

SET OFF AND CARRY FORWARD OF LOSSES

Some key points

Inter source adjustment [Section 70]

Any loss incurred by the assessee in respect of one source shall be set off against income from any other source under the same head of income, since the income under each head is to be computed by grouping together the net result of the activities of all the sources covered by that head. In simpler terms, loss from one source of income can be adjusted against income from another source, both the sources being under the same head.

Inter head adjustment [Section 71]

Loss under one head of income can be adjusted or set off against income under another head. The following points are worth noting -

- (i) Where the net result of the computation under any head of income (other than capital gains) is a loss, the assessee can set off such loss against his income assessable for that assessment year under any other head, including capital gains.
- (ii) However, the net result of the computation under the head 'profits and gains of business or profession' is a loss, such loss cannot be set off against income under the head 'salaries'.
- (iii) Where the net result of computation under the head 'capital gains' is a loss such loss cannot be set off against income under any other head.
- (iv) Speculation loss and loss from the activity of owning and maintaining race horses cannot be set off against income under any other head.

Carry forward and set off of losses of specified business [Section 73A]

Any loss in respect of specified business referred to in section 35AD shall be set off only against profits and gains, if any, of any other specified business.

The unabsorbed loss, if any, will be carried forward for set off against profits and gains of any specified business in the following assessment year and so on.

There is no time limit specified for carry forward and set off and therefore, such loss can be carried forward indefinitely for set off against income from specified business.

Carry forward and set off in the case of change in constitution of firm or succession [Section 78]

Where there is a change in the constitution of a firm, so much of the loss proportionate to the share of a retired or deceased partner remaining unabsorbed, shall not be allowed to be carried forward by the firm. This restriction however, will not apply to unabsorbed depreciation of the firm.

Where any person carrying on any business or profession has been succeeded in such capacity by another person otherwise than by inheritance, such other person is not eligible to carry forward and set off of the loss incurred by the predecessor.

Where there is succession to business by inheritance the legal heirs are entitled to set off the business loss of the predecessor. Such carry forward and set off is possible even if the legal heirs constitute themselves as a partnership firm. In such a case, the firm can carry forward and set off the business loss of the predecessor.

Question 1

Explain those conditions which are required to be fulfilled by the predecessor and successor co-operative banks in order to claim benefit of section 72AB of the Act.

Answer

The benefit of carry forward and set-off of accumulated loss and unabsorbed depreciation allowance in case of business re-organisation of co-operative banks would be available under section 72AB only on fulfillment of the following conditions -

(a) Conditions to be fulfilled by the predecessor bank

- (1) it should have been engaged in the business of banking for three or more years; and
- (2) it should have held at least three-fourths of the book value of fixed assets as on the date of the business re-organisation, continuously for two years prior to the date of business re-organisation.

(b) Conditions to be fulfilled by the successor bank

- (1) it should hold at least three-fourths of the book value of fixed assets of the predecessor co-operative bank acquired through business re-organisation, continuously for a minimum period of five years immediately succeeding the date of business re-organisation;
- (2) it continues the business of the predecessor co-operative bank for a minimum period of five years from the date of business re-organisation; and
- (3) it fulfils such other conditions as may be prescribed to ensure the revival of the business of the predecessor cooperative bank or to ensure that the business re-organisation is for genuine business purpose.

Question 2

M/s. JKLM, a firm, consists of four partners namely, J, K, L and M. They shared profits and losses equally during the year ended 31.3.2010. The assessed business loss of the firm for the assessment year 2010-11 which it is entitled to carry forward amounts to Rs.3,60,000. A new deed of partnership was executed among J, K, L and M on 1.4.2010 in terms of which they agreed to share profits and losses in the ratio of 15:15:20:50 respectively.

Compute the amount of business loss relating to the assessment year 2010-11, which the firm is entitled to set off against its business income for the assessment year 2011-12. The business income of the firm for the assessment year 2011-12 is Rs.3,30,000. Your answer should be supported by reasons.

Answer

The firm is entitled to set off its brought forward business loss amounting to Rs.3,60,000 relating to the assessment year 2010-11 to the extent of Rs.3,30,000 against its business income of Rs.3,30,000 for the assessment year 2011-12 as per the provisions of section 72(1).

Section 78(1) which deals with carry forward and set-off of losses in the case of change of constitution of firm is applicable only where there is retirement or death of a partner. **It is not applicable to a case where there is a change in the ratio of sharing profits and losses amongst the existing partners.** Therefore, section 78(1) is not applicable to the case of M/s. JKLM. The unabsorbed business loss of Rs.30,000 relating to the assessment year 2010-11 will be carried forward further after its set-off against the business income of the assessment year 2011-12.

Question 3

An assessee sustained a loss under the head "Income from house property" in the previous year relevant to the assessment year 2010-11, which could not be set off against income from any other head in that assessment year. The assessee did not furnish the return of loss within the time allowed under section 139(1) in respect of the relevant assessment year. However, the assessee filed the return within the time allowed under section 139(4). Can the assessee carry forward such loss for set off against income from house property of the assessment year 2011-12?

Answer

Section 139(3) stipulates that an assessee claiming carry forward of loss under the heads "Profits and gains of business or profession" or "Capital gains" should furnish the return of loss within the time stipulated under section 139(1). There is no reference to loss under the head "Income from house property" in section 139(3). The assessee, in the instant case, has filed the return showing loss from property within the time prescribed under section 139(4). The

Direct Tax Laws

assessee is, therefore, entitled to carry forward such loss for set off against the income from house property of the subsequent assessment year.

Question 4

M, an individual, was carrying on a business as sole proprietor. On his death, his legal heirs decide to continue the same business by forming a firm.

At the time of death, M had a determined business loss of Rs.2 lakhs, under the provisions of the Income-tax Act, to be carried forward.

Does the firm, consisting of all the legal heirs of M, get a right to have this loss adjusted against its current income? Discuss.

Answer

Section 78(2) provides that where a person carrying on any business or profession has been succeeded in such capacity by another person, otherwise than by inheritance, then the successor is not entitled to carry forward and set-off the loss of the predecessor against his income. This implies that the only exception is when the business passes on to another by inheritance.

The Apex Court, in *CIT v. Madhukant M. Mehta (2001) 247 ITR 805*, has held that where the business is succeeded by inheritance, the legal heirs are entitled to the benefit of carry forward of the loss of the predecessor. Even if the legal heirs constitute themselves as a partnership firm, the benefit of carry forward and set off of the loss of the predecessor should be made available to the firm.

In this case, the business of M was continued by his legal heirs after his death by constituting a firm. Hence, the exception contained in section 78(2) along with the decision of the Apex Court discussed above, would apply in this case. Therefore, the firm is entitled to carry forward the business loss of Rs.2 lakhs of M.

Question 5

A private limited company has share capital in the form of equity share capital. The shares were held upto 31st March, 2009 by four members A, B, C and D equally. The company made losses/profits for the past three assessment years as follows:

Assessment Year	Business Loss	Unabsorbed Depreciation	Total
	Rs.	Rs.	Rs.
2007-2008	Nil	15,00,000	15,00,000
2008-2009	Nil	12,00,000	12,00,000
2009-2010	9,00,000	9,00,000	18,00,000
Total	9,00,000	36,00,000	45,00,000

Set off and Carry Forward of Losses

The above figures have been accepted by the tax department.

During the previous year ended 31.3.2010, A sold his shares to Y and during the previous year ended 31.3.2011, B sold his shares to Z. The profits for the past two previous years are as follows:

31.3.2010 Rs.18,00,000 (before charging depreciation of Rs.9,00,000)

31.3.2011 Rs.45,00,000 (before charging depreciation of Rs.7,50,000)

Compute taxable income for A.Y.2011-12. Workings must form part of your answer.

Answer

A, B, C and D are the four shareholders of a private limited company. The shareholding pattern of the company in the last three financial years are given below:

As on 31 st day of March	A	B	C	D	Y	Z
	%	%	%	%	%	%
2009	25	25	25	25	-	-
2010	-	25	25	25	25	-
2011	-	-	25	25	25	25

Section 79 provides that, in case of a closely held company, no loss incurred in the previous year shall be carried forward and set off against the income of the subsequent previous year unless the shares carrying at least 51% of the voting power of the company are beneficially held on the last day of the previous year in which the loss is sought to be set off, by the same shareholders, who beneficially held the shares carrying at least 51% of the voting power on the last day of the previous year in which the loss was incurred.

Since shareholders holding at least 51% of the voting power are the same in the first and second year, the restriction imposed by section 79 is not applicable for the second year. Thus, the taxable income for the assessment year 2010-2011 would be:

Particulars	Rs.
Business profit	18,00,000
Less: Current year's depreciation	9,00,000
	9,00,000
Less: Brought forward business loss (as per section 72(2))	9,00,000
Taxable income	Nil

Unabsorbed depreciation relating to the earlier assessment years can be carried forward to the next assessment year i.e. 2011-12. There is no brought forward business loss and section 79 is not applicable in case of carry forward of unabsorbed depreciation. Section 32 governs

Direct Tax Laws

the carry forward and set off of depreciation for which the shareholding pattern is not relevant at all. Consequently, the income for A.Y.2011-12 will be determined as under -

Particulars	Rs.	Rs.
Business income		45,00,000
Less: Current year's depreciation		7,50,000
		37,50,000
Less: Unabsorbed depreciation:-		
Assessment year 2007-08	15,00,000	
Assessment year 2008-09	12,00,000	
Assessment year 2009-10	9,00,000	36,00,000
Taxable Income for A.Y.2011-12		1,50,000

Question 6

Rajesh & Co., the sole proprietary concern of Mr. Rajesh got converted into partnership after his death on 02-04-10 by his two sons and the business of Rajesh & Co., was continued to be carried in the same manner. There were business losses of Rs.4.25 lakhs till 31-03-10. The net results of the business for the year ended 31-03-11 were profits of Rs.5 lakhs. The partners want to set off the losses of Rs.4.25 lakhs from the profits of the firm. Can they do so?

Answer

The business of sole proprietary concern was converted into a partnership because of the death of the proprietor. His two sons, who are the legal heirs, continued the business. Section 78(2) provides that in the case of succession by inheritance, the successor can carry forward and set-off the loss of predecessor against his income. The Supreme Court, in the case of *CIT v. Madhukant M. Mehta [2001] 247 ITR 805*, has held that where the legal heirs of a deceased-proprietor enter into partnership and carry on the same business in the same premises under the same trade name, there is succession by inheritance as contemplated in section 78(2) and the assessee-firm is entitled to carry forward and set off the deceased's business loss against its income for subsequent years.

Therefore, the partnership firm formed by the two sons who inherited the business of Mr. Rajesh can set-off the loss of the predecessor i.e. sole-proprietary concern.

Question 7

X Ltd., a pharmaceutical company having accumulated losses and unabsorbed depreciation to be set off in future for Rs.130 lakhs and Rs.250 lakhs as on 31.3.2010 was demerged on 16.5.2010 and 30% of its total assets were transferred to the resulting company, XY Ltd. How

Set off and Carry Forward of Losses

shall the accumulated losses and unabsorbed depreciation of the demerged company be dealt with in the return for Assessment Year 2011-12 of the resulting company:

- (i) *When the same are not directly relatable to the undertakings transferred and*
- (ii) *When the same are directly relatable to the undertakings transferred.*

Answer

The accumulated business loss and unabsorbed depreciation of the demerged company shall be carried forward and set off by the resulting company under section 72A(4) of the Act in the following manner:

- (i) Where such loss or unabsorbed depreciation is not directly relatable to the undertaking transferred to the resulting company, such loss shall be apportioned between the demerged company and the resulting company in the same proportion in which assets of the undertaking have been retained by the demerged company and transferred to the resulting company and shall be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be. In this case, therefore, 30% of Rs.130 lakhs and Rs.250 lakhs, shall be allowed to be carried forward and set off by the resulting company and the balance by the demerged company.
- (ii) Where such loss or unabsorbed depreciation is directly relatable to the undertaking transferred to the resulting company, the entire loss or unabsorbed depreciation shall be allowed to be carried forward and set off in the hands of the resulting company. Accordingly, in such a case, the entire amount of Rs.130 lakhs and Rs.250 lakhs shall be allowed to be set off in the hands of the resulting company.

Question 8

Write short note on:

Carry forward and set off of losses in the event of change in shareholdings of companies in which public are not substantially interested.

Answer

Section 79 prescribes the condition for carry forward and set off of losses in the case of companies, not being companies in which the public are substantially interested. No loss incurred in any year prior to the previous year shall be carry forward and set off unless the persons who beneficially held shares of the company carrying not less than 51% of the voting power on the last day of the year or years in which loss was incurred continue to be the shareholders on the last day of the previous year on which the loss is to be set off.

There are two exceptions to this rule.

Direct Tax Laws

- (i) Where a change in the voting power takes place consequent upon the death of a shareholder or on account of transfer of share by way of gift to any relative of such shareholder.
- (ii) Where a change in the voting power takes place in an Indian subsidiary of a foreign company as a result of amalgamation or demerger of a foreign company provided 51% of the shareholders of the amalgamating or demerged company continue to be shareholders of the amalgamated or the resulting foreign company.

Question 9

Amalgamation of companies 'A' and 'B' has been approved by the BIFR in order to rehabilitate the sick company 'B'. During the course of assessment of 'B' company, the Assessing Officer refuses to allow carry forward of losses under section 72A of the Income-tax Act for the reason that the activities of the sick company had been closed consequent to labour unrest and that the loss suffered by the said company was "Capital loss". Is the Assessing Officer justified?

Answer

The Assessing Officer is not justified in treating the loss as capital loss since the order of BIFR is a speaking order and binding on the transferee-company under amalgamation. In order to rehabilitate the sick company, the BIFR constituted by the Central Government passed an order to enable the transferee-company to enjoy the benefits of carry forward of losses under section 72A. The order has been passed in the interest of public, shareholders and institutions, who have funded the cost of the project and the workmen. The Assessing Officer has no jurisdiction to deny the benefits granted under section 72A in the course of assessment of company, if the prescribed conditions are satisfied.