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Policy Communiqué Series

Rethinking Section 79 of the Income-tax Act for a Digital Economy

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Introduction to the Policy Communiqué Series

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India is the world's second largest Internet market in terms of numbers and is adding 100 million users on an average every year.

The Internet is a huge enabler—it is helping to create thousands of digital business enterprises, which in turn are generating direct and indirect employment for millions. These digital business enterprises are catalysing entrepreneurship across the length and breadth of the country and allowing new products and business ideas to be tested and perfected.

Global capital and talent is flocking to India and ease of doing business has now become a topic of mainstream conversation. We are at an inflection point, where a simple and updated regulatory environment for businesses can accelerate growth significantly. It is imperative that regulation, policy and business evolve in sync and recalibrate often so that the rules of engagement are mutually clear, contemporary and relevant.

Collaborative effort is needed to ensure that various issues of policy and regulation receive continued attention in building the India of tomorrow. We are pleased to contribute in this regard through our joint initiative with PwC, wherein we will publish a series of communiqués focussing on policy matters relevant to digital businesses.

We are confident that PwC's depth of global experience and Snapdeal's close understanding of industry issues will add value to this ongoing discourse that is helping shape India's digital businesses.

Foreword

India's digital economy is disrupting the current business landscape, given that the number of Internet users in India is expected to cross 790 million by 2020. Also, more than 80% of these users will get online through mobile phones. With improvements in network infrastructure, significant investor interest and foreign funding, India has emerged as one of the fastest growing bases of start-ups worldwide. Driven by the ambitious technology-centric initiatives launched by the government last year—viz. Digital India and Start Up India—one can expect that for sectors like eCommerce, Internet businesses and fintech, the best is yet to come.

As per the NASSCOM Start-up report 2015, there are currently 4,200 venture/private equity-funded start-ups/eCommerce/Internet businesses in the country. The thriving start-up environment is driven by favourable investor sentiment to tap a huge market, high-potential tech talent and the increased risk appetite of young Indians. To tap this opportunity, the government, through its Start Up India initiative, has announced progressive measures to support the ecosystem.

Against the backdrop of these developments, Snapdeal and PwC have come together with the aim of creating a bimonthly communiqué to highlight emerging tax, policy and regulatory issues relevant to the growth of the ecosystem of these companies in India, and to provide recommendations for creating an overall favourable environment and thus making India an attractive investment destination.

In this first issue, we have covered an issue applicable to start-ups/eCommerce/Internet companies who are unable to carry forward and set off the tax business losses that they typically incur in the initial years of their operations, because of the dilution of the original promoter shareholding beyond 49% to other investors/VCs/PE players. Amending section 79 of the Income-tax Act, 1961, is one such low-hanging fruit. Although this aspect has not been covered in the start-up policy, it can provide significant relief to these companies. We offer some recommendations in this regard.

We are delighted to present the first edition of this communiqué, and hope that you will find it interesting and useful.

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Introduction to section 79 of the Act

The extant provisions of section 79 of the Income-Tax Act, 1961 (hereafter, the Act), restrict closely held companies from carrying forward and setting off losses in case beneficial shareholding of the companies changes by more than 49% in the year in which the loss is considered to be set off vis-a-vis the year in which the loss is incurred.

Historically, a provision similar to section 79 of the Act was not provided under the Income-tax Act, 1922. The section was introduced pursuant to recommendations of the report of the Taxation Inquiry Commission (Mathai Commission), 1953–54. The Mathai Commission noticed that it was possible for a few persons to acquire the shares of companies which have sustained losses in earlier years and then start to engage in profitable business, thereby reducing tax liabilities by securing set-off of losses of earlier years when the shares of the company were held by different shareholders. The Mathai Commission suggested introducing an anti-abuse provision by which attempts at transferring losses in this manner could be curbed. On the basis of the aforementioned suggestion, draft provisions of section 79 were introduced in the draft bill.

A subject of debate prior to introduction

Shri M R Masani, a member of the Mathai Commission, appended a minute of dissent to the report of the Mathai Commission and recommended that while other countries even provided carry back of losses, the proposed provision tried to abridge even the limited right of carry forward of losses. It was noticed that the draft provision put the onus on the assessee to prove that the change in shareholding was not effected with a view to avoiding or reducing tax liability. He recommended that draft provisions of section 79 should be deleted and if they were sought to be retained at all, they should apply in cases where the circumstances show that the change in shareholding was effected with a view to avoiding or reducing tax liability, without casting the onus on the taxpayer to prove the negative. It is relevant to note that based on this recommendation, clause (b) was added in the final provisions of section 79 of the Act. According to this clause, provisions of section 79 shall not be applicable in a case where the change in shareholding was not effected with a view to avoiding or reducing any tax liability and the onus for proving the same shall fall on the assessing officer (AO). Hence, the intent of section 79, as introduced in the Act, was to restrict the carry forward of losses in case of change in shareholdings effected to avoid or reduce tax liability.

Periodic changes to mitigate taxpayer burden

The introduction of clause (b) to section 79 of the Act resulted in prolonged litigation at that time. Courts held that the burden of proving any mala fide intentions was on the AO, and hence, this relief became prone to misuse. Later on, clause (b) of Section 79 was deleted by the Finance Act, 1988. Circular no. 528 dated 16 December 1988 (the Circular), which defines the scope and effect of such deletion, clarified the intention behind the deletion of clause (b), which is extracted below:

> *26.2 Some courts have held that the above two conditions are cumulative in effect and unless both are satisfied, the assessee cannot be deprived of the benefit of carry forward of loss. As per these decisions the burden of proof to show that the change in the shareholding has been effected with a view to avoid or reduce the tax liability envisaged in clause (b) of this section is on the Assessing Officer.* ***To set at rest the judicial controversy in this regard,*** *clause (b) of section 79 has been deleted by the Amending Act.*
>
> *26.3 With a view to avoiding hardship likely to be caused in genuine cases, it has also been provided that the set off of brought forward losses in the case of closely-held companies will not be denied in a case where change in shareholding to the extent of 51 per cent or more of the voting power takes place in the event of death of any shareholder or on account of a gift by any shareholder to his relatives, as defined in section 2(41) of the Income-tax Act, 1961.*

However, while tracing the legislative history of the provisions of Section 79, one observes that at various points of time, the legislature itself has recognised the hardships that may be caused due to the strict applicability of these provisions.

Therefore, as and when the need has arisen, the legislature, in order to avoid hardships in genuine cases, has also carved out exceptions to the applicability of Section 79. These are as follows:

1. **First proviso to section 79 (inserted vide the Finance Act, 1988):** Where change in shareholding results from the death of a shareholder, or by way of gift to a relative of the shareholder (which is uniformly exempted from the taxability under the Act), the same have been recognised

as cases of genuine hardship and thereby excluded while calculating the change in ownership for the purpose of determining the applicability of section 79.

2. **Second proviso to section 79 (inserted vide Finance Act, 1999):** This was introduced in order to provide exemptions to cases of any change in the shareholding of an Indian company which becomes a subsidiary of a foreign company as a result of the amalgamation or demerger of a foreign company, subject to the certain conditions in relation to shareholding.

3. **Exception to sick industrial units referred to by the Board of Industrial & Financial Reconstruction (BIFR):** Under the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), the central government has the power to grant consent for excluding or limiting the applicability of, inter alia, the provisions of section 79 to companies that have been declared sick under the provisions of SICA.

The issue of whether section 79 of the Act becomes ineffective in case of a change in shareholding on account of 'bona fide reasons' has been a matter of litigation and the courts, in general, have strictly interpreted section 79 of the Act (as it stands today) as not providing protection to a bona fide commercial transaction. Therefore, the provisions of section 79 of the Act, as it reads today, being introduced as a Special Anti-Abuse Rule (SAAR), shall be applicable even if a change in shareholding occurs as a result of a bona fide commercial transaction.

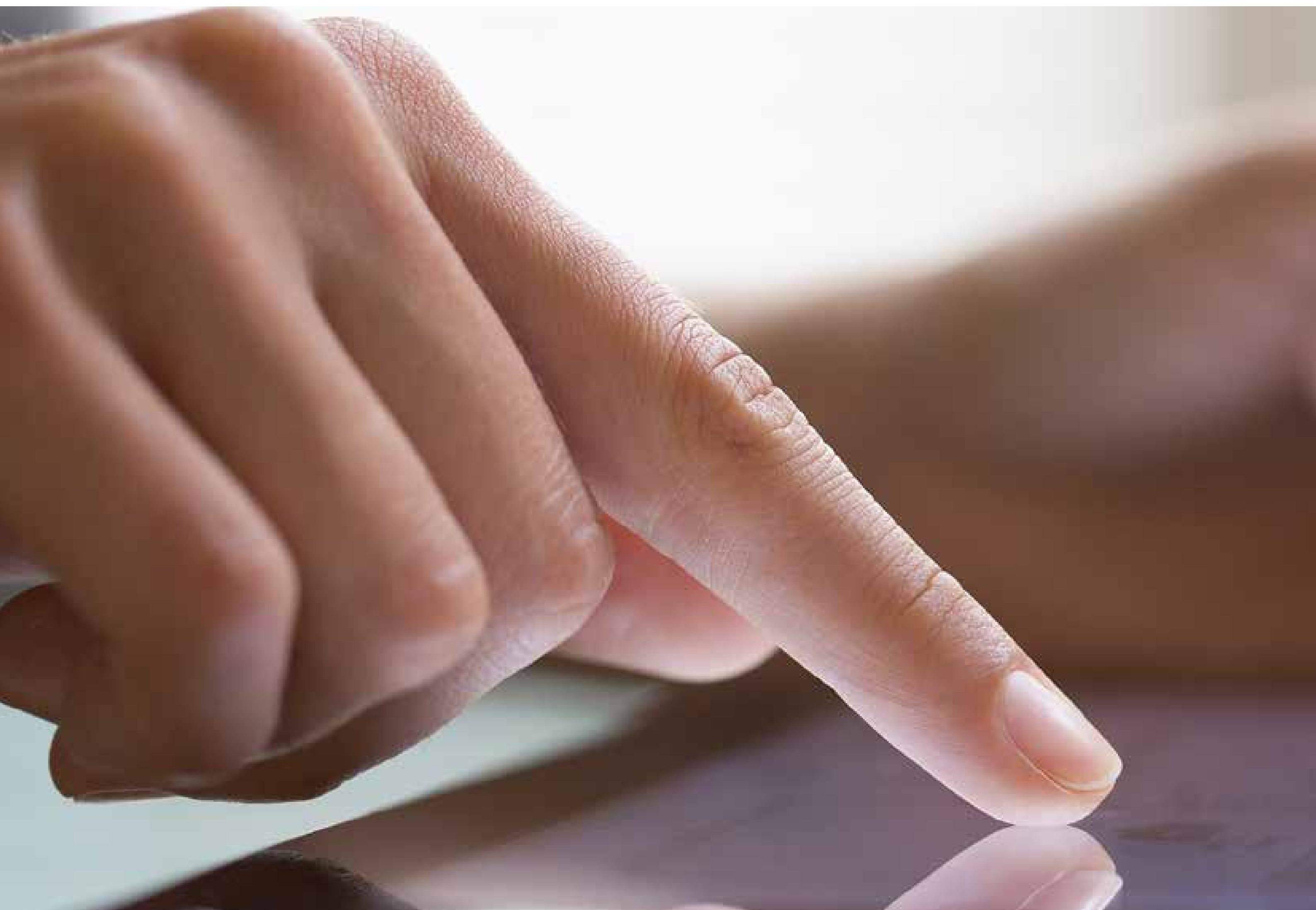
Limitations of section 79 in the current context

As per recent reports, India has emerged as one of the fastest growing bases of start-ups worldwide. This emergence of innovative start-ups and creative entrepreneurs has attracted foreign funding. However, these new opportunities come with a high risk on investment. Further, these start-ups have been observed to have significant profitability and liquidity concerns, especially in the early years of operations, when revenue is slow.

Typically, such businesses are formed with small investments by the entrepreneur during the initial years, when they are at an experimental stage. Once viability is established and risk factors reduce, additional funds are infused for future expansion and generation of profits. Additional funds come mostly as share capital from third-party investors like private equity, angel funds and venture capitalists.

In addition to various structural and regulatory challenges faced by young businesses, the rigours of section 79 of the Act are adding to the woes of the start-up community in general. Under this provision, the losses incurred in the early years are not allowed to be carried forward on account of a change in shareholding on the infusion of such additional funds.

Separately, in view of the huge business promotion expenditure and limited penetration of Internet accessibility in our country, it has been observed that these businesses usually take longer to break even because of the high upfront investments required in creating an enabling ecosystem. Under this scenario, the loss carry forward period of eight years under the current law may also prove to be insufficient for the utilisation of entire losses.



Global perspective: Provisions similar to section 79[1]

In view of the booming digital environment, and in order to provide a benefit to genuine cases, many countries have incorporated provisions to offer relief to companies that undergo change of ownership for bona fide reasons.

Some of the provisions relating to treatment of losses, under the laws of the other countries, are summarised below:

1. **Carry forward of losses:** Countries like Australia, Singapore, New Zealand, Norway and the UK allow for 'indefinite' carry forward of losses, while Spain allows carry forward for 15 years.

2. **Carry back of losses:** Countries like the UK, Germany, Ireland and Singapore allow carry back and set-off of losses with profits of earlier years, although the same is subject to certain conditions and restrictions.

3. **Change of ownership:** Countries like Singapore and Germany allow carry forward even in case of substantial change in ownership, if the company is able to demonstrate the absence of a tax avoidance motive. Some countries like Australia, Canada and France allow the benefit of carry forward on satisfaction of certain criteria like a similar business test.

Closer home, the tax laws of China provide no restriction on the utilisation of losses by the companies on account of a change of ownership. Chinese tax laws provide reduced rates of taxes for certain businesses in order to give impetus to them, especially for new technology enterprises and small and thin profit enterprises. China is a well-known hotbed for start-ups, where companies such as Alibaba and Baidu have flourished and grown into well-established business. A regulatory and taxation regime which is responsive to the emerging requirements of the economy does play a significant role in the growth and development of a country.

In light of the above discussions and the evident hurdles and challenges faced by digital companies due to the rigours of section 79, this paper attempts to make certain recommendations for the amendment of the provisions of section 79 relating to the carry forward of losses under the Act.

1 Information sourced from public domain

Recommendations

Recently, the Income Tax Department has introduced several taxpayer-friendly initiatives with the aim of simplifying both the tax administration system as well as the provisions of the law. This is in line with the government's objective to promote India as an investor-friendly nation through initiatives like Make in India. The government has also constituted a 10-member committee with a view to simplifying the provisions of the Act, etc.

Such measures are necessitated in light of the current global business environment, which is buzzing with innovation and entrepreneurial activity. In the race to become the top jurisdiction for attracting start-ups, as discussed above, India requires not only infrastructural support but also tax laws which are in line with the requirements of the changing business trends. The government is undertaking significant measures for the digital empowerment of citizens under the Digital India Programme. With many such initiatives on the government's roadmap, one needs to take a holistic view and also align the age-old tax laws in the wake of the requirements of the new age economy.

The government has time and again amended the tax laws to suit the requirements of the dynamic economy, be it tax neutrality provisions for group restructuring or benefits to special economic zones, infrastructure development, information technology, etc.

As per Nasscom's report,[2] India is one of the first five largest start-up communities in the world, with the number of start-ups crossing 4,200. Considering the needs of the fast-growing digital economy, with a substantial boom in entrepreneurship and consequent funding requirements, one needs to view the impact of the provisions of the Act on such businesses.

Further, the government has also recognised the growing role played by innovative start-ups in building the economy. Recently, several measures have been introduced for boosting and supporting the start-up culture and adding to the ease of doing business in India, including initiatives like Make In India, Smart Cities Mission, Pradhan Mantri Mudra Yojana and Start-up India. The Start-up India mission has been specifically introduced for easing the business environment for start-ups. However, since the policy document is only at the draft stage, this paper has not analysed the impact that the provisions of this document may have on the start-up environment. Among other tax and regulatory benefits for start-ups, one may contemplate introducing appropriate relaxations from the applicability of the provisions of section 79 of the Act for start-ups also under this scheme.

Accordingly, it is proposed that the rigours of section 79 of the Act should be restricted only in cases where the change in shareholding is effected with a view to 'avoid or reduce tax liability'—i.e. bona fide cases like the entry of new shareholders bringing additional funds for expansion and growth of business should be kept out of the ambit of section 79 of the Act.

Considering the case of digital companies, as discussed above, as a case of genuine hardship, and also keeping in view the objective of setting up the committee, which is to identify provisions impacting ease of doing business and suggest alterations/ modifications, such genuine cases may be exempted from the scope of section 79 either in totality or at least for a specified period of time during a start-up's life cycle. One may consider putting in place the required checks and balances to avoid the abuse of such relaxed provisions of introducing section 79 by certain criteria in order to identify bona fide cases and restrict such benefits to them. Some of the recommendations that may be contemplated are given below:

1. **Restricting the application of Section 79 at the time of exit of old shareholders**:

   In order to support digital companies, it is possible to consider exempting from the scope of section 79 genuine cases where the change in shareholding is on account of the infusion of additional funds in such start-ups for bona fide business purposes and not due to exit of shareholders.

   Further, it may be noted that the provision recommended above already exists within the tax law in the case of change in constitution of firms or succession of business/ profession (under section 78 of the Act). The rigours of Section 78 are only triggered when a partner of a firm has retired or deceased or on succession of business, and not at the time of admission of new partners. It is recommended to modify section 79 and bring it on par with the provisions of section 78, and to consider allowing businesses to carry forward losses despite a change in shareholding pattern, till the time that the original promoters continue to remain shareholders and take part in management.

   Another alternative could be to consider restricting the amount of lapse of losses to the proportion of change in shareholding, rather than disenabling the utilisation of the entire amount of brought forward loss, as the provision currently requires.

2 'Startup India - Momentous rise of the Indian startup ecosystem', released in 2015 (http://www.nasscom.in/startup-india-%E2%80%93-momentous-rise-indian-startup-ecosystem)

An illustrative working of this recommendation is given in the **annexure**.

2. **Exemption to bona fide cases**:

   One may consider granting relief to start-ups from the provisions of section 79 on the condition of establishing the bona fide intentions of the company. In order to determine the criteria for demonstrating bona fides of the company, reference may be drawn from the existing provisions of the Act, such as section 2(1B) and section 2(19AA) and the related provisions, which provide tax neutrality to internal reorganisation in the nature of amalgamation and demerger. The legislature in its own wisdom had recognised the growing trends in the business environment by inserting such provisions to make capital gains (section 47), loss carry forward (section 72A), expenditure on restructuring, etc., tax neutral for companies undertaking amalgamation or demerger. Further, these provisions also have inbuilt safeguards (like section 47A) to safeguard the interests of the revenue and prevent tax avoidance or abuse of the provisions.

   Reference can also be drawn from the tax laws across the globe. For instance, there are anti-abuse measures, such as the same business test (SBT) or the same activity test (SAT), which serve as criteria to establish bona fides of the company post a change of its shareholding, in countries like Australia. Similar criteria can be introduced in order to grant relief from the application of the provisions of section 79 where, even after change in shareholding beyond the threshold, the company continues to remain in substantially the same business and under the same management, who were part of it before such change in shareholding.

3. **Period of allowance of losses**:

   As discussed earlier, considering that the gestation period for digital businesses lasts long, and in line with the best international practice, it is recommended that the period of carry forward of business losses be extended from the current 8 years to 10–12 years. The gestation period is typically long for these businesses as a certain scale needs to be achieved in order to hit profitability. Revenue streams like advertising, which is a major source of income, only kicks in after sufficient users are engaged with the platform.

   Another example is that some of the online marketplaces incur huge upfront costs to set up fulfilment centres which bring significant efficiency to their supply chains. These are genuine business expenses that need to be front-loaded due to the nature of the business.

4. **Specific exemption to start-ups**:

   In line with the government's Start Up India initiative, one may consider exempting the application of the provisions of section 79 to all start-ups, as defined under the policy. The definition of start-ups under this policy is likely to be based on the time limit from the formation of the company (e.g. in case of infusion of fresh capital in new companies which have not yet earned taxable profits in any of the years since formation), turnover threshold or other criteria.

In sum, the recommendations outlined above, if implemented by the government, will align well with the its intentions of providing the right ecosystem to start-ups from the stability and growth perspective.

Annexure

Illustrative workings for carry forward and set-off of losses under recommendation 1

Consider the case of a newly formed start-up, owned and managed by two shareholders, A and B (having equal shareholding in the company).

The following tables give an illustration of the comparison of the effects of the current provisions of section 79 vis-à-vis the recommendations.

Table 1: Pattern of change in shareholding

(million INR)

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Additional share capital	70	-	30	17	29	16	-
Total share capital	70	70	100	117	146	162	162
A	50%	50%	35%	30%	24%	22%	22%
B	50%	50%	35%	30%	24%	22%	22%
Angel investor C			30%	40%	32%	28%	-
PE D					20%	18%	18%
PE E						10%	10%
PE F							28%
Total	100%	100%	100%	100%	100%	100%	100%

Table 2: Computation of carry forward and set off of losses[4]

(million INR)

Ref	Particulars	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
A	Loss incurred during the year	30	40	50	35	20	(75)	(100)	-
	I. Under current provisions								
B	Total b/f loss	-	30	70	120	155	105	30	175
C	Less: Losses lapsed under the existing provisions of section 79	-	-	-	-	70[1]	-	10[2]	80
D=B-C	Net losses allowed to be set-off/ carried forward	30	70	120	155	105	30	20	95
E=A-D	Taxable income	-	-	-	-	-	-	80	80
	II. Under proposed provisions								
F	Total b/f loss	-	30	70	120	155	175	100	175
G	Less: Losses lapsed under the proposed provisions of section 79	-	-	-	-	-	-	= (45*30%) + (35*40%) + (20 *32%) = 34[3]	34
H=F-G	Net losses allowed to be set off/ carried forward	30	70	120	155	175	100	66	141
I=F-H	Taxable Income	-	-	-	-	-	-	34	34

Therefore, from the above, one can see that there is a saving of losses of 46 million INR [i.e. 80-34 million INR] under the computation, as provided in Recommendation 1.

1. In Year 5, since the combined shareholding of A and B falls below the 51% level, the losses relating to years 1 and 2 lapse, under the current provisions of section 79.
2. In Year 7, angel investor C has exited from the company. Therefore, the change in shareholding has gone below the threshold of 51% as compared to that in years 3 and 4. Following the FIFO method of set off of losses, the losses of 30 million INR brought forward at the start of Year 7 relate to Year 5 (20 million INR) and Year 4 (10 million INR). Therefore, only the amount of 10 million INR relating to Year 4 has lapsed in this year. After setting off the losses of Year 5, the company is liable to pay taxes on 80 Million INR.
3. Under the proposed provisions, brought forward losses relating to those years shall lapse to the extent of the loss which relates to the existing investor's shareholding. Therefore, losses do not lapse between years 3 and 6, when there is only additional funding taking place.

However, in Year 7, where angel investor C has exited, the brought forward losses of years 3 to 5 (i.e. the loss-making period during which it was a shareholder of the company) shall lapse to the extent of the respective shareholding of C.

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About Snapdeal

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