Capital reduction and Buy-back of Shares - Tax and Allied Aspects

CA. Paras K. Savla

SPECIAL STORY

1.1 Capital reduction and buyback of shares are one of the techniques of corporate restructuring. It leads to return of financial slack and also amounts to liquidating future dividend in the hands of shareholders. Broadly, excluding certain exceptions both of the techniques try to achieve the same objectives.

1.2 Capital reduction and buyback of shares have following objectives:

a) To reorganise the capital structure of the company

b) To distribute cash to shareholders. This being not a regular exercise, it does not raise expectation of the shareholder for higher future dividend.

c) To optimise own funds and manage EPS & ROE

d) To squeeze out minority shareholders

e) To increase promoter-holding

f) To support share-price during period of temporary weakness

g) To prevent unwelcome takeover bids

Further capital reduction tool is also used for internal restructuring especially when company has huge book losses.

1.3 However, under both these techniques there are different tax consequences in the hands of shareholders and companies. Let us analyse one by one:

2. Capital Reduction

2.1 Under Companies Act 1956 (CA) Capital Reduction can be in situation:

(i) Capital reduction u/s 100 to 104 of CA

(ii) Company Law Board may order Capital Reduction u/s. 402(c) of CA when a application is filed before it under following scenarios:

- Relief in case of oppression u/s 397 of CA and
- Relief in case of mismanagement application u/s 398 of CA

2.2 The share represents the interest of the shareholder in the company and this interest consists broadly of three distinct rights in action:

(i) the right to receive dividend out of the profits of the company;

(ii) the right to attend and vote at meetings and thereby indirectly participate in the management of the company; and

(iii) the right to share in the distribution of the net asset on a winding up of the company.

The first two rights are available to a shareholder when the company is a going concern; they come to an end when the company goes into liquidation. On a winding up of the company the third right becomes operative and by virtue of this right the shareholder becomes entitled to his share on distribution of the net assets of the company after satisfaction of its liabilities according to the rights and interests of the shareholders in them.

When a shareholder receives moneys representing his share on distribution of the net assets of the company in liquidation, he receives such moneys in satisfaction of the right which belongs to him by virtue of his holding the share. Whereas, in case of capital reduction, shareholder receives consideration for the extinguishment of his right or rights in the share[1]. Further conversion of equity shares into redeemable preference shares amounts to capital reduction[2].

2.3 With this brief background let us analyse direct tax implications. The question about taxability of an amount received by a shareholder from a company on reduction in the face value of shares in a company has arisen before Supreme Court in case of Kartikeya V. Sarabhai[3]. The court observed that it is not necessary for a capital gain to arise that there must be a sale of a capital asset. Relinquishment of the asset or extinguishment of any right in it, which may not amount to a sale, can also be considered as a transfer. Any profit or gain which arises from the transfer of a capital asset is liable to be taxed under section 45. A reduction in share capital by reduction in the face value of the share, the right of the shareholder to the dividends and his right to share in the distribution of the net assets upon liquidation, is extinguished proportionately to the extent of reduction in the capital.

Even though the shareholder remains a shareholder, his right as a holder of those shares stands reduced with the reduction in the share capital. Therefore, this extinguishment of right is a transfer. The amount received by the assessee for such reduction is liable to capital gains under section 45. In view of this judgment, the property and money received by the assessee from the company on the reduction in the face value of his shares is a capital receipt subject to section 45. However, in the case of Kartikeya V. Sarabhai, the Court did not consider the provisions of section 2(22)(d) in the context of capital gains arising on a reduction of the share capital.

2.4 Under section 2(22)(d) any distribution to its shareholders by a company on the reduction of its capital, is deemed to be a distribution of dividend to the extent that the company possesses accumulated profits—whether such profits have been capitalised or not.

Therefore, any distribution which is made by a company on a reduction of its share capital which can be correlated with the company's accumulated profits (whether capitalised or not), will be dividend in the hands of the assessee. It is only when any distribution is made which is over and above the accumulated profits of the company (capitalised or otherwise), that the question of a capital receipt in the hands of a shareholder arises. The original cost to that shareholder of acquisition of that right in the share which stands extinguished as a result of reduction in the share capital will have to be deducted from the capital receipt so determined. Only when the capital receipt is in excess of the original cost of the acquisition of that interest which stands extinguished, will any capital gains arise.

2.5 The expression "whether capitalised or not" covers the profits which are deemed to be dividend, would be those which were capable of being accumulated and which would also be capable of being capitalised. This would exclude return of a part of the capital by the company from section 2(22), as the same cannot be regarded as profits capable of being capitalised, the return being of the capital itself[4].

1. *CIT vs. R. M. Amin 106 ITR 368 (SC)*
2. *Chowgule & Co Pvt Ltd., In re 1972 Tax L R 2163*
3. *[1997] 228 ITR 163 (SC)*
4. *CIT vs. Urmila Ramesh [1998] 230 ITR 422 (SC)*

Thus the amount distributed by a company on reduction of its share capital has two components—distribution attributable to accumulated profits and distribution attributable to capital (except capitalised profits). Therefore, the return to the shareholder on the reduction of share capital would be taxable as dividend where such return is on account of accumulated profits. The balance, if any, may be subject to tax as capital gains.

2.6 Section 115-O levies additional tax on distribution of dividend at the rate of 15% increased by surcharge and cess. Dividend for the purpose of this section shall carry same meaning as given to dividend in section 2(22) but deemed dividend u/s. 2(22)(e) is excluded. Accordingly, capital reduction to the extent of accumulated profits would be subject to Dividend Distribution Tax (DDT).

2.7 Capital Gains arising on capital reduction would not be eligible for concessional rate of tax u/s 111A (short term capital gains) or exemption u/s 10(38) (long term capital gain), since transaction is off market and is not subject to STT. However non-residents generally would be entitled for treaty benefits, subject to fulfilment of conditions specified therein.

However, in case of capital reduction where face value of shares is reduced and no payment has been made, such reduction would be capital loss in the hands of shareholder.

2.8 Issue may arise whether face value of the share would be excluded for the purpose Section 115-O or not. Considering the observation of Supreme Court in case of Urmila Ramesh a view can be formed that the deduction in face value of shares should not be subject to DDT. However contrary view has been taken by Kolkatta High Court in case of *CIT vs. Jai Hind Investment Industries (P.) Ltd. [1993] 202 ITR 316.*

2.9 Capital Reduction involves initial approval by board and then followed by shareholders. Subsequently approval from jurisdictional High Court and Registrar of Companies is also required. In view of these multi level approvals, issue may arise as to at what point of time, company would be subject to pay DDT?

In this regards support may be drawn from the decision of Supreme Court in the case of *Punjab Distilling Industries Ltd. vs. CIT [1965] 57 ITR 1* ". . . that the expression 'distribution' connoted something actual and not notional. It could be physical, it could also be constructive. One might distribute amounts between different shareholders either by crediting the amount due to each one of them in their respective accounts or by actually paying to each one of them the amount due to him. The expression 'distribution' had to be given the same meaning which was given to the expression 'credited or paid' in section 16(2) of the Act. Dividend must be deemed to have been paid or distributed in the year when it was actually, whether physically or constructively, paid to the different shareholders, i.e., when the amount was credited to the separate accounts of the shareholders or paid to them. . . ."

Accordingly, in light of the Supreme Court judgment a view can be formed that the date of order of the High Court approving reduction is not the decisive date of distribution. It is only when the dividend is distributed, whether physically or constructively, may it be said that the distribution has taken place.

2.10 However, exception to what is discussed supra is when such shareholder is a dealer in shares. In such case, difference between cost and amount realised, if any, would be treated as business income or loss, as the case may be, and would be taxed at normal rates.

Buyback of shares

3.1 Section 77A of the Companies Act, 1956 has been introduced to provide an alternative method by which a company can buy-back up to 25 per cent of its paid-up capital in any financial year. However, it does not supplant or take away any part of pre-existing jurisdiction of Company Court to sanction a scheme under section 100 to

104 (pertaining to capital reduction)[5]. Further, said provisions are merely an enabling provision providing for alternative mode by which a company can buy back its shares and is not given any overriding effect over provisions of section 391 and 394 of Companies Act, 1956[6].

3.2 Buyback of Shares can be through

- Tender offer
- Open Market purchase (Book building or Market Purchase)

3.3 Post introduction of provisions of buy-back of securities under Companies Act, two amendments were carried under Income-tax Act one u/s 2(22) by introduction of clause (iv) and another by introduction of Section 46A. CBDT Circular No 779 dt 14-9-1999 explained the amendment as:

> "28.1 The Companies (Amendment) Ordinance, 1998 [subsequently enacted as the Companies (Amendment) Act, 1999] inserted section 77A in the Companies Act, 1956 which allows a company to purchase its own shares subject to certain conditions. The shares bought back have to be extinguished and physically destroyed and the company is precluded from making any further issue of securities within a period of 24 months from such buy-back.
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> 28.2 The above newly introduced provisions of buy-back of shares threw up certain issues in relation to the existing provisions of the Income-tax Act. The two principal issues are whether it would give rise to deemed dividend under section 2(22) of the Income-tax Act and whether any capital gains would arise in the hands of the shareholder. The legal position on both the issues were far clear and settled and there was apprehension that there will be unnecessary litigation unless the issues are clarified with finality.
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> 28.3 The Act, therefore, has amended clause (22) of section 2 of the Income-tax Act by inserting a new clause to provide that dividend does not include any payment made by a company on pur¬chase of its own shares in accordance with the provisions con¬tained in section 77A of the Companies Act, 1956. It has also inserted a new section, namely, section 46A in the Income-tax Act, to provide that any consideration received by a shareholder or a holder of other specified securities from any company on purchase of its own shares or other specified securities shall be, subject to provisions contained in section 48, deemed to be the capital gains.
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> 28.4 This amendment will take effect from 1st day of April, 2000 and will, accordingly, apply in relation to the assessment year 2000-2001 and subsequent years."
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> ***(emphasis supplied)***

3.4 Accordingly consideration received on buy-back of shares would be taxed under the head capital and no amount would be considered as dividend u/s 2(22). In case of buy-back of shares by the company through market and where STT is paid, capital gains would be chargeable to concessional rate of tax u/s 111A (short term gains) or exempt u/s 10(38) (long term capital gain) as the case may be. Assessee would also be entitled for exemption u/s 54EC or 54F. However in case of trader in shares, difference between consideration received and cost would be chargeable as business income.

Non-resident shareholder would be entitled for treaty benefits. Accordingly, in case investor investing through tax efficient jurisdiction, capital gains may be exempt from tax.

3.5 Section 77A of Companies Act lays down series of conditions for buy-back. Income-tax Act specifies that in order to qualify for above tax treatment, buy-back has to be in accordance with provisions of Companies Act. In case if buy-back is not complying with the provisions of Companies Act, issue may arise about taxability

5. *SEBI vs. Sterlite Industries (India) Ltd [2003] 45 SCL 475 (Bom)*
6. *TCI Industries Ltd., In re [2004] 50 SCL 450 (AP)*

of consideration. Whether it would be taxed as dividend or as a capital gains? Similary, issue may also arise if such buy back is as per the scheme u/s 391 to 394 of CA.

3.6 To understand taxability in above case, we need to understand whether amendment is clarificatory amendment or not. Considering CBDT's rationale for the amendment in following lines "The legal position on both the issues were far from clear and settled and there was apprehension that there will be unnecessary litigation unless the issues are clarified with finality" view may be formed that amendment is clarificatory amendment. However, there may be another school of thought with a contrary view.

3.7 In case amendment is considered as a clarificatory amendment, even if the conditions specified under Companies Act are not fulfilled, it would be taxed as capital gains.

3.8 Further, it may be noted that Section 77A of Companies Act allows buy back of shares and other specified securities and section 46A also deals with the shares and specified securities. However Section 2(22)(iv) exempts buyback from the ambit of deemed dividend only if such buy back is of shares.

Company's Angle

TAX

4.1 Consideration paid by the company to the shareholders on capital reduction or buy-back of shares would not be entitled for any tax deduction. Similarly, any reduction in face value of shares would also not be considered as income in the hands of company. However, in the write off of losses against the share capital and reserves may be disadvantageous to the company while computing tax under MAT.

FEMA

4.2 Vide A.P. (Dir Series) (2004-05) Circular No. 16 dt. 4-10-2004 RBI has amended FEMA 20/2000-RB Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000. As per amendment, transfer by a person resident outside India to a person resident in India is covered under automatic route. However, such transfer is subject to compliance of the terms and conditions, pricing guidelines and reporting requirements, specified therein.

4.3 Further, by A.P. (Dir Series) (2005-06) Circular No. 10, dt. 30-8-2005 it was further clarified that Transfer of shares by a non-resident to an Indian company under buy-back and/or capital reduction scheme of the company would fall under automatic route subject to compliance specified in A.P. (Dir Series) (2004-05) Circular No. 16 dt. 4-10-2004.

STAMP DUTY

4.4 The term "instrument" has been defined u/s 2(14) of Indian Stamp Act, 1899. As per the Act, term instrument includes every document, by which any right or liability is, or purports to be created, transferred, limited, extended, extinguished or recorded. Accordingly, any document which purports to create title in the name of any person.

4.5 In case of buy back there is offer by the company and shareholder tendering the shares amounts to acceptance. While tendering shares, shareholder executes a transfer form. Though such shares are tendered to facilitate cancellation by the company, it amounts to transfer of shares to company, before cancellation. This view also gets the support from language of s. 77A of CA, which is also exception to s. 77 of CA.

4.6 In view of this, buy-back of shares would be subject to stamp duty at the rate of 0.25% under article 62 of Indian Stamp Act, 1899. However, in case of shares in dematerialised form, no stamp duty would be leviable.

4.7 Issue may arise in case of buy-back of shares is effected under court sheme u/s 391 to 394 of CA. Whether Court order would be considered as instrument liable for stamp duty? Even though, in some cases issues are not free from ambiguity, Capital Reduction and buy back of shares are used extensively as a tool to achieve multifold business re-organisation objectives.