

Tax Implications and Controversies around Buyback of Shares



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Background

The Finance Act, 2013 introduced the provision of section 115QA (i.e. Tax on distributed income to shareholders) in the Income-tax Act, 1961 ('the Act'). This section creates a charge on domestic unlisted companies to pay additional income tax on the buyback of shares from the shareholders.

As per the Memorandum to the Finance Act, 2013, the intention behind the introduction of such provision was to bring within the tax net unlisted companies that resort to buyback of shares instead of payment of dividend in order to avoid dividend distribution tax which was levied under section 115-O r.w.s.2(22) of the Act.

Further, the Memorandum to the Finance Bill, 2019, mentioned that instances of even listed companies indulging in the similar practice of restoring to buyback of shares instead of payment of dividend had been noticed. Accordingly, vide Finance Act (No.2) of 2019 section 115QA has been expanded to include even listed companies within its ambit.

In the hands of the shareholders, any income arising from the buyback of shares held by it shall be exempted from tax under section 10(34A) of the Act.

Taxability in the hands of the company

As per the provision of section 115QA of the Act, where the consideration paid by the company for the purchase of its own shares (i.e. buy back of shares) is in excess of the sum received by it at the time of issue of such shares, then, such excess amount i.e. "Distributed Income", paid to the shareholders will be chargeable to tax in the hands of the company at the rate of 20% (plus applicable surcharge and cess)(hereinafter referred as Buyback Tax ('BBT')).

"Distributed Income" is the consideration paid by the company on buyback of shares as reduced by the amount, which was received by the company for the issue of such shares.

Rule 40BB of the Income-tax Rules, 1962 ('the Rules') prescribes the methodology for determining the amount received by the company for the issue of shares under different circumstances such as shares issued pursuant to amalgamation, demerge, ESOP, consideration in kind, bonus shares etc.

Overview of the provision of section 115QA of the Act

- The section provides for a levy of additional tax on the company by terming it tax in respect of Distributed Income.
- The provision starts with a non-obstante clause and applies notwithstanding any provision to the contrary in the Act.
- BBT is payable by a domestic company in addition to income tax which is chargeable in respect of its total income.

- It specifically provides that the company shall be liable to pay BBT even if no income tax is payable by the company under other provisions of the Act.

Taxability in the hands of the Shareholder

Scope of section 10(34A) of the Act

- It provides an exemption in respect of income which arises to the shareholder on account of buyback of shares by the company as referred under section 115QA of the Act.
- As per explanation to Section 115QA, "buyback" means purchase of share by the company in accordance with the provision of any law for the time being in force in relation to such companies.
- Thus, any income that arises to the shareholder on account of buyback of shares by a domestic company in accordance with the provision of any law for the time being in force should be exempt in the hands of the shareholder. Such exemption is available irrespective of whether shares bought back are held as stock in trade or capital assets or whether income is in the nature of capital gains or business income for the shareholders.

While the provision of section 115QA rw Rule 40BB provides clarity on various aspects, there are still many issues which need to be addressed while applying the said provisions practically. Specific practical issues/ambiguities arising from the interpretation and implementation of the provision of section 115QA rw Rule 40BB are discussed below:

Whether the provision of section 115QA of the Act will get triggered in case of a capital reduction (effected via National Company Law Tribunal ('NCLT') scheme under section 66 of the Companies Act 2013)?

- Here it is essential to evaluate whether, the provisions of section 115QA are wide enough to cover NCLT approved capital reduction within its scope. The amendment to section 115QA in 2016, which now covers consideration paid on buyback without referring to the specific provisions of the Companies Act under which buyback may be undertaken. The Explanation to section 115QA (prior to amendment in 2016) defined 'buyback' to mean purchase by a company of its own shares in accordance with the provision of section 77A of the Companies Act 1956. Thus, buy back undertaken under the other provision of the Companies Act (say section 391 read with section 100 to 104 of the Companies Act 1956) were not covered within the purview of section 115QA of the Act. The Hon'ble Bombay High Court also took this view in the case of Capgemini India (P.) Ltd¹
- Relevant extracts of the Memorandum to Finance Act, 2016 amending the definition of buyback under section 115QA of the Act is reproduced as under:

For the purpose of section 115QA of the Act, it is the effect of buyback being in the nature of distribution of income which is relevant rather than particular provision of the law relating to companies under which it has been undertaken.....

In order to provide clarity and remove any ambiguity on the above issues, it is proposed to amend section 115QA of the Act to provide that the provision of this section shall apply to any buyback of unlisted shares undertaken by the company in accordance with the provisions of the law relating to the Companies and not necessarily restricted to section 77A of the Companies Act 1956.....

- In view of the amended definition of buyback in section 115QA of the Act, a question arises whether shares cancelled pursuant to capital reduction would also fall within the purview of section 115QA of the Act.

¹Company Scheme Petition No.434 of 2014

- The following arguments may help to contend that capital reduction ought not to be covered by section 115QA of the Act.

The provisions of the Act regarding taxability of capital reduction transaction and buyback transaction have been provided distinctly. As per section 2(22) of the Act, dividend includes *inter-alia* any distribution to its shareholder by the company on the reduction of its capital, to the extent to which the company possesses accumulated profits.

The Hon'ble Supreme Court in the case of G Narasimhan² has held that distribution on reduction of capital by the company, to the extent of the accumulated profits, would be taxable as dividend and balance may be subject to capital gains in the hands of the shareholder.

Therefore, there is a specific provision of the Act and Supreme Court ruling specifically dealing with capital reduction transaction. As per the rules of interpretation of the statute, a specific provision in law overrides a general provision. Accordingly, section 2(22) of the Act being the specific provision on capital reduction, shall override section 115QA of the Act.

Further, while the meaning of the term 'buyback' for the purposes of section 115QA of the Act is amended to cover purchase by a company of its own shares in accordance with the provision of any law relating to companies (and not restricted only to section 68 of the Companies Act 2013), corresponding amendment is not made to sub-clause (iv) of section 2(22) of the Act to exclude capital reduction from the purview of section 2(22) of the Act.

Therefore, a view is possible that the distribution of accumulated profits in the case of capital reduction still fall within the ambit of section 115-O rw 2(22)(d) of the Act. If the capital reduction is also to be taxed under section 115QA, then section 2(22)(d) of the Act will become redundant or lead to double taxation of the same income, which cannot be the intention of the law.

The decision of the Mumbai Tribunal in the case of Goldman Sachs³ also support the proposition that buyback is different from capital reduction.

In the case of capital reduction, the shares stand directly cancelled, the same may not be tantamount to the purchase of shares by the company within the meaning of section 115QA of the Act.

Section 66(6) of the Companies Act 2013 dealing with capital reduction provides that “*Nothing in this section shall apply to buyback of its own securities by a company under section 68*”. Accordingly, this further supports the above contention that the company law also provides a distinction between buyback of shares and capital reduction.

- Having regard to the above contentions, the provisions of section 115QA of the Act should be restricted to buyback of issued share capital and should not apply in case of capital reduction. However, the revenue authorities may take a divergent view and allege that the transaction of capital reduction is akin to the purchase of own shares. Accordingly, section 115QA of the Act should apply. It is essential that the company maintains adequate documentation to demonstrate that capital reduction is the cancellation of shares and does not involve any purchase of shares by the company.

For determining Distributed Income, whether all the shares which are being bought back by the company needs to be considered on a consolidated basis (qua an event) or should it be calculated vis-à-vis each shareholder/each share)?

²[1999] 236 ITR 327 (SC)

³ITA No.3726/Mum/2015

- The above issue is explained by way of an illustration as under:

XYZ Private Limited ('XYZ') is proposing to buyback equity shares as per the provision of the Companies Act, 2013. Pursuant to the announcement made by XYZ, multiple shareholders may furnish shares which may have been allotted by XYZ in different tranches. Consideration paid on the buy back of each share is same i.e. INR 300 per share. Shareholders X, Y and Z have placed the following 3 shares for the buyback.

Shareholder	Buyback consideration (A)	Mode of shares issue	Amount received on issue (B)	Distributed income (A) - (B)
X	300	Tranche I - Shares issued at a premium	650	(350)
Y	300	Tranche II- Bonus	0	300
Z	300	Tranche III- Shares issued at face value	100	200
Total	900		750	150

- In the above situation, the issue arises whether BBT will be payable only on INR 150 or INR 500 (INR 300 + INR 200 for Tranche II and III, respectively)?
- The tax authorities on the following premises may likely to contend that, BBT is payable on INR 500 and the benefit to set-off INR 350 is not available.

Negative value of distributed income ought to be considered as nil as there is no set-off provision in section 115QA of the Act.

There is a sale by each shareholder.

The amount is paid to each shareholder separately. It is therefore, possible to compute Distributed Income for each shareholder/share separately.

- The following arguments may support a view that BBT is payable on INR 150.

While the amount is paid to each shareholder separately, it still qualifies as the consideration paid by the company on buyback. Further, even the amount received by the company for the issue of shares is more than the consideration paid on buyback, it still qualifies as the amount received by the company for the issue of shares which are bought back. Therefore, with presence of amount paid to the shareholder on buyback and amount received from the shareholder for the issue of shares, computation of Distributed Income is possible.

The entire section refers buyback of given shares (plural).

The following provisions of the Companies Act and Rules indicate that the buyback is an event.

- ❑ The offer is made to all the shareholders, fixed consideration for all the shareholders.
- ❑ The offer remains open for the same number of days for all the shareholders.
- ❑ In case of an excess number of valid applications qua the offer size, the acceptance needs to be on a proportionate basis.
- ❑ There is a single date of completion of buyback.
- ❑ Securities bought back needs to be extinguished and physically destroyed within 7 days of the last day of completion of the buyback.
- ❑ The company needs to file a return with MCA qua the event of buyback.
- There is no specific provision under section 115QA of the Act read with Rule 40BB of the Rules suggesting that gains on buyback have to be computed separately qua each shareholder/share. Accordingly, it may be possible to adopt a view that while computing the Distributed Income, consolidation could be done for all the shares bought back, and only the net income (INR 150) ought to be subject to BBT.
- In this regard, the following steps could be adopted :-

The computation of distributed income as under:-

- a) Identification of shares purchased.
- b) Determination of the amount received for each such share in the prescribed manner.
- c) Aggregating such amount received from all shareholders
- d) Computing total consideration paid by the company for buyback of all the shares.
- e) Distributable income is equal to (d) – (c).

For the purpose of determining the amount of each such share as mentioned in clause (b) above, the amount received by the company for the issue of such shares has to be determined individually shareholder wise as per Rule 40BB of the Rules.

Thus, net distributed income is to be computed for all the shareholders together at a company level on the difference between the consideration paid by the company for buyback of shares and the total amount received by the company on such shares.

Whether buyback of shares at a price below Fair Market Value ('FMV') (determined as per Rule 11UA of the Rule) of such shares would attract provisions of section 56(2)(x) of the Act, in the hands of the company undertaking buyback of equity shares?

- Section 68 of the Companies Act 2013 (erstwhile section 77A of the Companies Act, 1956) empowers a company to buy back its own shares or other specified securities. A company is required to ensure compliance with the provision of the said section to conduct a buyback.
- As per section 68(7) of the Companies Act 2013, once the buyback process is completed, the company shall, within seven days of the last day of the completion of buyback, extinguish and physically destroy the shares bought back by the company.

- The provision of section 56(2)(x) of the Act are attracted when any person receives, *inter-alia*, any shares for a consideration which is less than the FMV of such shares. The difference between the FMV of such shares and the consideration received would be chargeable to tax as 'Income from other sources' in the hands of a recipient.
- The term 'receives' as mentioned in section 56(2)(x) is not defined in the Act. As per the Advanced Law Lexicon Dictionary, the term 'receive' has been defined as "To receive means to get by a transfer, to receive a gift, to receive a letter, or to receive money and involves an actual receipt.
- Whether the meaning of the term "receives" can be extended to the temporary custody of shares on account of buyback of shares by an Indian company which are subsequently extinguished in accordance with the provision of section 68 of the Companies Act, 2013.
- Such an interpretation may not be entirely apt, as section 67 of the Companies Act 2013 restricts a company from issuing shares to itself. Hence, no company can hold its own shares. The company cannot be called as a 'recipient' of its own shares on buyback, which are received merely for cancellation/extinguishment.
- The company making a buyback under section 68 has to maintain a register of the shares or securities bought back as per Companies (Share Capital and Debentures) Rules, in Form SH-10. The format of SH-10 has field (the name of the last holder of the security bought back), it does not mention the company's name as the holder of the securities bought back.
- In this context, reliance can be placed on the decision of the Mumbai Tribunal in the case of Vora Financial Services (P) Ltd⁴. Wherein in relation to the provision of section 56(2)(viiia), it was held that deeming provision would not be applicable in case of buyback in the hands of the recipient of the shares. The relevant extract of the judgement are cited below –

"Therefore, it follows the shares should become "property" of recipient company and in that case, it should be shares of any other company and could not be its own shares. Because own shares cannot become property of the recipient company. Accordingly, we are of the view that the provisions of section 56(2)(viiia) should be applicable only in cases where the recipient of shares become property in the hands of recipient and shares the shall become property of the recipient only if it is "shares of any other company". In this instant case, the assessee herein has purchases its own shares under buyback scheme and the same has been extinguished by reducing the capital and hence the tests of "becoming property" and also "shares of any other company" failed in this case. Accordingly, we are of the view that the tax authorities are not justified in invoking the provision of section 56(2)(viiia) for buyback of own shares".

- Additionally, it can also be argued that when shares are held in dematerialised form, there may not be a receipt even as custodian of shares as there is no receipt in the hands of the company.
- In light of the above discussions, provisions of section 56(2)(x) of the Act may not apply to the buyback of shares in the hands of the company. However, considering that section 56(2)(x) is relatively new, having limited jurisprudence, litigation with the tax authorities cannot be ruled out.

Whether the expenses incurred in relation to buyback of share can be claimed under section 37(1) of the Act?

- Often during the process of buyback, companies incur various expenses such as brokerage fees, SEBI Fees, expenses on advertisements, stock exchange fees, legal charges, certification fees etc. The buyback is a process where the share capital of the company is reduced. Since the capital is reduced, there is no creation of any assets or enduring benefit. Hence, these expenses should be treated as revenue in nature.

⁴ITA 532/Mum/2018 (Mumbai Tribunal)

- The Delhi High Court in the case of Selan Exploration Technology Limited⁵ held that “ *where no such flow of funds or increase in the capital employed, the expenditure incurred would be revenue expenditure, as in such a case the company would not acquire benefit or addition of enduring nature*”.
- A similar view has been upheld in the case of Aditya Birla Nuvo Ltd⁶, Bayer Vapi (P.) Ltd⁷, Bramha Bazar Hotels Ltd⁸, Merck Ltd⁹.
- It is imperative to note that the nature of buyback expenses may impact the allow ability of the expense. The expenditure incurred should be in relation to carrying out the buyback scheme or for implementation of buyback of shares and may not include the price paid to the shareholder for buying back the shares.
- Further, as per provision of section 115QA(5) of the Act, no deduction is allowed to the company in respect of BBT paid. Here it would be interesting to explore whether the 'education cess' paid on BBT can be claimed as a deduction by adopting the principles emanating from the following decisions :-
 - Education cess paid on income tax held as allow able deduction
Chambal Fertilisers and Chemicals Limited¹⁰
Sesa Goa Limited¹¹
(*There are catena of Tribunal decisions allowing deduction of education cess*)
 - Education cess paid on dividend distribution tax held as allow able deduction in case of Aditya Birla Nuvo Ltd¹².

Whether the capital loss incurred by the shareholder on the buyback can still be claimed by the shareholder?

- Section 10(34A) of the Act provides for an exemption of “ *any income arising to an assessee, being a shareholder, on account of buyback of shares by the company as referred in section 115QA*”.
- Here the department may raise a contention that when a source of income is exempt from tax, then as a corollary, even loss from such source of income cannot be set-off against any other income that is chargeable to tax.
- In this regard, the reference to the decision of Hon'ble Supreme Court in the case of J.H.Gotla¹³ would be relevant, wherein it was held that income includes loss.
- There is no direct judicial precedent dealing with the issue of set-off / carry forward of capital loss on the buyback of shares by the shareholder. Further, the judicial view in the context of allow ability of long-term capital loss arising out of the sale of shares [covered within the scope of section 10(38)] is also divided as discussed below.

In the following decisions, the claim of long term capital loss on listed equity shares (on which Security Transaction Tax ('STT') is paid) was allowed on the premise that

when a source of income (Capital Gain under section 45) is otherwise chargeable to tax, but only specific item of income derived from such source is granted exemption (income under section 10(38)), in such cases, the proposition that the term “ *income*” includes loss will not be applicable.

⁵ITA No.508 of 2009 (Delhi High Court)

⁶ITA No. 1571 of 2014 (Bombay High Court)

⁷ITA No.166 of 2019 (Gujarat High Court)

⁸ITA No.1721 of 2013 (Bombay High Court)

⁹ITA No.726 of 2017 (Bombay High Court)

¹⁰ITA No.52 of 2018 (Rajasthan High Court)

¹¹ITA No.17 of 2013 (Bombay High Court)

¹²ITA No. 2525/Mum/2014 (Mumbai Tribunal)

¹³[1985] 156 ITR 323 (SC)

Raptako Brett and Co. Ltd¹⁴
 United Investments¹⁵
 Somnath Vaijanath Sakre¹⁶
 Nomura India Investment Fund Mother Fund¹⁷
 Shiv Kumar Jatia¹⁸

In the following decisions it has been held that profits arising from the transfer of shares on which STT is paid are exempt under section 10(38) of the Act. Therefore loss arising from such source also cannot be set-off against any other income which is chargeable to tax.

Appolo Tyres Ltd¹⁹
 Kishorebhai Bhikhabhai Virani²⁰
 Asia Pacific Performance SICAV²¹
 G.K.Ramamurthy²²
 Nikhil Sawhney²³

- The above favourable ruling in the context of section 10(38) of the Act can be distinguished on the premise that, charging provision of the buyback is covered in section 46A of the Act and not under section 45 of the Act. Since section 46A deals with only capital gains on buyback of shares, the tax authorities can argue that the entire source of income under section 46A is exempt under section 10(34A) of the Act.
- Additionally, the Central Board of Direct Tax vide the FAQ²⁴ (Question 23) has clarified as under:-

“As the exemption from long-term capital gains under clause 10(38) of section 10 will be available for transfer made between 1st February 2018 and 31 March 2018 the long term capital loss arising during this period will not be allowed to be setoff or carried forward”

In view of the above discussion and in the absence of direct judicial precedent, loss on account of buyback of shares may not be allowed to the shareholder.

Closing remarks

The above discussion is on the selected issues emanating from the interpretation and practical implementation of section 115QA of the Act and Rule 40BB of the Rules. There could be many more issues on several aspects such as whether redemption of preference shares and shares bought back pursuant to compromise or arrangement under section 230 of Companies Act 2013 gets covered under section 115QA of the Act, whether under a treaty the BBT is creditable in the hands of the non-resident shareholder, determination of the amount received by the company in case of buyback of split or consolidated shares, the applicability of transfer pricing provisions in case buyback is from associate enterprise, etc. The detailed analysis of the income tax provision in light of peculiar facts of the buyback scheme is paramount. Also, it is essential to evaluate the entire buyback transaction under the lens of General Anti Avoidance Rules) ('GAAR') before practically implementing the same.

¹⁴ ITA No.3317/Mum/2009 & ITA No.1692/Mum/2010 (Mumbai Tribunal)

¹⁵ ITA No.522/Kol/2017 (Kolkata Tribunal)

¹⁶ ITA No.2986/Pun/2016 (Pune Tribunal)

¹⁷ ITA No.8140/Mum/2010 (Mumbai Tribunal)

¹⁸ ITA No.241/Del/2019

¹⁹ ITA No.216 of 2013 (Kerala High Court)

²⁰ ITA No.440 of 2013 (Gujarat High Court)

²¹ ITA No.7106/Mum/2010 (Mumbai Tribunal)

²² ITA No.1367/Mum/2009 (Mumbai Tribunal)

²³ ITA No.1248/Del/2017 (Delhi Tribunal)

²⁴ (F No.370149/20/2018-TPL) dated 4 February 2018

