CAN A COMPANY BUYING BACK ITS SHARES BE TAXED U/S. 56(2)(viia)?

INTRODUCTION

A recent judgement of the Hon'ble Mumbai Tribunal in case of M/s. Vora Financial Services P. Ltd. vs. ACIT [ITA No. 532/Mum/2018] lays down an interesting aspect on taxation of buy-back of shares in the hands of the company buying back the shares. The decision was rendered in favour of the assessee to the effect that "own shares" received by a company on buy-back are not "property" of the company and hence, not chargeable to tax u/s 56(2)(viia) (S. 56(2)(x) post 01.04.2017) of the Income tax Act, 1961 (**ITA**).

This article analyses the aforesaid decision and other possible reasons in favour of the argument that buyback should not be taxed in the hands of the concerned company u/s 56(2)(viia).

DECISION – AN ANALYSIS

The case of M/s. Vora Financial Services P. Ltd relates to the addition of Rs. 82.89 lakhs made u/s. 56(2)(viia) of the Act in the hands of the company who bought back its own shares.

During the relevant AY 2014-15, the assessee made an offer for buy back of 25% of its existing share capital. The Assessing Officer (**AO**) noticed that the book value of shares as on 31.3.2013 was allegedly Rs. 32.80 per share, whereas the assessee company has bought back the shares at Rs. 26/- per share. Accordingly, the AO assessed the difference between the book value of shares and purchase price of shares amounting to Rs. 82.89 lakhs as income of the assessee u/s. 56(2)(viia) of the Act.

The Hon'ble Mumbai Tribunal held that the AO was not justified in invoking S. 56(2)(viia) for buyback of own shares for the following reasons:

1. S. 56(2)(viia) is applicable only in cases where the shares received become 'property' of the recipient;
2. Shares can become property of the recipient only if it is "shares of any other company"."

3. In case of buy-back, where assessee receives its own shares, which is immediately extinguished, the tests of "becoming property" and also "shares of any other company" fails.
4. Accordingly, since the requirement of section 56(2)(viia) is not satisfied in case of buy-back of shares, said section is not applicable in case of buy-back of shares.

This is a welcome decision that would bring relief to assessees undertaking buy-back of shares. Indeed, buyback of shares or other securities by a company is governed by S. 68 of the Companies Act, 2013 (erstwhile S. 77A of Companies Act, 1956). From the perusal of said provision, it is amply clear that shares bought back are mandatorily required to be destroyed and extinguished within a period of 7 days from the completion of buyback and the company has to maintain detailed records for cancellation of such shares. Thus, the shares, which cease to exist upon buyback, cannot be termed as "property" in the hands of the company.

In any case, since the shares so received by the company are to be mandatorily extinguished, it would be incorrect to attribute any value to the same. As far as the company receiving the shares is concerned, the fair value of said shares is zero. The company cannot trade in such shares, transfer them or procure funding against such shares. Accordingly, applying Rule 11UA for computing the fair value of the shares bought back from the perspective of company buying back the shares would be incorrect and illogical.

Also, S. 115QA was inserted in the statute vide the Finance Act, 2013, whereby unlisted companies buying back shares are now required to pay tax @ 20% (**BBT**) on the difference between sale consideration and amount received for shares bought back, and the resulting gains in the hands of the shareholders is exempted under section 10(34A) of the ITA. Thus, in the current scenario, where companies have already been subject to new distribution tax on buy-back of shares, making even provisions of section 56(2)(viia) applicable to them would result in undue hardship on the companies.

Further, S. 56(2)(viia) was introduced as an anti-abuse provision. The Memorandum to the Finance Act, 2010 explaining the introduction of S. 56(2)(viia) reads as under:

"Under the existing provisions of section 56(2)(vii)……..

These are anti-abuse provisions which are currently applicable only if an individual or an HUF is the recipient. Therefore, transfer of shares of a company to a firm or a company, instead of an individual or an HUF, without consideration or at a price lower than the fair market value does not attract the anti-abuse provision In order to prevent the practice of transferring unlisted shares at prices much below their fair market value, it is proposed to amend section 56 to also include within its ambit transactions undertaken in shares of a company (not being a company in which public are substantially interested) either for inadequate consideration or without consideration where the recipient is a firm or a company (not being a company in which public are substantially interested)."
(underlined for emphasis)

As is clear S. 56(2)(viia) is an anti-abuse provision introduced to tax transactions of transfer of shares of a closely held company to a "firm or another closely held company", which hitherto escaped the tax net.

In Capgemini India (P.) Ltd., In re [2016] 67 tamxann.com 1 (Bom.), the Hon'ble Bombay High Court has held that a company is entitled to buy back its own shares by means of a scheme under section 391, read with sections 100-104 of the Companies Act, 1956, the scheme cannot be said to be a colourable device to evade income tax. It is a legally permissible procedure, which the petitioner is entitled to follow to buy back its shares. This decision was followed in case of Goldman Sachs (India) Securities (P.) Ltd vs. ITO [2016] 70 taxmann.com 46 (Mum).

Accordingly, a buyback transaction in compliance of the provisions of the Companies Act cannot be treated as a tax evading transaction for the purpose of S. 56(2)(viia) or S. 56(2)(x). This would override the basic purpose of enactment of S. 56(2)(viia).

It is also arguable that S. 56(2)(viia) presupposes that there is a 'transfer' of shares, which involves three parties – a transferor, a transferee (a firm or a closely held company) and another company whose shares are "property" of the subject matter of the transaction. This is also clear from the afore-quoted Explanatory Memorandum, which indicates that the said section was introduced to apply to 'transfer' of unlisted shares. Thus, there should be 3 parties for the purpose of levy of tax u/s 56(2)(viia). However, in case of a buy-back, the transaction only involves two

parties – the transferor or shareholder and the company whose shares are bought back. Accordingly, it would not possible to invoke the provisions of section 56(2)(viia) in case of buy-back.

In fact, the Apex Court has in Khoday Distilleries Ltd v CIT (2008) 307 ITR 312 (SC) explained the difference between creation of asset and transfer of asset. In that context, it has held that on allotment of shares, there is a creation of asset and accordingly, same cannot be equated with transfer of asset. Applying same analogy in case of buy-back, it can be argued that in case of buy-back there is destruction of asset and not transfer of asset and accordingly, such a transaction cannot fall within the ambit of S. 56(2)(viia). There also exists a view that buy-back of shares is not regarded as 'transfer of shares' even for the purposes of stamp duty and accordingly, the same is not payable since on buy-back, the shares not required to be registered in the name of any shareholder-recipient.

Accordingly, even for said reason, it is arguable that S. 56(2)(viia) cannot apply in case of buy-back.

CONCLUSION

There are ample arguments to support the view that buyback cannot be brought within the gamut of S. 56(2)(viia), which is further strengthened by the afore-quoted decision of the Mumbai Tribunal. Yet, we need to wait and watch if the Department goes into appeal against the aforesaid decision of Vora Financial Services.

Interestingly, since after introduction of sections 115QA and 10(34A), the resulting capital gains in case of buy-back of unlisted shares is not taxable in the hands of the shareholders, even the provisions of section 50CA would not apply even if there is difference in the purchase price and the Rule 11UA value of the shares bought-back.