

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.

The loss of an assessee claiming deduction under section 35AD in respect of a specified business can be set-off against the profit of another specified business under section 73A, irrespective of whether the latter is eligible for deduction under section 35AD. As assessee can, therefore, set-off the losses of a hospital or hotel which begins to operate after

1st April, 2010 and which is eligible for deduction under section 35AD, against the profits of the existing business of operating a hospital (with atleast 100 beds for patients) or a hotel (of two-star or above category), even if the latter is not eligible for deduction under section 35AD.

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

X carrying on a business as sole proprietor, died on 31st March, 2013. On his death, the same business was continued by his legal heirs, by forming a firm. As on 31st March 2013, a determined business loss of ₹5 lacs is to be carried forward under the Income-tax Act, 1961.

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

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 generally, set-off of business losses should be claimed by the same person who suffered the loss and the only exception to this provision is when the business passes on to another person by inheritance.

The facts of case given in the question are similar to the case *CIT v. Madhukant M. Mehta* (2001) 247 ITR 805, where the Supreme Court has held that if 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 would be available to the firm.

In this case, the business of X 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 ₹ 5 lacs of X.

Question 2

Can the brought forward business losses and unabsorbed depreciation be set off against the profit determined under section 44B?

Answer

The provisions of section 44B, introduced w.e.f. 1.4.1976, requiring computation of income of a non-resident from shipping business on a presumptive basis are mandatory and not optional. Therefore, there is no possibility of having a business loss where income is computed on presumptive basis under section 44B. There is an inbuilt presumption that the business losses and depreciation mentioned in the question relate to another business of the non-resident and not the shipping business. In such a case, both business loss and unabsorbed depreciation of another business can be set-off against the profits determined under section 44B in respect of shipping business.

Even though the provisions of section 44B are applicable "notwithstanding anything to the contrary contained in sections 28 to 43A", it is possible to take a view since the *non obstante* clause is relevant only for computation of income from shipping business under section 44B, it does not bar set-off of unabsorbed depreciation relating to some other business.

Question 3

ABC Limited was amalgamated with XYZ Limited on 01.04.2013. All the conditions of section 2(1B) were satisfied.

ABC Limited has the following carried forward losses as assessed till the Assessment Year 2013-14:

	Particulars	₹(in lacs)
(i)	Speculative Loss	4
(ii)	Unabsorbed Depreciation	18
(iii)	Unabsorbed expenditure of capital nature on scientific research	2
(iv)	Business Loss	120

XYZ Limited has computed a profit of ₹ 140 lacs for the financial year 2013-14 before setting off the eligible losses of ABC Limited but after providing depreciation at 15% per annum on ₹ 150 lacs, being the consideration at which plant and machinery were transferred to XYZ Limited. The written down value as per income-tax record of ABC Limited as on 31st March, 2013 was ₹ 100 lacs.

The above profit of XYZ Limited includes speculative profit of ₹ 10 lacs.

Compute the total income of XYZ Limited for Assessment Year 2014-15 and indicate the losses/other allowances to be carried forward by it.

Answer

Computation of total income of XYZ Limited for the A.Y. 2014-15

Particulars	₹(in lacs)	
Business income		
Business income before setting-off brought forward losses of ABC Ltd.		140
<i>Add:</i> Excess depreciation claimed in the scheme of amalgamation of ABC Limited with XYZ Limited.		
Value at which assets are transferred by ABC Ltd.	150	
WDV in the books of ABC Ltd.	<u>100</u>	
Excess accounted	50	
Excess depreciation claimed in computing taxable income of XYZ Ltd. [₹ 50 lacs × 15 %] [Explanation 2 to section 43(6)]		<u>7.50</u>
		147.50
Set-off of brought forward business loss of ABC Ltd. (See Notes 2 & 4)		(120.00)
Set-off of unabsorbed depreciation under section 32(2) read with section 72A (See Notes 2 & 4)		(18.00)
Set-off of unabsorbed capital expenditure under section 35(1)(iv) read with section 35(4) (See Note 5)		<u>(2.00)</u>
		<u>7.50</u>

Notes:

1. It is presumed that the amalgamation is within the meaning of section 72A of the Income-tax Act, 1961.
2. In the case of amalgamation of companies, the unabsorbed losses and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or unabsorbed depreciation of the amalgamated company for the previous year in which the amalgamation was effected and such business loss and unabsorbed depreciation shall be carried forward and set-off by the amalgamated company for a period of 8 years and indefinitely, respectively.
3. As per section 72A(7), the accumulated loss to be carried forward specifically excludes loss sustained in a speculative business. Therefore, speculative loss of ₹ 4 lacs of ABC Ltd. cannot be carried forward by XYZ Ltd.
4. Section 72(2) provides that where any allowance or part thereof unabsorbed under section 32(2) (i.e., unabsorbed depreciation) or section 35(4) (i.e., unabsorbed scientific research capital expenditure) is to be carried forward, effect has to be first given to brought forward business losses under section 72.

5. Section 35(4) provides that the provisions of section 32(2) relating to unabsorbed depreciation shall apply in relation to deduction allowable under section 35(1)(iv) in respect of capital expenditure on scientific research related to the business carried on by the assessee. Therefore, unabsorbed capital expenditure on scientific research can be set-off and carried forward in the same manner as unabsorbed depreciation.
6. The restriction contained in section 73 is only regarding set-off of loss computed in respect of speculative business. Such a loss can be set-off only against profits of another speculation business and not non-speculation business. However, there is no restriction under the Income-tax Act, 1961 regarding set-off of normal business losses against speculative income. Therefore, normal business losses can be set-off against profits of a speculative business.

Consequently, there is no loss or allowance to be carried forward by XYZ Ltd. to the F.Y. 2013-14.

Question 4

Explain in brief about the treatment to be given in the following case under the Income-tax Act, 1961, for A.Y. 2014-15:

A loss of ₹ 85,000 was sustained by Simran in the activity of owning and maintaining camels for races.

Answer

Sec 74A(3) lays down the provisions for set-off and carry forward of loss from the activity of owning and maintaining race horses. According to provisions of section 74A(3), the losses incurred by an assessee from the activity of owning and maintaining race horses cannot be set-off against the income from any other source other than the activity of owning and maintaining race horses. Since the scope of this section is confined to the activity of owning and maintaining race horses only, therefore, set-off and carry forward of loss from the activity of owning and maintaining camels is not covered under section 74A(3).

It is possible to take a view that the loss from the activity of owning and maintaining camels for races may be governed by section 72 provided such activity amounts to business. Accordingly, the loss from the activity of owning and maintaining of camels for races can be set-off against any income (other than income from salary) of current year and unadjusted amount shall be carried forward for set off against any business income for a maximum period of 8 assessment years immediately succeeding the assessment year in which the loss was incurred.

Question 5

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

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 6

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 31.3.2013. The assessed business loss of the firm for the assessment year 2013-14 which it is entitled to carry forward amounts to ₹ 3,60,000. A new deed of partnership was executed among J, K, L and M on 1.4.2013 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 2013-14, which the firm is entitled to set off against its business income for the assessment year 2014-15. The business income of the firm for the assessment year 2014-15 is ₹ 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 ₹ 3,60,000 relating to the assessment year 2013-14 to the extent of ₹ 3,30,000 against its business income of ₹ 3,30,000 for the assessment year 2014-15, 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 ₹ 30,000 relating to the assessment year 2013-14 will be carried forward further after its set-off against the business income of the assessment year 2014-15.

Question 7

An assessee sustained a loss under the head "Income from house property" in the previous year relevant to the assessment year 2013-14, 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 2014-15?

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

Question 8

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 ₹ 2 Lacs, under the provisions of the Income-tax Act, 1961 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 ₹ 2 Lacs of M.

Question 9

A private limited company has share capital in the form of equity share capital. The shares were held up till 31st March, 2012 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 ₹
2010-2011	Nil	15,00,000	15,00,000
2011-2012	Nil	12,00,000	12,00,000
2012-2013	9,00,000	9,00,000	18,00,000
Total	9,00,000	36,00,000	45,00,000

The above figures have been accepted by the tax department.

During the previous year ended 31.3.2013, A sold his shares to Y and during the previous year ended 31.3.2014, B sold his shares to Z. The profits for the past two previous years are as follows:

31.3.2013 ₹ 18,00,000 (before charging depreciation of ₹ 9,00,000)

31.3.2014 ₹ 45,00,000 (before charging depreciation of ₹ 7,50,000)

Compute taxable income for A.Y.2014-15. 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
	%	%	%	%	%	%
2012	25	25	25	25	-	-
2013	-	25	25	25	25	-
2014	-	-	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.

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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 2013-14 would be:

Particulars	₹
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. 2014-15. There is no brought forward business loss and section 79 is not applicable in case of carry forward of unabsorbed depreciation. Section 32 governs the carry forward and set off of depreciation for which the shareholding pattern is not relevant at all. Consequently, the income for A.Y.2014-15 will be determined as under -

Particulars	₹	₹
Business income		45,00,000
Less: Current year's depreciation		7,50,000
		37,50,000
Less: Unabsorbed depreciation:-		
Assessment year 2010-11	15,00,000	
Assessment year 2011-12	12,00,000	
Assessment year 2012-13	9,00,000	36,00,000
Taxable Income for A.Y.2014-15		1,50,000

Question 10

Rajesh & Co., the sole proprietary concern of Mr. Rajesh got converted into partnership after his death on 02.04.2013 by his two sons and the business of Rajesh & Co., was continued to be carried in the same manner. There were business losses of ₹ 4.25 Lacs till 31.03.2013. The net results of the business for the year ended 31.03.2014 were profits of ₹ 5 Lacs. The partners want to set off the losses of ₹ 4.25 Lacs 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 11

X Ltd., a pharmaceutical company having accumulated losses and unabsorbed depreciation to be set off in future for ₹ 130 lacs and ₹ 250 lacs as on 31.3.2013 was demerged on 16.5.2013 and 30% of its total assets were transferred to the resulting company, XY Ltd. How shall the accumulated losses and unabsorbed depreciation of the demerged company be dealt with in the return for Assessment Year 2014-15 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) 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 ₹ 130 lacs and ₹ 250 lacs, 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 ₹ 130 lacs and ₹ 250 lacs shall be allowed to be set off in the hands of the resulting company.

Question 12

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.

- (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 13

The 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, 1961 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.

Self-examination Questions

1. Write short notes on -
 - a) Inter-head adjustment
 - b) Inter-source adjustment.
2. Discuss the correctness of the following statements -
 - (i) Long term capital loss can be set-off against short-term capital gains arising in that year.
 - (ii) Business loss can be set-off against salary income arising in that year.
3. Discuss briefly on -
 - a) Carry forward and set-off of losses by closely held companies

- b) Set-off and carry forward of speculation business loss.
4. State the conditions to be fulfilled by an amalgamated company for carry forward of the accumulated loss and unabsorbed depreciation of the amalgamating company.
 5. Discuss the provisions of the Income-tax Act, 1961 regarding set-off and carry forward of the following losses -
 - a) Loss under the head "Capital Gains"
 - b) Loss from the activity of owning and maintaining race horses.
 6. What are the conditions to be fulfilled to carry-forward and set-off losses in the event of change in shareholding of a company in which public are not substantially interested? State the situations when the carry-forward and set-off is permissible without such restrictions.
 7. Write a short note on carry forward and set-off of losses in case of -
 - (a) change in constitution of firm;
 - (b) succession by inheritance; and
 - (c) succession otherwise than by inheritance.
 8. Aditya, an Indian citizen who is about 70 years old, submits the following information for the previous year 2013-14:

Particulars	₹
Profit from leather goods business in Lucknow	5,00,000
Profit from textile export business in Chennai	6,00,000
Loss from wholesale business in Sri Lanka	8,50,000
Unabsorbed depreciation of wholesale business	70,000
Income from house property in Lucknow (computed)	1,10,000
Income from house property in Sri Lanka (computed)	80,000

The profits from wholesale business in Sri Lanka are received in the bank account in Sri Lanka. Rental income from the Sri Lanka property is also received there. Assuming that Aditya is a resident and ordinarily resident for P.Y.2013-14, compute the taxable income and tax payable by Aditya for the A.Y. 2014-15.