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Tax Flash News

26 September 2023

Purchase of own shares by a company is liable for dividend distribution tax as it amounts to 'distribution of accumulated profits'

Executive summary

The Chennai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Cognizant Technology Solutions India Pvt Ltd[1] (the taxpayer) dealt with the buyback of shares by the taxpayer company and held that the purchase of its own shares through a scheme amounted to 'distribution of accumulated profits' which entails the release of all or part of assets of a company on reduction of capital. The Scheme adopted by the taxpayer was a colorable device to avoid tax. The real intent of the transaction was to transfer the capital base of the company to Mauritius-based shareholders and distribute the company's accumulated profits to non-resident shareholders without coming within the ambit of any of the provisions relating to taxation of payments made for the purchase of its own shares. Thus, the transaction results in the distribution of accumulated profits and is taxable as deemed dividend within the meaning of Section 2(22) of the Income-tax Act, 1961 (the Act) and consequently liable for Dividend Distribution Tax (DDT) under Section 115-O.

Facts of the case

- The taxpayer, an Indian private limited company, engaged in the business of software development and related services/solutions. The taxpayer was originally a wholly owned subsidiary of CTS, USA.
- In the Financial Year 2011-12, there was a restructuring of various businesses directly or indirectly under the control of CTS, USA. Through a court-approved scheme, the taxpayer was amalgamated with Cognizant India Pvt. Ltd. (CIPL) and MarketRx India Pvt. Ltd. (MIPL).
- CIPL was a wholly owned subsidiary of Cognizant (Mauritius) Ltd., whereas MIPL was a wholly owned subsidiary of MarketRx Inc. USA. Such holding companies are wholly owned subsidiaries of Cognizant Technology Solutions Corporation, USA.
- During the FY 2016-17, the taxpayer had purchased its own shares from non-resident shareholders in a 'Scheme of Arrangement & Compromise' sanctioned by the Madras Court in terms of provisions of Section 391-393 of the Companies Act, 1956.
- In accordance with the scheme as sanctioned by the Madras High Court, the taxpayer has purchased 94 lakh equity shares (representing 54.70 per cent of the paid-up share capital) from its shareholder at a price of INR 20,297 per share and paid total consideration of INR 19,080 crores.
- Admittedly, the share capital of the taxpayer was held by 4 non-resident shareholders, and out of which, 3 shareholders are residents of USA, and one shareholder is a tax resident of Mauritius.

[1] Cognizant Technology Solutions India Pvt Ltd v. ACIT (ITA No. 269/Chny/2022) – Taxsutra.com

- The taxpayer deducted tax on the consideration paid to non-resident shareholders of the USA as the benefit of the India-USA tax treaty was not available. However, no tax was deducted on the consideration paid to Cognizant (Mauritius) Ltd. as capital gain was not chargeable to tax in the hands of Mauritius shareholders in India under the India-Mauritius tax treaty.

- The Assessing Officer (AO) and the Commissioner of Income-tax (Appeals) [CIT(A)] held that the purchase of its own shares through the 'scheme of arrangement and compromise' is not a buyback under Section 77A and thus, Section 46A will not apply. Further, the consideration paid by the taxpayer for the purchase of its own shares from non-resident shareholders fell within the ambit of 'deemed dividend' provisions under Section 2(22)(a)/(d). Therefore, the taxpayer was liable to pay DDT under Section 115-O.

Tribunal's decision

Artificial shifting of the shareholding base

- There has been an artificial shifting of the shareholding base from the USA to Mauritius solely to claim India-Mauritius tax treaty benefits. Prior to the amendments made to the India-Mauritius tax treaty, capital gains on the transfer of equity shares were not taxable in India.

- The entire scheme itself was moved hurriedly and it was evident from the dates and events brought on record by the AO.

- There was a proposal to amend Section 115QA[2] and the same was announced in the public domain on 29 February 2016. The taxpayer immediately convened a Board Meeting on 10 March 2016 to consider the scheme of purchasing its shares to avoid taxability under buyback provisions.

Deemed dividend under Section 2(22)(d)

- Section 2(22) ensures that the taxpayer does not camouflage payments out of accumulated profits to its shareholders through different channels to avoid payment of tax.

- The term 'dividend' is explained by various Courts[3]. It indicates that any distribution by a company of accumulated profits, if such distribution entails the release by the company to its shareholders all of or any part of the asset of the company shall come within the definition of 'dividend' under Section 2(22).

- Two essential pre-requisites must be satisfied to fall within the ambit of Section 2(22)(d), i.e., there must be a distribution to the shareholders on the reduction of the capital and it must be to the extent that the company possesses accumulated profits.

- As per the scheme, the distribution of money will be out of the general reserves and accumulated credit balance in the profit and loss account. Thus, both conditions under Section 2(22)(d) were satisfied.

Purchase through offer and acceptance is also 'distribution'

- The taxpayer contended that the scheme of purchase of own shares was made through offer and acceptance. Therefore, it involves an element of quid pro quo and hence there was no 'distribution' for the purpose of Section 2(22)(d). The said contention was not correct.

- The Supreme Court in the case of Punjab Distilling Industries observed that the definition of 'distribution' does not contain any aspect of quid pro quo or lack thereof. The prerequisites for distribution are that there must be payment, and the disbursal must be made to more than one person. Section 2(22)(d) does not distinguish whether the reduction of share capital is the intended result of the resultant consequence of the scheme.

Purchase of own share is nothing but the distribution of accumulated profits and reduction of capital

- The transaction of the taxpayer would either to fall under Compromises & Arrangements read with Section 77[4] and Section 100 (reduction of capital) of the Companies Act,1956 or Compromises & Arrangements read with Section 77A[5] of the Companies Act, 1956.

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[2] The Finance Bill, 2016 proposed an amendment to Section 115QA with effect from 1 June 2016 to provide that the provisions of Section 115QA shall apply to any buy-back of unlisted shares 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

[3] Shashibala Navnitlal v. CIT [1964] 54 ITR 478 (Guj), Punjab Distilling Industries Ltd. v. CIT [1965] 57 ITR 1 (SC), J. Dalmia v. CIT [1964] 53 ITR 83 (SC)

[4] Section 77 of the Companies Act, 1956 in India prohibits a company from buying its own shares unless it is by way of reduction of share capital

[5] Section 77A of the Companies Act 1956 is a provision that enables companies to buy-back their own shares or other specified securities

- Once the buyback is not under Section 77A of the Companies Act, 1956, then, it will fall back under Section 391-393 read with Section 100-104 of the Companies Act, 1956, because, without any reference to Section 100-104 (reduction of capital), no company can buy-back its shares under Section 391-393 alone.

- Therefore, the transactions of purchase of its own shares are nothing but the distribution of accumulated profits and reduction of capital which falls under the definition of dividend under Section 2(22)(d).

Deemed dividend or capital gains

- The taxpayer's contention that the consideration paid for the purchase of its own shares was to be taxed only in the hands of shareholders under section 46A, as capital gains, was not correct.

- Section 46A is only applicable to buyback under Section 77A of the Companies Act and not to other forms of purchase of own shares.

- Further Section 115-O contains a non-obstante clause which would override the provisions of Section 46A.

Taxability under buyback tax provisions

- Buyback tax provisions of Section 115QA were amended to include all forms of buyback of shares under any provisions of the Companies Act because divergent views have been expressed by various Courts and Tribunal on this issue and to overcome such views amendment has been made to capture all forms of buyback under Section 115QA.

- In any event, assuming without conceding that the purchase of own shares amounts to buyback, but not buyback under Section 77A, which would still be taxable under Section 115-O.

- As per the proviso to Section 2(22), only buyback under Section 77A is excluded from the definition of dividend under Section 2(22).

- In other words, any other form of buyback, including the purchase of own shares under Section 391-393 would fall back under the definition of Section 2(22), because it entails the release of all or part assets of a company to its shareholders.

- Thus, the contention of the taxpayer that the purchase of own shares by a 'Scheme of Arrangement & Compromise' under section 391-393 of the Companies Act is taxable under section 115QA, only after an amendment to the term 'buyback' by the Finance Act 2016[6] was incorrect.

- If all conditions of Section 115-O read with Section 2(22) are satisfied, the same cannot be impliedly excluded based on the amendment to Section 115QA.

Effect of the scheme sanctioned by the High Court and AO's powers

- The Company Court will look at the scheme and act as an umpire to just verify whether the requisite meetings under Section 391(1)(a) of the Companies Act,1956, have been complied with. Therefore, the High Court, while sanctioning the scheme will merely look at the commercial wisdom of the creditors and approve the same if it is just and fair and there are no illegalities. The tax consequences and otherwise would be for the AO to look into the scheme in light of the relevant provisions of the Act.

- The AO was fully empowered to analyse the effects of the scheme and to determine whether they attract the provisions of the Act or not.

- Therefore, the court-approved scheme is binding on all stakeholders, wherever it comes to the commercial wisdom of the persons who proposed the scheme. However, it does not mean that other consequences like tax implications are fully absorbed by the Court when the scheme is sanctioned.

The scheme was a colorable device

- The real intent of the transaction was to transfer the capital base of the company to Mauritius-based shareholders and distribute the company's accumulated profits to non-resident shareholders without coming within the ambit of any of the provisions relating to taxation of payments made for the purchase of its own shares.

- The scheme was only a colorable device intended to evade legitimate tax dues. Such colorable devices that do not have any commercial purpose can be excluded for physical nullity and the AO was empowered to 'look through' rather than 'look at' the transactions.

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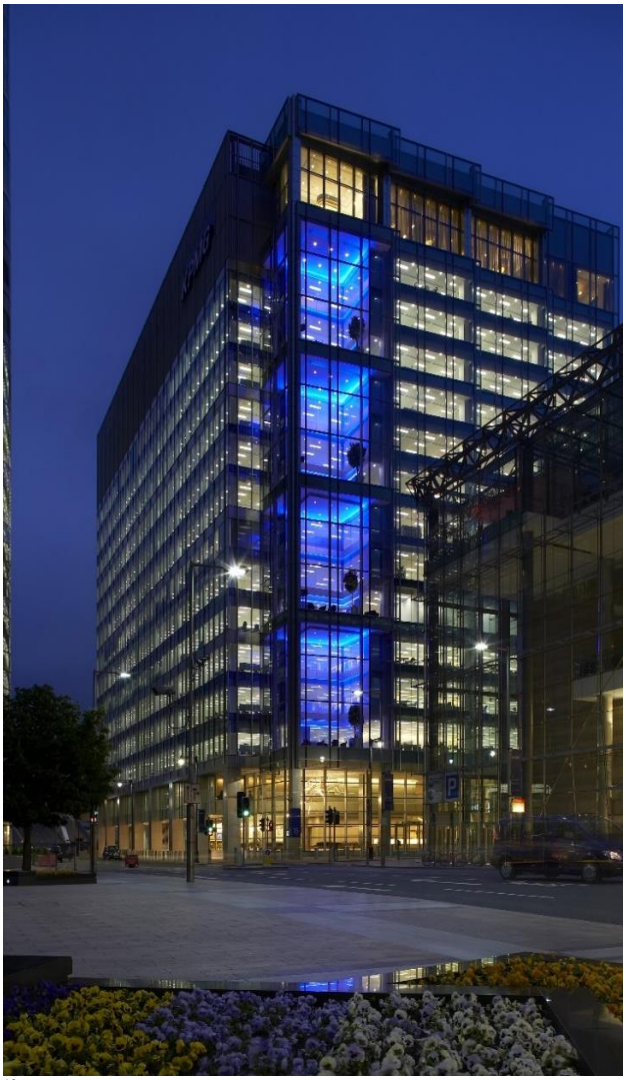
[6] The Finance Act, 2016 amended Section 115QA with effect from 1 June 2016 to provide that the provisions of Section 115QA shall apply to any buy-back of unlisted shares undertaken by the company in accordance with the provisions of the law relating to the Companies and not necessarily restricted to Section 77A of the Companies Act, 1956

Our comments

In view of this decision, it is important for corporates to carefully analyse their structuring by way of buyback, capital reduction, etc. because the tax department may apply a 'look through' approach while dealing with such transactions. With the introduction of anti-abuse provisions like GAAR, the tax department may adopt stricter scrutiny of transactions to deny any undue tax benefits. Further, with the amendment under Section 115QA and the abolition of DDT provisions, it would be interesting to see how the courts will deal with such transactions.



[10] CIT v. Kelvinator of India Ltd. [2023] 151 taxmann.com 154 (Mad)

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