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Tax Effects of Trading in Future and Options - A Practical Approach

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MAJOR ISSUES

- ▶ Whether the F & O transaction is a speculative transaction or non – speculative transaction ?
- ▶ Taxability - whether as business income or capital gains?
- ▶ Whether set off of losses from F & O transactions is possible and upto how many assessment Years ?

Points to keep note of:

- ▶ There is no specific provisions under the Act regarding taxability of Derivatives.
- ▶ Provisions having an indirect bearing on derivative transactions are Section 28, 73(4) and Section 43(5)



Derivative ?

- ▶ A **derivative** means an instrument whose **value is derived**. It has **no value of its own**. Its price is **based on the underlying asset**. Derivatives of stocks and indices can be traded on Indian stock exchanges. The **most popular form of derivatives are futures & options (F&O)**.
- ▶ A **futures contract** means an **agreement to buy or sell on a future date**. This contract expires on a pre-set date. On **expiry**, futures are **executed by delivery of the underlying asset** or via payment.
- ▶ **Options** and futures are alike but when you do an options contract, you can **choose to not make the transaction**.

(AS 30, 31, 32 and IAS 39)

What is the treatment of profit / loss from F & O Trading ?

For the answer to the above question, We have to refer to **Section 43(5)** of the **Income Tax Act'1961**, the relevant extract of which is reproduced below:

“speculative transaction” means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips:

Provided that for the purposes of this clause—

- (a).....
- (b).....
- (c).....
- (d) an **eligible transaction in respect of trading in derivatives** referred to in clause (ac) of section 2 of the **Securities Contracts (Regulation) Act, 1956** (42 of 1956) carried out in a recognised stock exchange; ⁷⁶[or]
- (e) an **eligible transaction in respect of trading in commodity derivatives** carried out in a recognised association [, which is chargeable to commodities transaction tax under Chapter VII of the Finance Act, 2013 (17 of 2013),]

shall not be deemed to be a speculative transaction.

Eligible transaction in respect of Section 43(5) means any transaction:-

- (a) carried out electronically on screen-based systems through a stock broker or sub-broker or such other intermediary registered under section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) or the Securities and Exchange Board of India Act, 1992 (15 of 1992) or the Depositories Act, 1996 (22 of 1996) and the rules, regulations or bye-laws made or directions issued under those Acts or by banks or mutual funds on a recognised stock exchange; and
- (b) which is supported by a time stamped contract note issued by such stock broker or sub-broker or such other intermediary to every client indicating in the contract note the unique client identity number allotted under any Act referred to in sub-clause (A) and permanent account number allotted under this Act;

2. **“Recognised stock exchange”** means a recognised stock exchange as referred to in clause (f) of section 2 of the **Securities Contracts (Regulation) Act, 1956 (42 of 1956)** and which fulfils such conditions as may be prescribed and notified by the Central Government for this purpose;



From the reading of Section 43(5), it is clear that trading in **derivatives including commodity derivatives on a recognised stock exchange** will not be considered as a speculative transaction and hence not treated as speculative business.

Therefore since these are not considered as speculative business, therefore income from such transactions will be considered as normal business income and loss from such transactions will be considered as normal business loss.

Conclusion:

Speculative business income: Income from **intraday equity trading** is considered as speculative.

Non-speculative business income: Income from **trading F&O (both intraday and carry forward)** on is considered as non-speculative business.

Explanation 2 to Section 28 — Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business (hereinafter referred to as "speculation business") shall be deemed to be distinct and separate from any other business.

Applicability of Tax Audit in case of F&O

Since income from derivative trading is considered as normal business income, therefore normal rules as applicable to tax audit as stated in section 44AB will be applicable in case of F&O trading also.

Therefore, the applicability of tax audit will be as follows in case of F&O Trading:

1) In case of Profit from transactions of F&O trading

- In the case of profit from derivative transactions, tax audit will be applicable if the turnover from such trading exceeds Rs. 1 crore.
- If the turnover from such trading exceeds Rs. 1 crore but less than 2 crore then the audit can be avoided if we can show the profit at minimum 8% (6%, if all trades are digital).
- Tax audit u/s 44AB r/w section 44AD will also be applicable, if the net profit from such transactions is less than 8% (6%, if all trades are digital) of the turnover from such transactions.
- Further, please note that any turnover more than 2 crore then audit u/s 44AB will be applicable irrespective of Profit and Loss

Applicability of Tax Audit in case of F&O

2) In case of Loss from F&O Trading

In case of **Loss from derivative trading**, since profit (Loss in this case) is less than 8% (6%, if all trades are digital) of the turnover, therefore Tax Audit will be applicable u/s 44AB read with section 44AD.

Summarize tax audit would be required in the following scenarios:

1. If your trading turnover is more than Rs. 2 Crores:

Tax audit is mandatory as presumptive scheme is not available.

2. If your trading turnover is between Rs. 1 Crore and Rs. 2 Crores:

Tax audit is required, if you are not opting for the presumptive scheme.

3. If your trading turnover is less than 1 Crore:

Tax audit is not required. However, if you are under losses or your income is less than 8% of the turnover and your 'total income' is greater than the basic exemption limit. (eg: in situations where you have salary income along with your trading loss/income) and you wish to claim such lower profit in your ITR, tax audit would be required.

Calculation of turnover in case of F&O Trading:

Para 5.14 of Guidance Note on Tax Audit under Section 44AB:

Determination of turnover in case of F&O is one of the important factors for every individual for the income tax purpose. Turnover must be firstly calculated, in the manner explained below:

- ▶ The total of positive and negative or favorable and unfavorable differences shall be taken as turnover.
- ▶ Premium received on sale of options is to be included in turnover.
- ▶ In respect of any reverse trades entered, the difference thereon shall also form part of the turnover.
- ▶ Whereas actual turnover will be determined based on accounting entries passed in the books of account, in case of derivative transactions one will pass entry in books for differential amount only and the same will be regarded as turnover of the business for the purpose of Income tax.

Here, it makes no difference, whether the difference is positive or negative. All the differences, whether positive or negative are aggregated and the turnover is calculated.

Calculation of Turnover of Futures

For every trade, contract notes are issued which show the value of Futures bought or sold. While for the recording purpose only the difference between is used. Take this example:

- ▶ RK bought one lot of RAK Foundation at 2.0 lakhs and sold it for 2.8 lakhs (Profit = Rs 80,000)
- ▶ RK bought one lot of RAK Inc. at 3.5 lakhs and sold it for 3.00 lakhs (Loss= Rs 50,000)

The turnover shall be calculated as $\text{Rs } 80,000 + \text{Rs } 50,000 = \text{Rs. } 1.30 \text{ lakhs.}$

Calculation of Turnover of Options

For every trade, contract notes are issued which show the value of options bought or sold. While for the recording purpose only the difference between is used. Take this example:

- ▶ AZ bought one lot (75) of Nifty Options 16000 @ 1000/- premium per lot at Rs. 75,000/- and sold it @ Rs. 2000/- premium per lot for Rs. 1,50,000/- (Profit = Rs 75,000/-)
- ▶ AZ sold 4 lots (25 per lot) Bank Nifty options 35000 @ Rs. 1000/- premium per lot i.e. AZ received premium of Rs. 4,000/- on writing an option

The turnover shall be calculated as $\text{Rs } 75,000 + \text{Rs } 4,000 = \text{Rs. } 79,000/-$

*Any premium received when you're writing (Sale) an option must be added to the turnover value.

Applicability of Section 44AD and 44AB in case of F&O Transactions:

- Section 44AB(a) of Income tax Act, 1961 ("the Act") provides that if the turnover or gross receipts exceeds Rs. 1 Crore then he is liable to get his books of accounts audited under Income tax. *First Proviso to section 44AB* provides that section 44AB will not be applicable in case the person declares profits and gains from business as per provision of section 44AD(1) and his total sales or turnover as the case may be doesn't exceeds Rs. 2 Crore.
- Section 44AD(1), starts with non-obstante clause with regards to section 28 to section 43C, provides that a sum equal to 8% of the total turnover or a sum higher than the 8% claimed to have been earned by the eligible assessee shall be deemed to be the profit and gains of such business and chargeable under the head "PGBP". Explanation to section 44AD doesn't specifically exclude transactions in derivatives – F&O as not eligible business.
- Explanation 2 to section 28 provides that speculative transactions are of business nature then the same will be distinct transactions from any other business of the assessee.

Applicability of Section 44AD and 44AB in case of F&O Transactions:

- ▶ Section 43(5) defines speculative transactions and specifically excludes derivative (F&O) transactions from the definition of speculative transactions.
- ▶ Combined reading of section 28 and section 43(5) provides that derivatives (F&O) transactions will be treated as business and profit or loss will be taxable as business income only.
- ▶ In case of **Nand Lal Popli vs D.C.I.T. (ITA No.1161/Chd/2013 & ITA No.1162/Chd/2013)** the **Hon'ble ITAT, Chandigarh** has held that *asking the assessee to prove to the satisfaction of the Assessing Officer, the expenditure to the extent of 92% of gross receipts, would also defeat the purpose of presumptive taxation as provided under section 44AD of the Act or other such provision.* Since the scheme of presumptive taxation has been formed in order to avoid the long drawn process of assessment in cases of small traders or in cases of those businesses where the incomes are almost of static quantum of all the businesses, the Assessing Officer could have made the addition under section 69C of the Act, once he had carved out the case out of the glitches of the provisions of section 44AD of the Act.

Applicability of Section 44AD and 44AB in case of F&O Transactions:

- ▶ In case of ***Pawa Industries Pvt. Ltd. vs ITO-14(2) (ITA No.1161/Chd/2013 & ITA No.1162/Chd/2013)*** the **Hon'ble ITAT, Delhi** has held that w.e.f. assessment year 2011-12, the choice available with the assessee of choosing the option, has been taken away and now, the **assessee is required to declare the income whichever is higher, out of estimated income or the amount claimed to have been actually earned from such vehicle.**
- ▶ The said ruling is with regards to section 44AE of the Act and is in line with the **Circular No. 5/2010** – Explanatory notes to the provisions of the Finance (No. 2) Act, 2009 wherein it is specifically mention that “Further an anti-avoidance clause is provided to state that a prescribed fixed sum or a sum higher than the aforesaid sum claimed to have been earned by the assessee shall be deemed to be profits and gains of such business.” However such clause doesn't exist for section 44AD.

Applicability of Section 44AD and 44AB in case of F&O Transactions:

Example:

- ▶ Purchase value of lot as per contract note – 14 Crore and sale value of lot as per contract note is 15 Crore, then there is net favourable difference is of 1 Crore which will be regarded as turnover for the purpose of section 44AB and the same will be accounted as sales in the books of account of the assessee.
- ▶ As per provision of section 44AD it is at the option of assessee to offer 8% or actual profit that he claims to have been earned from the said F&O transactions. If profit is offered at 8% then there will be addition to asset at actual profit that was earned by the assessee. It may possible that AO add differential amount as unexplained investment under section 69C of the Act, however there is decision of Chandigarh ITAT (supra) in which similar addition was directed by ITAT to be deleted.

Maintenance of Books of Accounts in case of F&O

Since income from F&O Trading is considered as normal business income, therefore normal rules for the maintenance of Books of accounts as stated in section 44AA of the Income Tax Act'1961 are applicable. These rules can be summarised as follows:

- ▶ If there is loss in F&O trading or the Net profit is less than 8% (6%, if all trades are digital) of the turnover or the turnover exceeds Rs. 1 crore, then provisions of Tax Audit are applicable and in order to get tax audit done, maintenance of books of account are mandatory.
- ▶ if there is a profit in F&O and the profit is 8% (6%, if all trades are digital) or more of total turnover , then only the income has to be declared as business income and accordingly ITR has to be filed. There will be no need to maintain books of accounts.

Carry Forward and set off of Loss from F&O Transactions

Section 73:

(1) *Any loss, computed in respect of a speculation business* carried on by the assessee, shall not be set off except against profits and gains, if any, of another speculation business.

(2) Where for any assessment year any loss computed in respect of a speculation business has not been wholly set off under sub-section (1), so much of the loss as is not so set off or the whole loss where the assessee had no income from any other speculation business, shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

- ▶ (i) it shall be set off against the profits and gains, if any, of any speculation business carried on by him assessable for that assessment year; and
- ▶ (ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on.

Carry Forward and set off of Loss from F&O Transactions

Section 73:

(3) In respect of allowance on account of depreciation or capital expenditure on scientific research, the provisions of sub-section (2) of section 72 shall apply in relation to speculation business as they apply in relation to any other business.

(4) No loss shall be carried forward under this section for more than [four] assessment years immediately succeeding the assessment year for which the loss was first computed.

[Explanation.—Where any part of the business of a company [other than a company whose gross total income consists mainly of income which is chargeable under the heads “Interest on securities”, “Income from house property”, “Capital gains” and “Income from other sources”, or a company the principal business of which is the business of banking or the granting of loans and advances)

consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares.]

Carry Forward and set off of Loss from F&O Transactions

- ▶ You should file it before due date to carry forward the loss and set off from income in future.
- ▶ However, there are case laws which prohibit the carry forward and set-off of loss from F&O transactions stating share derivative transactions carry the character of speculative transactions for section 73 and any loss arising therefrom will be characterised as loss from speculative business and same cannot be set-off against normal business income
- ▶ As per court section 43(5) defining speculative transaction is only for the purpose defining terms used in section 28 to 41. Section 43(5) has no application over section 73. (CIT v/s DLF Commercial Developers Ltd.) Delhi HC

(CIT v/s DLF Commercial Developers Ltd.) Delhi HC – 261 CTR 127

- It is apparent, facially, that the term “speculative transaction” has been defined only in Section 43 (5). At the same time, it is qualified, i.e. that the scope of the definition is restricted in its application to working out the mandate of Sections 28 to 41 of the Act.
- Section 43 defines, for the purpose of Sections 28 to 41, certain terms. These latter provisions fall in Chapter IV, in Section D, which deal with computation of business income.
- The Court cannot ignore or overlook that the definition – to the extent it excludes such transactions from the mischief of the expression “speculative transactions” is confined in its application. Parliamentary intendment that such transactions are also excluded from the mischief of Explanation to Section 73 (4), however, is not borne out.
- Explanation to Section 73 (4) has been enacted to clarify beyond any shadow of doubt that share business of certain types or classes of companies are deemed to be speculative. That in another part of the statute, which deals with computation of business income, derivatives are excluded from the definition of speculative transactions, only underlines that such exclusion is limited for the purpose of those provisions or sections.

Sucon India Ltd. 184 TTJ 713 (Delhi Trib)

- ▶ assessee was engaged in the business of trading of shares and securities etc. and works contract.
- ▶ In the course of scrutiny proceedings, the Assessing Officer observed that the assessee claimed loss of Rs.27,63,30,230/-from business of trading of shares etc, which was partly set off against the profit of Rs.1,80,42,386/- shown from work contracts resulting into net loss of Rs. 25,94,45,470/-.
- ▶ In respect to loss, from shares it was Rs. 10.10 crores, intraday trading it was Rs. 25.38 lakhs and from derivatives it was Rs. 17.27 crores.
- ▶ The Assessing Officer held that the assessee company was engaged in dealing in shares and, therefore, explanation to section 73 of the Act applies directly to the assessee and according to the said explanation if any part of the business of the company consists in the purchase and sale of shares of other companies, then for the purpose of section 73 of the Act, the assessee shall be deemed to be carrying on the speculation business to the extent of business of purchase and sale of such shares. Accordingly, the loss from trading in share amounting to Rs.10,10,75,192/- was held as loss from speculation business. Similarly, he held that derivative transaction might not be speculative under section 43(5) of the Act, but when the dealing in those is undertaken by the company which forms the business of such company, the provision of Explanation to section 73 come into play. According to the Assessing Officer, the provision of section 73 are specific and relevant for the limited purpose of set off of the business.

Sucon India Ltd. 184 TTJ 713 (Delhi Trib)

- ▶ Learned counsel of the assessee submitted that as far as losses from the derivative transactions was concerned the issue in dispute has been decided in favour of Revenue in the case of *CIT v. DLF Commercial Developers Ltd.* by the Hon'ble Delhi High Court, [2013] 35 taxmann.com 280/218 Taxman 45, whereas same issue in dispute has been decided by the Hon'ble Calcutta High Court in the case of *Asian Financial Services Ltd. v. CIT* [2016] 70 taxmann.com 9/240 Taxman 192 in favour of the assessee.
- ▶ "It would appear that the activities appearing in Clauses (a) to (e) are not to be deemed to be speculative transactions. Therefore, this comes within the category of deemed business which is however distinct and separate from any other business. Now, the question is, whether loss arising out of such deemed business can be set off against the profit arising out of other business or businesses which may for clarity be called proper business. Under Section 70 of the Act, the assessee is entitled to have the loss set off against his income from any other source under the same head unless otherwise provided. Therefore answer to the question is that the assessee is entitled to have the loss arising out of deemed business set off against the income arising out of business proper unless otherwise provided. The question however remains whether the explanation to Sub-Section (4) of Section 73 relied upon by Mr. Lodh provides otherwise. A plain reading of the explanation quoted above cannot be said to have provided otherwise. In that case the irresistible conclusion is that the assessee is entitled to set off such loss arising out of deemed business against the income arising out of business proper.

Sucon India Ltd. 184 TTJ 713 (Delhi Trib)

The learned Tribunal has supported the contention of the revenue relying upon the judgment of the Delhi High Court quoted above. The views expressed by the Hon'ble Delhi High Court are contained in a part of the sentence, which is as follows:

"by all accounts the derivatives are based on stocks and shares, which fall squarely within the Explanation to Section 73(4)"

We are **inclined to think that the clause of the sentence which fall squarely....', qualifies the word 'shares' and not the word 'derivatives'**. We have no difficulty in accepting the views of the Delhi High Court when they say that shares fall squarely within the Explanation to Section 73(4) but we are unable to agree when derivatives are treated at par with the shares because the legislature has treated them differently."

- ▶ Respectfully following the above decision of the Hon'ble Supreme Court in the case of *Vegetable Products Ltd. (supra)*, we are inclined to follow the decision of the Hon'ble Calcutta High Court on the issue in dispute. Accordingly, we hold that the loss incurred on derivative transaction was not a speculative loss and is allowed to be adjusted against business income.

Felex Enterprises ITA No. 5129/DEL/2012

- ▶ Assessee was engaged in the business of trading in share futures and options. The return of income was filed on 27.10.2007 declaring a loss of Rs.1,80,53,696/-
- ▶ Assessing Officer did not accept the contentions of assessee and treated the loss incurred by assessee as speculative in nature to be set off only against receipts of similar nature.
- ▶ **Before CIT(A)** - It is contended by the appellant that F& O derivative trading were done through M/s Religare Securities Ltd., who is a registered member of National Stock Exchange (NSE). It is submitted by the appellant that NSE is a recognized stock exchange for doing F&O transactions which has been recognized by CBDT circular dated 25.01.2006. It is further submitted by the appellant that all transactions were done through M/s Religare Securities Ltd. who is a recognized member of National Stock Exchange of India. Therefore, the income derived from F & O derivative trading was a business income during the year under consideration. Such loss or profit has to be treated as business loss or profit as the case may be.

Felex Enterprises ITA No. 5129/DEL/2012

► Before ITAT:

We find that there is no dispute that assessee had incurred loss in sale of share futures and not in trading of shares. Explanation to [section 73](#) is applicable in the cases where the business of a company consists of sale and purchase of shares of other companies. **Share futures are different from the shares and these are meant only for trading purposes whereas shares are meant for trading as well as for investment purposes.** The purpose of investment in shares is capital appreciation as well as earning of dividends whereas in the case of trading in share futures the only purpose is to earn business income. **Explanation to [section 73](#) is applicable only in the case of a [company](#) whereas section 43(5) is applicable to all classes of persons.**

The Ld. Departmental Representative's argument that the case of the assessee is hit by explanation to [section 73](#) does not carry any force as if that be the intention of legislature, the whole purpose of amending [section 43\(5\)](#) is defeated. The amendment was meant for the development and benefit of capital markets. Therefore, we are of the view that the loss incurred by assessee was not speculative loss but was a normal business loss and Ld. CIT (A) has rightly dealt with the issue.

Accounting Treatment

As per Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options (Year 2003):

- ▶ Derivative contracts not settled as on balance sheet date should be marked to market.
- ▶ Any loss arising from mark-to-market should be recognised in Profit & Loss A/c and gains, if any, should be ignored

The presentation and disclosure of derivatives in financial statements is required by 'AS-31 and 32' respectively issued by ICAI.

Capital gain vs. Business Income

- ▶ As per section 2(14) of the Act, 'capital asset' means property of any kind held by an assessee, whether or not connected with his business or profession.
- ▶ Derivatives are security defined under Securities Contracts (Regulation) Act and are the contracts carrying right, thus they can be considered as a property carrying value.

Circular No. 4/2007, Dated 15/6/2007

Principles to be adopted for distinction between shares held as stock in trade and investment:

- Assessee to produce evidence for distinction between shares held as stock-in-trade and held as investment – CIT vs. Associated Industrial Development (82 ITR 586) (SC)
- Relevant principles for determining capital gains vs. business income as laid down by AAR in 288 ITR 641

Where a company purchases and sells shares, it must be shown that they were held as stock-in-trade

Substantial nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and Sales and the holding would determine the nature of transactions;

Ordinarily the purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade / adventure in the nature of trade;

Where the object of the investment in shares of a company is to derive income by way of dividend etc. then the profits accruing by change in such investment (by sale of shares) will yield capital gains and not revenue receipt.

Possible to have two portfolios i.e, an investment portfolio comprising of securities which are to be treated as capital assets and a trading portfolio comprising of stock-in-trade

Q & A

I am engaged in buying and selling of shares. I **do not take delivery of the shares and these transactions are speculative in nature.**

What is to be taken as the turnover for the purpose of determining whether a tax audit is required in such cases?

In this case, since the transactions in shares are non-delivery based, it is only the net of the sales and purchases that is to be treated as turnover. Tax audit under Section 44AB would be required only if the turnover so computed exceeds Rs 100 lakh. You may refer to the decision of the Mumbai Bench of the Tribunal in the Babu Lal Enterprises vs ACIT (ITA NO.6031/MUM/1996) case as also the ruling in the **Royal Cushion Vinyl Products Ltd** case.

Are short-term and long-term capital gains to be taxed under the same head?

Both short-term and long-term capital gains are to be taxed under the head 'capital gains'

Q & A

Is a speculative business also to be taxed under the head capital gains?

Any profits and gains from a speculative transaction is to be taxed under the head 'profits and gains of business or profession'. In case of speculative transaction, all expenditure allowable under Sections 30 to 38 can be claimed since the charge arises under the head 'profits and gains of business or profession'.

Can expenditure, such as depreciation on assets such as computer, air-conditioner, furniture and postage, telephone, conveyance, and so on, be claimed against speculative income?

You can claim expenses, such as postage, conveyance and telephone, incurred by you for carrying on the business. You can also claim depreciation on assets used for the business or profession.

Q & A

Can a business loss be set off against salary income?

- ▶ You may, note that a **loss, if any, from a speculation business cannot be set off against income from other sources or other heads**. It can only be set off against speculation income and the balance, if any, after such set off, **can be carried forward and set off against speculation income within four assessment years** immediately succeeding the assessment year in which the loss was first computed.
- ▶ In case of **business loss not being a speculative loss, it can be set off against income from other sources or other heads**. It **cannot, however, be set off against income under the head `salaries`**. The balance, if any, can be **carried forward and set off against business income within eight assessment years immediately** succeeding the assessment year in which the loss was first computed. Unabsorbed depreciation can, however, be set off and carried forward and set off without any restriction either in the manner of set off or the timeframe for such set off.



THANK YOU

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