Restructuring the shareholding pattern: Transfer of Shares, Capital Reduction, Conversion of Securities

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"Restructuring encompasses formulating a new structure, to rebuild or to rearrange. It starts with the intention of redefining or researching on the purpose of doing business. Once the purpose is adequately explored and examined, scope for restructuring surfaces"

- With rapid advances in information technology and acute resource constraints across the globe, the business world has become more complex and fluid in recent times. To survive and compete the present day, organizations have to put more emphasis on the business process as a whole to achieve certain predetermined objectives at corporate level. Such objectives include the following:

- orderly redirection of the firm's activities;
- deploying surplus cash from one business to finance profitable growth in another;
- exploiting inter-dependence among present or prospective businesses within the corporate portfolio;
- diversification and risk reduction; and
- development of core competencies

- Business restructuring is the process of significantly changing a company's business model, management team or financial structure to address challenges and increase shareholder value. It is an inorganic growth strategy to ensure long term viability.

The restructuring process requires various aspects to be considered before, during and after the restructuring. They are:

- Valuation & Funding
- Legal and procedural issues/ regulatory approvals and disclosures
- Taxation and Stamp duty aspects
- Accounting aspects
- Competition considerations etc.
- Human and Cultural synergies

Based on the analysis of aforesaid aspects, an appropriate strategy is determined and implemented.

- Various techniques of Business Restructuring include the following

Expansion Techniques	Divestment Techniques	Other Techniques
Merger	Sell – off / Hive off	Going Public / IPOs
Takeover	Demergers	Share Repurchasing/ Buyback
Joint Ventures	Slump sale	Share Transfers
Strategic Alliance	Leveraged Buy outs	Capital reduction
Franchising	Liquidation/ winding off	Conversion of securities
Holding Companies		Legal entity rationalization

1. Transfer of Shares

1.1 General overview

1.2 Tax implications

The authority responsible for tax on transfer of shares includes the following: The Central Board of Direct Taxes, which is a part of the Department of Revenue in the Ministry of Finance. The Central Board of Direct Taxes supports policy framing and planning for direct taxes, which are administered federally through the income tax department
Stamp Duty Authorities

A) Capital Gains Tax:

i) **Where Securities Transaction Tax ('STT') is paid** (for an equity share in a company),the tax rates (excluding surcharge and cess) are as follows:

- (STT paid at the time of acquisition and transfer) for a long-term capital asset, the gains exceeding INR100,000 are subject to a tax of 10% for residents and non-residents

- (STT paid at the time of transfer) for a long-term capital asset, the gains are taxable at 20% (with indexation benefit) and 10% (without indexation benefit) for residents and non-residents

- (STT paid at the time of transfer) for a short-term capital asset, the gains are taxable at 15% for residents and non-residents

ii) **Where no STT is Payable**(for an equity share in a company),the tax rates (excluding surcharge and cess) are as follows:

- Domestic companies:

- short-term capital gains: 30%; and
- long-term capital gains: 20%
- FPIs:
- short-term capital gains: 30%; and
- long-term capital gains: 10%
- Non-residents(including body corporates) other than FPIs:
- short-term capital gains: 40%;
- long-term capital gains: 10% (without indexation and foreign exchange fluctuation benefit);

iii) Capital gains = Full Value Consideration (less) expenses incurred wholly and exclusively in connection with transfer (less) cost of acquisition/ indexed cost of acquisition (less) cost of improvement/ indexed cost of improvement.

One needs to determine each of the aforesaid parameters adequately and also the period of holding of shares as contained under the Indian income tax provisions, to further determine the capital gains (long term/ short term).

iv) The following transactions are exempt from tax (subject to certain conditions):

- The transfer of a capital asset by a holding company to its wholly-owned Indian subsidiary, or the transfer of a capital asset by a wholly-owned subsidiary to its Indian holding company.
- Transfers involving the conversion of bonds, debentures, debenture stocks and deposit certificates into shares and debentures of the same company.
- Transfer by way of conversion of preference shares into equity shares of a company.
- Any transfer of shares between shareholders in certain corporate restructurings such as company mergers and demergers.

B) Other considerations

- The transaction value is to be in accordance with Indian income tax provisions and supported by a Valuation Report or it may lead to gif tax implications for the transferee
- In the case of closely held companies, losses cannot be carried forward and set off if more than 49% of equity shares change hands. However, companies that undergo a change in shareholding under an insolvency resolution plan can apply to the jurisdictional tax authority for an exception from this rule.
- A non-resident seller can be exempt from tax on the sale of shares under a DTAA.
- A non-resident is not necessarily able to take credit for securities transaction tax paid on a disposal of shares. The non-resident can also be required to comply with an annual tax filing and comply with transfer pricing rules in the case of a sale to a related party.

- Tax clearances: In the case of a pending proceeding against the transferor, the tax authorities have the power to claim any tax on account of completion of the proceeding from the transferee. Income tax law provides the mechanism for obtaining a tax clearance certificate for transfer of assets/business.

- Indirect taxes: No indirect taxes are applicable on transfer of shares

- Stamp duty: Stamp duty is payable on specified instruments and documents (i.e. share transfer deeds, share subscription agreements, share purchase agreements etc). Generally, stamp duty is charged at a percentage of the value in the instrument liable to stamp duty. The rates of stamp duty on instruments differ from state to state in India. However, transfers of shares (on delivery basis) are subject to stamp duty at the rate of 0.015 percent of the market value of the shares transferred under the Indian Stamp Act. The buyer generally pays the stamp duty. However, parties to an agreement can agree otherwise

- Securities Transaction Tax: STT may be payable if the sale of shares is through a recognized stock exchange in India. STT is imposed on purchases and sales of equity shares listed on a recognized stock exchange in India at 0.1 percent based on the purchase or sale price. STT is payable both by the buyer and the seller on the turnover (which is a product of number of shares bought/sold and price per share).

- Tax indemnities and warranties: In a share acquisition, the purchaser takes over the target company together with all its related liabilities, including contingent liabilities. Hence, the purchaser normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

1.3 Legal and Regulatory considerations:

The following laws needs to be adhered to from a legal and regulatory perspective

- Provisions contained under the Companies Act, 2013 and the rules, orders, notifications and circulars issued thereunder
  - prescribes the procedure for the transfer of shares by public and private companies including passing of Board resolutions and shareholders resolutions
  - a company will register the transfer of shares and other securities only upon successfully filing of share transfer form i.e. Form No.SH 4 - duly stamped with adequate value executed on the behalf of the transferor and transferee
  - Company shall register the transfer of securities of beneficial owners with the proper instrument of transfer is not more than sixty days from the date of execution.

- Provisions contained under the Foreign Exchange Management Act, 1999and the rules and regulations issued thereunder, read together with the circulars, directions and rules issued by the Reserve Bank of India (where transfer is between a resident and a non-resident)
  - Contains pricing guidelines for determination of price at which securities of an Indian company can be issued,
  - Contains sector related restrictions and sectorial caps i.e. permitting investments in certain sectors under automatic route and others under Government approval route
  - Specifies the various reporting requirements

- Securities and Exchange Board of India Laws (where transfer pertains to listed securities)

  Governs the transfer of listed shares, requirements of making open offer on crossing certain thresholds, pricing, exemptions etc

  Lays out the disclosure requirements pre-transfer and post transfer

- Provisions contained under the Competition Act, 2002 - Notifiable transactions are reviewed and regulated by the Competition Commission of India (CCI), a quasi-judicial body set up under the Competition Act, 2002

2. Capital Reduction

2.1 General Overview

- Share Capital Reduction is the trimming of issued, subscribed and paid-up capital of a company. Companies reduce their existing share capital for a variety of reasons some of which include making the capital structure more efficient or eliminating losses or providing returns to the shareholders.

- A company limited by shares or a company limited by guarantee and having a share capital may, if authorized by its articles, by special resolution, and subject to its confirmation by the Court on petition, reduce its share capital in any way and in particular: (a) by reducing or extinguishing the liability of members in respect of uncalled or unpaid capital e.g., where the shares are of Rs. 100 each with Rs. 75 paid-up, reduce them to Rs. 75 fully paid-up shares and thus relieve the shareholders from liability on the uncalled capital of Rs. 25 per share; (b) by paying off or returning paid-up capital not wanted for the purposes of the company, e.g., where the shares are fully paid-up, reduce them to Rs. 75 each and pay back, Rs. 25 per share; (c) by paying off the paid-up capital on the conditions that it may be called up again so that the liability is not extinguished; (d) by following a combination of any of the preceding methods; (e) by writing off or canceling the capital which has been lost or is under represented by the available assets

- In the recent past, a few companies like Syngenta India Limited, Atlas Copco, etc. have, after their delisting from the stock exchanges, followed the Sec 66 of Companies Act, 2013 route to selectively reduce their non-promoter capital and provide a means of exit to minority shareholders.*[1]* Sec 66 allows a company to distinguish between shareholders of the same class by compulsorily extinguishing their holding without affecting others within the same class. This is one form of Share Capital Reduction.

2.2 Tax implications

Since, the shareholder is receiving some form of income/return on the investment he/she has made, there is bound to be a liability to pay income tax.

Taxability on reduction of share capital can be dividend in the following two parts:

A) Part I – Taxability as dividend income

- Any distribution by a company on reduction of its capital is 'dividend' to the extent to which the company possesses accumulated profits, whether capitalized or not, shall be taxable as dividends

- As per the Supreme Court ruling in the case of *PK Badiani*,[1] accumulated profits can be interpreted as profits made by the company in a real and true sense and not merely assessable profits or profits liable to tax, as a company distributes dividend out of its business profits and not out of its assessable income. Further, in the case of *Shree Balaji Glass Manufacturing Pvt. Ltd.*, [2] the High Court of Calcutta held that securities premium should not be considered as accumulated profits for the purposes of capital reduction. This view has been upheld subsequently in other cases as well and is thus a settled view. However, CRR is created out of a company's profits under certain circumstances like buybacks, as per the provisions of the Companies Act, 2013 . Essentially, a transfer to CRR is merely a book entry to comply with the provisions of the law. The wording of section 2(22) of the Act reads as "*accumulated profits, whether capitalized or not*". From this, it appears that CRR forms a part of accumulated profits.

- Dividends is taxable in the hands of shareholders. The domestic company paying dividends (in this case reducing the share capital) shall be liable to deduct taxes.

i. Taxability in the hands of resident shareholders:

- Head of income for taxability:

  A person can deal in securities either as a trader or as an investor. The income earned by him from the trading activities is taxable under the head business income. Thus, if shares are held for trading purposes then the dividend income shall be taxable under the head business or profession. Whereas, if shares are held as an investment then income arising in nature of dividend shall be taxable under the head other sources.

- Withholding tax liability

  An Indian company shall deduct tax at the rate of 10% from dividend distributed to the resident shareholders if the aggregate amount of dividend distributed or paid during the financial year to a shareholder exceeds Rs. 5,000.

- Taxability in the hands of shareholders

  In the hands of shareholders, dividend income shall be chargeable to tax at normal tax slab rates as applicable in case of an assessee.

- Deduction of expenses

  Where dividend is assessable to tax as business income, the assessee can claim the deductions of all those expenditures which have been incurred to earn that dividend income such as collection charges, interest on loan etc.

  Whereas if dividend is taxable under the head other sources, the assessee can claim deduction of only interest expenditure which has been incurred to earn that dividend income to the extent of 20% of total dividend income. No deduction shall be allowed for any other expenses including commission or remuneration paid to a banker or any other person for the purpose of realizing such dividend.

ii. Taxability in the hands of non-resident shareholders

- Head of income for taxability

  A non-resident generally invests in India either directly as private equity investors or as Foreign Portfolio Investors (FPIs). A non-resident person can also be a promoter of an Indian Company. A non-resident person generally hold shares of an Indian company as an Investment and, therefore, any income derived by way of dividend is taxable under the head other sources except where such income is attributable to Permanent Establishment of such non-resident in India.

  As regards FPIs, securities held by them are always treated as a capital asset and not as stock-in-trade. Thus, in case of FPIs also, the dividend income shall always be taxable under the head other sources.

- Withholding tax liability

  Where the dividend is distributed to a non-resident shareholder, the tax shall be required to be deducted as per section 195 of the Income-tax Act. As per section 195, the withholding tax rate on dividend shall be as specified in the Finance Act of the relevant year or under Double Taxation Avoidance Agreement ('DTAA'), whichever is applicable in case of an assessee.

  The dividend income, in the hands of a non-resident person (including FPIs and nonresident Indian citizens (NRIs)), is taxable at the rate of 20% without providing for deduction under any provisions of the Income-tax Act, However, one needs to consider the eligibility to claim beneficial rate as contained in the relevant read with the Multilateral Instrument to determine the dividend taxation rate for non-residents as If the withholding tax rate as per DTAA is lower than the rate prescribed under the Finance Act then tax shall be deducted at the rate prescribed under DTAA

B) Part II – Taxability as capital gains

- Where the reduction is greater than the accumulated profits, then it is a case of genuine reduction of capital. Reduction of share capital by a company and paying off the balance to the shareholders would result in extinguishment of rights in the shares held by the shareholder and would amount to transfer. On reduction of share capital the rights of the shareholders in the dividend and net assets are extinguished. Therefore, capital gains would arise (Supreme Court decision in the case of Kartikeya V. Sarabhai v CIT (1997) and *G. Narasimhan*).

- Taxability of capital gains shall be the same as highlighted above for "transfer of shares"

- Applicability of deemed income tax provisions: Section 56(2)(x) of the Act provides for taxation in the hands of the recipient in case of receipt of property for inadequate consideration.

- However, in case of capital reduction, the shares are cancelled immediately on the scheme becoming effective. Therefore, in essence, the company does not receive any property and therefore, should not be subjected to tax. This view has been upheld in the context of buyback by the Mumbai Tribunal in the case of Vora Financial Services Pvt. Ltd.[5] as well. Further, the cost of the property which has been subject to taxation under section 56 has been specifically provided under section 49. This implies that for section 56 to apply, the property should remain in existence even after receipt, which necessitates providing for a cost for such properties in section 49. Based on the above arguments, one might possibly argue that section 56 should not apply to capital reduction.

2.3 Procedure for capital reduction[1]:

i. Convene a Board Meeting a) To approve the reduction of share capital; b) To fix the date of general meeting of the company to get approval of members.

ii. Hold the general meeting and pass Special Resolution approving reduction of share capital.

iii. File e-form MGT-14 with ROC within 30 days of passing the Special Resolution.

iv. Apply to NCLT by filing an application to confirm reduction of share capital of a company along with prescribed fees. The application shall be accompanied with the prescribed attachments.

v. The NCLT shall within 15 days of submission of the application give a notice to Central Government, ROC and SEBI and to every creditors of the company in prescribed form seeking their representations and objections, if any.

vi. The notice shall be sent, within 7 days of the direction or such other period as may be directed by the Tribunal, to each creditor whose name is entered in the list of creditors submitted by the company about the presentation of the application and of the said list, stating the amount of the proposed reduction of share capital and the amount or estimated value of the debt or the contingent debt or claim or both.

vii. The NCLT shall also give direction for the notice to be published within 7 days of such direction in a leading English and vernacular language newspaper, both having wide circulation in the State in which the registered office of the company is situated, or such newspapers as may be directed by the Tribunal and for uploading on the website of the company (if any) seeking objections from the creditors and intimating about the date of hearing.

viii. The Company shall file an affidavit confirming the dispatch and publication of the notice within 7 days from the date of issue of such notice.

ix. Representation by Central Government, ROC, SEBI and creditors shall be sent to the NCLT within 3 months of receipt of notice and copy of which shall also be sent to the company. If no such representation has been received by NCLT within the said period, it shall be presumed that they have no objection to the reduction.

x. Company shall send the representation or objections so received along with responses of the company thereto to the NCLT within 7 days of expiry of period up to which objections were sought.

xi. The Tribunal may, if it is satisfied that the debt or claim of every creditor of the company has been discharged or determined or has been secured or his consent is obtained, make an order confirming the reduction of share capital on such terms and conditions as it deems fit.

xii. The order of confirmation of the reduction of share capital by the Tribunal shall be published by the company in such manner as the Tribunal may direct.

xiii. The company shall deliver a certified copy of the order of the NCLT and of minute approved by the Tribunal to the ROC within 30 days of the receipt of order.

xiv. The ROC shall issue a certificate to that effect.

[1] *Brief procedure has been highlighted. The same is subject to confirmation from lawyers/ subject matter experts*

<u>**Other compliances**</u>

- Additional compliance by a Listed Company: In case a listed entity is in the process of implementation of any scheme with respect to reduction of capital they have to comply with various provisions under SEBI (LODR) Regulations, 2015.
- Transfer of shares by a non-resident to an Indian company under capital reduction scheme of the company require to comply with the provisions of Foreign Exchange Management Act, 1999, Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 read with Foreign Direct Investment (FDI) Policy 2020.
- Stamp duty consideration need to be considered.

(Please note the Article is based per the laws and regulations contained as on the date of this Article. In case of any subsequent amendments to the laws and regulations, the Article needs to be revisited. I have expressed my views in the said Article. They are not linked to the views of my employer)