LESSON 11
SET OFF AND CARRY FORWARD OF LOSSES

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STRUCTURE

11.0 INTRODUCTION

Income-tax is a composite tax on the total income of a person earned during a period of one previous year. There might be cases where an assessee has different sources of income under the same head of income. Similarly, he may have income under different heads of income. It might also happen that the net result from a particular source/head may be a loss. This loss can be set off against other sources/head in a particular manner. For example, where a person carries on two businesses and one business gives him a loss and the other a profit, then the income under the head 'Profits and gains of business or profession' will be the net income i.e. after the adjustment of the loss. Similarly, if there is a loss under one head of income, it should normally be adjusted against the income from another head of income while computing the Gross Total Income, of course subject to certain restrictions. These provisions for set off or carry forward and set off of loss are contained in sections 70 to 80 of Income-tax Act.

11.1 OBJECTIVE

After going through this lesson you should be able to understand:
If there is a loss sustained by the assessee,
Whether such a loss can be

- Set off against income from any other source/head and the restrictions for the same.
- If it cannot be set off, can that loss be carried forward and,
- What are the provisions/restrictions for the above and for how many years it can be carried forward

11.2 MEANING OF IMPORTANT TERMS

Head of Income
An assessee may have income from various sources like employment, business, interest, rent, etc. For the purpose of income tax we divide these incomes into five heads namely,
Income from Salaries
Income from house property
Income from Business & Profession
Capital Gains
Income from other sources
The rules for computation of income under each head is different (You have already studied these five heads)

Source of Income
An assessee may have 3-4 sources of income under one particular head . For example a person might have two businesses A and B which are two sources of income under the same head business and profession . Similarly a person might be having two part time employments. He will receive salary from both the employers; each salary received is a source of income. But both are taxable under the head 'Income from Salary.'

11.3 NO LOSS TO BE SET OFF AGAINST WINNINGS FROM LOTTERIES, CROSSWORD PUZZLES, ETC.

As discussed in the introduction, losses sustained by an assessee can be set off against other incomes subject to certain restrictions. The detailed provisions for the same will be discussed later.

The first and the foremost restriction that I.T. Act puts are ;

No loss can be set off against any income from lottery, crossword puzzles, horse races, gambling, etc.

Government does not promote such kind of activities which depend totally on luck/ chance and likelihood of losing is very high. Hence any income from these sources is fully taxable irrespective of any loss sustained by the assessee even from the same source or a different source or a different head.

As already discussed in the lesson Income from other sources no expenditure or allowance is even allowed to be deducted from winnings from lotteries or crossword puzzle, etc. Hence it is very clear and obvious that no question arises of any loss to be set off against such incomes.

Hence we can conclude any income from lottery, crossword puzzles, horse races, gambling, etc. is fully taxable always. No expenses even if they relate to earning of such income are allowed to be deducted. Furthermore, no loss can be set off against such income even if it is from the same source.

11.4 STEPS IN SET OFF AND CARRY FORWARDS

There are three steps involved in this

Step1

Inter-source adjustment under the same head of income (Para 10.5)

Step 2

Inter head adjustment in the same assessment year. (Para 10.6). Step 2 is only applied if it is not possible to set off a particular loss under *Step1*

Step3

Carry forward of a loss (Para 10.7) this step is only applicable if a loss is not set off under *Step* 1 and 2.

11.5 INTER SOURCE ADJUSTMENT (SEC.70)

Where the net result for any assessment year in respect of any source is a loss, the assessee shall be entitled to have the amount of such loss set off against his income from any other source under the same head. This may also be referred to as inter source adjustment.

For example, if the assessee has two houses and the net income from one house is Rs. 84,000 while from the other house there is a loss of Rs. 60,000 the loss shall be adjusted against the income (as both fall under the same head i.e. 'Income from house property) and after set off, the income under the head 'income from house property' shall be Rs. 24,000.This is **Inter source adjustment**.

On the other hand, if an assessee has two houses and there is a net Income of Rs.80,000 from one house and loss of Rs.1,20,000 from another, the net loss under this head will be (-) 40,000. Such a loss can be set off against any kind of income under any other head which is termed as **Inter-head adjustment**. This has been explained in detail later in the Chapter.

However, there are certain *exceptions* to this general rule of inter source adjustment. In the following cases loss from one source cannot be adjusted against income from another source of income although it falls under the same head:

11.5.1 LOSS FROM SPECULATION BUSINESS

"Speculation business" means a business in which contracts for the purchase or sale of any commodity including stocks and shares is periodically or ultimately settled without the actual delivery or transfer of the commodity or scrips .

As per section 73 any loss arising from a speculation business carried on by an assessee shall be set off only against income of any another speculation business run by the assessee. It cannot be set off from a non-speculative business income, although income from both kinds of businesses are taxable under the head 'profits and gains of business or profession'. However, a loss from a non-speculative business can be set off against income from speculation business but vice versa is not possible.

Illustration 11.1:
R carries only two businesses A and B. Business A is a manufacturing business while business B is a speculative business. State whether the loss can be set off in the following two situations.

	Situation I Rs.	**Situation II Rs.**
Manufacturing business	(+) 800,000	(-) 5, 00,000
Speculation business	(-) 3, 40,000	(+) 2, 00,000

Solution

In situation I, set off is not possible as speculation loss can be set off only against income from speculation business.

In situation II, set off is possible and the manufacturing business loss will have to be set off against income from speculation business.

CHECK YOUR PROGRESS

Activity A

X carries two businesses P and Q. Business P is a retail business while business Q is a speculative business. State whether the loss can be set off in the following two situations.

	Situation I Rs.	Situation II Rs.
Retail business	(+) 200,000	(-) 3, 00,000
Speculation business	(-) 1, 20,000	(+) 5, 00,000

Situation I --

Situation II ---

11.5.2. LOSS FROM THE ACTIVITY OF OWNING AND MAINTAINING RACE HORSES

As per section 74A, the loss incurred by an assessee, in the activity of owning and maintaining race horses, shall only be set off against the income from such an activity. It cannot be set off against the income from any other sources.

11.5.3. LONG TERM CAPITAL LOSS

Long term capital loss can be set off only against long-term capital gain. However, short-term capital loss can be set off from any capital gain (long-term or short-term)

Illustration 11.2:

	Situation I	Situation II
Short-term capital gain	(-) 2, 00,000	(+) 5, 00,000
Long-term capital gain	(+) 5, 20,000	(-) 1, 80,000

Solution:

In situation I, short-term capital loss of Rs. 2, 00,000 will have to be set off from long-term capital gain. Hence, the net long-term capital gain in this case shall be RS. 3, 20,000.

In situation II, it is not possible to set off long-term capital loss from short-term capital gain. Hence, short-term capital gain of Rs. 5, 00,000 shall be taxable and Rs. 1, 80,000 of long-term capital loss shall have to be carried forward

11.5.4. LOSS FROM A SOURCE WHICH IS EXEMPT

Loss incurred by an assessee from a source of income which is exempt, cannot be set off against income from a taxable source.

CHECK YOUR PROGRESS

Activity B

Fill in the blanks

a) Set off of loss from one source of income to another source of income under the same head is known as ----------------.
b) Speculation business losses can be set-off only against profits of ------------ business.
c) Long term capital loss can be set off only against ---------------------.
d) No loss (of whatsoever nature) can be set off against any income from ------------, crossword puzzle , etc.
e) Loss from activity of owning & maintaining race horses can be set off only against income from ----------------.

11.6 INTER HEAD ADJUSTMENT (SECTION 71)

As explained above, any loss from one source of income is firstly set off against any gain from another source within the same head. Any remaining loss can then be set off against Income from any other Head. This is known as **Inter-Head adjustment.** However, there are exceptions to this rule also as discussed below.

As already discussed above, in the following cases no inter source adjustment is permitted, hence, the question does not arise of any inter-head adjustment. In other words following are the exceptions to inter-head adjustment also.

- No loss of whatsoever nature can be set off against winnings from lotteries, crossword puzzles, card games etc.
- Loss from a speculation business;
- Loss from the activity of owning and maintaining race horses;
- Loss from a source which is exempt.
- Long-term capital loss- only from LTCC

Besides the above mentioned exceptions which are applicable both in inter source adjustment and inter head adjustment, there are two more exceptions to inter head adjustment. They are;

- Loss under the head capital gain (Para 10.6.1)
- Loss under the head business and profession (Para 10.6.2)

11.6.1 LOSS UNDER THE HEAD 'CAPITAL GAINS'

In case of an Inter-head adjustment of losses, any capital loss, whether short-term or long-term, shall not be allowed to be set off against income under any other head. It shall however be allowed to be carried forward.

11.6.2 LOSS UNDER THE HEAD BUSINESS OR PROFESSION [SECTION 7 (2A)]

From the Assessment Year 2005-06, any loss under the head 'Business and Profession' cannot be set off against income from 'Salaries'. However, it can be set off against the Income from any other head.

Illustration 11.3

From the following information submitted to you, compute the taxable income in the following situation.

	Situation I Rs.	Situation II Rs.
Long term capital gain/loss	(+) 2, 80,000	50,000
Short term capital gain/loss	(-) 50,000	(-) 1, 20,000
Business income/loss	(-) 1, 80,000	1, 40,000

Solution

	Situation I Rs.	Situation II Rs.
Capital gain		
Long term capital gain/loss	(+) 2, 80,000	50,000
Short term capital gain/loss	(-) 50,000	(-) 1, 20,000
Capital gain/loss after set off	2, 30,000	(-) 70,000
Set off of business income/loss	(-) 1, 80,000	1, 40,000
Total income	1, 50,000	1, 40,000*

*In situation II, capital loss of Rs. 70,000 will be carried forward and the total income shall be Rs.1, 40,000.

Hence , we observe business loss can be set off against capital loss but vice-versa is not allowed.

Illustration 11.4

From the following information submitted to you by Mr. X, calculate the gross total income for the A.Y 2006-07.

	I	II
Income from salary	2, 00,000	2, 00,000
Income from Bus/Prof	(-) 50 ,000	(-) 50 ,000
Income from House Property	_	80,000

Solution

In situation I his GTI would be 2, 00,000 and his loss from business and profession will be carried forward (Any loss under the head Business & Profession cannot be set off against any income from Salary). In situation II business loss can be set off against income from House Property and his GTI would be Rs. 2, 30,000.

CHECK YOUR PROGRESS

Activity C

Match the following:

Table A	Table B
i).Long term capital loss can be set off	(a) only against profit from speculation business
ii). Loss from speculation business can be set off	(b) against winning from lottery or any other kind of income.
iii)loss of lottery cannot be set off	(c) can be set off against income under any head of income
iv)Loss under the head house property	(d) only against long term capital gain

11.7 CARRY FORWARD AND SET OFF OF LOSSES

If the losses could not be set off under the same head or under different heads in the same assessment year, such losses are allowed to be carried forward to be claimed as set off from the income of the subsequent assessment years.

All losses are not allowed to be carried forward. Another very important aspect is that in case of carry forward, losses can be only set off under the same head of income only. Inter head adjustment is not allowed.

Only the following losses are allowed to be carried forward and set off in the subsequent years.

a) House property loss; (Para 10.7.1)
b) Business loss; (Para 10.7.2)
c) Speculation loss; (Para 10.7.3)
d) Capital loss; (Para 10.7.4)
e) Loss on account of owning and maintaining race horses.(Para 10.7.5)

Hence any loss under the head income from other sources is not allowed to be carried forward.(except race horses)

Compulsory filing of loss of return (Section 80):
Although the above losses are allowed to be carried forward, it is allowed only when such loss has been determined in pursuance of a return of loss submitted by the assessee on or before the due date for filing of the returns prescribed under section 139(1) (See Para --------) However loss under the head income from house property can be carried forward even if the return is not filed within the due date mentioned under section 139(1).

11.7.1 CARRY FORWARD AND SET OFF OF LOSS FROM HOUSE PROPERTY (SECTION 71B)

A loss under the head house property will be allowed to be carried forward for 8 assessment years to claim it as a set off in the subsequent years under the head ‘Income from house property’. Therefore, if the loss of house property of the previous year 2003-2004 which could not be set off because of absence or inadequacy of the income of previous year 2003-2004, it may be carried forward for 8 assessment years succeeding assessment year 2004-2005 to be set off from income under the head house property.

11.7.2 CARRY FORWARD AND SET OFF OF BUSINESS LOSSES (SECTION 72)

Where the loss under the head ‘profits and gains of business or profession’ *other than loss from speculation business,* could not be set off in the same assessment year because either the assessee had no income under any other head or the income was less than the loss, such loss which could not be set off in the same assessment year, can be carried forward to the following assessment years, However it is subject to following conditions.

I) Business losses can be adjusted only against business income: Business income may be from the same business in which the loss was incurred, or may be any other business.

II) Business in respect of which a loss is incurred may or may not be continued.

III) Losses can be set off only by the assessee who has incurred loss with a few exceptions like when a partnership firm is converted into a company, amalgamation of companies, etc.

IV) *Period of carry forward:* Each year’s loss is a separate loss and no loss shall be carried forward for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed. Therefore, a loss of previous year 2002-2003, i.e. assessment year 2003-2004 can be carried forward till assessment year 2011-12. Besides the above, the following can also be carried forward indefinitely, as per income tax law:

i) Unabsorbed depreciation
ii) Unabsorbed capital expenditure on scientific research;
iii) Unabsorbed expenditure on family planning.

11.7.3. SET OFF AND CARRY FORWARD OF SPECULATION LOSS (SECTION 73).

As stated earlier, the loss of a speculation business of any assessment year is allowed to be set off only against the profits and gains of another speculation business in the same assessment year.

If a speculation loss could not be set off from the income of another speculation business in the same assessment year, it is allowed to be carried forward for 8 assessment years immediately succeeding the assessment year for which the loss was first computed. Also, it can only be set off against the income of only a speculation business. It may be observed that it is not necessary that the same speculation business must continue in the assessment year in which the loss is set off. However, filing of return before the due date is necessary for carry forward of such a loss.

10.7.1 LOSS UNDER THE HEAD CAPITAL GAIN

Loss on short term capital asset
Any loss on short-term capital asset is allowed to be carried forward to be set-off in subsequent years against capital gains (short-term as well as long-term). The period of carry forward is 8 years.

Loss on Long-term capital asset
Any loss from long-term capital assets can also be carried forward to be set-off in subsequent years but against only long-term capital gains. The period of carry forward is 8 years.

10.7.5 LOSS ON OWNING AND MAINTAINING RACE HORSES SECTION 74 A (3)

Any loss suffered by the assessee in respect of maintaining of race horses can be set-off against the income from the activity of owning and maintaining race horses in subsequent years .The period for carry forward of such a loss is only *four* years immediately succeeding the assessment year in which the loss was computed for the first time.

Illustration11.5
Following are the particulars of net incomes and losses of X for the year ending 31 March 2006. Find out his total income.

			Rs.
1.	Income from salary (net)		1,50,000
2.	Income from house property:		
	i)	Income from house A	5,000
	ii)	Loss from house B	8,000
3.	Income from business:		
	i)	Profit from cloth business	20,000
	ii)	Loss from hardware business	45,000
	iii)	Profit from speculation business	15,000
4.	Income from capital gains:		
	i)	Short-term capital gain	10,000
	ii)	Long-term capital gain	5,000
	iii)	Loss from another long-term capital asset	18,000

Solution:

1.	Income from Salary		1,50,000
2.	Income from house property		
	Income from House A	5,000	
Less:	Loss from B	-8,000	-3,000
3.	Income from business:		
	Profit from cloth business	20,000	
	Profit from speculation business	15,000	
		35,000	
Less: Loss from hardware business		-45,000	-10,000
4.	Income from capital gains		10,000
	i) Short-term capital gain		
	ii) Long-term capital gain	5,000	
Less: Loss from long-term capital asset		-18,000	
	Long-term capital loss to be carried forward		**-13,000**
	Total Income		1,47,000

Note:

1. Loss of hardware business is set-off against the profit of cloth business combined with profit from speculation. But a loss from speculation business, if there is any, is not allowed to be set-off against other business income.
2. Loss from long-term capital asset can be set-off against long-term capital gains only. Therefore capital loss of Rs 13,000 will be carried forward.

3. Loss from house property can be set off against income from house property or income under any other head in the same year..
4. Loss from business has been set-off against STCG.

11.8 LET US SUM UP

Set-off of losses means setting-off losses against the income of the same year. Where it is not possible to set-off the losses during the same assessment year in which they occurred, so much of the loss as has not been so set-off (only certain specified losses) can be carried forward for being set-off against his income in the succeeding years. Set-off can be inter source and Inter-head. Inter-source means when loss of one source is set-off against the income of some other source under the same head of income. Inter-head means when a loss remains unabsorbed from inter-source set-off, the balance of it can be set-off against income under other head of income.
If both the adjustments are not possible then certain losses namely loss from house property, loss from business including speculation business, capital loss, and loss from activity of maintaining race horses can be carried forward.

11.9 GLOSSARY

The various key words that arise in the chapter are:
Inter-head adjustment: Where in respect of any assessment year the net result of the computation under any head of income is a loss. He shall be entitled to have the amount of such loss set-off against his income, if any, under any other head of income.

Inter-source Adjustment: When there is more than one source of income under the same head, the loss from one or more sources is allowed to be set-off against income from the other source under the same head.

Set-off losses: Setting off losses against the income of the same year.

Carry forward of losses: The losses which cannot be set-off in the same year are carried to the next year to set-off against income of next year.

11.10 SELF ASSESSMENT EXERCISE

Q 1) State whether they are true or false:
A) Speculation business losses can be set-off against profits of regular business.
b) Non-speculative (regular) business losses can be set-off against speculation business profits.
c) When inter-source Adjustment exhausts, inter-head adjustments begin.

d) Loss under the head house property can be carried forward for 8 years to be set-off in the following and subsequent seven years.
E) If a speculation business is discontinued its brought forward losses cannot be carried forward any further to be set-off against profits of any other speculation business.
F) Loss from business and profession can be set off against income from salary.

Q 3) Discuss the provisions relating to set-off of losses in the following cases:
A) Speculation loss B) Short term capital loss C) Long term capital loss D)Losses from horse race, gambling and crossword puzzles.

Q 4) Discuss the conditions subject to which losses are allowed to be set –off in the current year and carried forward.

11.11 FURTHER READINGS AND SOURCES

1. Bhagwati Prasad, *Law and practice of Income Tax*, Navaman Prakashan, Aligarh
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4. Girish Ahuja & Ravi Gupta, *Simplified Approach to Income Tax and Sales Tax*, Sahitya Bhawan Publishers and Distributors Ltd., Agra