



Buyback of shares as per the Companies Act is not a colourable device and such transaction is not treated as deemed dividend under the Income-tax Act

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) held that the buyback of shares under Section 77A of the Companies Act, 1956 (the Companies Act) is not a colourable device. The amount received under such buyback scheme is treated as capital gain and not deemed dividend under Section 2(22) of the Income-tax Act, 1961 (the Act). Such capital gain is not taxable under the India-Mauritius tax treaty (the tax treaty).

Facts of the case and contentions

- The taxpayer is a wholly owned subsidiary of Mauritian Company (M Co). It was set up to undertake merchant banking and security business in India.
- In November 2010, the taxpayer had remitted a certain amount to M Co under a buyback scheme, whereby certain equity shares having the face value of INR10, were bought back by the taxpayer from M Co at INR46.79 per share.
- The Assessing Officer (the AO) held that the excess payment of INR36.79 per equity share for the shares bought back, was the distribution of its accumulated profits to its ultimate beneficiary and the only shareholder i.e. M Co. The buyback was a colourable transaction to avoid the payment of Dividend Distribution Tax (DDT).
- The AO also held that the excess payment was in the nature of dividend as per the provisions of Section 2(22)(d) of the Act. Since the taxpayer had not deducted any DDT under Section 115-O of the Act, such dividend income did not qualify for exemption under Section 10(34) of the Act. Therefore, it was taxable in the hands of M Co.
- On remittance of such amount to a non-resident, the tax was to be deducted under Section 195 of the Act, and as the tax was not deducted, the taxpayer was held to be a 'taxpayer in default' in terms of the provisions of Section 201 of the Act. The taxpayer was also liable to pay simple interest under Section 201(1A) of the Act.
- Tax at the rate of 5 per cent of the gross amount of such dividend was determined by the AO as payable by the taxpayer in terms of Article 10(2)(a) the tax treaty.
- The taxpayer contended that the shares were bought back in accordance with Section 77A of the Companies Act. After the introduction of Section 77A of the Companies Act, amendments were carried out in Section 2(22) of the Act to provide that amount received on buyback of shares in accordance with Section 77A of the Companies Act shall not be treated as deemed dividend. Further Section 46A of the Act was introduced to tax consideration

received on such buyback as capital gains. The Authority of Advance Ruling (AAR) in the case of XYZ India¹ has not considered the provisions of sub-clause of (iv) of Section 2(22) of the Act.

- The tax department relied upon AAR's decision in the case of XYZ India and contended that the buy-back was not genuine and was a colourable device. The scheme of buyback resulted in a reduction in capital and provisions of Section 2(22)(d) of the Act were applicable.

Tribunal's ruling

- Section 77A of the Companies Act deals with a buy back of shares, whereas Sections 100-105 read with Section 391 of the Companies Act deal with the reduction of capital after obtaining the permission of the Court, and both deal with different situations.
 - In the case of Capgemini India Private Limited², the Bombay High Court has held that buyback of shares cannot be equated with reduction of capital.
 - A perusal of Section 2(22)(d) and Section 46A of the Act, indicates that buyback of shares and reduction of share-capital are different concepts. Buyback of shares of a corporate entity cannot be characterised as deemed dividend, and the profit arising out of the buyback schemes should be taxed under the head capital gains. As per Article 13 of the tax treaty capital gains would not be taxable in the hands of M Co.
 - If the taxpayer was not liable to deduct tax as per the provisions of Section 195 of the Act, it could not be held as 'taxpayer-in-default' under Section 201 of the Act.
- The provisions of Section 115QA of the Act have been introduced with effect from 1 June 2013, and the profit arising out of buyback of shares is to be taxed at a specified tax rate. However, the relevant year under consideration was before such amendment and therefore, the issue was decided as per the law prevailing prior to such amendment.
 - In the case of Capgemini India Private Limited, the Bombay High Court has deliberated upon the almost identical facts and circumstances. Based on that case, it was held that the transaction would not fall under the category of colourable device.
 - If a taxpayer enters into a deal, which does not violate any provision of the Act, the deal cannot be termed as a colourable device, even if it results in non-payment or lesser payment of taxes. The whole exercise should not lead to tax evasion.
 - In the given circumstances, non-payment of taxes by a taxpayer could be a moral or ethical issue, for which the taxpayer cannot be penalised.

Our comments

After the introduction of Section 77A of the Companies Act, amendments were carried out in Section 2(22) of the Act to provide that the amount received on buyback of shares in accordance with Section 77 shall not be treated as deemed dividend. Further Section 46A of the Act was introduced to tax consideration received on such buyback as capital gains.

The AAR in the case of A Ltd. while dealing with the issue of taxability of consideration of buyback of shares held that buyback of shares by an Indian company from a Mauritian shareholder is a 'colourable device'. The scheme was devised to avoid payment of DDT, which is otherwise payable on the distribution of a dividend under Section 115-O of the Act. On the basis of this decision the tax department has been contending that the consideration of buyback of shares is to be treated as deemed dividend.

¹ XYZ India [AAR No. P of 2010 dated 22 March 2012]

² Company Scheme Petition No. 434 of 2014 dated 28 April 2015

The Tribunal in the instant case held that buyback of shares under Section 77A of the Companies Act cannot be characterised as deemed dividend, and the profit arising out of the buyback scheme should be taxed under the head capital gains. As per Article 13 of the India-Mauritius tax treaty such capital gains would not be taxable in India. The Tribunal observed that if a taxpayer enters into a deal, which does not violate any provision of the Act, the deal cannot be termed as a colourable device, even if it results in non-payment or lesser payment of taxes. The whole exercise should not lead to tax evasion. In the facts of the case, non-payment of taxes by a taxpayer could be a moral or ethical issue, for which the taxpayer cannot be penalised.



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