

# TAX IMPLICATIONS ON BUY BACK OF UNLISTED SHARES

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# Buy back and its Tax implications

## What is 'Buy Back'?

Under the Income Tax Act, "buy-back" means purchase by a company of its own shares in accordance with the provisions of *any law for the time being in force relating to companies*.

## Provisions governing tax on Buy Back

Buy Back of Listed shares and securities	Buy Back of unlisted shares
Section 46A <i>(inserted vide Finance Act, 1999)</i>	Section 115QA read with Section 10(34A) <i>(inserted vide Finance Act, 2013)</i>

## Legislative intend behind introduction of tax on buy back of unlisted shares



### Memorandum explaining provisions of the Finance Bill, 2013

- ❑ A company, having distributable reserves, has two options to distribute the same to its shareholders either by declaration and payment of dividends to the shareholders, or by way of purchase of its own shares (*i.e.* buy-back of shares) at a consideration fixed by it. In the first case, the payment by company is subject to DDT and income in the hands of shareholders is exempt. In the second case the income is taxed in the hands of shareholder as capital gains.
  
- ❑ Unlisted Companies, as part of tax avoidance scheme, were resorting to buy-back of shares instead of payment of dividends in order to avoid payment of tax by way of DDT particularly where the capital gains arising to the shareholders are either not chargeable to tax or are taxable at a lower rate.\*
  - Goldman Sachs (India) Securities Pvt. Ltd. vs. ITO (ITA No. 3726/Mum/2015)
  - Capgemini India Private Limited (C.P. 434 of 2014) (Bom HC)

## Legislative intend behind introduction of tax on buy back of unlisted shares



### Memorandum explaining provisions of the Finance Bill, 2013

- ❑ In order to curb such practice it was proposed to amend the Act, by insertion of new Chapter XII-DA, to provide that the consideration paid by the company for purchase of its own unlisted shares which is in excess of the sum received by the company at the time of issue of such shares (distributed income) will be charged to tax and the company would be liable to pay additional income-tax @ 20% of the distributed income paid to the shareholder. The additional income-tax payable by the company shall be the final tax on similar lines as dividend distribution tax. The income arising to the shareholders in respect of such buy back by the company would be exempt where the company is liable to pay the additional income-tax on the buy-back of shares.

# Tax on buy back of unlisted shares



## IN THE HANDS OF THE COMPANY:

### **Section 115QA: (inserted vide Finance Act, 2013 with effect from the 1st day of June, 2013)**

- any amount of distributed income by the company on buy-back of shares (not being shares listed on a recognised stock exchange) from a shareholder shall be charged to tax and such company shall be liable to pay additional income-tax at the rate of 20 percent on the distributed income [Note: surcharge shall be levied at the rate of 12 percent]
  
- For the purposes of this section 115QA, “buy-back” means purchase by a company of its own shares in accordance with the provisions of **section 77A of the Companies Act, 1956\***; “distributed income” means the consideration paid by the company on buy-back of shares as reduced by the amount which was received by the company for issue of such shares\*\*.

\* any law for the time being in force relating to companies,

\*\* determined in the manner as may be prescribed.

substituted vide Finance Act, 2016 w.e.f. 01.06.2016

# Tax on buy back of unlisted shares



## IN THE HANDS OF THE COMPANY:

### **Section 115QA: *(inserted vide Finance Act, 2013 with effect from the 1st day of June 2013)***

- The tax on the distributed income shall be payable by such company, notwithstanding that no income-tax is payable by a domestic company on its total income computed in accordance with the provisions of this Act.
- The principal officer of the domestic company and the company shall be liable to pay the tax to the credit of the Central Government within fourteen days from the date of payment of any consideration to the shareholder on buy-back of shares.
- The tax on the distributed income by the company shall be treated as the final payment of tax in respect of the said income and no further credit therefor shall be claimed by the company or by any other person in respect of the amount of tax so paid.

# Tax on buy back of unlisted shares



## IN THE HANDS OF THE COMPANY:

**Section 115QA: *(inserted vide Finance Act, 2013 with effect from the 1st day of June 2013)***

- No deduction under any other provision of this Act shall be allowed to the company or a shareholder in respect of the income which has been charged to tax.

## IN THE HANDS OF SHAREHOLDERS:

**Section 10(34A): *(inserted vide Finance Act, 2013 with effect from the 1st day of April, 2014)***

Any income arising to an assessee, being a shareholder, on account of buy back of shares (not being listed on a recognised stock exchange) by the company as referred to in section 115QA, is exempt.

# Significance of amendments introduced vide Finance Act, 2016



## Memorandum explaining the provisions of the Finance Bill, 2016

- ❑ Doubts were raised regarding the effect of buybacks undertaken by the company under different provisions of the Companies Act, 1956 or the Companies Act, 2013 and applicability of provisions of section 115QA to such transactions.
- ❑ An issue arose regarding lack of clarity in determination of consideration received by the company at the time of issue of shares being bought back by the company. There are situations where shares may have been issued by the company in tranches, for different considerations, at different point of time or may have been issued in lieu of existing shares of another company under amalgamation, merger or demerger.
- ❑ For the purposes of section 115QA, 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.



# Significance of amendments introduced vide Finance Act, 2016



## Memorandum explaining the provisions of the Finance Bill, 2016

- Further, lack of clarity in the manner of determination of consideration received by the company would lead to avoidable disputes and also presents a tax arbitrage opportunity of scaling up of consideration particularly under a tax neutral business reorganisation followed by buyback of shares.
- In order to provide clarity and remove any ambiguity on the above issues, Section 115QA to provide that the provisions of this section shall apply to any buy back of unlisted share 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, and further that for the purpose of computing distributed income, the amount received by the Company in respect of the shares being bought back shall be determined in the prescribed manner. The rules to provide for manner of determination of the amount in various circumstances including shares being issued under tax neutral reorganisations and in different tranches.

## Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



**CBDT vide Notification No. 94/2016 dated 17<sup>th</sup> October 2016 notified Rule 40BB of the Income Tax Rules, 1962 inserted** by the Income-tax (Twenty Eighth Amendment) Rules, 2016 **w.e.f. 1<sup>st</sup> June, 2016**

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
2	Where the share has been issued by a company to any person by way of subscription	amount actually received by the company in respect of such share including any amount actually received by way of premium.

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
3	Where the company had at any time, prior to the buy-back of the share, returned any sum out of the amount received in respect of such share	the amount as reduced by the sum so returned shall be the amount received by the company for issue of said share; <b>Provided</b> that if the sum or any part of it so returned was chargeable to additional income-tax under section 115-O and the company has paid such additional income tax then such sum or part thereof, as the case may be, shall not be reduced.

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
4	Where the share has been issued by a company under any plan or scheme under which an employees' stock option has been granted or as part of sweat equity shares	<p>fair market value of the share as computed in accordance with Rule 3(8), to the extent credited to the share capital and share premium account by the company shall be deemed to be the amount received by the company for issue of said share.</p> <p>"sweat equity shares" shall have the meaning assigned to it in clause (b) of the Explanation to Section 17(2)(vi).</p>

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
5	Where the share has been issued by a company being an amalgamated company, under a scheme of amalgamation, in lieu of the share or shares of an amalgamating company	the amount received by the amalgamating company in respect of such share or shares determined in accordance with this rule, shall be deemed to be the amount received by the amalgamated company in respect of the share so issued by it.

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
6	Where the amount is received by a company, being a resulting company in respect of shares issued by it under a scheme of demerger,	the amount received by the resulting company shall be the amount which bears the amount received by the demerged company in respect of the original shares determined in accordance with this rule in the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger.

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
6 & 7	Where the amount is received by a company, being a resulting company in respect of shares issued by it under a scheme of demerger,	<p>the amount received by the resulting company shall be the amount which bears the amount received by the demerged company in respect of the original shares determined in accordance with this rule in the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger.</p> <p>The amount received by the demerged company in respect of the original shares in the demerged company shall be deemed to have been reduced by the amount as so arrived above.</p>

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
8	Where the share has been issued or allotted by the company as part of consideration for acquisition of any asset or settlement of any liability	Amount received = $A/B$ A = lower of (a) the amount which bears to the fair market value of the asset or the liability, as determined by a merchant banker, the same proportion as the part of consideration being paid by issue of shares bears the total consideration; (b) the amount of consideration for acquisition of the asset or settlement of the liability to be paid in the form of shares, to the extent credited to the share capital and share premium account by the company; B = the number of shares issued by the company as part of consideration:



# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub- Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
9	Where the shares have been issued or allotted by a company on succession or conversion, as the case may be, of a firm into the company or succession of sole proprietary concern by the company	Amount received = $A - B / C$ A = book value of the assets in the balance-sheet ( <i>excluding revaluation</i> ) as reduced by any amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance-sheet as asset including the unamortized amount of deferred expenditure which does not represent the value of any asset;

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub-Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
9	Where the shares have been issued or allotted by a company on succession or conversion, as the case may be, of a firm into the company or succession of sole proprietary concern by the company (contd...)	B = book value of liabilities shown in the balance-sheet, but does not include the following amounts, namely:— (a) capital, by whatever name called, of the proprietor or partners of the firm, as the case may be; (b) reserves and surpluses, by whatever name called, including balance in profit and loss account; (c) any amount representing provision for taxation, other than amount of tax paid, as TDS/TCS/Advance tax reduced by the amount of tax claimed as refund under the Income-tax Act, if any, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;

# Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



## Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub-Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
9	Where the shares have been issued or allotted by a company on succession or conversion, as the case may be, of a firm into the company or succession of sole proprietary concern by the company (contd...)	(d) any amount representing provisions made for meeting liabilities, other than ascertained liabilities; and (e) any amount representing contingent liabilities,  C = number of shares issued on conversion or succession.

## Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



### Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub-Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
10	Where the share has been issued or allotted, without any consideration, on the basis of existing shareholding in the company,	the consideration in respect of such share shall be deemed to be "Nil".
11	Where the shares have been issued on conversion of preference shares or bond or debenture, debenture-stock or deposit certificate in any form or warrants or any other security issued by the company,	the amount received by the company in respect of such instrument as so converted.

## Methodology for computation of amount received by companies on issue of shares, for the purpose of buy back



### Rule 40BB of the Income Tax Rules, 1962 (contd...)

Sub-Rule	Particulars of shares issued	Basis of determining 'amount was received by the company for issue of such shares'
12	Where the share being bought back is held in dematerialised form and the same cannot be distinctly identified,	the amount received by the company in respect of such share shall be the amount received for the issue of share determined in accordance with this rule on the basis of the first-in-first-out method.
13	In any other case	the face value of the share shall be deemed to be the amount received by the company for issue of the share.

## Consequences of default in payment of tax on buy back



### Section 115QB. Interest payable for non-payment of tax by company—

Where the principal officer of the domestic company and the company fails to pay the whole or any part of the tax on the distributed income section 115QA(1), within the time allowed (i.e. 14 days) , he or it shall be liable to pay **simple interest at the rate of one per cent for every month or part thereof** on the amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

### Section 115QC. When company is deemed to be assessee in default—

If any principal officer of a domestic company and the company does not pay tax on distributed income in accordance with the provisions of section 115QA, then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of this Act for the collection and recovery of income-tax shall apply.

## Applicability of Section 56(2)(viia) / 56(2)(x) on buy back



- ❑ Section 56(2)(viia) is applicable where a taxpayer “receives” any property, being shares of a company, without consideration or for inadequate consideration.
- ❑ In a recent ruling by the **Hon’ble Mumbai Tribunal in Vora Financial Services Pvt. Limited (ITA No. 532/Mum/2018)**, the recipient company made an offer of buy back of shares at a value less than the FMV of the shares and the AO invoked the provisions of Section 56(2)(viia) in the hands of the recipient company for taxing the difference between the FMV and the consideration paid for buy back. The Tribunal held that the provisions of Section 56(2)(viia) are applicable only in cases where the receipt of shares become property in the hands of the recipient and the shares shall become the property of the recipient only if they were ‘shares of any other company’. Where the taxpayer had purchased its own shares under the buy-back scheme and the same had been extinguished by reducing the capital, the test of becoming ‘property’ and also ‘shares of any other company’ in the hands of the recipient fail in the instant case, and accordingly, the provisions of Section 56(2)(viia) cannot be invoked with respect to buy-back of own shares.



**THANK YOU**