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SET OFF AND CARRY FORWARD OF LOSS UNDER THE INCOME-TAX ACT

Loss from exempted source of income cannot be adjusted against taxable income

If income from a particular source is exempt from tax, then loss from such source cannot be set off against any other income which is chargeable to tax.

E.g., Agricultural income is exempt from tax, hence, if the taxpayer incurs loss from agricultural activity, then such loss cannot be adjusted against any other taxable income.

Meaning of intra-head adjustment

If in any year the taxpayer has incurred loss from any source under a particular head of income, then he is allowed to adjust such loss against income from any other source falling under the same head.

The process of adjustment of loss from a source under a particular head of income against income from other source under the same head of income is called intra-head adjustment, e.g. Adjustment of loss from business A against profit from business B.

Restrictions to be kept in mind while making intra-head adjustment of loss

Following restrictions should be kept in mind before making intra-head adjustment of loss:

- 1) Loss from speculative business cannot be set off against any income other than income from speculative business. However, non-speculative business loss can be set off against income from speculative business.
- 2) Long-term capital loss cannot be set off against any income other than income from long-term capital gain. However, short-term capital loss can be set off against long-term or short-term capital gain.
- 3) No loss can be set off against income from winnings from lotteries, crossword puzzles, race including horse race, card game, and any other game of any sort or from gambling or betting of any form or nature.
- 4) Loss from the business of owning and maintaining race horses cannot be set off against any income other than income from the business of owning and maintaining race horses.
- 5) Loss from business specified under section 35AD cannot be set off against any other income except income from specified business (section 35AD is applicable in respect of certain specified businesses like setting up a cold chain facility, setting up and operating warehousing facility for storage of agricultural produce, developing and building a housing projects, etc.).

Meaning of inter-head adjustment

After making intra-head adjustment (if any) the next step is to make inter-head adjustment. If in any year, the taxpayer has incurred loss under one head of income and is having income under other head of income, then he can adjust the loss from one head against income from other head, E.g., Loss under the head of house property to be adjusted against salary income.



Restrictions to be kept in mind while making inter-head adjustment of loss

Following restrictions should be kept in mind before making inter-head adjustment:

- 1) Before making inter-head adjustment, the taxpayer has to first make intra-head adjustment.
- 2) Loss from speculative business cannot be set off against any other income. However, non-speculative business loss can be set off against income from speculative business.
- 3) Loss under head “Capital gains” cannot be set off against income under other heads of income.
- 4) No loss can be set off against income from winnings from lotteries, crossword puzzles, race including horse race, card game, and any other game of any sort or from gambling or betting of any form or nature.
- 5) Loss from the business of owning and maintaining race horses cannot be set off against any other income.
- 6) Loss from business specified under section 35AD cannot be set off against any other income (section 35AD is applicable in respect of certain specified businesses like setting up a cold chain facility, setting up and operating warehousing facility for storage of agricultural produce, developing and building housing projects, etc.)
- 7) Loss from business and profession cannot be set off against income chargeable to tax under the head “Salaries”.
- 8) Loss under the head “house property” shall be allowed to be set-off against any other head of income only to the extent of Rs. 2,00,000 for any assessment year.
- 9) However, unabsorbed loss shall be allowed to be carried forward for set-off in subsequent years as per the existing provisions of section 71B. (Provisions relating to carry forward of loss from house property is discussed later.)

Carry forward of unadjusted loss for adjustment in next year

Many times it may happen that after making intra-head and inter-head adjustments, still the loss remains unadjusted. Such unadjusted loss can be carried forward to next year for adjustment against the income of subsequent years. Separate provisions have been framed under the Income-tax Law for carry forward of loss under different heads of income.

Provisions under the Income-tax law in relation to carry forward and set off of business loss other than loss from speculative business

If loss of any business/profession (other than speculative business) cannot be fully adjusted in the year in which it is incurred, then the unadjusted loss can be carried forward for making adjustment in the next year. In the subsequent year(s) such loss can be adjusted only against income charged to tax under the head “Profits and gains of business or profession”

Loss under the head “Profits and gains of business or profession” can be carried forward only if the return of income/loss of the year in which loss is incurred is furnished on or before the due date of furnishing the return, as prescribed under section 139(1).

Such loss can be carried forward for eight years immediately succeeding the year in which the loss is incurred.



Above provisions are not applicable in case of unabsorbed depreciation (provisions relating to unabsorbed depreciation are discussed later)

Loss from business specified under section 35AD cannot be set off against any other income except income from specified business (section 35AD is applicable in respect of certain specified businesses like setting up a cold chain facility, setting up and operating warehousing facility for storage of agricultural produce, developing and building a housing projects, etc.). Such loss can be carried forward for adjustment against income from specified business for any number of years.

Loss from business specified under section 35AD can be carried forward only if the return of income/loss of the year in which loss is incurred is furnished on or before the due date of furnishing the return as prescribed under section 139(1).

Loss from the business of owning and maintaining race horses cannot be set off against any income other than income from the business of owning and maintaining race horses. Such loss can be carried forward only for a period of 4 years.

If loss of any speculative business cannot be fully adjusted in the year in which it is incurred, then the unadjusted loss can be carried forward for making adjustment in the next year. In the subsequent year(s) such loss can be adjusted only against income from speculative business (may be same or any other speculative business).

Loss from speculative business can be carried forward only if the return of income/loss of the year in which loss is incurred is furnished on or before the due date of furnishing the return, as prescribed under section 139(1).

Such loss can be carried forward for four years immediately succeeding the year in which the loss is incurred.

Above provisions are not applicable in case of unabsorbed depreciation of speculative business (provisions relating to unabsorbed depreciation are discussed later).

Provisions under the Income-tax Law in relation to carry forward and set off of house property loss

If loss under the head “Income from house property” cannot be fully adjusted in the year in which such loss is incurred, then unadjusted loss can be carried forward to next year.

In the subsequent years(s) such loss can be adjusted only against income chargeable to tax under the head “Income from house property”.

Such loss can be carried forward for eight years immediately succeeding the year in which the loss is incurred.

Loss under the head “Income from house property” can be carried forward even if the return of income/loss of the year in which loss is incurred is not furnished on or before the due date of furnishing the return, as prescribed under section 139(1).

Provisions under the Income-tax law in relation to carry forward and set off of capital loss

If loss under the head “Capital gains” incurred during a year cannot be adjusted in the same year, then unadjusted capital loss can be carried forward to next year.

In the subsequent year(s), such loss can be adjusted only against income chargeable to tax under the head “Capital gains”, however, long-term capital loss can be adjusted only against long-term capital gains. Short-term capital loss can be adjusted against long-term capital gains as well as short-term capital gains.

Such loss can be carried forward for eight years immediately succeeding the year in which the loss is incurred.

Such loss can be carried forward only if the return of income/loss of the year in which loss is incurred is furnished on or before the due date of furnishing the return, as prescribed under section 139(1).

Meaning of unabsorbed depreciation, unabsorbed capital expenditure on scientific research and unabsorbed capital expenditure on promoting family planning amongst the employees

Apart from several other deductions, while computing income chargeable to tax under the head “Profits and gains of business or profession” a person is allowed to claim deduction on account for depreciation, capital expenditure incurred by him on scientific research and capital expenditure incurred by a company for promoting family planning amongst its employees.

If the income of the year in which these expenses are incurred falls short of these expenses, then the unabsorbed expenses can be carried forward to next year in the form of unabsorbed depreciation or unabsorbed capital expenditure on scientific research or unabsorbed capital expenditure on promoting family planning amongst the employees.

Illustration for better understanding

Business income (computed as per the provisions of Income-tax Law) of Mr. Kiran before allowing deduction on account of depreciation amounted to Rs. 84,000. Depreciation as per the provisions of section 32 amounted to Rs. 1,00,000. What will be the amount of unabsorbed depreciation in this case?

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It can be observed that business income before claiming deduction under section 32 on account of depreciation is Rs. 84,000 and depreciation allowable as per section 32 is Rs. 1,00,000, hence, after claiming deduction on account of depreciation of Rs. 1,00,000, there will be a loss of Rs. 16,000.

This loss is on account of depreciation and, hence, loss of Rs 16,000 will be termed as unabsorbed depreciation.

Provisions under the Income-tax Law relating to set off of unabsorbed depreciation, unabsorbed capital expenditure on scientific research and unabsorbed capital expenditure on promoting family planning amongst the employees

Depreciation is first deducted from the income chargeable to tax under the head “Profits and gains of business or profession”. If such depreciation could not be fully adjusted against such income chargeable to tax in that previous year, the unabsorbed portion shall be added to the amount of depreciation for the following year and shall be deemed to be the part of depreciation for that year(similar treatment would be given to other allowances as mentioned above). However, in the case of set off, following order of priority is to be followed:



- 1) First adjustments are to be made for current scientific research expenditure, family planning expenditure and current depreciation.
- 2) Second adjustment is to be made for brought forward business loss.
- 3) Third adjustments are to be made for unabsorbed depreciation, unabsorbed capital expenditure on scientific research or on family planning.

Carry forward of loss in case of change in the constitution of business

Generally, the person incurring the loss is only entitled to carry forward the loss to be adjusted in subsequent year(s). However, in certain cases of reconstitution of the business like amalgamation, demerger, conversion of proprietary firm into company or conversion of partnership firm into company, etc., the reconstituted entity is entitled to carry forward the unadjusted loss of predecessor entity (provided that conditions specified in this regard are satisfied).

Provisions relating to carry forward of loss in case of retirement of a partner from a partnership firm

Section 78 contains provisions relating to carry forward and set off of loss in case of change in constitution of a partnership firm due to death or retirement of a partner (i.e. when a partner goes out of firm by retirement or death). In such a case, the share of loss attributable to the outgoing partner cannot be carried forward by the firm.

Restriction of section 78 is applicable only in case of loss and is not applicable in case of adjustment of unabsorbed depreciation, unabsorbed capital expenditure on scientific research or family planning expenditure.

Special provisions relating to carry forward and set-off of losses in case of change in shareholding of certain companies

Section 79 of the Income-tax Act, 1961 provides for carry forward and set-off of losses where a change in shareholding has taken place in a previous year in case of following companies:-

- 1) In case of a company, being a company in which the public are not substantially interested but not being an eligible start-up as referred to in section 80-IAC, no loss incurred in any year prior to the previous year in which change in shareholding has taken place shall be carried forward and set off against the income of the previous year, unless on the last day of the previous year, the shares of the company carrying not less than 51% of the voting power were beneficially held by 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 the loss was incurred
- 2) In case of a company, being a company in which the public are not substantially interested and an eligible start-up as referred to in section 80-IAC, the loss incurred in any year prior to the previous year in which change in shareholding has taken place, shall be allowed to be carried forward and set off only if all the shareholders of the company who held shares carrying voting power on the last day of the previous year in which the loss was incurred, continue to hold shares on the last of the current year. Further, the loss should have been incurred during the period of 10 years beginning from the year in which the company is incorporated.

However, to facilitate ease of doing business in case of an eligible start-up, the Finance (no.2) Act, 2019 has amended section 79 to provide that loss incurred, by the closely held eligible start-up, shall be allowed to be carried forward and set off against the income of the previous year on satisfaction of either of the two conditions specified above, i.e., continuity of 51% shareholding or continuity of 100% of original shareholders. [w.e.f. Assessment Year 2020-21]

However, the provisions of section 79 shall not apply in following cases. In other words, there shall be no restriction on carry forward and set-off of losses if-

- a) the change in shareholding takes place consequent upon the death of a shareholder or on account of transfer of shares by way of gift to any relative of the shareholder making such gift; or
- b) the assessee is a subsidiary of a foreign company and the foreign holding company is amalgamated or merged with another foreign company subject to condition that 51% shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or the resulting foreign company.
- c) the change in shareholding take place in the previous year pursuant to approved resolution plan under the Insolvency and Bankruptcy Code, 2016 after affording a reasonable opportunity of being heard to the jurisdictional Principal CIT or CIT.
- d) A company, and its subsidiary and the subsidiary of such subsidiary, where:
 - i. National Company Law Tribunal (NCLT), on a petition moved by the Central Govt., has suspended the board of directors of such company and has appointed new directors.
 - ii. Change in shareholding has taken place in a previous year pursuant to a resolution plan approved by the NCLT.
- e) Change in the shareholding has taken place during the previous year on account of relocation referred to in the *Explanation* to clauses (viiac) and (viiad) of section 47.

Change in shareholding due to strategic disinvestment

With effect from Assessment Year 2022-23, The Finance Act, 2022 has introduced one more situation wherein the provisions of section 79 shall not apply. It has been provided that the section 79 shall not apply to an erstwhile Public Sector Company (PSU), subject to condition that the ultimate holding company of such erstwhile PSU, immediately after completion of the strategic disinvestment, continues to hold, directly or through its subsidiary or subsidiaries, at least 51% of the voting power of such PSU in aggregate.

However, this relaxation shall cease to apply from the previous year in which the ultimate holding company ceases to hold, directly or through its subsidiary or subsidiaries, 51% of the voting power of the erstwhile public sector company. If the relaxation ceases to apply in any previous year, the provisions of section 79 shall apply for such previous year and subsequent previous years.

The erstwhile public sector company shall have the same meaning as assigned to it in clause (ii) of the Explanation to clause (d) of section 72A(1).

No set-off of loss against undisclosed income discovered during search

The Finance Act, 2022 has inserted a new section 79A to the Income-tax Act to restrict set off of losses consequent to search, requisition and survey. It has been provided that in case the total income of any previous year of an assessee includes any undisclosed income detected as a result of:

- (a) Search initiated under section 132; or
- (b) A requisition made under section 132A; or
- (c) A survey conducted under section 133A other than under section 133A(2A).

Then, no set-off of any loss, whether brought forward or otherwise, or unabsorbed depreciation, shall be allowed against such undisclosed income while computing the total income of the assessee for such previous year.

Meaning of undisclosed income

For this provision, the 'undisclosed income' means:

- (a) Any income of the previous year represented, either wholly or partly, by any money, bullion, jewellery or other valuable article or thing or any entry in the books of account or other documents or transactions found in the course of a search under section 132 or a requisition under section 132A or a survey under section 133A other than under section 133A(2A), which has:
 - not been recorded on or before the date of search or requisition or survey in the books of account or other documents maintained in the normal course relating to such previous year; or
 - not been disclosed to the Commissioner before the date of search or requisition or survey, as the case may be.

Any income of the previous year represented, either wholly or partly, by any entry in respect of an expense recorded in the books of account or other documents maintained in the ordinary course relating to the previous year which is found to be false and which would not have been found to be so, had the search not been initiated or the survey not been conducted or the requisition not been made.

The provisions of section 79A is effective from Assessment Year 2022-23.





MCQ ON SET OFF AND CARRY FORWARD OF LOSS UNDER THE INCOME-TAX LAW

Q1. If income from a particular source is exempt from tax, then loss from such source cannot be set off against any other income which is chargeable to tax.

- (a) True (b) False

Correct answer : (a)

Justification of correct answer :

If income from a particular source is exempt from tax, then loss from such source cannot be set off against any other income which is chargeable to tax.

Thus, the statement given in the question is true and hence, option (a) is the correct option.

Q2. The process of adjustment of loss from a source under a particular head of income against income from other source under the same head of income is called _____.

- (a) Inter-head adjustment (b) Intra-head adjustment
(c) Carry forward of loss (d) Clubbing of income

Correct answer : (b)

Justification of correct answer:

The process of adjustment of loss from a source under a particular head of income against income from other source under the same head of income is called intra-head adjustment. Thus, option (b) is the correct option.

Q3. While making intra-head adjustment of loss, short-term capital loss cannot be set off against long-term capital gain.

- (a) True (b) False

Correct answer : (b)

Justification of correct answer :

While making intra-head adjustment of loss, short-term capital loss can be set off against short-term capital gain as well as against long-term capital gain.

Thus, the statement given in the question is false and hence, option (b) is the correct option.

Q4. While making intra-head adjustment, loss from the business of owning and maintaining race horses can be set off against _____ only.

- (a) Income from winnings from lotteries
(b) Income from crossword puzzles
(c) Income from business of owning and maintaining race horses
(d) Income from card game

Correct answer : (c)

Justification of correct answer :

Loss from the business of owning and maintaining race horses cannot be set off against any income other than income from the business of owning and maintaining race horses.

Thus, option (c) is the correct option.



Q5. While making inter-head adjustment of loss, loss from business and profession cannot be set off against income chargeable to tax under the head “Salaries”.

- (a) True (b) False

Correct answer : (a)

Justification of correct answer :

While making inter-head adjustment of loss, loss from business and profession (including unabsorbed depreciation) cannot be set off against income chargeable to tax under the head “Salaries”.

Thus, the statement given in the question is true and hence, option (a) is the correct option.

Q6. Loss under the head “Profits and gains of business or profession” can be carried forward even if the return of income/loss of the year in which loss is incurred is not furnished on or before the due date of furnishing the return, as prescribed under section 139(1).

- (a) True (b) False

Correct answer : (b)

Justification of correct answer :

Loss under the head “Profits and gains of business or profession” can be carried forward only if the return of income/loss of the year in which loss is incurred is furnished on or before the due date of furnishing the return, as prescribed under section 139(1).

Thus, the statement given in the question is false and hence, option (b) is the correct option.

Q7. However, if loss under the head “Income from house property” cannot be fully adjusted in the year in which such loss is incurred, then unadjusted loss can be carried forward for _____ years immediately succeeding the year in which the loss is incurred.

- (a) 2 (b) 5
(c) 8 (d) 10

Correct answer : (c)

Justification of correct answer :

With effect from the assessment year 2018-19, loss under the head “house property” shall be allowed to be set-off against any other head of income only to the extent of Rs. 2,00,000 for any assessment year.

If loss under the head “Income from house property” cannot be fully adjusted in the year in which such loss is incurred, then unadjusted loss can be carried forward for 8 years immediately succeeding the year in which the loss is incurred.

Thus, option (c) is the correct option.

Comment on incorrect answer : Option (c) is the correct option since it gives the correct number of years, all the other options, viz., option (a), (b) and (d) giving incorrect number of years are not correct.





Q8. Restriction of section 78 is applicable only in case of loss and is not applicable in case of adjustment of unabsorbed depreciation, unabsorbed capital expenditure on scientific research or family planning expenditure.

- (a) True (b) False

Correct answer : (a)

Justification of correct answer :

Section 78 contains provisions relating to carry forward and set off of loss in case of change in constitution of a partnership firm due to death or retirement of a partner (i.e. when a partner goes out of firm by retirement or death). In such a case, the share of loss attributable to the outgoing partner cannot be carried forward by the firm. Restriction of section 78 is applicable only in case of loss and is not applicable in case of adjustment of unabsorbed depreciation, unabsorbed capital expenditure on scientific research or family planning expenditure.

Thus, the statement given in the question is true and hence, option (a) is the correct option.

Q9. In case of a Company, being a company in which public are not substantially interested but not being an eligible start-up as referred to in section 80-IAC, if the person beneficially holding _____ of the voting power as on the last day (i.e. 31st March) of the year in which the loss was incurred and on the last day (i.e. 31st March) of the year in which the company wants to set off the brought forward loss are different, then the company cannot set off such brought forward loss.

- (a) 20% (b) 25%
(c) 50% (d) 51%

Correct answer : (d)

Justification of correct answer :

In case of a company in which public are not substantially interested (i.e., closely held company), if the person beneficially holding 51% of the voting power as on the last day (i.e. 31st March) of the year in which the loss was incurred and on the last day (i.e. 31st March) of the year in which the company wants to set off the brought forward loss are different, then the company cannot set off such brought forward loss.

Thus, option (d) is the correct option.

