CARRY FORWARD & SET OFF OF LOSSES BY STARTUPS

Startup Series #5

Startups generally find raising funds from outside lenders difficult during initial stages of business and rely on raising equity, resulting in change in their shareholding pattern. Considerable time passes before Startups turn profitable and in turn, they are unable to utilize the losses for set off against profits as they lapse due to change in the shareholding pattern. Finance Act 2017 amended these provisions in order to promote Startup India.

*In continuation to our '**Startup Series',** let us look at the provisions relating to carry forward and set off of losses by eligible startups in **#5** of the series.*

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General provisions for carry forward & set off of losses

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Section 79 of the Income Tax Act, 1961 ('IT Act') provides restriction on carry forward and set off of losses (**unabsorbed depreciation is not covered**) by a closely held company if there is **substantial change** in shareholding pattern of such closely held company.

In order to carry forward and set off the losses against profits, the shareholders of the company who are **collectively holding at least 51% beneficial voting power** as at the end of the financial year in which losses are incurred, **must continue to** hold 51% of beneficial voting power in the same company in the year in which such losses are set off. If the said condition is not complied with, the company loses the right **to carry forward such losses.**

The **objective** behind the aforesaid provision is **to prevent buying loss-making companies,** where the benefit of the set off losses can be availed by the acquirers.

Provisions in case of Start-ups

In Startups, change in shareholding pattern is quite common each time the funds are raised by the promoters, resulting **in lapse of losses available for set off.** The aforesaid provisions were relaxed for Eligible Startups (refer definition in our alert #2) vide Finance Act 2017. It provides that even if there is substantial change in shareholding pattern (i.e., **more than 51%),** the eligible startup would be eligible to set off the losses, if the following **two conditions are satisfied**:

All the shareholders of the company **who held the shares** at the end of financial year in which loss are incurred **continue to hold shares in the year** in which losses are set off, and

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Such losses are incurred during **a period of 7 years** from the year of incorporation.

Illustration on Carry forward & Set off of losses

In the given case, I Co. has incurred losses in Year 1 and gained profits in Year 2. The shareholders of I Co. along with their shareholding pattern of both the years is provided:

Shareholders of I Co.	Year 1 (Loss)	Year 2 (Profit)
A	50%	1%
B	25%	33%
C	25%	1%
D	-	65%

<u>Scenario 1 – I Co. is not Eligible Start-up:</u>

All the shareholders of I Co. holding at least 51% shareholding in year 1 **do not hold 51%** shareholding in year 2. Hence, losses of year 1 **cannot** be set off against profits in year 2.

<u>Scenario 2 – I Co. is Eligible Start-up:</u>

All the shareholders of I Co. continue to hold shares in year 2 as well, irrespective of fact that shareholding pattern has changed for **more than 51%.** Hence, losses of year 1 **can be set off** against profits in year 2.

Stay tuned for more updates on Startups!

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In case you have missed the previous alerts, click on the hyperlinks to refer the same.

- #1 [Startup recognition]
- #2 [Tax holiday benefit]
- #3 [Angel Tax Exemption]
- #4 [Taxability of ESOPs]
- #5 **Carry forward & set off of losses by startups**
- #6 **Capital gains exemption on investment in startups**
- #7 **Exchange control provisions**
- #8 **Labor law relaxations**
- #9 **Startup India Seed Fund**
- #10 **Other regulatory provisions / benefits**

THANK YOU

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