

Set off and carry forward of losses under the Income Tax Act of India

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ABSTRACT

Tax is the Government's main source of revenue, the development of the economy of any country it depends primarily on the tax structure it has embraced. A tax system that makes it easy to do Business and not getting a chance to evade taxes add stability to the economy of a nation. On the other hand, the tax regime that has tax evasion clauses and the one that does not facilitate business-friendly slows the growth of the infrastructure of the nation. Thus as tax structure plays an important role in the development of the economy. India's tax structure is well-developed. The power to levy taxes and duties shall be distributed among the three levels of government under the provisions of the Constitution of India. The system of Indian taxes has undergone many changes and yet it is still far ahead of being an ideal tax structure. Lots of problems like tax evasion, indirect tax reliance, black money, the existence of parallel economy shows that in the future, Indian taxation system will require some major reforms to tackle all these problems. The study is based purely on secondary data, in the following paper. Different figures are obtained from the various Government of India websites.

Keywords

Constitution, carry forward, Income Tax, Setoff

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Introduction

The Income Tax Act, for the purpose of imposing income tax on citizens, collects income under five headings. These revenue headings include income from salaries, income from household property, income from business or occupation, income from capital gains and income from other sources. A loss may be set or carried forward under these revenue headings.

The word set off has been used under the Income tax legislation in lieu of the word, 'adjust'. To set off a loss against a profit means to adjust the loss incurred against that profit. A loss is set off against a profit made in the same year of assessment. When the loss under the head is to be adjusted against the profits to be made in the future, it is called the carry forward of losses, because the loss is carried forward to the next year for adjustment purposes. If a loss cannot be set off, only then will it be eligible for being carried forward.

The purpose of the set off and carry forward provisions is to enable an individual who incurred losses under any of the heads of revenue in a financial year, except income from salary as there is no computable loss from that income, laid down under the Act, to adjust the losses incurred which subject to the provisions of the Income Tax Act, 1961, for every other source of income under the same head of income or under another head of income.

Such rules are founded on the concept of natural justice, as it would be unreasonable not to have the means to change the losses accrued against the profits earned before the income tax is levied.

Discussion

Types of set off:

A set off of losses can either be intra head or inter head. If a loss is unable to be adjusted through intra head set off, then it can be adjusted by way of inter head set off and if the loss cannot be set off even through inter head set off, the same could be carried forward.

Intra head setoff, also known as Inter head set off, is the process under which a loss is adjusted through a source of income under the same head. This kind of set off can be used when an individual has multiple sources of income falling under the same head. For instance, if A is the owner of two house properties for the purpose of being let out and only one of them has been rented, the loss incurred through the vacant property shall be set off against the profit earned through the rented property.

Inter head set off, on the other hand, is the adjustment of losses, suffered through a source belonging to one head, against a source of income belonging to another head. Thus, if A incurs loss in his house property, he can adjust it against his salaried income.

If the income cannot be set off through any of the above ways, it can be carried forward to the following years, according to the provisions laid down in the Income Tax Act as explained below.

1. Carry forward and set off under various heads of income:

Income from house property

The losses resulting from a house property are to be measured against the profits from each of the other profit heads. Nonetheless, if the loss can not be compensated by any other head, it shall be carried forward to the next

assessment year and shall be balanced against the household income in that assessment year.

The inability to set off the income in the following assessment year shall make it eligible to be passed on to the following years. The loss can be carried forward till eight assessment years and no more than that.

Income from business and profession:

The losses suffered under this head of income, other than a speculation business which shall be elucidated later in the article, shall be set against all of the heads of income excluding salary income. Unless the loss in the same measurement year can not be measured against either of the heads, it can be carried forward and balanced against the company and occupation profits. This loss can be carried forward to 8 assessment years from the assessment year for which the loss was measured, but must be assessed after the return has been filed.

When a business of an industrial nature had to be discontinued due to heavy destruction to the plant, building, furniture or machinery, because of calamity such as flood, typhoon, hurricane, cyclone, accidental fire or explosion, a riot or civil disturbance, accidental, and such business is reestablished within three years of such destruction, the loss incurred by such an organization is entitled to be carried forward into the assessment year applicable to the previous year in which the organization was revived. This loss will be carried on up to seven years after its revival.

As assets are deemed to depreciate in value over time, an assessee can claim depreciation allowance on fixed assets of his business. This depreciation allowance, Unless the assessee could claim it in the assessment year, can be carried forward. Earlier, there was a cap to the carry forward of the allowance up to eight years which was later removed through an amendment to Section 32(2) of the Income Tax Act. The question as to the retrospectivity of the amendment was raised in **Pr. CIT Vs. British Motor Car Co.. The high court gave the following opinion:**

“Central Board of Direct Taxes Circular No. 14 of 2001 clarifies the purpose of the amendment to enable the industry to maintain adequate capital to replace the plant and machinery and, accordingly, the amendment dispenses with a maximum of eight years to carry forward and reduces unabsorbed depreciation. The provision is valid from the 2002–03 and subsequent years of the assessment. This means that any unabsorbed depreciation applicable to an assessee on the 1st day of April 2002 (the 2002–03 assessment year) will be dealt with in accordance with the provisions of section 32(2) as amended by the 2001 Finance Act and not in accordance with the provisions of section 32(2) as set out in b before the said amendment. If the Legislature's purpose had been to require the unabsorbed depreciation allowance worked out in the 1997–98 appraisal year for only eight subsequent evaluation years, even after the Finance Act 2001 amendment to section 32(2), it would have added a clause to that effect. This does not include any of those clauses, however. Considering therefore the intent of amending section 32(2) of the Act, a purposeful and harmonious interpretation must be taken.

The Income Tax Act, with respect to businesses engaged in scientific research, grants deductions for capital expenditure

on such scientific research, which if could not be set off in the previous year because of the lack of profits, can be carried forward and then adjusted in subsequent years.

Set off and Carry Forward of Unabsorbed Depreciation Allowance and Accumulated Loss:

Accumulated loss is the loss suffered by the predecessor enterprise, before the amalgamation or demerger was initiated, had the demerger or amalgamation not taken place, which it would have been entitled to carry forward. Similarly, unabsorbed depreciation means the depreciation allowance that would have been allowed to the predecessor enterprise if the demerger or amalgamation not occurred.

In case of amalgamations such as, a company, who owns an industrial undertaking, or a ship, or a hotel, with another firm; a banking company with a designated bank; or a public sector company engaged in the business of aircraft with a corporation or related companies, the accumulated loss as well as the allowance for unabsorbed depreciation, as defined above, In the previous year in which this amalgamation took effect, it shall be considered to belong to the amalgamated company.

The Set off or carry forward, as discussed above, is subject to the conditions that the amalgamating firm must have been active in the market for a period of three or more years prior to the amalgamation and at least three-fourths of the fixed assets owned by that corporation should have maintained their original costs for at least two years.

The amalgamated company also requires to fulfil certain conditions such as, it must have held the original value of at least three fourth of the fixed assets of the amalgamating company for no less than five years, the same was gained from an amalgamation scheme. Over a fixed duration of five years, the amalgamated company would have carried on the business of the amalgamating company. Aside from these two, the amalgamated corporation for the purpose of taking the cumulative loss and depreciation allowance off or carrying forward shall fulfil other conditions that it may be subjected to for the purpose of assurance of resurrection of the amalgamating company as well as for the purpose of ensuring that the amalgamation has, in fact, been carried out for genuine purposes. Non compliance with these conditions shall lead to the set off or carry forward of the accumulated losses or the depreciation allowance made by the amalgamated company in a previous year to be rendered taxable for the year that these conditions have not been obeyed with.

Likewise, if a banking company amalgamate with another banking institution, the cumulative loss or depreciation allowance of the banking company shall be considered to belong to the banking institution for the preceding year in which the amalgamation took place.

Moving forward to demerger where the demerger has occurred, where the loss or uninhibited depreciation may be attributed to the undertakings which have been transferred to the resulting company, the resulting company is entitled to set off or carry forward such losses or depreciation against its profits. Whereas where the losses or the unabsorbed depreciation can not be traced to the resulting company's undertaking, they shall be distributed to both companies in the same proportion as the assets of the undertakings were

divided among the undertakings and are therefore set off or forwarded accordingly.

There may be a reorganization of a business wherein, a company succeeds with a firm or a proprietary concern. In these cases, the accrued loss or depreciation allowance of the business or proprietary interest shall be passed to the resulting company and the loss or allowance shall be considered to belong to the company for the previous year in which the reorganization was carried out.

Wherein a business reorganization of cooperative banks is to occur, the successor bank shall set off or carry forward the loss or allowance of the predecessor bank. Under such reorganization, the predecessor bank is required to have been carrying out the banking services for three or more years while it is also required to have at least three-fourths of the original value of its fixed assets for at least two years before the reorganization takes place.

Similarly, the successor bank is also required to necessarily fulfil certain conditions prior to the reorganization. It is required to be holding at least three fourth of the original value of the fixed assets of the predecessor bank for a minimum period of five years from the date of reorganization. The successor bank is also required to be carrying on with the business of the predecessor bank for the same period and shall be called on to fulfil such other conditions as may be imposed upon it for the purpose of verifying that no malice is involved behind thereorganization of such banks.

In the case of demerger of a cooperative bank, the same rules, as addressed above, shall apply to the set-off or carry-forward of losses and depreciation allowances in the case of demerger of a company. It is not sufficient for the predecessor company and the subsequent business or companies to be considered to have two previous years in order to cover and carry forward the cumulative losses and depreciation allowance.

1.1. Set off and Carry Forward in the case of Speculation business:

A speculative transaction, as the word suggests, is a transaction wherein the outcome is dependent on a mere probability or postulation rather than skill or experience.

The Income Tax Act defines Speculative transaction as a transaction with respect to the sale or purchase of a commodity which is settled without there being an actual transfer of that commodity or a certificate of such entitlement.

The speculation business, for the aims to set off and carry forward of losses, applies to any part of a company engaged in the business of dealing with shares of other companies which is considered to be carrying on a speculation undertaking, exception: firms that are mainly engaged in profit-generating activities, paid under headings, 'interest on debt,' 'household income,' 'capital gains' or 'revenue from other sources'.

There has been a perplexity as to the computation of such primary involvement, or as to the verbatim of the Act, 'consisting mainly' of income chargeable under the above-mentioned heads. The concern was addressed by the In CIT vs M / s Pvt Darshan Securities. Ltd, wherein Bombay High Court, said that "the words 'consists primarily' are indicative of the fact that in its reflection the legislature had that the gross total income consists predominantly of income from

the four heads referred to therein. Clearly, the usual provisions of the Act must be applied in the calculation of the gross total income and it is only subsequently appropriate to decide if the gross total income so measured consists solely of income paid under the headings referred to in the definition."

Mere Speculative transactions have been held to not attract the provision of set off and carry forward of losses as a single transaction does not constitute a speculation business. In Commissioner of Income tax vs. Kamani Tubes Ltd., the Bombay High Court was of the opinion that "there is a perceptible distinction between" speculative business "and" speculative "transactions." An individual settlement of a contract agreement other than actual delivery of the goods may lead to a "speculative transaction" under the context of s. 43(5) However in the absence of anything else to prove that the essence of the transactions was such as to constitute a corporation, it cannot be called a 'speculative business' which was regarded as distinct and different from other businesses."

After ample light being thrown on the nature of a speculation business, it is important to note that a set of or carry forward of losses sustained under a speculation organization can only be set off or carried forward against the income of the assessee's speculation undertaking.

The deduction granted for scientific work on capital expenditure is also valid in the case of speculation businesses and can be set off or carried forward against the profits of such businesses. Any loss resulting from this gain can only be carried forward for a period of four years and must have been assessed in conjunction with the income tax return in order to take advantage of the benefits.

Set off and Carry Forward in case of Specified Businesses:

The term 'Specified businesses' under the Act, pertains to the following businesses:

- Operation of a cold chain facility;
- Warehousing facility for storage as well as agricultural produce;
- Construction or operation of a cross-country natural gas or crude or oil pipeline network for delivery purposes along with storage facilities for the same purposea;
- **Construction or operation of a hospital with a capacity of at least 100 beds;**
- **Construction and operation of a hotel, having been categorized as at least a two-star hotel by the central government;**
- Building and constructing a housing project under the slum rehabilitation scheme of the central government or the state government;
- Construction and construction of a housing project under an affordable housing scheme adopted by the Indian state or central government;
- Fertilizer production;
- Construction and establishment of an inland container depot or container freight station;
- Beekeeping; producing beeswax and honey;
- Storage facility for storage of sugar;

- Construction and operation of a slurry pipeline for the transport of iron ore;
- Establishment and operation of a semiconductor wafer manufacturing unit;
- Development, maintenance or operation of new infrastructure.

The set off and carry forward of losses under the above specified businesses can only be done against profits made in any of the other specified businesses.

No limit has been ascribed to the carry forward of a loss under any of the specified businesses and thus can be carried forward to any number of years, the reason behind the same being the emboldening of the infrastructure sector of India.

Income from capital gains:

A capital gain is a benefit which is made by selling a capital asset. Such an asset may be a stock, a bond, an asset, etc. This capital gain may be either a short-term capital asset or a long-term capital asset in which a long-term capital asset is held by the assessee for more than one year before it is sold, while a short-term capital asset is held by the assessee for less than one year before it is sold.

Table 1: The following table encapsulates the eligibility of various losses to be set off and carried forward against various sources and heads

LOSSES INCURRED	SET OFF		CARRY FORWARD		
	Eligibility to be set off against different HOI	Eligible source/Head of Income	Eligibility for being carry forward	No. of assessment years	Eligible source/Head of Income
House Property	Eligible	All heads	Eligible	8	Same head
Non-speculative/Non specified Business	Eligible	All heads except salary	Eligible	8	Same head
Short term capital loss	Not eligible	-	Eligible	8	Same head
Long term capital loss	Not eligible	-	Eligible	8	Similar Source
Race Horses	Not eligible	Similar source	Eligible	4	Similar Source
Speculation business	Not eligible	Similar source	Eligible	4	Similar source
Specified business	Not eligible	Similar source	Eligible	No limit	Similar source

Conclusion

Income Tax has been an ever-changing regime with respect to reforms being brought in order enable a better organization of the taxes in the densely populated country that India is. The average rate of tax paid in India is among the most excessive universally which demands awareness by the tax payers regarding any available tax saving methods and one of them is the set off and carry forward of the losses that may have been incurred by an assessee under any of the heads of the income, except income from salary. The Annual budget for the year 2020 has instigated a new taxation mechanism wherein the assessee can divert to more concessional rates of tax, in return of which the assessee will be required to give up a total of seventy deductions as well as exemptions as provided by the older system. These 70 exclusions include set off of losses that have been carried forward. The air surrounding this new mechanism needs to

The Income Tax Act, 1961, does not require any capital gains income to be set aside. Such an benefit can only be carried forward, because although a loss arising from a short-term capital asset can be carried forward against a short-term capital asset or long-term capital asset earnings, the loss resulting from a long-term capital asset can be carried forward only against the earnings of a long-term capital asset. These losses can be carried forward to a period of eight years of evaluation. Losses of this type must be reported and revealed in the slip to the income tax return.

1.2. Income from other sources:

The set off and carry forward provisions, under this head elucidate the set off and carry forward of losses in horse racing. The loss incurred from owning and maintaining race horses has to be adjusted against an income, none other than one originating from owning and maintaining race horses.

The loss, in this case, has to be calculated after taking into consideration the stake money, which is the total amount of prize money won by the assessee through such race or races. The loss, thus, is deemed to be the amount of expenditure through which the stake money falls short and can be carried forward up to four assessment years and must be displayed in the income tax return slip (Table 1).

be cleared with respect to the position of the losses that an individual has been carrying forward, once he/she opts for this new mechanism.

Reference

- [1] ITA 1031/2017
- [2] 341 ITR 556 (Bom)
- [3] . 207 ITR 0298, (1994)
- [4] Section 35AD (8)(c)