

# 'Losses' under the Head—Profits and Gains of Business or Profession

BY

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Income chargeable under the Income Tax Act, 1961 is classified under the following heads :

- A. Salaries
- B. Interest on securities
- C. Income from House property
- D. Profits and Gains of Business or Profession
- E. Capital Gains
- F. Income from other sources.

Income tax is, however, levied on sum total of the income chargeable under all these heads; as a natural corollary to this principle, if there is a loss under any head, the same would generally be adjusted/set off against the profits under the other heads.

A person who enters into a business always does so with the expectation of making profits, however, all those who do business are not fortunate enough to make profits, some sustain losses as well. Government has made special provisions for those who incur losses.

The Income Tax Act, 1961 has classified losses for the purpose of set off and carry forward under two following categories.

- (1) Losses suffered in non-speculative business known as trading losses.
- (2) Losses suffered in speculative business known as speculative losses.

**Set-off :** Section 71(1) of the Act lays down that where in respect of any assessment year, the net result of the computation under any head of income other than 'Capital Gains' is a loss, such loss shall, subject to the other provisions of the Act, be set off against the income of the assessee, if any, assessable for that assessment year under any other head. There is, however, an exception to this, that is in respect of losses of a speculation business being a source within the head 'business or profession' under section 73(1) a loss in a speculation business can be set off against profits if any from another speculation business of the year. If even after such adjustment, there is a net loss it cannot be wiped out or adjusted against any income of the year from any other source.

**Carry forward and set-off :**

Even after adjustment of losses arising under the head 'business or profession' against the profits of the same year under any other head, if it is found that there still remains some unabsorbed loss, sub-section (1) of Section 72 of the Act entitles the assessee to carry forward to subsequent assessment(s).

(A) **Loss in Non-Speculation Business :** If the unabsorbed loss be in respect of a business other than a speculation business, such loss is to be carried forward, subject to certain conditions to the following assessment year and may be set off against the profits and gains, if any, of any business or profession, carried on by the assessee during that year and not necessarily of the same business or profession as that in which the loss was incurred.

*The Conditions are :*

(i) *The business which resulted in a loss should be continued.* The business or profession in which the loss was originally sustained must be continued to be carried on by the assessee in the year in which the carried forward loss is sought to be set off. There are however two exceptions to the generality of the above condition. One is provided by Section 41(5) of the Act and the other by the provision to Section 72(1)(ii) of the Act.

Section 41(1 to 4) of the Act lays down cases where certain receipts, in the nature of remission or cessation of liabilities, profits on sale of depreciable asset, surplus on sale of an asset, representing capital expenditure on scientific research and amounts of bad debts previously allowed but subsequently recovered, are deemed to be profits of a business or profession and become chargeable to income tax as the income of the previous year in which the same has been received, irrespective of the fact that the business or profession to which those relate has been discontinued. Section 41(5) of the Act lays down that in such cases, an unabsorbed loss which arose in that business during the previous year in which it ceased to exist may be set off so far as may be, against the income chargeable under Section 41 in the subsequent year in spite of break in continuity. The circumstances relating to the other exception provided by Section 33B of the Act, whereby an assessee is entitled to what is known as "Rehabilitation Allowance" on the re-establishment, reconstruction or revival of a business within three years from the end of the previous year in which it was discontinued by reason of extensive damage to or destruction of any building, plant, machinery or furniture belonging to the assessee and used by him in such business caused by flood, cyclone, earthquake or other natural calamities, riot, accidental fire or enemy action etc. The proviso to Section 72(1)(ii) lays down that the unabsorbed loss shall, on revival, in such circumstances, be available for adjustment against any business profits made in the year of revival of business. If the loss remains unabsorbed the same can be carried forward for a maximum period of 8 years following the year of re-establishment, reconstruction or revival of the discontinued business.

(ii) *Carryforward permissible only to the same assessee* : The loss can be carried forward and set off against the profits of the assessee who incurred the loss. A successor in business cannot claim to carry forward the loss incurred by his predecessor in business. Section 78(2) of the Act, however provides an exception to this rule too and states that in cases of succession of business by inheritance, the loss would still be allowed to be carried forward by the legal representative who inherits the same.

(iii) *Right to carry forward is for eight years* : Such loss can be carried forward for a maximum period of eight years. To this rule also there is an exception arising from the application of the proviso to Section 72(1)(ii) of the Act. In cases of discontinuance and revival as mentioned in Section 33B of the Act, the loss of the discontinued business remaining unabsorbed even after due adjustment in the year of revival is allowed to be carried forward for further period of 8 years following the year of re-establishment or revival irrespective of the fact that 7 years may have already passed following the assessment year for which the loss was first computed. Thus for instance, if a loss is incurred by an assessee in a business in the previous year relevant to the assessment year 1961-62 and a part of the loss is still lying unabsorbed in the assessment year 1968-69, and the business which was discontinued in January, 1968 under circumstances mentioned in Section 33B is revived in 1970, thereby entitling it to claim rehabilitation allowance, such unabsorbed loss gets an extension for set off for another 8 years following the year of re-establishment or revival.

(b) **Loss in Speculation Business** : The same provisions, as discussed earlier are also applicable for the carryforward and set off of losses suffered in speculation business *subject however to the same basic condition that the speculative losses can be set off against the profits and gains, if any, of any speculation business carried on by the assessee and assessable for the assessment year.* Although normally adjustments for carried forward losses are to be made only in the last, that is to say, after all the provisions regarding adjustment of losses for the year itself are given effect to, the Central Board by its Circular No. 23 (XXXIX4) D of 1960 issued on 12th September, 1960 has allowed the assessee the following option :

(1) either to first set off the speculative losses carried forward from an earlier year against the speculative profits of the current year and then to set off the current year's losses from other sources against the remaining part: if any, of the current year's speculation profits, or

(2) to first set off the current year's losses from non-speculation business and other sources against the current year's speculation profits and then to set off the carried forward speculation losses, whichever is advantageous to him.

The importance of this circular would be evident when we consider that although speculative losses can not be adjusted against profits arising from non-speculation business, there is nothing in the language of Section 70 or Section 72 to prohibit the wiping out of speculation profits by adjustment against non-speculation business losses. The result would be that the department may try to adjust non-speculation business losses against speculation profits of the year by way of intra-head adjustment under the head "business or profession" depriving the assessee of the relief which would otherwise have been available to him of having his speculation losses, brought forward from earlier years, adjusted against the speculation profits of the current year. In the circumstances, since the maximum period for which the carryforward is allowed, being 8 years, the speculative losses may lapse. The same position also follows when both speculative and non-speculative losses are brought forward for adjustment. The department in such event, might choose first to adjust brought forward non-speculative business losses against speculation profits of the current year.

The Board as mentioned above, thus gives an important right to the assessee of having his brought forward speculation losses adjusted against the speculation profits of the current year in preference to other losses, whether suffered during the year or brought forward from earlier years.

**Unabsorbed Depreciation, Unabsorbed Scientific Research Expenditure and Unabsorbed Development Rebate etc.**

Section 32(2) of the Act provides that the amount of depreciation remaining unabsorbed on account of absence or insufficiency of profits in any year shall be carried forward to the subsequent assessment(s). It must, however, be mentioned in the very beginning that the provisions relating to carryforward and set off of unabsorbed depreciation apply to Scientific Research Expenditure, unabsorbed Development Rebate, unabsorbed Family Planning expenditure (in the case of cos. only). The following special features may be noted in respect of carryforward and set off of unabsorbed depreciation as distinguished from trading and professional losses :—

(1) While trading loss under the head “business or profession” brought forward from an earlier year, can be set off in a subsequent year against income from “business or profession” only, the unabsorbed depreciation etc. carried forward to a subsequent year can be set off against any income assessable under any head for that year. This follows from the decision of the Supreme Court in the case of CIT vs Jaipuria China Clay Mines (P) Ltd. (1966) (59 I.T.R. 555).

(2) While trading losses can be carried forward for a maximum period of 8 years subsequent to the year in which such loss arises, unabsorbed depreciation can be carried forward for any number of years without any limitation of time. However, unabsorbed development rebate in respect of any previous year can be carried forward for a maximum period of 8 years immediately succeeding the assessment year relevant to the previous year in which the ship concerned was acquired or the machinery was purchased or the immediately succeeding previous year where that asset in question was first put to use in such immediately succeeding previous year. However, priority must be given to the setting off of unabsorbed development rebate as compared to the amount of development rebate for the current year. Similarly the Development Allowance can be carried forward for a maximum period of 8 years from the end of the previous year in the assessment whereof the development allowance is computed.

(3) The unabsorbed depreciation brought forward from a previous year shall, subject to one exception, be deemed as a part of the depreciation for the current year and shall be added to the amount of depreciation allowance for the said year. The exception is provided by Section 72(2) of the Act which states that where there is a competition between Trading losses and depreciation that is to say when both unabsorbed depreciation and trading losses are brought from a previous year, for adjustment in the current year, the priority must be given to the adjustment of brought forward trading losses against the profits if any, from business or profession carried on during the current year. The provisions of Section 72(2) referred to above however, do not prohibit the adjustment of unabsorbed depreciation, when such competition ceases.

It was decided by the Bombay High Court in Sahu Rubbers (P) Ltd. vs CIT (1963) 48 I.T.R. 464 that in order to have the benefit of unabsorbed depreciation to be carried forward, the business in relation to which the depreciation remained unabsorbed must itself be continued in the subsequent year.

The Privy Council held in *Indian Iron & Steel Co. Ltd. vs C.I.T.* (1943) 2 I.T.R. 328 that the unabsorbed depreciation allowance cannot be assigned to the transferee of the business, that is to say, when a business is acquired by another, the amount of depreciation allowance remaining unabsorbed becomes a capital loss. Even the previous owner cannot claim to carry forward the unabsorbed depreciation allowance of the business which he has assigned to another. This follows from the decision in the case of *re. David Sassoon & Co. Ltd.* (1940) I.T.R. 7.

**Order of Set off :** When alongside the brought forward losses in speculation and in non-speculation business, there are brought forward unabsorbed statutory allowances, viz. depreciation, capital expenditure on Scientific Research, Development Rebate, Development Allowance, etc., the order of set off would be as follows:

- (1) Current depreciation, section 32(2)
- (2) Brought forward speculative losses against profits from speculation business only. Section 73(3) read with section 72(2)
- (3) Brought forward Trading losses against profits from any business whether speculative or otherwise. Sec. 73(3) read with Section 72(2)
- (4) Unabsorbed depreciation, *ibid.*
- (5) Unabsorbed capital expenditure on Scientific Research, *ibid.*
- (6) Unabsorbed Development Allowance. Explanation (ii) to Section 33A(2) (ii)
- (7) Current Development Allowance, *ibid.*
- (8) Unabsorbed Development Rebate-Explanation (ii) to Sec. 33(2) (ii)
- (9) Current Development Rebate, *ibid.*

**Losses in Firms :** Although there is no difference between any other assessee and a firm whether registered or unregistered in respect of treatment and adjustment of losses arising in the assessment in respect of a previous year against the profits of the said previous year, the provisions relating to carrying forward losses of one year to a subsequent year differ considerably in regard to registered firms and unregistered firms treated as registered firms under Section 183(b) of the Act on the one hand and unregistered firm treated as such on the other. Section 75, 76, and 77 of the Act contain provisions relating to treatment of

losses of registered firms, unregistered firm treated as such respectively. Sections 75 and 76 of the Act provide that neither a registered firm nor an unregistered firm treated as registered firm shall be allowed to carry forward the losses sustained by them in any previous year. Such losses will have to be apportioned amongst the partners in accordance with the provisions of section 67 and the partners of the firm along shall be entitled to have the amount of such loss set off or carried forward for set off under the provisions of Sections 70 to 74 of the Act. However, in the case of an unregistered firm treated as such, a different rule obtains. According to the provisions of Section 77, it is only the unregistered firm treated as such, that can carry forward its losses for set-off to a subsequent year against its own income for that year. A partner of an unregistered firm treated as such cannot claim any benefit in his personal assessment in respect of his share of the partnership losses whether the same be in the shape of current adjustment or be in the shape of carryforward.

A delicate situation may arise when a particular assessee is a partner in two firms, one registered and the other unregistered treated as such, In such a case if his share in the registered firm for a particular year works out at a loss and in the unregistered firm at a profit, the question arises whether his share of loss can be adjusted against his share of income from the unregistered firm and whether the assessee can still claim that the loss from the unregistered firm should be carried forward in accordance with the provisions of Section 72 of the Act. All the controversies in this regard have been set at rest by the decision of the Supreme Court in the case of Seth Jamnadas Daga vs C.I.T. (1961) 41 I.T.R. 630. The Supreme Court observed that provisions for carrying forward a loss in business had nothing to do with the manner in which the total income of an assessee had to be computed for the purpose of finding out the rate of tax applicable to it and it was held that in such cases the assessee would be entitled to have his share of loss in the registered firm carried forward to a subsequent year for set off.

**Change in Constitution or Succession :** Section 78(1) of the Act lays down that where there has been a change in constitution of a firm, the firm is not entitled to have carried forward and set off so much of the loss proportionate to the share of a retired or a deceased partner as exceeds his share of profits, if any, of the previous year in the firm. It bears repetition to mention here that such a situation may arise only in the case of an unregistered firm because it is only in the case of such a firm, that a loss is allowed to be carried forward for set off to a subsequent year. Sub-section (2) of Section 76 prohibits the carrying forward of a loss in case of succession otherwise than by inheritance, of any business or profession by persons other than those who have sustained such loss.

**Carryforward and Set Off of Losses in the case of Certain Companies :** Section 79 of the Act provides a deviation from the general rule as to carrying forward of unabsorbed losses for set off against subsequent years' profit in the case of companies in which public are not substantially interested within the meaning of Section 2(18) of the Act. In the case of such companies, the loss will not be allowed to be carried forward for set off to a subsequent year unless—

(a) on the last date of the previous year in which the set off of past losses is claimed at least 51% of the voting power is held by the same persons as held the shares of the Company in the year or years in which the losses occurred; or

(b) the Income Tax Officer is satisfied that the change in shareholding was not due to attempt to avoid or reduce any liability to tax.

#### **Return of Loss Intended to be Carried Forward :**

The assessee must furnish a return in order to carry forward any business loss or a loss under the head capital gains. Such return may be filed either under Section 139(1) or under section 139(2) or under sub-section (3) of Section 139 definitely claiming a loss. Section 139(3) of the Act provides that any assessee who has not been served with a notice under Section 139(2) and who intends to carry forward a business loss or a loss under the head "capital gains" should furnish "within the time allowed under Section 139(1)" a return of loss in the prescribed form and verified in the prescribed manner and all the provision of the Act shall apply as if it was a return under Sub-section (1) of Section 139.

Similar provisions also existed under the Income Tax Act, 1922 hereinafter referred to as the Old Act. It was provided in Section 22(2A) of the Old Act that if any person who has not been served with a notice under Section 22(2) of the old Act (Corresponding to Section 139(2) of the New Act) has sustained a loss under the head "Profits and Gains of business, profession or vocation" and such loss or any part thereof would ordinarily have been carried forward under section 24(2) of the old Act, he shall, if he is to be entitled to the benefit of carryforward of any loss in any subsequent year furnish "within the time specified in the general notice under Sub-section (1) of Section 22 of the Old Act or within such further time as the Income Tax Officer in any case may allow" all the particulars required under the prescribed form of return. A return submitted under Section 22A(2A) is to be considered to all intent and purpose as a return under Section 22(1) of the old Act.

The question arises as to whether an assessee who has suffered a loss under the head "profits and gains of business or profession" and who furnishes a voluntary return after the expiry of the period specified in Section 22(1) of the old Act Corresponding to Section 139(1) of the new Act but before assessment is made, is entitled to have the loss determined and carried forward. This question came up before the Supreme Court in *C.I.T. vs Kulu Valley Transport Co. (P) Ltd.* (1970) 77 I.T.R. 518. The Supreme Court by a majority judgement held that in such circumstances, the assessee's claims for carry forward the loss is justified. Mr. Justice Grover, while delivering the majority judgment observed that Section 24(2) confers the benefit of losses being set off and carried forward there is no provision in Section 22 of the old Act under which losses have to be determined for the purpose of Section 24(2). Section 22(2A) simply says that in order to get the benefit of

Section 24(2) the assessee must submit his loss return within the time specified by Section 22(1), that provision must be read with Section 22(3) is merely a proviso to Section 22(1). Thus a return submitted at any time before the assessment is made is a valid return. In considering whether a return made is within time, Sub-section(1) of Section 22 must be read along with Sub-section(3) of that section. A return whether it is a return of income, profits or gains or loss must be considered as having been made within the time prescribed if it is made within the time specified in Section 22(3). In other words, if Section 22(3) is complied with, Section 22(1) also must be held to have been complied with. If compliance has been made with the later provision, the requirement of Section 22(2A) would stand satisfied.

We have now to see as to how far the above decision of the Supreme Court is material in deciding the relevant issue under the new Act.

Before I proceed further, I would like to point out certain similarities between the provisions of Section 22 of the old Act and Section 139 of the new Act.

(a) Section 139(3) of the new Act corresponds to Section 22(2A) of the old Act. Both the said Sections are applicable only when no notice is served under Section 22(2) of the old Act corresponding to Section 139 (2) of the new Act.

(b) Section 22(2A) requires the return to be submitted within the time specified in the general notice or within such further time as the I.T.O. in any case may allow, Section 139(3) on the other hand requires the return to be submitted "within the time allowed under Sub-section (1) of Section 139(1) not within the time prescribed by Section 139(1).

(c) Section 22(3) of the old Act corresponding to Section 139(4) of the new Act provides that a return can be submitted at any time before assessment is made.

The Mysore High Court in the case of Danganavan vs I.T.O. (1967) 65 I.T.R. 100, while considering Section 22(2A) of the old Act and Section 139(3) of the new Act observed that whereas Section 22(2A) granted to the I.T.O. discretion to extend the time for furnishing the return on account of the fact that the section required the return to be furnished within the time specified in the general notice or within such further time as the I.T.O. may allow, no such discretion is allowed to the I.T.O. to extend the time for furnishing return of income under section 139(3) of the new Act for there was a change in law by omission of the words "or within such further time as the I.T.O. in any case may allow."

However, on going deep into the matter, it would be apparent that there is a material difference between the words 'time specified' and 'allowed' as used under the said Sub-section.

Since time specified as used in Sub-section 22 of the old Act means the time stipulated therein and nothing else, an express power was granted to the I.T.O. under the old Act to extend the time. But the words used in sub-section (3) of Section 139 are "time allowed under Section 139(1)". The time allowed here does not only mean the time prescribed under Section 139(1) but also means and includes the extension allowed by the I.T.O in his discretion under the provision to that Sub-section. Therefore, the question of allowing time expressly under Section 139(3) does not arise at all.

It is submitted with due respect that the Mysore High Court's judgement reported in 65 I.T.R. 370 is incorrect since it has overlooked this important difference between the terms "time specified" and "time allowed" as used in the relevant sub-sections. It is therefore submitted that even under the new Act, an I.T.O. has ample powers to extend the time for furnishing a loss return and the decision of the Supreme Court in the case of C.I.T. vs Kulu Valley Transport Co. (P) Ltd. (1970) 77 I.T.R. 518 though given under the purview of the old Act is equally applicable to the new Act.

#### **Determination of Loss and Intimation to Assessee :**

Section 80 of the Act lays down that unless the assessee has filed the return and the loss has been determined thereon, it is not competent for him to claim to carryforward any loss. Under Section 139, the assessee has to submit a return of loss and under Section 143 and 144; in making the assessment the I.T.O. has to determine the total income or loss as the case may be. Under Section 157, the assessee is to be informed of the loss. The loss to be carried forward under Section 72 of the Act is the figure as determined by the I.T.O. and this figure alone can be set off in later years. But there is no *resjudicata* in respect of this figure though ordinarily it will not be altered once it has been settled in the normal course. It was decided by the Supreme Court in the case of C.I.T. vs Manmohandas 59 I.T.R. 699 that a decision of the I.T.O. in an earlier year that the loss could not be carried forward and set off does not bind the assessee. It is not for the I.T.O. making the assessment for the year in which the loss arises to determine whether such loss can be carried forward.