certificate in Form No. 62, duly verified by an accountant, with reference to the books of accounts and other documents showing particulars of production, along with return of income for the assessment year relating to the previous year during which the prescribed level of production is achieved and for



subsequent assessment years relevant to the previous year falling within 5 yrs from the date of amalgamation.

2. **Demerger:-**

In case of demerger, the accumulated loss and unabsorbed of the demerged company will be allowed to be carried forward and set off in the hands of the resulting company.

Central govt. may specify conditions as it consider necessary to ensure that demerger is for genuine business purposes.

**Computation of loss/depreciation to be carried forward to the demerged company:-**

If the loss/depreciation is directly relatable to the undertaking transferred to the resulting company, then such loss/depreciation shall be allowed to be carried forward in the hands of the resulting company.

Where however, such loss/depreciation is not directly relatable to the undertaking transferred to the resulting company, then such loss/depreciation it will be apportioned between the demerged and the resulting company.

3. **Loss in case of Conversion of proprietary concern/ firm into a company (Sec 72A(4)):-**

Sub section (4) has been inserted with effect from the A.Y. 1999-2000 which states that in case of succession of a business where a firm is succeeded by a company fulfilling the conditions u/s 47 (xiii) or a proprietary concern is succeeded by a company fulfilling the conditions u/s 47 (xiv), the accumulated loss and the unabsorbed depreciation of the predecessor firm or proprietary concern as the case may be, shall be deemed to be the loss and unabsorbed depreciation for the successor company for the previous year in which the business reorganization took place.

If the specified conditions u/s 47(xiii) and 47(xiv) are not complied with, then brought forward loss and unabsorbed depreciation which has been set off shall be treated as the income of the successor company chargeable to tax in the year in which such conditions are not complied with.

One of the conditions for carry forward of the loss of the firm is that the aggregate of the shareholding in the company of the partners of the firm is not less than 50 per cent of the total voting power in the company and their

shareholdings continues to be as such for a period of 5 years from the date of the succession.

**4. Amalgamation of a banking company with banking institution:**

Section 72AA has been inserted with effect from the A.Y. 2005-06 for providing carry forward & set off of the accumulated loss and the unabsorbed depreciation of a banking company, against the profits of a banking institution under a scheme of amalgamation sanctioned by the Central Government.

Section 72AA would be applicable if the following conditions are satisfied:

1. There is an amalgamation of a “banking company” with any other “banking institution”. Banking company for this purpose means a company which transacts the business of banking in India. A banking institution for this purpose means any banking company and includes State Bank of India or a scheduled bank.
2. The amalgamation is sanctioned and brought into force by the Central Government u/s 45(7) of the Banking Regulations Act, 1949.
3. The provisions of section 2(1b)(i)/(ii)/(iii) may or may not be satisfied.
4. The provisions of section 72A may or may not be satisfied.

**Accumulated loss does not include speculative business loss.**

**5. Accumulated loss and unabsorbed depreciation allowance in business reorganization of cooperative banks (Sec 72AB, w.e.f. A.Y. 2008-09): -**

The successor cooperative bank can set off and carry forward loss and depreciation allowance of the predecessor cooperative bank if following conditions are satisfied:-

- A. The predecessor has been engaged in the business of banking for three or more years.
- B. The Predecessor has held at least  $\frac{3}{4}$  of the book value of fixed assets of the predecessor acquired through business reorganization, continuously for a minimum period of 5 years immediately succeeding the date of business reorganization.
- C. The successor continues the business of the predecessor for a minimum period of 5 years from the date of business reorganization.
- D. The successor fulfills such other conditions as may be prescribed.

**Section 78: Carry forward and set off of losses in case of change in the constitution of firm or on succession:-**

**Sec 78(1) Change in the constitution:-**

When a change has occurred in the constitution of a firm, then nothing shall entitle the firm to have carry forward and set off so much of the loss proportionate to the share of the retired or deceased partner as exceeds his share of profits, if any, of the previous year in the firm. No partner can also avail the benefit of the said loss.

**Sec 78(2) Succession:-**

Where any person carrying on any business or profession has been succeeded to in such capacity by another person otherwise than by inheritance, nothing in the chapter VI shall entitle any person other than the person incurring the loss to have it carried forward and set off against his income.

**Special provisions for set off & carry forward of losses in case of certain companies(Sec. 79):-**

1. Applicable to companies in which the public is not substantially interested.
2. There has been a change in the shareholding pattern in the previous year.
3. No loss incurred prior to the previous year unless:-
  - a. At least 51% shares must be held by the previous beneficial owners having voting power in the year in which the loss was incurred.
  - b. Nothing contained in this section applies in case of death of a shareholder or gift by a shareholder to his relative.
  - c. Nothing contained in this section will apply to an Indian company which is a subsidiary of a foreign company on account of amalgamation or demerger of the foreign company.

**Sec. 80 Submission of return for losses:-**

If a return has not been filled in accordance with the section 139(3), the loss shall not be carried forward & set off under the sections 72, 73, 74 & 74A.