Chapter VII

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The dilemma

One of the acute problems that periodic income determination gives rise to relates to the treatment of losses. If income for purposes of taxation was viewed as net accretion to wealth over a lifetime instead of over an arbitrarily fixed period like the calendar year, the question of recognizing any loss would not arise in taxation for no one comes into the world clothed in any asset. Where however income is taxed on a periodic basis, inequity arises if the diminution in assets occurring over a period (otherwise than through consumption) is ignored while accretions only are taken notice of and brought under taxation. Hence income tax systems, based as they are on annual assessment of income, usually provide for offset and carryforward of losses.

It is not always realized however that deduction for losses in the determination of taxable income can operate as a source of base erosion unless the tax is levied on the comprehensive concept of income so that all accretion to wealth including gifts, bequests, capital gains or any other gain are recognized as income. Where capital receipts or gains of any other category are excluded from the base or are treated preferentially, to permit losses to be set off freely against taxable income obviously involves an inconsistency. For a loss in essence means nothing but depletion of capital -
an excess of expenditure over receipts which has in some way been found out of capital. Hence as the British Royal Commission on Taxation (1955) noted, in a scheme of taxation which does not permit capital gains to be taxed like ordinary income not to allow any loss from one source of income to offset the taxable income of the year from another source would be most consistent. Rather, in such a system, to set the loss against taxable income, current or future, is to allow the depletion of capital to be made good at the expense of taxable income. Kaldor has argued that where income is viewed as a periodic return from a given source, "the very notion that the net yield from a positive source of income can be a negative one is questionable." Indeed, unless all capital accretions are subjected to tax on an equal footing there can be no case in equity for set-off of losses against income and in such a system a loss should be treated merely as 'nil' income.

That apart, loss offset provisions often constitute a potent source of base erosion because of the fact that taxation of income proceeds on the basis of realization and where income recognition depends on 'realization' taxpayers can vary

1 Royal Commission on the Taxation of Profits and Income (1955), Final Report, para 486.
2 N. Kaldor, Indian Tax Reform (1956), para 146.
their tax liability by suitably timing the realization of gains and losses on their assets. It is this factor which primarily seems to have deterred the British Royal Commission (1955) from recommending the taxation of capital gains in Britain. Another factor facilitating the use of loss offset provisions as an avoidance device is the amorphous nature of the personal-business border line. Quite often the losses claimed to have been suffered in business are in fact nothing but the result of a consumption choice exercised by the taxpayer. Distinguishing personal from business is often as tricky in the case of losses as in case of expenditures. One may even say that suffering continued loss from a particular source represents in a sense a non-business choice as no one is compelled to keep a losing concern running and the owner of a business that turns out a deficit year after year has the option of liquidating it and investing the proceeds in such a way as to earn a positive rate of interest. Under a progressive tax system the right to carry forward losses unabsorbed in any year carries the further risk of losses being traded in by taxpayers to reduce their tax liabilities. There is also the possibility that free offset of losses from one source against gains from any other source might encourage the continuance of moribund or unproductive

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4 Kaldor, op. cit., para 146.
business at the expense of government revenue and ultimately at the expense of the taxpayers in general.

Even so, as the Royal Commission (1956) stressed, the ascertainment of profits of a running business at fixed intervals of twelve months is so arbitrary a process, considering the continuous nature of business operations, that to treat income from each separate source as part of a running account between taxpayer and Revenue and to allow the carryforward of losses against future income from that source is an obvious concession to common sense. This common sense approach can also be justified by arguing that, if the arbitrary time limitation of an accounting period is ignored, a loss can be viewed as an expenditure of savings from previously accrued income which has borne tax or an advance consumption of future income which will bear tax. The case for loss offset in income tax has derived further support from the demonstration by Domar and Musgrave that full offset of losses under a proportional income tax is conducive to risk-taking.

6 Nock, op. cit.
Treatment of losses in income taxation thus gives rise to a dilemma. Ignoring losses altogether is iniquitous under a progressive tax system based on periodic evaluation of income. Full and free offset and carryforward of losses on the other hand is fraught with the danger of base erosion, especially where the tax is levied only on realized income and exemption or preferential treatment is accorded to some of the receipts. Policy-makers usually resolve this dilemma by laying down certain restrictions while permitting loss offsets and carryforward of losses.

**Alternative solutions**

To minimize the scope for abuse the Carter Commission, while advocating liberal loss offsets as a logical corollary to the comprehensive tax base approach, proposed certain restrictions on the deductibility of specified categories of losses. Loss from holding or disposition of property used for personal use or consumption, the Commission said, should not be deductible at all. Losses from holding of property of other kinds may be carried forward against operating income from the same property for an indefinite period or, if the taxpayer so desires, reduced by the amount of certain expenditure related to the property which would be added to the cost basis of the property for purposes of computing capital gain when the property is disposed of. The Commission however

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thought that losses on the disposition of property except those in respect of which capital gain is not chargeable to tax may be deducted from any other income in the year of loss, carried back for two years and carried forward indefinitely against income of all kinds. The Commission's recommendations regarding treatment of business losses ran on similar lines, i.e., setoff against any other income, carry-back for two years and indefinite carryforward. To prevent deduction of personal expenditure however, the Commission felt that certain limitations were necessary. Hence, they suggested:

A business with persistent losses should not be allowed to deduct such losses except against gains from the same business. Thus, if a business produces losses for three years within a five year period, the taxpayer should not be allowed to apply subsequent losses against income from sources other than the same business, until such income derived from the business has exceeded all losses claimed earlier, including the losses deducted from other income. The losses of the first three years would be deductible from all income. (9)

The intention behind the suggestion for these restrictions is to ensure that expenditures that are mainly of a personal consumption nature do not get deducted from other income; that is, no deduction is allowed in respect of a business maintained despite persistent losses because the owner is obtaining a non-monetary personal benefit from the operation (e.g., from

9 Ibid., p. 109.
a 'hobby farm'). The limitation that losses beyond three years would not be allowed to be set off against other incomes would, the Commission thought, prevent the erosion of tax revenue by the continued application against gains from other sources of losses sustained by business that are carried on with no reasonable expectation of profit. The Commission also favoured the retention of restrictions on the transferability of losses, although in their scheme (of the comprehensive tax base and liberal carry over provisions) most losses would be deductible at some time. As regards other losses (that is, other than from property holding and business) the Commission was of the view that it should be possible to apply such losses against any other income in the year of loss and to carry them back two years and forward indefinitely against all income provided however that such losses were computed in accordance with the general rules for computing income. Thus though in logic there is little justification for putting any limit on loss deduction under the comprehensive base approach which envisages full taxation of economic gain of all kinds, the Carter Commission did not think it advisable to travel all the distance for fear of abuse of too liberal loss offset provisions and consequent loss to revenue. In fact, the logical course consistent with the comprehensive income approach was to permit refund of tax

10 Ibid., p. 95.
in respect of a loss. This, the Commission thought, would not be acceptable. "I felt that most of my fellow taxpayers would be aghast at the idea of their funds being used to recoup people who for one reason or another had incurred losses", said LeM Carter the Chairman of the Commission later.

U.S. income tax allows a carryback of 'net operating loss' for three years and carryforward of unabsorbed losses for five years. Tax paid in the three earlier years is also refunded on redetermination of liability after adjusting the losses. But, in determining a 'net operating loss' of a taxpayer adjustments are made to his negative taxable income by adding back those deductions that are ordinarily allowed to him but do not require the disposition of any funds (e.g., personal exemptions, and long term capital gain deduction).

According to Kaldor, where capital gains are not taxed there is no case for recognizing losses for tax purposes in any manner except perhaps as a means of averaging income over time. Considerations of averaging however would only justify a carryforward of losses against future income from the same source and not against income from any other source, whether business or non-business. Even where capital gains are taxed, from a consideration of equity, economic effects

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...the ideal method is to treat income from each source as part of a separate 'running account' between the taxpayer and the Revenue, and in consequence to allow a loss from any particular business to be carried forward against future income from the same business but not to allow it to be set off against income from other sources, either in the same year or the subsequent years. The one respect in which some relaxation of this general rule may be permitted is in allowing a strict trading loss (i.e., an excess of unavoidable current outlays against current receipts) to be offset against other business income in the same year. 13

The need to restrict free setoff only to 'current losses' arises from the fact that capital gains are usually not taxed to the same extent as ordinary income. Hence Kaldor insisted that losses which represent unabsorbed capital allowances should be permitted to be carried forward only against future income from the same source, and, if the business is wound up, against capital gains from the sale of assets or if that is insufficient, a tax claim should be allowed on an unabsorbed capital loss to be credited against estate duty (or gift tax) liability at death.

Kaldor's conditions for circumscribing loss offset are thus more rigorous than those of the Carter Commission, which is partly explained by the fact that the Carter Commission

13 Kaldor, op. cit., para 152.
14 Kaldor, op. cit., paras 149 and 152.
contemplated a wider tax base than perhaps what Kaldor had in mind. The point to note however is that carryforward and setoff of losses suffered continuously over a number of years is not favoured in either scheme except against income from the same source. Another important principle generally insisted upon in any scheme of loss offset in income computation is that no unabsorbed loss should be allowed to be carried forward except by the taxpayer who incurs the loss; otherwise opportunities for avoidance are opened up through trading in losses.

The provisions in the Indian Income-tax Act governing the treatment of losses no doubt reflect an attempt to steer through the conflicting considerations of equity, economic efficiency and administrative requirement to prevent abuse. But, as in other areas of the income tax law, lack of a clear perspective to guide the judicial decisions and legislative changes has tended to obscure the basic purposes underlying the various conditions laid down in this context and thereby erode the base.

Treatment of losses in Indian Income-tax

In India, as in Britain, the law at first permitted only the setoff of a loss under one head against income under any other head in the same year. The 1922 Act did not provide for any carryforward originally. This was the position in U.K. also till 1926. But in U.K. there was a provision for
averaging over a three-year period. From 1926 this was discontinued and a scheme of carryforward of losses was introduced. The facility of carryforward of losses over a long period, it was thought by some, might create financial difficulties for countries heavily dependent for its income tax revenue on some particular industry. But this consideration was not relevant for India. Representations were made for the right of carryforward, and its denial was called unfair. The Todhunter Committee recognized the merit of this claim but recommended that the right to carryforward might be allowed subject to suitable safeguards against abuses. That Committee did not favour a carryforward of more than a year. Subsequently a provision was introduced in the law permitting carryforward of business losses initially for six years, later extended to eight years.

The salient features of the current law relating to

15 It is pertinent here to recall Kaldor's comments on this aspect of the British income tax. He said: "Though of the two methods of allowing an offset of losses - against other income in the same year or against income from the same source in any future year - only the latter can be made consistent with the English conception of taxable income, historically it was the former, not the latter, which was the first to be introduced.... This explains why the justification of the right to set off is rarely questioned, and the carryforward is commonly treated as a marginal provision to be made use of only when, and to extent to which, there is insufficient 'other income' to absorb the losses in the same year." (Kaldor, op. cit., p. 80, f.n. 4).


17 Ibid.
losses are: (1) a loss from any source other than capital gain can ordinarily be set off against income from any other source or income from any other head of the same year (Secs. 70 and 71 of the Act); (2) unabsorbed losses under the head 'business' only are allowed to be carried forward against business income of subsequent years for eight years, provided the business which incurred the loss continued to be carried on (Sec. 72); (3) unabsorbed capital allowances like depreciation, development rebate, development allowance and capital expenditure on scientific research are allowed to be carried forward and set off against income from any source in subsequent years (Secs. 32, 33, 33A & 35A). The newly introduced initial depreciation will, for this purpose, be treated on the same footing as ordinary depreciation. In the case of unabsorbed depreciation allowance there is no time limit for carryforward; (4) long-term capital losses can be set off only against long-term gains while losses under other heads (including short-term capital gains) can be set off against income under any head including long-term capital gain unless the taxpayer desires otherwise; (5) unabsorbed losses can be carried forward only by the taxpayer who has incurred the loss and also by his heir. (This rule is subject to certain conditions in the case of closely held companies);

18 Vide Sec. 3 of the Direct Taxes (Amendment) Act, 1974.
19 Vide Secs. 78 & 79.
(6) Loss from speculation business can be set off only against gains from speculation. Losses from certain other sources (lottery winnings, crossword puzzles, racing, card games and other games) can be set off only against income from the same source. Carryforward is permitted in the case of speculation losses but only against speculation gains. From 1974-75 race horse owners can carry forward their losses from racing business against income from the source 'races including horse races' but only for four years. No carryforward is allowed in respect of losses from lottery winnings and other gambling activities. Losses from agriculture also can be set off only against income from agriculture, but unabsorbed agricultural loss cannot be carried forward except for one year and that too against agricultural income only.

It is evident that the loss offset and carryforward provisions of the Indian income tax seek to achieve a measure of equity without unduly risking revenue. Certain deficiencies of the provisions as they are currently framed and as they are interpreted however seem to frustrate this aim to a considerable extent. From the angle of base erosion the points that need to be noted are, first, though the law

20 Sec. 73.
21 Sec. 74A.
22 Vide Rules 7 and 10 of Part IV of the First Schedule to Finance Act 1974.
permits preferential treatment for many categories of receipts, facility of offset is available in respect of losses occurring under any source of income against income from any other source of the same year whether falling under the same head or any other head, subject only to some restrictions regarding speculation losses, losses from disposition of long term capital assets, from lotteries, crossword puzzles, racing and from agriculture. Losses under the head 'business' and capital gain and under activities like racing etc. can be carried forward and set off against gains of the same broad category. Thus, except for a few specified activities there is practically no attempt to treat the losses under different sources separately under a 'running account' between the taxpayer and the revenue. Business loss incurred from one source can be set off against business income from any other source and this applies not only to trading losses but capital allowances including initial depreciation and capital expenditure on scientific research. Such facility for setting off capital allowances, Kaldor had repeatedly stressed, goes beyond the notion of subsidising certain types of investment to the extent of allowing expenditure upon them to be deducted from the receipts of the business concerned and provides an incentive to take uneconomic risks together with wide opportunities for deliberate tax avoidance. Full

23 Cf. "Wherever developmental expenditure - either capital expenditure or expenditure on research, (f.n. contd.)
deduction of capital expenditure on scientific research incurred after 1.4.1967 clearly offends the criterion suggested by Kaldor in respect of loss arising from capital allowances. Since these allowances are treated in the same way as depreciation unabsorbed by current year's profits, they are eligible for carryforward and setoff against not only the income from same source or head but against any other income of the subsequent years, and without any time limit. Weighted deduction currently provided for certain expenditures like contribution to scientific research and export market development (Secs. 35 & 36B), if unabsorbed, can also be set off against other incomes of the current year and carried forward like ordinary business loss. It is also to be noted that the Indian law permits a negative figure to be computed (and adjusted against other incomes) under such heads as house property and 'other sources' which include income from dividend on shares, although, as Kaldor had pointed out, this is incompatible with the concept of income as a recurring return from a definite source and the fact that no one is compelled to incur losses by investing in property.

advertising etc. - enters into the calculation of a current trading 'loss', the effect of allowing such a loss to be off-set against income from other sources is that a taxpayer is able to build up a business at the expense of the revenue." (Kaldor, op. cit., p. 81, f.n. 1).

24 "This is the reason why the United Kingdom law has never recognized the possibility of a loss being incurred in connection with the ownership of property." (Kaldor, op. cit., p. 80, f.n.1).
Secondly, the Indian law does not provide adequate arrangement to ensure that income from each source is regarded as part of a running account between the assessee and the Revenue. Prior to 1955 the law stipulated that a business loss could be carried forward only against income from the same source. The TEC thought that this arrangement was unduly harsh and restrictive. On its recommendation the said condition was removed. At present business losses alone can be carried forward but loss from one business source can be set off against income from any other business source in later years provided the original source continues to exist. It is difficult to see what purpose is served by insisting on the continuance of the original source where the loss offset is not restricted to income from that source alone. If anything, it goes directly against the objective of discouraging the continuance of moribund, inefficient units and checking the use of loss offset facilities to carry on 'hobby' businesses at the expense of revenue. In other words, the arrangement now in force betrays a failure to appreciate the purpose behind the suggestion for treating the income from each source as part of a running account between the taxpayer and the Revenue.

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25 TEC Report vol. II, p. 70, para 64. While recommending its removal the TEC wanted the position to be reviewed after five years. No such review however appears to have been carried out.
It is doubtful however whether that aim could be achieved even if the carryforward of business losses continued to be hedged with the condition that loss incurred in one business could be set off only against the income from the same business. For the tests by which courts have decided in particular cases whether the same business continues in a subsequent year are so broad and ambiguous that it is virtually impossible to draw any distinction between one line of business activity from another so long as both happen to be owned by one taxpayer. For two things that the courts look for in deciding whether two income sources constitute one business are, 1) whether the assets from which the income is derived from part of the same business and 2) whether there is "any inter-connection, any inter-lacing, any inter-dependence, any unity" embracing the two businesses. Applying the first test the courts have held that when income is derived from certain assets held in business (e.g., government securities) even though it is assessable under a different head, it should be treated as derived from one business source. Hence carried forward business losses can be set off against investment income (such as dividend, house rent or interest on securities) if the asset yielding the income forms part of the business balance sheet. Explaining the reasons for this ruling, the Supreme Court said in one case:

The scheme of the (I.T.) Act is that income tax is one tax.... Though for the purpose of computation of the income, interest on securities is separately classified, income by way of interest on
securities does not cease to be part of the income from business if the securities are part of the trading assets.\textsuperscript{26}

By the same test, it was held in another case that if shares are held by a taxpayer as part of his trading assets, dividends on those shares would form part of the income from business and consequently the assessee will be entitled to claim set-off of loss carried forward from earlier years against dividend income of the current year.

What has thwarted the source-wise compartmentalisation of losses more is that when a taxpayer has more than one line of business the question whether they constitute separate business or one has come to be decided not by the nature of the different activities but by the test of 'inter-connection interlacing, interdependence and unity'. Thus in a case where the question arose whether the business of life insurance and that of general insurance carried on by a company was one business, the Supreme Court gave an affirmative answer on the ground that there was "common management, common business organization, common administration, common fund and a common place of business." The Appellate Tribunal had taken a

\textsuperscript{26} CIT v. Coconada Radhaswami Bank Ltd. (1965) 57 ITR 306 (S.C.)

\textsuperscript{27} Western States Trading Co. P. Ltd. v. CIT (1971) 80 ITR 21 (S.C.).


\textsuperscript{29} Ibid.
different view on the ground that "the business of life insurance possesses peculiar characteristics which do not exist in respect of other insurance businesses". The need to look into the nature of the business in this context was recognized by one High Court too in a subsequent case in which a company doing business in diverse commodities and also in shares suffered a loss of over Rs. 3 lakhs in its share dealings and wanted the loss to be adjusted against the profits from transactions in other commodities. The Supreme Court allowed the taxpayer's claim, overruling the High Court, because of the 'common management', 'unity of trading organization' etc. The Supreme Court clearly disapproved of the idea that "the decisive test for determining whether the two lines of businesses constitute the same business is the nature of the two businesses."

Where interdependence and unity of control are so crucial, it is obvious that attempts to distinguish between different lines of activity carried on by the same assessee can rarely succeed. For as the Supreme Court itself admitted, "the concepts of inter-connection and interlacing, inter-dependence and unity are not free of ambiguities." The Court

30 Produce Exchange Corporation Ltd. v. CIT (1970) 77, ITR 739 (S.C.).

31 Ibid., p. 742.

of course tried to lay down certain objective criteria but the stress again was on 'unity of control'. But where the assessee is the same, unity of control would obviously be the natural presumption. To prove the contrary is not easy. In any case, the criteria followed are so ambiguous that one leading commentator says,

It is impossible to formulate any infallible general rule or test applicable to all cases for determining whether two businesses are separate or whether they constitute one and the same business.

Inevitably, the determination of that question depends upon the facts and circumstances of each case. Thus while tobacco business and money-lending have been held to be separate business in certain circumstances, in some cases money-lending and cloth-business, dealing in sewing machines and dealing in stocks and shares have been held to constitute one and the same business.

Another factor that has undermined the efficacy of the statutory conditions designed to restrict the scope of the loss offset/carryforward provisions is the principle often invoked by the courts that business profits have to be determined according to commercial principles first and since losses to be allowed for under these principles, the provisions governing losses laid down in the law do not come into play

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34 Ibid.
until the profits are determined. Thus losses and gains from different lines of activity have to be adjusted against each other no matter what the statutory provisions regarding them happen to be. This view found its expression in the following observations of the Supreme Court:

It is worthy of note that though the profits of each distinct business may have to be computed separately, the tax is chargeable under Section 10, not on the separate income of every distinct business, but on the aggregate of the profits of all the businesses carried on by the assessee. It follows from this that where the assessee carries on several businesses, he is entitled under Section 10, and not under Section 24(1), to set off losses in one business against profits in another.35

Application of the above doctrine has led to a substantial erosion of the tax base by permitting deduction in respect of losses incurred from sources income from which is not taxable in the hands of the assessee. This comes out clearly in the rulings which allow a partner's share of loss incurred by an unregistered firm (URF) to be set off against his income from other sources. Under the scheme contemplated by the Income-tax Act, a URF is liable to be taxed as a separate entity. Accordingly, its losses can be set off and carried forward against its own income. A partner's share in the

35 CIT v. P. M. Muthuraman Chettiar (1962) 44 ITR 710, 713. Sec. 10 of the IIT Act, 1922 referred to in this quotation laid down the manner of computation of income under the head 'Profits and Gains of Business and Profession' while section 24 specified the manner in which losses were to be treated for purposes of determining taxable income.
income of a URF however is aggregated with his other incomes in the hands of the partner in order to determine the rate of tax applicable to his other income. The share income from the URF is not ordinarily taxed in the hands of the partner. There is a specific provision in the Act to regulate the treatment of loss suffered by a URF (Sec. 77). Disregarding the special provision, however, Delhi High Court has held, following similar decisions by the Bombay High Court and the Gujarat High Court, that a taxpayer is entitled to set off his share of loss in a business carried on by a URF against the profits of his personal business for the same assessment year. Of course in one case the Supreme Court did hold that the loss suffered by a registered firm in a joint venture with another (treated as a URF for tax purposes) cannot be set off against its profits from other business. But whether the adjustment for the loss could be claimed by the partners in their own assessments was left open by the Supreme Court. Meanwhile the Andhra Pradesh High Court has held that a taxpayer's share in the loss incurred as a member of an Association of Persons or AOP (another assessable entity taxed like URFS) can be set off against his

36 CIT v. Ram Swarup Gupta (1973) 92 ITR 495. Some of the High Courts however have taken a different view vide, for example, the judgment of the Patna High Court in CIT v. Gangadhar Nathmal (1966) 60 ITR 7927.

income under any other head, even though the share of income from an AOP is not taxable in the hands of the members. Such share can only be included in the total income of the members for rate purposes as in the case of share of income from a URF. In a converse situation however, that is, where the taxable sources of an assessee show a loss, but his non-taxable sources yield a profit, it has been held by one High Court that the loss cannot be set off against the taxpayer's non-taxable income. If the logic that income from business must be computed before looking into the specific provisions relating to the treatment of losses is followed rigorously, none of the existing restrictions intended to contain the losses from different sources within broad compartments can work. It would appear that even agricultural losses can be set off against taxable income, if only the agricultural lands are shown among the business assets.

As regards the possibility of trading in losses which the facility of carryforward might give rise to, the Indian tax laws provide safeguards which seem to be fairly adequate.

38 Smt. Abida Khatoon v. CIT (1973) 87 ITR 627.

39 Delhi High Court in Mahaluxmi Sugar Mills Ltd. v. CIT (1974) 94 ITR 592. This is what the High Court said while permitting such set-off:

"On a parity of reasoning, an assessee is not to set off his loss from a source the income from which is not assessable to tax against his profits which are assessable to tax" (at p. 603).

The inconsistency of this view with the same High Court's decision in Ram Swarup Gupta's case referred to earlier (vide note 36) is obvious.
The basic principle followed in permitting carryforward of losses is that the taxpayer who avails of the facility must be the same as the one who incurred it originally. That is to say, unabsorbed losses of one assessee cannot be utilized to reduce the income of another - a notable exception to the rule being that carryforward of losses is allowed in inheritance. In the case of companies, in which public are not substantially interested, carryforward is not permitted unless on the last day of the relevant year shares carrying at least 51 per cent of the voting power are held by persons who beneficially held shares carrying at least 51 per cent of the voting power on the last day of the year in which the loss was incurred. This condition is waived when "the Income-tax Officer is satisfied that the change in the shareholding was not effected with a view to avoiding or reducing any liability to tax" (Sec. 79). When a firm is succeeded to by another or ceases to do business, unabsorbed losses are not allowed to be carried forward except in the hands of the erstwhile partners, provided of course, the other conditions specified in this regard e.g., continuance of the same business are satisfied. The courts have however ruled that when an individual succeeds or is succeeded by a registered firm in which he was or is a partner, it should be accepted that the same business continues and the carryforward facility for unabsorbed past losses is available in such cases in the assessment of
the individual partner.

On the whole it might be said that the Indian law takes care to see that the loss carryforward facilities are not abused. By and large, only the person who incurs the loss can avail of the facility and the exceptions to the general rule (e.g., in the case of inheritance and succession in certain circumstances) do not appear to be unduly liberal. To allow the successor of a deceased taxpayer to carry forward his unabsorbed losses would seem to be equitable since unrealized capital gains of a deceased taxpayer are liable to be taxed in the hands of his successor when the assets are disposed of as there is no provision for step-up of basis (i.e. cost) of assets at the time of inheritance. Viewed in this context, the ruling that the value of opening stock of a business inherited by one from his father should be taken as at market price on date of death is clearly incongruous.

Certain other anomalies are also noticeable in the matter of carryforward of losses especially those resulting from capital allowances. Allowances like development rebate and development allowances can be carried forward in situations where the facility is not available for ordinary losses. While

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40 Darshan Kumar, "Set off and Carry Forward of Losses Under the Income Tax Act", Taxation (Delhi), January 1974, Sec. II.

41 CIT v. Appu Chettiar (1962) 45 ITR 152.
unabsorbed losses cannot be carried forward except by the person who incurs it, capital allowances in excess of the income of a year are allowed to be accumulated and set off against future income without hindrance. Thus a closely held company can carry forward unabsorbed depreciation irrespective of any change in the ownership of its shares though losses cannot be carried forward unless the holding of majority shares remains unchanged. Again, development rebate, development allowance, capital expenditure on scientific research and expenditure on acquisition of patent rights or copy rights, if unabsorbed, are allowed to be carried forward by a company formed on the amalgamation of the company which was originally entitled to it, provided certain conditions are satisfied.

This facility is available also in respect of unabsorbed allowance towards amortization of certain capital expenditures contemplated in Sec. 35D but not in respect of ordinary losses.

42 Where however the ownership of an undertaking undergoes any change, unabsorbed depreciation allowance have to be treated as capital loss in the hands of the previous owner as per a ruling of the Privy Council, and the transferee cannot get the benefit of the unabsorbed depreciation (Indian Iron & Steel Co. Ltd. v. CIT 1943 ITR 328).

43 Vide Sec. 2(1A) of the Act. Broadly, the required conditions are that all the assets and liabilities of the amalgamating company or companies are taken over by the amalgamated company and not less than nine-tenths in value of the shares in the amalgamating company (or companies) are held by shareholders of the amalgamated company by virtue of the amalgamation.
The rationale for this inconsistency is not clear. It is also not clear why, when the general policy is oriented towards a lessening of concentration of ownership in industry, the fiscal system should provide any such encouragement for mergers.

In the case of widely held companies losses are allowed to be carried forward irrespective of any change in their share ownership. This might seem reasonable as no particular group of shareholders can be expected to benefit from this facility. But as is well known, in reality the control over many public limited companies remains a family affair. Thus the possibility of trading in losses which provides the rationale for stipulation of the condition regarding the continuity of majority share holding in the case of closely held companies cannot be ruled out in the case of widely held companies. There are of course difficulties in enforcing any condition in the case of public limited companies to ensure that the bulk of the equity holdings remain in the same hands. Perhaps the remedy lies in a more stringent control over the affairs of widely held companies and a revision of the relevant definitions in the Act.

On the whole, the loss provisions in the Indian income tax as originally framed were well founded in that losses could be set off only against income from other sources as well as other heads only in the year in which such losses were

44 Kaldor, op. cit., p. 83, f.n. 3.
first incurred and carryforward was permissible only in respect of business losses and that too against income from the same source. Fairly stringent conditions are also stipulated regarding set-off of capital losses and losses from speculative activities. Three things have however operated to undermine the restrictions laid down in the law on the offset and carryforward of losses; 1) the treatment of unabsorbed depreciation and other allowance on a more liberal footing than ordinary trading losses; 2) removal of the condition that carried forward business losses could be set off only against income from the same business; and 3) the doctrines evolved by the courts, viz., that income tax is one tax and that a business is one if the investments from which the income is received form a part of one balance sheet and there is unity of control. Though the law reflects a desire to compartmentalize the losses under certain heads like long term capital gain, speculative gains and certain casual incomes, treating the income of a particular year from different sources as part of a separate running account has been rendered difficult because of the inclination of the courts to allow business income/loss to be computed on general commercial principles often in disregard of the special provisions laid down in the statute to govern the treatment of losses.

If the loss provisions are not to act a source of base erosion, they ought to be cast on the lines envisaged by Kaldor. (Carter Commission's recommendations are also based
on cogently argued principles but they are more suited for a system where the tax is levied on a comprehensive base). That is to say, offset may be permitted in respect of a trading loss against income from any other source or head. But carry-forward and offset of losses and also unabsorbed capital allowances should be allowed only against income from the same source. The provisions in the law should be more specific on the point so that commercial principles cannot be invoked in order to ignore or override them. The way the segregation of 'speculation losses' and gains are operating—despite much litigation, the segregation does seem to be effective—shows this may not be impossible to achieve. The existing condition that the business in which the loss was originally incurred must be carried on serves little purpose. Whether a business can be said to have been carried on in a given year or whether it was in a suspended state has given rise to many disputes. When earning of profit is not essential, mere continuance of a particular business is not very difficult to establish on paper. That apart, such a condition only serves to keep alive moribund units. On the other hand, the fact that in the year in which the loss is incurred, offset is available against any other income even if the loss generating activity

45 Decided cases on the point show that even when an activity is 'dormant', that is, no apparent sign of activity is there, the business may still be regarded as continuing. See, for instance, Karsondas Ranchoddass v. CIT (1972) 83 ITR 17.
is closed in that year itself, may serve to encourage resort to 'hobby' business to keep down one's taxable income. This possibility would be removed if the facility of loss offset is limited only to income from the same source. In such a scheme some carryback and carryforward for an indefinite period should, in equity, be allowed. Carryback will remove the inequity which is sometimes caused by the existing provision that the business in which loss was incurred must be carried on in the year in which the carried forward loss is sought to be set off. This will also get round the troublesome question of the priority to be given to different categories of losses to which the Act does not always provide a clear answer. For administrative reasons and also in order not to encourage the growth of 'hobby' business or continuance of inefficient business ventures, it is necessary to limit the

46 The TEC also recommended the indefinite carryforward of losses. In the absence of any sourcewise containment of losses this recommendation was hardly justified.

47 The inequity is obvious in genuine cases where the benefit of carryforward is lost when a particular business is closed down before the carried forward loss is fully set off [For example, Indraprastha Steel Industries Ltd. v. ITAT (1973) 88 ITR 138].

48 For instance, as Iyengar points out, when a taxpayer's income shows loss in business but gain from other sources including share of profits in a URF, it is not clear whether the loss should be set off first against the share income while deriving the figure of total income or against other income first. The tax liability however varies significantly under the two methods (Iyengar on Income Tax (1972), vol. 2, p. 1230).
right to carryforward to eight years as at present and carryback up to, say, three years. There is also no case for allowing any loss to be computed under any head of income except business and the existing provisions which permit these are incompatible with the basic concept on which legal view of income is based in India.

So far as capital losses and losses from speculative activities are concerned the safeguards against abuse seem to be adequate. Short-term capital losses can be set off against any income of the year and carried forward for eight years against short-term gains. Long-term losses can be set off and carried forward only against long-term gains. In USA capital losses are deductible up to a maximum of $1000 in a year. Long-term losses can be deducted from ordinary income on a $2-for $1 basis (since long-term gains are taxed at 50 per cent of their value). Very recently the Ways and Means Committee of the U.S. Congress decided that capital losses of more than $30,000 should be allowed to be carried back for three years. Reform of the capital loss set off provisions would be rational but administratively cumbersome especially since long-term capital gains are taxed at varying rates.

As regards 'personal' losses such as those allowed in USA for casualty, theft, etc. when the loss is substantial

49 Congressional Quarterly (U.S. Congress) XXXII, No. 49.
(that is, exceeds a prescribed minimum), there can be no logic in entertaining claims for such losses where capital receipts are not subjected fully to tax. If the tax system was such that all receipts of a tax payer (starting from the point when he is recognized as a separate tax unit) were duly accounted for and subjected to tax and the imputed income from all consumer durables too was included in taxable income, it would be justified to permit deduction for losses of assets held for personal use. But such a system would require taxation of all gifts, inheritances and acquisitions and imputed incomes. Unless all capital receipts are subjected to tax at some stage, there is no case in equity for allowing for losses of wealth held for personal use.

In conclusion, it needs to be emphasized that all losses represent, in essence, depletion of capital and where capital receipts are not taxed or taxed to the same extent as ordinary income any allowance for losses is a privilege granted to the taxpayer. Moreover, in the concept of income which has come to find favour with judicial authorities, viz. a more or less recurrent return from a definite source, there can be no place for a loss. The only ground on which a loss -

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50 Sec. 165 (e)(3) of the Internal Revenue Code of USA provides for the deduction of unreimbursed losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty or from theft to the extent that each such loss exceeds $100.
if it is a purely trading loss - can be permitted to be off set against other incomes is that this furnishes a kind of averaging device. But in a system of taxation based on the realization principle any provision for loss offset must be carefully framed as otherwise there is grave risk of base erosion. These points - though these are basic to an understanding of the role of loss offset on any income tax - somehow appear to have missed by the judicial authorities. Thus the courts in India have gone on repeating that income includes losses for 'profit and gains' are 'plus income' and losses represent 'negative income'. There is also little evidence of any awareness in India that free offset and carry forward of capital allowance is not only illogical, having regard to the scheme of income taxation, but constitutes an encouragement for uneconomic investment - and perhaps excessive capital intensity. Surprisingly little attention has been paid to the treatment of losses by the panels appointed since Kaldor to study Indian income tax structure. Recent studies on company finances have revealed that a large number of companies go on accumulating losses, so much so that in many cases accumulated losses far exceed their share capital as well as net worth, and yet continue to

52 function, which is an indication that the loss offset facilities in income tax are widely used as an avoidance device. It is time the loss offset and carryforward provisions in the Indian income tax were given a close look keeping in mind the basic issues observations of Kaldor on their deficiencies, trend of judicial opinion and a study of how the provisions are manipulated to their advantage by inter-connected groups of taxpayers, despite safeguards in the law.

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52 Lall's studies on company finances of private limited companies in Maharashtra covering, on a census basis, about 3200 companies showed that companies with accumulated losses accounted for 56 per cent of the total. (V. D. Lall, "Structure of Private Limited Companies in Maharashtra," EPW, July 3, 10 & 17, 1971). The situation, according to Lall, is not much different for public limited companies (V. D. Lall, "Changing the Corporate Tax Base," EPW, March 22, 1975).