NEWSLETTER

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DIRECT TAX

ADJUSTMENT AND CARRY FORWARD OF LOSSES

According to the Indian Income Tax law, the Income Tax is leviable on 'Total Income' of assessees. The Total income is arrived at by aggregating income under all the 'heads of income' during the year and allowing certain deductions that the assessee is eligible to claim in accordance with the Income Tax Act. Further, there are certain defined nature of income which are specifically 'exempt' from tax and thus they do not form part of the total income for the year.

In case an assessee has incurred loss in any year, it is only fair that such loss be allowed to be carried forward and set-off against the income of the subsequent year. The Income Tax Law does recognise this need to set off loss incurred in a particular year against the income of the subsequent year before arriving at the 'total income' on which tax becomes payable by the assessee. However, such loss is allowed to be carried forward and set off subject to satisfying of certain conditions and restrictions as specified under the Act. Contrary to the common belief that all the losses are allowed to be set against any income in the same year or carried forward and set off against any income in the subsequent year, it is extremely important to be aware about the conditions and restrictions so as not to lose out on the benefit of this provision and optimise the tax liability.

Section 70: **Inter source (under the same head of income) adjustment:**

The question arises whether loss incurred from a source of income under the same head of income is allowed to be set off against income earned from another source taxable under the same head of income in the same year?

The answer is a yes in most cases. However, there are exceptions to this rule, which are enumerated below:

- Speculation loss which is taxable under the head "Business Income" cannot be set-off against income earned under any other business income.
- Loss incurred under the head 'Long-term capital Gain' can only be allowed to be adjusted against income earned under the source 'Long-term capital Gain'. It cannot be set-off against Short Term Capital Gain. However, a short-term capital loss can be set off against both long-term capital gains as well as short-term capital gain.
  It was held in the case of. Kishorebhai Bhikhabhai Virani that Loss arising on sale of Long-Term capital asset (which are essentially the securities sold on the stock market) covered under section

10(38) was not available for set off. However, with effect from Assessment Year 2019-20, Long term capital gains from the transfer of equity shares listed on recognised stock exchange are now taxable @10% and therefore, in our opinion, such loss shall now be allowed to be set off from other long-term capital gain.

- Short-term capital loss determined as per section 111A (essentially the transaction on recognised stock exchange) is allowed to be set off from other short-term capital gain, although the former is taxed at concessional rate of tax of 15% and the later may be taxable at higher rate of tax. [Fidelity Investment Trust, Fidelity Overseas Fund – Mumbai Tribunal)
- Further, there was an interesting observation by Mumbai Tribunal in the case of Vipul Shah that Long Term Capital Loss worked out by assesse **with indexation** can also be set off against Long Term Capital Gains computed **without indexation**.

Section 71: **Inter head adjustments:**

After the inter source adjustments, the taxpayers can set off remaining losses against income from other heads of income. For example: Loss under the head "Business Income" can be set off against income under Capital Gains etc.

Loss from house property can be set off against other heads of income subject to a maximum amount of Rs. 200,000/-.

Exceptions:

- Speculation Loss on trading under securities and mutual funds cannot be set off against any other head of income. It can only be set off against Speculation Profit. However, normal business loss can be set-off against speculation business profits.
- Loss under Capital gains (both short term and long term) cannot be set-off against any other head of income.
- Business Loss cannot be set off against income from salary.
- Loss from an activity of owning and maintaining race-horses can be set off only against the profit from an activity of owning and maintaining race-horses.

Carry forward of losses and set off of loss:

The tax payer can first adjust the loss under one source/head of income against income from another source/head of income in the same assessment year in accordance with the provisions of Section 70 and Section 71 as stated above. The remaining amount of loss, if any, after the adjustment as stated above can be carried forward to the next assessment year and allowed to be set off against income of the next year subject to the conditions as restrictions as stated below:

Section 71B: **Income from House Property:** Loss under the head "Income from house property" can be carried forward and set-off only against "Income from House Property" in the subsequent years. Such loss can be carried forward for a maximum period of 8 years only.

Section 72: **Business Loss:**

Loss incurred under the head "Business Income" other than from speculation business, to the extent it is not adjusted in the year of loss with any other income, can be carried forward and set off against income under the head "Business Income" only. Such loss is allowed to be carried forward for 8 years only.

Section 73: **Speculation Loss:**

Speculation loss can be carried forward and set off against Speculation income only. Such loss is allowed to be carried forward for 4 years only.

Section 73A: **Loss from 'Specified Business':**

Loss incurred from 'Specified Business' as mentioned under section 35AD can only be allowed to be set off from income from any other 'Specified Business' as mentioned in that section. Interestingly, there is no restriction in terms of number of years that such loss is allowed to be carried forward.

Section 35AD lists various businesses that are regarded as 'Specified Businesses". Few of these businesses are:

- Setting up and operating a cold chain facility;
- Setting up and operating a warehouse facility for storage of agricultural produce or sugar;
- Build and operate a 2 Star and above category hotel;
- Build and operate a hospital with at least 100 beds;
- Develop and build a housing project under affordable housing scheme;
- Production of fertiliser in India

Section 74: **Capital Loss:**

Loss under the head "Capital Gains" can be carried forward and set off as follows:

- Loss from short term capital asset can be set-off both against Long Term Capital Gain and Short-Term Capital Gain;
- Loss from long term capital asset can be set off only against income from long term capital asset.

Loss under the head 'Capital Gains' can be carried forward for 8 years only.

Section 78: **Change in constitution of firm or on succession**:

- In the case of change in constitution of a firm, the continuing firm shall not be entitled to carry forward and set off so much of the loss proportionate to the share of the retired or deceased partner in respect of previous year.

  The provision of this section does not apply in the case of adjustment of unabsorbed depreciation.

- Where any business or profession is succeeded by another person otherwise than by inheritance, it is only the person incurring the loss who will be entitled to carry forward and set off such loss against their income.

Section 79: **Change in shareholding in certain companies:**

- In the case of change in shareholding of a Private company, loss incurred shall be allowed to be carried forward and set off only if on the last day of the previous year, the shares of the company carrying not less than fifty-one per cent of the voting power were beneficially held by persons who beneficially held shares of the company carrying not less than fifty-one per cent of the voting power on the last day of the year in which the loss was incurred.

  This essentially mean that benefit of carry forward and set off of the loss incurred will be available only if 51% or more of voting power is common in the year in which loss was incurred and the year in which set off is sought.

- In case of change in shareholding of a start-up company u/s. 80-IAC, the loss incurred in any year shall also be allowed to be carried forward and set off against the income of the previous year if all the shareholders of such company who held shares carrying voting power on the last day of the year in which the loss was incurred, continue to hold those shares on the last day of such previous year and such loss has been incurred during the period of seven years beginning from the year in which such company was incorporated.

  The provision of section 79 also does not apply in the case of adjustment of unabsorbed depreciation.

The provisions are also not applicable in case of change in shareholding on account of death of shareholder or on account of transfer of shares by way of gift to any relative of the shareholder or change in shareholding in case of an Indian company which is a subsidiary of foreign company, when such foreign company is amalgamated/demerged with another foreign company and 51% or more shareholders of the amalgamating/demerged foreign company continues to be the shareholders of the amalgamated/resulting foreign company and where any change in shareholding in the company takes place pursuant to a resolution plan approved under the Insolvency and Bankruptcy Code, 2016.

Further, there are also substantial relaxation on the companies that are governed by the National Company Law Tribunal (NCLT).

Case Study – Set off against gain from sale of depreciable asset:

Where the assessee set off the brought forward long-term capital loss against capital gain on sale of depreciable asset and the Assessing Officer did not allow the set off of long-term capital loss from capital gain on sale of depreciable asset by holding it to be short-term capital gain as per section 50, it was held that prescription of section 50 are to be extended only up to the stage of computation of capital gains. Therefore, capital gain resulting from transfer of depreciable assets which were held for a period more than 3 years would retain the character of long-term capital gain for all other provisions except section 50. Consequently, such capital gain shall qualify for set off against brought forward loss from long-term capital assets. [Manali Investments – Mumbai Tribunal and also upheld by Bombay High Court and referred in Pursarth Trading Co. (P) Ltd.]

Section 74A: Loss from activity of owning and maintaining race horses allowed to carry forward for 4 years to adjust against income from the same activity only.

Section 80: **Filing of Tax Return within prescribed time:**

It is mandatory on the part of the tax payer to file the tax return within the time specified under section 139(1) to be able to carry forward loss under any head of income to the subsequent assessment years except in the case loss from 'Income from House Property' and 'Unabsorbed depreciation'.

Other Noteworthy Points:

- A taxpayer incurring loss from a source, income from which is otherwise **exempt from tax**, cannot set off these losses against profit from any taxable source of Income. For ex: loss from agricultural activity cannot be set off against income from normal business income.
- Losses cannot be set off against **any casual income** i.e. crossword puzzles, winning from lotteries, races, card games, betting etc.
- Unabsorbed depreciation can be carried forward and set off against any other income in the subsequent assessment years. Where after set off of business loss against current year business income, the assessee was entitled to set off unabsorbed depreciation against income from other sources. The Madras High court in the case of SPEL Semi-Conductor Ltd. held that section 72(2) does not control operation of section 32(2) to have set off of unabsorbed depreciation against income from other sources.

Example:

From the below information, compute the total income of 'A' for Assessment Year 2020-21;

Description	Rs.
Income under the head salary	3,00,000
Income under the head house property	40,000
Business loss	(–) 1,90,000
Loss from a specified business referred to in section 35AD	(–) 60,000
Short-term capital loss	(–) 60,000
Long-term capital gain without STT	2,40,000

Solution

Description	Rs.	Rs.
Income from salary		3,00,000
Income from House Property		
Income	40,000	
Less: Business loss adjusted	(–) 10,000	30,000
Business loss	**(–) 1,90,000**	
Less: Set off against capital gain	1,80,000	
Less: Set off against house property income	10,000	Nil
Loss from specified business not allowed to be set off	(–) 60,000	
Income from Capital Gain		
Long-term Capital Gain without STT	2,40,000	
Less: Short-term capital loss	(-) 60,000	
	1,80,000	
Less: Business loss adjusted	(-) 180,000	Nil
Gross total income		**3,30,000**
Less: Deductions		**Nil**
Total Income		**3,30,000**

Note: Business loss should first be set off from long-term capital gain as it is taxable @ 20% whereas the income from house property is taxable at much lower rate, in this case, @ 5%.

SMALL BUSINESS? – OPT FOR SIMPLIFIED TAX REGIME

Income Tax is calculated on 'Total Income' of the assessee. The Income Tax law is always perceived to be quite a complex law with so many claims, disallowances, deductions, exemptions etc. There is no doubt that to arrive at a correct 'total income' on which the tax liability is calculated, one has to make so many calculations to the Net Profit as reflected in the Profit and Loss account of an enterprise. One has to be informed about which kind of expenses cannot be 'claimed', what expenses will be disallowed, which are the nature of income that is exempt from payment of any tax and how one can optimise their tax liability by investing certain sum of money in specified assets. It is very obvious that a business person is not expected to know all these complexities and to prepare the computation of their taxable income and return of income without the help of an expert consultant or a chartered accountant in most cases.

In a move to avoid these complex calculations and to simplify the life of relatively smaller business people, The Government of India has rolled out a scheme for a certain category of entrepreneurs with low turnover and volume of business. The scheme specifies determination of total income as a fixed rate of the turnover of these business enterprises. This is referred to as computation of profits and gains of business on **'Presumptive basis'** under the Income Tax. The 'total income' for that year is presumed to be a certain percentage of turnover of the business in that year. Let us understand what this presumptive basis of taxation scheme is and under what circumstances and manner it is applicable to the small businesses.

Section 44AD – Presumptive taxation for Small business owners:

The purpose of this section in the Income Tax Act is to free up the business person from making the complex calculations and also to substantially reduce their compliance burden. Such business owner is also not required to maintain the books of accounts and get them audited by a Chartered Accountant. The salient features of this scheme are as follows:

Eligible assessee – This section is applicable only to Individual, Hindu Undivided Families (HUF) or a Partnership firm who is a resident in India. It is specifically provided that a Limited Liability Partnership **(an LLP) is not eligible** to take benefit of this section.

All the assessees who opt to be assessed under this section, are not eligible to claim any deductions under sections 10A, 10AA, 10B, 10BA or under any provisions of chapter VI-A under the heading

"Deduction in respect of certain incomes" ie. Section 80HH to Section 80RRB.

Eligible business – The benefit of this presumptive tax under this section will not be available to eligible assessee engaged in any of the following businesses:

- A person carrying on **profession** as defined under section 44AA – For these professionals, a different scheme under section 44ADA is available.
- A person earning income in the nature of **commission or brokerage**
- Any **agency business**
- Any business of plying, **hiring or leasing of goods carriages** referred in section 44AE

Presumptive Profit - All the eligible assessees engaged in the eligible business and whose turnover or gross receipts in the previous year **does not exceed INR 2 crores**, can declare **8% of the turnover or gross receipt** or a higher amount, as their net profit from the business. The assessee may declare only **6% of the turnover/gross receipt** as its net profit in respect of the turnover/gross receipts which are received by account payee cheques/ bank drafts or any of the electronic mode of payment.

Accordingly, the assessee may simply derive at its Total income by calculating 8% or 6% as the case may be on the business turnover during the year. He may simply calculate and pay tax on the total income without having to maintain books of accounts for the business.

Depreciation - Since depreciation on fixed assets is **deemed to have been considered** while calculating the net profit, the written down value of the fixed assets will be regarded as the value arrived at after reducing the depreciation. This is particularly important at the time of sale of that asset. The Capital Gain will be calculated as the difference between the sale value and the 'written down value' so calculated after reducing the depreciation as mentioned above.

Opting out - When an assessee declares profit on the basis of this section and opts not to follow this presumptive basis of declaring income in any of the next 5 years, he shall not be allowed to opt for this section again for a **further period of 5 years** from the year in which he has opted not to follow declaring income on the presumptive basis as per this section. In such circumstances, the assessee will be required to maintain the books of accounts as required by law and get them audited under section 44AB of The Act.

Salary and interest to partners - In case of a partnership firm, salary and interest paid to partners **shall not be eligible** to be deducted from the net profit @ 8% of 6% as the case may be, so calculated in accordance with this section. In calculating the net profit on the presumptive basis, it is assumed that the salary and interest to partners have been deemed to have been deducted/allowed.

Section 44ADA - Presumptive taxation for Small Professionals:

The presumptive basis of income for small professionals is very similar to that of small business owners as explained in section

44AD. The professionals are defined under section 44AA to include Legal, Medical, Engineering, Architectural, interior decoration, Accountancy, technical consultancy or such other professions as may be defined by the Board in the official gazette.

The professionals are eligible to opt for calculating their income on presumptive basis only if their gross receipt **does not exceed INR 50 Lakhs.**

These professionals can declare their net income as **50% or more of their gross receipts** in the previous year.

All the other conditions as applicable and mentioned for small business owners would also apply to professionals.

It indeed is a big relief to the small business owners and professionals to not to maintain books of accounts for their business/profession and declare a profit which is a certain percentage of its business turnover or professional receipts. The business owner or professional thus will not be required to indulge in explaining all the deduction of its expenses and justification of claims for the expenses incurred in the course of their business to the tax officer.

Compiled by **Sunil Singh** (Tax Assistant), **DNV & Co**.

DEEMED INCOME – REAL TAX

Income tax is a direct tax that a government levies on the income of its residents or the non-residents if the source of income is in India.

To calculate the amount of income tax payable to the Government, you will first need to compute your total income for the financial year. Should this income be real income? Or some receipt which prima facie are not in the nature of income may also be 'deemed' to be your income for the year? There are numerous instances in which you may be required to pay income tax on the receipts which are not necessarily in the nature of income but is regarded as your 'deemed income' by virtue of the deeming provisions of the Income Tax Act. One must be alert and cautious with regards to these kinds of receipts or deemed income instances.

Income is defined under Section 2(24) of the Income Tax Act which is an inclusive defination of income. This means that the Act specifically defines certain nature of receipts which are regarded as income of the assessee and there could be certain other nature of receipts which, though may or may not be in the nature of income, may also be regarded as or deemed as the income of the assessee.

There are certain receipts which are not real income but with this deeming fiction in the Act, are regarded as income and these kinds of income too are subject to income tax.

Therefore, it is extremely important to understand which are the nature of these kind of receipts which are not in the nature of income but which will be deemed as income and tax liability arises on such deemed income. Let us examine a few of them:

Section 2(22)(e) – deemed dividend:

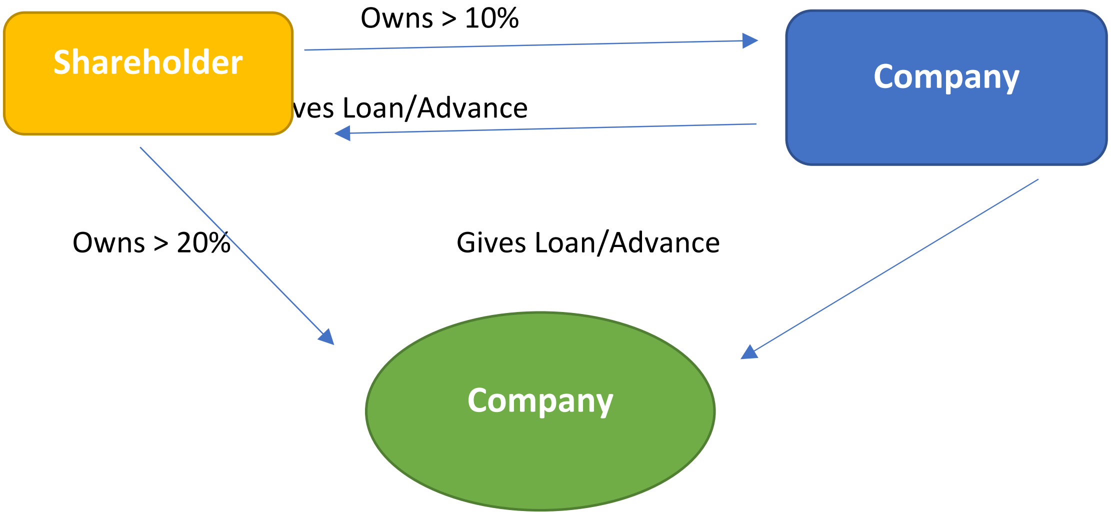
If a Company (which is not a company in which public are substantially interested) makes any payment by way of loan or advance to a shareholder, who holds not less than 10% of the voting power in the company, such receipt will be deemed to be dividend income for the receiving shareholder.

This section also covers instances where, if such company gives loans or advance to any concern in which such shareholder is a member/partner beneficially holding at least 20% of its income, such receipt will also be deemed to be dividend income for the receiving shareholder.

Albeit, the amount of such deemed dividend will be restricted to the accumulated profits in the company.

So, if a Pvt. Ltd. Company gives a temporary loan to one of its shareholders (say ABC) holding more than 10% of voting power, the said amount will be regarded as dividend income for such shareholder ABC.

Further, if a Pvt. Ltd. Company gives temporary loan to another company in which ABC owns more than 20% shares, the amount shall also re deemed as dividend income for ABC.



Therefore, even if such shareholder has received temporary money from the company which he has returned to the company after a certain period of time, the receipt will be deemed to be his dividend and he will be required to pay tax on such 'deemed income'.

Section 50C – Transfer of Immovable Property (IP) – deemed sale consideration:

Where an assessee transfers/sells an IP and the sale proceeds received as a result of this transfer is less than the "stamp duty market value" of the property, the stamp duty market value of the IP will be deemed to be the full value of consideration received on transfer of IP. It has however been provided that if the stamp duty market value is more by 5% of the sale consideration then the deeming fiction will not apply.

This can be illustrated by following table:

Description	**Actual deal**	**Deemed deal**
Sale value of IP	50,00,000	
Stamp duty market value of the IP		70,00,000
Indexed cost of the IP	20,00,000	20,00,000
Long Term Capital Gain	30,00,000	40,00,000
Tax payable @ 20%	6,00,000	8,00,000

As can be seen from above, even if the assessee has actually sold the property for Rs. 50 Lakhs and received only Rs. 50 Lakhs on sale of the IP, the transaction value and the sale consideration is deemed to have been at Rs. 70 Lakhs since the stamp duty market value of that property is Rs. 70 Lakhs. Accordingly, the assessee's tax liability went up by Rs. 2 Lakhs.

Certainly, this section is inserted to curb black money transactions in property deals, but this has led to a lot of hardship and much higher effective rate of taxation for even some genuine transactions.

The assesses, in such cases, has an option to dispute/appeal the value adopted by the stamp valuation authority before the appellate authority or apply to the Assessing Officer to refer the valuation of the property to a Valuation Officer as prescribed under the Act. Accordingly, the value derived at by the appellate authority or the valuation officer will be considered as the final sale consideration for this transaction.

Section 50CA – Transfer of Shares – deemed sale consideration:

Where an assessee transfers Shares (other than shares quoted on recognised stock exchange), for a consideration which is less than Fair Market Value (FMV) of the share, such FMV shall be deemed to be full value of consideration received as a result of such transfer. The FMV of the shares shall be determined in accordance with Rule 11UA of the Income Tax Rules. The FMV in normal circumstances be calculated at "Net Worth" or "book value" of the company.

Again, in such a case, a shareholder is required to pay tax on the amount which he has neither actually received nor is he going to receive in future but on the amount which he is deemed to have received based on certain valuation principals.

Section 56(2(viib) – Issue of shares by Company – deemed income

When a Company (in which public are not substantially interested) receives any consideration, from a resident, for issue of shares exceeding the fair market value (FMV) of the share, the excess amount so received will be regarded as income of the company.

The Company can arrive at the FMV of the shares of the company by calculating the same at Networth or Book value of the company.

If the shares are issues at a price which is higher than the Net worth of the company, the same needs to be justified and supported by a valuation report as valued and certified by a certified valuer. The method of valuation is prescribed under Rule 11UA of the Income Tax Rules.

In such case, the company has actually received money against issue of its own shares at a premium, which essentially is a 'Capital Account transaction'. The company does not earn any income when it issues share at a premium. However, by virtue of deeming fiction, the premium which is received in excess of the FMV of the shares of the company so determined will be deemed to be income of the company and tax will be payable on the same by the company. Therefore, it is important for the company to get their shares valued from a registered valuer whenever it issues share at a premium, higher than the FMV of the shares. It is worthwhile to mention here that this deeming fiction does not apply when the shares are issued to a non-resident.

Section 56(2)(ix) – Forfeiture up on failed negotiation

If an assessee has received any sum of money during the course of negotiation for transfer of an capital asset, which is in the nature of advance and if the negotiation does not result into a deal of transfer of the capital asset and if the assessee forfeits the advance money so received, the money so received will be deemed to be the income of the assessee. Earlier, this advance receipt would go on to reduce the cost of the capital asset but now the section is amended to state that the advance so received and forfeited will be regarded as the income of the assessee.

In addition to the above, there are various instances where even though a receipt of money that prima facie does not represent income, is treated as income under a deeming fiction on which tax is payable.

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