

kcmSpark

Transaction Advisory

Buy-back Tax!

End of an Era!

September 2024



Background & Context

Coverage



Buybacks are one of the most common methods to rationalise capital structure and distribute surplus funds lying in companies to the shareholders of such companies. To add to this, in India, buybacks were also the preferred mode of repatriation for Indian shareholders of domestic companies due to the favourable tax rates (explained later) when compared to that of dividend simpliciter. This was especially true for closely held companies. The Finance Act (No. 2), 2024 (the "Finance Act") has amended the Income-Tax Act, 1961 (the "Act") such that the tax arbitrage of buybacks over dividends is eliminated. The amendments to buyback tax are applicable on buybacks undertaken on and after October 01, 2024!

In this brief note we attempt to highlight the eligibility criteria, certain procedural aspects and tax intricacies of a buyback under the new and the old buyback tax regime. For the sake of simplicity, we have restricted the discussion to cases, where the shareholders as well as the company are Indian residents. For cross-border cases, there are other considerations involved like tax treaties, credit availability and foreign exchange regulations. If as promoters/shareholders, you are contemplating a repatriation of funds through a buyback from your Indian company, it would hold you in good stead to get a quick glance through this document!

**Comparing buyback-tax regimes: Old v. New**

Coverage

**Old Regime**

Under the old regime, buyback income is exempt in the hands of the shareholders whereas the company buying back its shares is responsible to pay the buyback-tax on the amount of difference between the buyback consideration and the amount received¹ by the company for the shares bought back. Such buyback-tax was calculated at the rate of 23.296%². However, for the shareholders the tax rate effectively comes to 18.89%³. This is the rate which applies irrespective of the amount of buyback consideration or identity of the shareholder (corporate/non-corporate/individual). As opposed to this in case of dividend income, practically no expenses are tax deductible against it and it is subject to tax at the normal slab rates which adds up to 35.88% (i.e., the highest tax rates for individual shareholders).

As mentioned earlier, this old regime of buyback-tax shall be applicable for any buybacks completed prior to 01.10.2024.

New Regime

For payments under a buyback taking place on or after 01.10.2024, the entire amount paid for buyback of shares shall be deemed as dividends and thus, the whole of buyback consideration shall be subject to the same tax treatment as that of a dividend simpliciter i.e., no deduction shall be allowed from such dividend income, and it will be taxed at slab rates (highest rate being 35.88%). As a result, the tax arbitrage is lost. Thus, one would appreciate that the old regime is beneficial over the new regime by 16.99% [i.e., 35.88% - 18.89%].

At the same time, the shareholder would also get a capital loss equal to the cost of acquisition which they had paid for his shares which are bought back. He may offset such capital loss from any future capital gains income subject to the normal rules of carry forward & set-off of tax losses. But this is little consolation to the taxpayer, if at all.

¹ Amount received by the company is the issue price at the time of primary infusion. Rule 40BB of Income-Tax Rules, 1962 provides how to determine this amount in various scenarios.

² 20% + 12% (surcharge) + 4% (H&E Cess) = 23.296%

³ Ex: Total outflow for the company under buyback is 100 [this includes buyback-tax (23.296%) + buyback price]; So, Effective buyback tax = $100 \times (23.296/123.296) = 18.89$



Some special cases

Coverage



The aforementioned explanation holds true in cases where the shareholders are Indian tax residents, and the company is a domestic Indian company with a robust balance sheet and sufficient surplus. However, in a case where such Indian company was acquired in a distressed sale, an interesting situation may arise where the original promoters would have invested a high amount for their shares in the company but thereafter, they sold these shares at a cheaper price to the acquirer. If such shares of the acquirer are then bought back under the old regime, then the Indian company can enjoy a deduction (from the buyback proceeds) of the higher value invested by the original promoters instead of the lower price the acquirer had paid under the acquisition. In this manner in such circumstances, a higher repatriation may have been possible under the old regime. Under the new regime, the benefit of higher cost of shares invested by original promoters is not allowable to the company and neither to the new shareholder claiming capital loss under section 46A.

Then there can also be a situation where an Indian company is receiving dividends from another company and intends to further pass on such benefit to its own shareholders. Should the company declare a dividend or consider a buyback under old regime? In such a case, the company may consider declaring a simple dividend since it can claim the pass-through

benefit⁴ under which the Indian company will not be subject to any tax on the dividend it has received to the extent of dividend distributed. If, in this case, the company opts for a buyback under the old regime, it will be chargeable to buyback tax as well as tax on its dividend income. Since under the new regime, the buyback shall be treated as deemed dividend, the company should be eligible to get the pass-through benefit and shareholders may obtain the benefit of capital loss under section 46A of the Act.

Lastly, in a case where most of the shareholders of the domestic Indian company are non-residents, the company may evaluate declaring dividend vis-à-vis buybacks under old regime (till 1 October 2024). The dividend tax rate for non-resident shareholders is 23.92%, and this may be further reduced by availing double tax avoidance treaty ("treaty") benefit, if any. There may be no treaty benefit available for buybacks under the old regime which would lead to economic double taxation of the buyback proceeds. There are interesting treaty implications for buyback of shares under the new regime but that is beyond the scope of this write-up. Accordingly, a cost-benefit analysis within the rigors of tax law may be made to evaluate the option of dividend vs buyback under the old and new regime.

⁴ Refer Section 80M of the Act



FAQs relating to the buyback process

Coverage



1 What are the conditions which need to be kept in mind prior to executing a buyback under the corporate law?

A company is eligible to execute a buyback if the following conditions are met –

- The buy-back should be authorized by the Articles of Association of the company.
- The shares which are proposed to be bought back should be fully paid up.
- Maximum amount which can be paid as consideration for a buyback cannot exceed – 25% x (paid up share capital of the company + free reserves of the company).
- Debt-equity ratio of the company after the proposed buyback should not exceed 2:1.
- Where a company has done a buyback earlier, it cannot make another offer for buyback until the completion of 1 year (this is to be reckoned from the date of closure of the earlier buyback offer).

2 What are the sources of funds from which shares can be bought back?

Company can buy-back shares only out of the balances appearing in free reserves, securities premium and/or out of proceeds of an earlier fresh issue of shares.

⁵ There are broadly two “kinds” of shares – preference shares and equity shares

⁶ The buyback offer should remain open for at least 15 days from when it was made (can be reduced subject to shareholders resolution).

⁷ Requires the company to open a separate bank account to deposit the buyback consideration prior to payment.

3 Are there any restrictions on fresh issue of shares once a buyback is completed?

Once a company has completed a buyback of its shares, it cannot make a further issue (including rights issue) of same kind of shares⁵ for the next 6 months.

4 What is the process for buying back shares and what is the estimated time it takes for completion?

Broadly, the process of buyback consists of – (i) passing a special resolution in a shareholders’ meeting (ii) making an offer⁶ to buyback to the shareholders (buyback offer letter) (iii) shareholders would tender their shares for buyback to the company based on the buyback offer letter. (iv) company buys back the shares and makes payment⁷ to the shareholders (v) company to make requisite reporting to the Registrar and updating the shareholders’ register.

Subject to proper availability of all documents and other practical considerations, it is possible to complete the entire process mentioned above in less than one (1) month.

5 What are the documents which need to be in place for a buyback?

These are some critical documents which become the cause of delay in executing a buyback in the middle of a financial year –



FAQs relating to the buyback process

Coverage



- a. Latest audited financial statements which are not older than 6 months⁸. If latest audited financial statements are older than 6 months, then the company can get a limited review report from its auditor for a more recent set of financial statements (since conducting a new audit is time consuming).
- b. The company also needs a report from its auditor which is addressed to the company's board, stating⁹ that the corporate law requirements/conditions for the buyback are met.
- c. The company needs to disclose the 'basis of arriving at the buyback price'. Generally, a valuation report is used for this purpose.

6 Is dematerializing the shares to be bought back essential?

As per the recent amendments in corporate laws, all private companies are required to dematerialize their shares on or before 30.09.2024¹⁰. These amendments mandate dematerialization of shares prior to making any offer for buyback of shares. In case of contravention, penalty is levied to regularize the same.

⁸ 6 months to be reckoned from the date of offer document

⁹ For details on what the report needs to state, refer Rule 17(n) of Companies (Share Capital & Debentures) Rules, 2014

¹⁰ There are cases where the deadline for dematerialization maybe longer than 30.09.2024 – for details refer Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023 [MCA Notification G.S.R. 802(E). dated 28.07.2023]



FAQs for some critical tax questions

Coverage



If you are contemplating a buyback for repatriation or you have already commenced the buyback procedure, we have compiled certain tax aspects which may help you to determine the tax implications in certain dicey situations -

7 What stage of buyback process, if completed prior to 01.10.2024, would trigger tax under the old regime?

Of course, the safest position would be if the entire buyback process is completed prior to 01.10.2024. If not, then the taxpayer should at least strive to make the payment of buyback consideration prior to 01.10.2024 because buyback-tax under the new regime is triggered on "payment". So, if payment is made prior to 01.10.2024, while defensible, the position may be prone to litigation. However, any payment after 01.10.2024 is likely to give rise to difficulties.

8 Does the Act provide any valuation requirements for buyback of shares?

No. The Act does not provide any cap/floor valuation for a buyback. Further there are Tribunal rulings¹¹ to the effect that section 56(2)(x) (i.e., provision which taxes deemed gifts) of the Act are not applicable to buyback of own shares. Therefore, while the buyback value itself may not directly determine tax

¹¹ Vora Financial Services (P.) Ltd. v. ACIT [2018] 96 taxmann.com 88; DCIT v. Globe Capital Market Ltd. [2023] 156 taxmann.com 620 (Delhi - Trib.); DCIT v. Venture Lighting India Ltd. [2023] 150 taxmann.com 523 (Chennai - Trib.); VITP (P.) Ltd. v. DCIT [2022] 143 taxmann.com 304 (Hyderabad - Trib.)

implications, it is still essential for the buyback to be conducted at a reasonable price since it is required by corporate law to provide a basis for the buyback price.

9 Can there be a case where the buyback transaction is not taxed at all – since the tax triggers for old regime and new regime differ?

Buyback tax is triggered on completion of "purchase" in the old regime, whereas it is triggered at the time of "payment" in the new regime. Consider a case where purchase (technically) is completed after 01.10.2024 but the payment of buyback consideration is done prior to 01.10.2024. This would result in neither of the regimes being triggered and thus, no buyback tax at all!

There are extremely strong grounds¹² to say that under a buyback, the purchase of own shares by the company is completed when the shareholders have tendered their shares for buyback and the company has accepted the shares so offered. Payment can happen only after offer and acceptance. Thus, the case of purchase completing after payment is an impossibility.

Hence, there cannot be a case of complete non-taxation of a buyback since there are no gaps emerging due to the different tax triggers.

10 Can there be a case where the buyback transaction is doubly taxed – since the tax triggers for old regime and new regime differ?

Consider a case where purchase is completed prior to 01.10.2024 but the payment of buyback consideration is made after 01.10.2024. In such a case, both the mechanisms are triggered, and one can possibly contend that the

¹² T.N. Aravinda Reddy [1979] 2 Taxman 541 (SC); Relevant provisions of Indian Contract Act, 1872



FAQs for some critical tax questions

Coverage



buyback transaction should be taxed under both the regimes – in the hands of the company under the old regime, and in the hands of shareholders in the new regime.

It is a fundamental principle of law that the same income cannot be taxed twice¹³. Further, once we conclude that the buyback (i.e., purchase) of shares relates to period which is prior to 01.10.2024, the proviso inserted in section 10(34A) by the Finance Act should apply, and the dividend income arising on payment of buyback consideration under the new regime should be exempt from tax in the hands of the shareholders.

Thus, there should be no possibility of double taxation of income in such cases and only the tax under the old regime should apply. Nevertheless, to avoid unwarranted litigation, the taxpayers must tread with caution and make sure that the payment of buyback consideration is done prior to 01.10.2024 as mentioned earlier.

11 Is there a risk of application of General Anti-Avoidance Rules (GAAR)?

As long as there is a strong commercial rationale for the buyback transaction, GAAR provisions should not apply.

However, for the technically inclined readers – it would be interesting to consider a possibility which can arise in such cases. Whether the tax authorities can invoke GAAR based on the taxpayer's choice of timing for executing the transaction? This question requires an in-depth technical analysis which is not

within scope of this write-up. Below are some broad thoughts on this aspect intended to serve as food for thought to the reader –

- a. The most fundamental requirement for applying GAAR is the existence of an "arrangement". Based on the definition of this term, can one argue that the decision to prepone or postpone a transaction cannot be regarded as an arrangement altogether and hence, not subject to GAAR?
- b. The CBDT¹⁴ has clarified that GAAR shall not interfere with the right of the taxpayer to choose from the available methods of implementing a transaction¹⁵. Since buyback is a commercially valid repatriation alternative to a simple dividend, GAAR should not interfere with the taxpayer's choice of not opting for a simple dividend instead. And continuing with the same logic, can one argue that this concept, of GAAR's inability to interfere with the taxpayer's right to choose from available methods, be extended to the contention that GAAR cannot interfere with the taxpayer's right to choose the timing of the transaction.

¹³ Laxmipat Singhania v. CIT [1969] 72 ITR 291 (SC)

¹⁴ The Central Board of Direct Taxes (CBDT)

¹⁵ Question 3, CBDT Circular No. 7/2017 dated 27.01.2017 ("GAAR Circular")

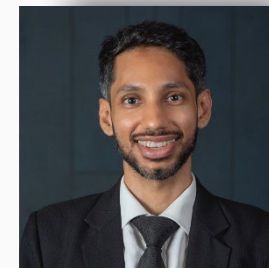


Conclusion

There is a dramatic shift in the buyback tax provisions which is not conducive to the taxpayer's pockets. There are alternative methods for rationalizing capital structure and / or distribution of surplus funds and tax consultants are always there to guide businesses and business-owners on the best-suited alternative available. Although such alternatives result in significant benefits, they usually warrant a lot of time and efforts from the businesses/owners. The old buyback-tax regime was beneficial to the shareholders since it was a reasonable trade-off between the tax cost and the time/effort involved. The old regime will become defunct soon, and considering the new regime, it seems that buybacks will soon become a thing of the past, for those who wanted to use the same only as a tax efficient repatriation strategy.

[Coverage](#)

Should you need more information, kindly reach out to



Suril Mehta

Partner

Suril.mehta@kcmehta.com

+91 265 2440 446 (Direct)

+91 85111 85339 (Handheld)

About **kcmSpark**

kcmSpark is a periodic, highly research-oriented publication which covers research and analysis on specific topics by our subject matter experts. As the name suggests, our endeavour is to present to you, interesting and thought-provoking aspects about a particular topic, in each edition of **kcmSpark**.

This publication is prepared exclusively for the benefit and use of member firms of KCM Network and their clients. This should not be used as a substitute for professional advice. Reasonable care has been taken for ensuring the accuracy and the authenticity of the contents of this publication. However, we do not take any responsibility for any error or omission contained therein on any account. It is recommended that the readers should take professional advice before acting on the same. No part of this document may be reproduced in whole or in part in any manner without prior written permission from K C Mehta & Co LLP.

Locations

Ahmedabad

Arpit Jain

Level 11, Tower B,
Ratnaakar Nine Square,
Vastrapur,
Ahmedabad - 380 015

Phone: + 91 79 4910 2200
arpit.jain@kcmehta.com

Bengaluru

Dhaval Trivedi

4/1, Rudra Chambers, First
Floor, 4th Main, B/W 8th & 9th
Cross Road, Malleshwaram,
Bengaluru - 560 003

Phone: +91 99983 24622
dhaval.trivedi@kcmehta.com

Mumbai

Bhadresh Vyas

315, The Summit Business Bay,
Nr. WEH Metro Station,
Gundavali, Andheri East,
Mumbai - 400 069

Phone: +91 22 2612 5834
bhadresh.vyas@kcmehta.com

Vadodara

Milin Mehta

Meghdhanush,
Race Course,
Vadodara - 390 007

Phone: +91 265 2440 400
milin.mehta@kcmehta.com

Independent Member

kcm
NETWORK