BUY-BACK OF SECURITIES – DEEMED DIVIDEND OR CAPITAL GAINS?

1. INTRODUCTION

1.1 Compromise or arrangement allows companies to restructure their affairs to achieve certain objectives. It paves way for mergers, acquisitions, demerger or reorganization of a company. This compromise or arrangement creates a scenario for interplay of the Companies Act, 1956 ("**Cos Act 1956**")/Companies Act, 2013 and the Income Tax Act, 1961 ("**ITA**"). The technicalities of the company law, for instance, when buy-back of shares is through automatic route or through High Court/National Company Law Tribunal ("**NCLT**") route may result in different treatment of the arrangement under ITA.

1.2 In one such interesting case, buy-back through a court approved scheme was held to be liable to tax a Dividend Distribution Tax ("**DDT**"). The taxpayer was Cognizant Technology Solutions India Pvt. Ltd. ("**Cognizant India**"), one of the well-known companies engaged in the business of software development and related services.

2. FACTS AND ISSUE

2.1 Cognizant India had 4 (four) shareholders (prior to buy-back); with 3 (three) United States of America ("**USA**") shareholders owning approximately 24% and a Mauritius shareholder owning balance 76%. Through a Scheme of Arrangement and Compromise, as approved by the Madras High Court, under sections 391 to 393 of the Cos Act 1956 ("**Scheme**"), Cognizant India purchased 24% shares owned by the USA shareholders and a substantial chunk of shares from the Mauritius based shareholder, such that the Mauritius based shareholder became 99.87% owner of Cognizant India after the buy-back. Below mentioned is a tabular representation depicting the shareholding pattern prior to and after buy-back of shares.

Shareholder	Shareholding Percentage before purchase of own shares in accordance with the Scheme	Shareholding Percentage after purchase of own shares in accordance with the Scheme
Cognizant Technology Solutions Corporation, USA	21.53%	**Nil**
Marketrx, Inc, USA	1.39%	**Nil**
CSS Investments LLC, Delaware, USA	0.99%	**0.13%**
Cognizant (Mauritius) Limited, Mauritius	76.09%	**99.87%**
Total	**100%**	**100%**

2.2 The key issue in this case pertained to taxability of the consideration paid by Cognizant India for purchase of its own shares. Cognizant India treated this transaction as capital gains. It withheld tax on consideration paid to non-resident shareholders who were resident of USA

and did not withhold tax on consideration paid to Cognizant (Mauritius) Limited, Mauritius, on the basis that capital gains are not chargeable to tax in India under the India-Mauritius tax treaty. On the other hand, the Assessing Officer ("**AO**") treated the consideration paid by Cognizant India to its shareholders for purchase of its shares as a "***deemed dividend***" under section 2(22)(a)/2(22)(d) of ITA and therefore, held Cognizant India liable for payment of DDT under section 115-O of ITA.

2.3 A timeline chart is given below with relevant dates highlighting different events:

DATES	RELEVANT EVENTS
February 29, 2016	Proposal to amend section 115QA of ITA (Tax on distributed income to shareholders on buy-back of shares) was announced by the Government of India.
March 10, 2016	Cognizant India convened a board meeting to consider the Scheme of purchase of its own shares.
April 05, 2016	Details of the Scheme were sent to the Registrar of Companies.
April 07, 2016	The Registrar of Companies sent their objections to the Regional Director.
April 11, 2016	The Scheme came up for final hearing before the Madras High Court.
April 18, 2016	The Madras High Court approved the Scheme.
May 18, 2016	The Cognizant India implemented the Scheme.
June 01, 2016	The amendment to section 115QA came into force causing all forms of buy-back of shares to be subject to additional income tax.

3. APPLICABLE LAWS

3.1 The two relevant laws in this case are the Cos Act 1956[1] and ITA. The relevant provisions under these two laws are tabulated below:

SECTION	DESCRIPTION
Cos Act 1956	
77A	Buy-back of shares means a company purchasing back its shares from the shareholders. There are two modes of buy-back. One is through an automatic route, meaning thereby, that there is no approval required for this kind of buy-back. The other mode is, by an approval route, that is after the approval of NCLT, one can undertake such a buy-back. This section lays down conditions relating to the power of the company to purchase back its own shares through an automatic route. For instance, if the buy-back is upto 25% of the total paid-up capital and free reserves of the company, then, no approval is required by NCLT.

[1] For the purposes of this case, Cos Act 1956 is the relevant law since the corresponding provisions of Companies Act, 2013 were not in force. However, similar provisions exist under the Companies Act, 2013. Under the new Companies law, section 68 provides for buy-back of securities through automatic route and section 230 provides for buy-back of securities through NCLT route.

SECTION	DESCRIPTION
391	This section enables buy-back of securities through approval. It empowers NCLT (earlier "High Court") to grant approval to a compromise or arrangement between a company and its creditors or a company and its members. This can be termed as the "NCLT Route".
100 to 104	Lays down procedure to be followed in case of reduction of share capital.
ITA	
2(22)(a)	Any distribution by a company of accumulated profits, resulting in release of all or part of the assets of the company to its shareholders is treated as deemed dividend.
2(22)(d)	Any distribution by a company to its shareholders, on the reduction of capital to the extent to which the company possesses accumulated profits is treated as deemed dividend.
115-O	Any amount declared, distributed or paid by a company by way of dividends (whether interim or otherwise) shall be charged to additional income tax known as DDT. The concept was introduced through Finance Act, 1997 under Chapter XII-D. The rate of tax was 10%. Section 115-O was amended in 2003 and the rate was increased to 12.5%. Further, through an amendment in 2020, the obligation of the company to deduct DDT was abolished and the liability of the company would arise only for dividends declared, distributed, or paid upto March 31, 2020.
115QA	This section was introduced through Finance Act, 2013, as a special chapter, that is, Chapter XII-DA to tax distributed income to shareholders on buy-back of shares. In 2013, it was restricted to buy-back of shares under section 77A of the Cos Act 1956. However, an amendment was brought in 2016 with effect from June 01, 2016, through which, section 115QA also covers buy-back **under any other law in force**. As an implication, buy-back through NCLT Route is also now covered under section 115QA.
46A	This section states that in case a shareholder receives any consideration from any company for purchase of its own shares held by such shareholder, then the difference between cost of acquisition and consideration received by the shareholder shall be deemed to be capital gains arising to such shareholder.

4. DECISION

4.1 The issue of taxability of the consideration paid by Cognizant India for purchase of its own shares as deemed dividend or capital gains was decided by the Income Tax Appellate Tribunal

("**ITAT**") Chennai.

4.2 The Tribunal saw the entire scheme of Cognizant India as a colourable device intending to evade legitimate tax dues. The basis for this view was that when the Cos Act 1956 specifically provides a separate provision for buy-back of shares (section 77A of the Cos Act 1956), Cognizant India took a general provision (section 391 of the Cos Act 1956) for its advantage and carried out buy-back of shares. This was done specifically to evade the additional income tax under section 115QA of ITA. Additionally, the Tribunal found no commercial nexus between the company's activities and Mauritius. The Tribunal, thus, held that, such colourable devices do not have any commercial purpose and AO is empowered to 'look through' rather than 'look at' the transactions.

4.3 Cognizant India argued that the consideration paid for purchase of its shares is taxable in the hands of the shareholder as capital gains. It is submitted that a combined reading of provisions of sections 46A, 115QA and 10(34) of ITA, clearly indicates that buy-back of shares under section 77A of the Cos Act 1956, would be taxable in the hands of the shareholders under section 46A of ITA, up to May 31, 2013 and from June 01, 2016, the company is liable to pay additional income tax under section 115QA of ITA and the shareholders not need pay any tax by virtue of exemption provided under section 10(34) of ITA. On the other hand, in case of buy-back of shares under sections 391-393 of the Cos Act 1956, upto May 31, 2016, it is taxable as capital gains in the hands of the shareholders under section 46A of the Act. Additional income tax under section 115QA of ITA, is not applicable as it applies only for purchase of own shares under section 77A of the Cos Act 1956. It is only from June 01, 2016 that a company is liable to pay additional income tax under provisions of section 115QA of ITA in all cases of buy-back.

4.4 The Tribunal however, held otherwise. It held that the scope of section 46A of the ITA is limited. Section 46A is only applicable to buy-back under section 77A of the Cos Act 1956 and not to other forms of buy-back. The Tribunal stated following reasons for the same:

a) Finance Act, 1999 introduced section 46A under ITA. The memorandum to this Finance Act, explaining the provision of the Finance Act, makes it clear that section 46A seeks to clarify the confusion created by insertion of section 77A under the Cos Act 1956, as to whether the same ought to be taxed as capital gains or dividends.

b) Insertion of section 46A under ITA was contemporaneous to the insertion of section 77A under the Cos Act 1956 and excluding it from deemed dividend under section 2(22) of ITA.

c) The explanation to section 46A, ITA also states that even the words 'specified securities' would have the same meaning attached to it under section 77A of the Cos Act 1956.

4.5 In the present case, the Scheme stated that it is not a transaction under section 77A of the Cos Act 1956. Additionally, the transaction involved purchase of 54.7% of the outstanding number of equity shares. It is above the allowed limit for automatic route under section 77A of the Cos Act 1956 that is, 25% of the total paid-up capital and free reserves of the company. Hence, the transaction is not covered by section 46A of ITA. The Tribunal also opined that even if one assumes that section 46A applies to all forms of buy-back, still, since section 115-O of ITA contains a non-obstante clause, it will have an overriding effect on section 46A of ITA.

4.6 Cognizant India argued if the transaction is not covered under section 46A of ITA, it would still be independently covered under sections 391-393 of the Cos Act 1956. The Tribunal, however, held, there cannot be any *sui generis* buy-back under sections 391-393 of the Cos Act 1956. A purchase of own shares involving reduction of share capital can only be done under sections 391-393 read with sections 77 and 100 of the Cos Act 1956.

4.7 Cognizant India also argued that the decision of the High Court approving the scheme operates as a judgment '*in rem*.' Thus, once having furnished 'no objection' from the Regional Director, the central government including the AO cannot change the nature of scheme approved by the court. However, the Tribunal reiterated the limited role of a High Court in approving such a scheme. The Court would look at the scheme and act as an umpire to just verify whether the requisite meetings and required majority in number representing three-fourths in value of the creditors, or class of creditors, or members, or class of members as the case may be, for voting have been complied with in accordance with section 391 of the Cos Act 1956. The Court would also look into the scheme as to whether it is fair to all members and reasonable to a prudent man. The Court thus, will look at only the commercial wisdom of the creditors and approve the same if it is just and fair and there are no illegalities. The tax consequences would still be for the AO to look into. The AO is fully empowered to analyse the effects of the scheme and to determine whether they attract the provisions of ITA.

4.8 Hence, Tribunal did not consider the consideration paid for purchase of its shares by Cognizant India as capital gains. The Tribunal considered the consideration paid to be a *deemed dividend*. It held that the definition under section 2(22) of ITA is an inclusive one and it goes beyond the conventional or traditional meaning associated with dividend. The definition is broad and covers a wide variety of payments made by a company. With respect to section 2(22)(d) of ITA, it held that there are two essentials that must be satisfied to come within the scope of section this provision. First, there must be a distribution to the shareholders on the reduction of capital and second, it must be to the extent that the company possesses accumulated profits. Both these conditions are satisfied in the present case to treat the transaction within the scope of section 2(22)(d) of ITA. Cognizant India argued that the scheme is made through offer and acceptance, which involves an element of *quid pro quo* and thus, there is no distribution per se. Further, distribution should be on reduction of capital. Reduction of capital is to be coterminous with the distribution. However, under the present Scheme, reduction was only a consequence of the Scheme and there has been no distribution on reduction of capital. Th Tribunal, however, did not concede to this argument. It held that the word 'distribution' means division/payment between/to several people. The only condition specified was that it must be actual and not notional. There is no aspect of quid pro quo or lack thereof in the definition. Secondly, the definition of dividend under section 2(22) is an inclusive definition. The intent of the provision is to cover all scenarios whereby a company distributes its accumulated profits without strictly coming within the term 'dividend.' Thus, the Tribunal held that, a very literal and hyper technical reading of the provision would be contrary to the legislative intent.

4.9 Recently, Cognizant India has appealed against this decision of the Tribunal before the Madras High Court which involves DDT of Rs. 19,000 crores on buyback of shares.

5. INDUSLAW ANALYSIS / COMMENTS

5.1 This is a significant ruling and has raised the debate over the scope of section 46A of ITA, that is, whether it would be attracted for all forms of buy-back or only when buy-back of securities is under section 77A of the Cos Act 1956 (automatic route).

5.2 The first rule to be applied in interpretation of a statute is the "literal rule". It generally means that the text of a statute should be interpreted as it is. The words in the statute should be construed according to their natural and ordinary meaning.

5.3 There is another rule of interpretation, that is, the golden rule of interpretation. It means if the language of the statute is ambiguous, then, one can look at the legislative intent to interpret the actual meaning of the legislation. However, this rule would be resorted to only when there is ambiguity in the text of the statute.

5.4 Applying the literal rule of interpretation to interpret section 46A of ITA, the section nowhere mentions that the provision is applicable only to buy-back under section 77A of the Cos Act 1956. The section does not create confusion on its scope based on ambiguity in the language itself. For instance, section 115QA under ITA as originally introduced stated, *"buy-back means purchase by a company of its own shares in accordance with the provisions of section 77A of the Cos Act 1956 (1 of 1956)."* It specifically restricted the scope of section 115QA to buy-back of securities under section 77A of Cos Act 1956. However, section 46A did not use this language / restrict its scope. Section 46A uses the phrase *"purchase of its own shares or other specified securities."* Based on the language contained in the section, it appears that any form of buy-back or purchase of own shares or other specified securities by a company should be covered under section 46A of the ITA.

5.5 The Supreme Court in the past has held that *"if the language of the statute is clear and unambiguous, and if two interpretations are not reasonably possible, it would be wrong to discard the plain meaning of the words used in order to meet a possible injustice."*[2] In another recent case, the Delhi High Court while interpreting section 245A of ITA held that *"there is no ambiguity in section 245A of the Act that makes it necessary or apposite for the court to discard the literal interpretation of the language of section 245A of the Act."*[3]

5.6 Besides, in the present case, the tax authorities have not made any reference to General Anti Avoidance Rules. The ruling is largely based on Tribunal viewing the entire scheme as a colourable device intending to evade legitimate tax dues.

5.7 Based on this ruling, tax authorities are likely to scrutinise in greater detail the tax-efficient structure for corporate reorganisation through court approved schemes. Besides, it will be interesting to see whether any refund will be available for taxes withheld and deposited (considering capital gain treatment) when the transaction is recharaterised to treat is a deemed dividend on which DDT becomes payable. All eyes will now be on the outcome from the Madras High Court on this ruling.

Authors: Lokesh Shah | Aarya Jha

Practice Area: Direct Tax

[2] CIT v T.V. Sundaram Iyengar & Sons (P.) Ltd [1975] 101 ITR 764 (SC).
[3] Sushil Kumar Goyal v Principal Commissioner of Income Tax [2023] 152 taxmann.com 54 (Delhi).

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