TAXING BUY-BACK OF SHARES | CREATING AN ARTIFICIAL QUAGMIRE

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Introduction

In the Budget of 2024, the Indian Government abolished buy-back distribution tax ("**BBT**"), and introduced a new regime for taxing share buy-backs ("**The New Regime**"). In the backdrop of the abolition of dividend distribution tax ("**DDT**") in 2020, introduction of this New Regime was motivated by the need for aligning the scheme of taxation of dividends and income from buy-back.[1] The New Regime, while trying to address the issues in the previous regime, has created its own set of challenges, especially in cross-border situations.

Evolution of Profit Distribution

Since the introduction of the provisions for buy-back under India's Companies Law in 1998[2], companies have been able to distribute their accumulated profits not only through dividends but also through buy-back of shares.

Dividends were taxable at the effective tax rate of 20.56% in the hands of the company distributing the dividends, as an additional corporate tax, in the form of DDT.[3] On other hand, buy-back of shares was taxable as capital gains,[4] which compared to dividends, were taxable at lower rates, ranging from 'nil' to 20% (now 12.5% to 20%).[5]

The dichotomy in tax treatment between a share buy-back and dividend distribution resulted in tax arbitrage. Given the relatively lower or nil tax rates on capital gains, it became common for taxpayers to elect for share buy-backs to distribute accumulated profits.[6] In order to eliminate the tax arbitrage, the Government introduced the buy-back distribution tax (BBT) in 2013, which was an additional corporate tax imposed on the company undertaking the buy-back on the

1 Memorandum explaining provisions of the Finance Bill, 2024.

2 Section 77A of the Companies Act, 1956 inserted by the promulgation of the Companies (Amendment) Ordinance, 1998; now contained in section 68 of the Companies Act, 2013.

3 Dividends fall under the head 'income from other sources.' Until 2003, dividends were taxed in the hands of the shareholders as ordinary income (20% in case of foreign share-holders) subject to applicable treaty relief. For ease of collection of tax, in 2003, the Government introduced the dividend distribution tax (DDT). Upon levy of DDT, the dividends were exempt in the hands of the shareholders. Subsequently in 2020, the Government abolished DDT and reverted to the classical system of taxation of dividends in the hands of the shareholders.

4 Pursuant to the introduction of its concept in 1998 and recognizing the issues in characterization of income from buy-back as dividends or capital gains, the Finance Act, 1999 introduced two amendments to specify that (i) buy-back proceeds would not be treated as dividends; and (ii) the consideration paid by a company to buy-back its own shares in excess of the sum received by it on issuance of such shares, shall be deemed to be capital gains. Even absent these amendments, income from buy-back of shares would have been treated as a 'transfer' for the purposes of capital gains tax.

5 Additionally, for certain non-residents, including those from Mauritius and Singapore, the capital gains tax rate was 'nil' due to exemptions under applicable tax treaties.

6 Memorandum explaining provisions of Finance Act, 2013.

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'distributed income', i.e. consideration paid by the company for undertaking the buy-back of shares in excess of the amount received for the issuance of such shares at the effective tax rate of 23.296%. Correspondingly, income arising to shareholders from buy-back of shares was exempt from tax.[7] In doing so, the Government had aligned the taxation of share buy-backs with that of dividends.

BBT being an additional corporate tax on companies undertaking buy-backs resulted in additional tax burden in their hands. It was particularly problematic for foreign shareholders. Given that BBT was a levy on the company and not the shareholders, foreign shareholders were unable to claim treaty relief, whether in the form of lower rates of tax on dividends, capital gains tax exemption, or foreign tax credit.

The New Regime

The New Regime taxes buy-back of shares in the following manner:

First, the entire buy-back proceeds shall be deemed to be to be dividends[8] and taxed accordingly.

Second, for the purposes of capital gains computation, in respect of the shares that have been bought back, the consideration shall be deemed to be NIL, resulting in capital loss to the extent of the cost of acquisition.[9]

Third, the capital loss may be carried forward for a period of 8 years from the financial year in which the buy-back takes place and set-off against future capital gains subject to the rules for set-off under the (Indian) Income-tax Act, 1961 ("**Act**").

Fourth, the company undertaking the buy-back shall also be liable to deduct taxes at source at the rate of 10% in case of resident investors[10] and at the rates in force in case of non-resident shareholders[11].

Income Characterization Issue under the New Regime

The New Regime creates significant issues around characterization of income. It is a settled principle of law that each head of income is mutually exclusive.[12] In other words, the same income cannot be brought within two different heads of income. However, this fundamental principle has been roughshod over by (i) deeming the entire buy-back proceeds to be dividends; and (ii) retaining the deeming fiction under capital gains regarding the treatment of buy-back as capital gains (loss). This effectively allocates the income from buy-back under two different heads of income, by creating an artificial dividend on one side and creating an artificial capital loss on the other side.

The problem gets exacerbated in case of foreign shareholders due to the added issue of conflict of classification under Tax Treaties. The conflict of classification under Tax Treaties is explained below.

7 Section 10(34A), Income-tax Act, 1961

8 Section 2(22)(f), Income-tax Act, 1961

9 Section 46A, Income-tax Act, 1961

10 Section 194, Income-tax Act, 1961

11 Section 195, Income-tax Act, 1961

12 *Nalinikant Mody v. Narayan Row*, 61 ITR 428; *Parthasarathy v. CIT*, 103 ITR 508; *Hamilton v. CIT*, 194 ITR 391

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Dividends under Treaties: The definition of 'dividends'[13] under the OECD Model Tax Convention recognizes that other corporate rights that is subject to the same treatment as dividends under domestic law can also be treated as 'dividends' for the purposes of the Tax Treaties. On the issue of whether deemed dividends constitute dividends under Tax Treaties, there are conflicting judgments in India. The Tribunal in the case of *KIIC Investment Company v. DCIT*[14] held that deemed dividends constitute dividends under the respective Tax Treaties entered into by India. However, in the case of *Rajiv Makhija v. DDIT*[15], the Tribunal took an opposing view to state that deemed income in the form of deemed dividends is not brought within the tax net under the Article for dividends in the India- Canada Tax Treaty. Presently, the law is not settled on whether deemed dividends under Indian domestic law can be treated as dividends for the purpose of the Tax Treaty.

Capital Gains under Tax Treaties: Capital gains under the OECD Model Convention includes 'alienation' of any property including shares. The phrase 'alienation of property' is used to cover, inter-alia, extinguishment of any rights in a capital asset. Accordingly, buy-back of shares should constitute alienation of property and therefore be subject to treatment as capital gains. In such a case, it is arguable that the more specific provision that will apply is that relating to capital gains, notwithstanding the deeming fiction in domestic law on dividends.

Interaction between Domestic Law and Treaty | A Recipe for Litigation

There remains a possibility of conflict on the characterization of share buy-backs as dividends or capital gains under the Tax Treaties themselves, while domestic law treats such share buy-backs as dividends. Further, the Act provides that a taxpayer has the right to adopt the position under domestic law or the Tax Treaty, whichever is more favorable. Such conflicts can result in multiple different scenarios, each of which can result in a different tax result:

Scenario 1: The taxpayer adopts a position that buy-back should be treated as 'alienation of shares' as per the Treaty, taxable as capital gains. The corresponding consequence as per domestic law would be that such buy-back would only result in a capital loss in the hands of the taxpayer due to the deeming fiction under domestic law that the consideration for buy-back of shares shall be NIL. The taxpayer can contend that the provisions related to taxing buy-back proceeds as 'dividends' do not apply, as the Tax Treaty offers a more favorable treatment by classifying them as 'capital gains'.

13 The term dividends has been defined as:
"The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as ***income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident****."*

14 [2019] 101 taxmann.com 19: The Court observed as follows:
Article 10(4) of the Treaty explains the term 'dividend' as used in the article. Essentially, the expression 'dividend' seeks to cover three different facets of income; firstly, income from shares, i.e., dividend per se; secondly, income from other rights, not being debt claims, participating in profits; and, thirdly, income from corporate rights which is subjected to same taxation treatment as income from shares by the laws of contracting state of which the company making the distribution is a resident. In the context of the instant controversy, i.e., 'deemed dividend' under section 2(22)(e), obviously the same is not covered by the first two facets of the expression 'dividend' in article 10(4) of the Treaty. So, however, the third facet stated in article 10(4) of the Treaty clearly suggests that even 'deemed dividend' as per section 2(22)(e) is to be understood to be a 'dividend' for the purpose of the treaty. The presence of the expression 'same taxation treatment as income from shares' in the country of distributor of dividend in article 10(4) of the treaty in the context of the third facet clearly leads to the inference that so long as the Indian tax laws consider 'deemed dividend' also as 'dividend', then the same is also to be understood as 'dividend' for the purpose of the treaty.

15 ITA No. 3148/ Del/2008; The Court observed as follows:
It is crystal clear from the plain reading of ***Article 10*** *that nowhere deemed income in the form of deemed dividend has been brought into tax net. Only the income from shares or other rights, not being debts claims, participating in profits, as well as income assimilated to income from shares by the taxation laws of the state of which the company making the distribution is resident falls within the term dividend.*

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Scenario 2: The taxpayer adopts a position that buy-back should be treated as 'alienation of shares' as per the Treaty, taxable as capital gains. However, the special provisions deeming the consideration for buy-back to be NIL under domestic law do not apply on the grounds that they only apply when the income from such buy-back is treated as 'dividends'. Consequently, the ordinary provisions relating to computation of capital gains under domestic law apply.

Scenario 3: If the taxpayer has significant capital gains from other sources in a given year, the taxpayer adopts the characterization under domestic law and treats the buy-back proceeds as dividends. Further, since the operation of computation rules for buy-back of shares under domestic law result in creation of capital losses (by way of the deeming fiction), the taxpayer utilizes these losses to offset against other capital gains.

Scenario 4: If the taxpayer has significant capital gains from other sources in a given year, the taxpayer adopts a position that the buy-back proceeds should be treated as dividends under the Tax Treaty, subject to the lower rates prescribed therein. Further, since the operation of computation rules for buy-back of shares under domestic law result in creation of capital losses (by way of a deeming fiction), the tax payer utilizes the losses to offset against other capital gains.

Each of the above scenarios can result in litigation due to the anomaly that the New Regime has brought in by classifying buy-back of shares under two heads of income. Further, considering the complexities associated with each of the aforesaid interpretations, these litigations will be long drawn and take years to attain any degree of finality.

Other Key Challenges under the New Regime

Apart from the above, the New Regime has other challenges in its application:

Deemed dividends: the entire buy-back proceeds are now deemed dividends and taxed in shareholders' hands. This approach disregards the principle that fundamentally dividends represent distribution out of profits and instead treats returns on an extinguishment of capital to be in the nature of deemed dividends. This leads to an anomalous situation where even a return of capital or a buy-back by a company that is in losses will be treated as being in the nature of deemed dividends. By deeming the full buy-back proceeds to be deemed dividends, the Government seems to have towed the fine line between anti-abuse and overtaxing.

Capital Loss: For capital gains computation, the full value consideration is deemed nil, resulting in a capital loss equal to the acquisition cost. While this loss can be carried forward for 8 years, it is contingent on shareholders having sufficient future capital gains to offset it, which is uncertain and inequitable.

Foreign Tax Credit: Different jurisdictions may interpret the characterization of buy-back proceeds differently, leading to inconsistent tax treatment. For instance, while Indian tax authorities may treat the proceeds as deemed dividends, the tax authorities in the shareholder's home country may not recognize this characterization, resulting in potential double taxation and denial of foreign tax credit.

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Conclusion

The New Regime is not in consonance with international practices when it comes to taxation of such income. While the intent of the Government in bringing about the New Regime was to negate any tax arbitrage between dividends and buy-back of shares, it has been at the cost of tax certainty. What the New Regime does is, bring in years of litigation on the issue along with significant confusion on its application.

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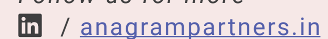

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