

Bombay Chartered Accountants' Society

Direct Tax Alert– Income-tax (28th Amendment), Rules, 2016 Special Provisions Relating to Tax on Distributed income of Domestic Company for Buy-Back of Shares

The Central Board of Direct Taxes ('CBDT'), vide Notification No.94/2016 [F.No.370133/30/2016-TPL]/ G.S.R. 982(E) dated 17th October 2016, has notified Income-tax (28th Amendment), Rules, 2016 by way of inserting PART VII-BA – Rule 40BB to the Income-tax Rules, 1962 ('the Rules') which shall come into force from the 1st June 2016.

These amendments are with regard to "Special Provisions Relating to Tax on Distributed income of Domestic Company for Buy-Back of Shares" which provides the computation mechanism for determination of 'amount received' by the company in twelve different scenarios depending upon mode of issue of shares – section 115QA of the Income-tax Act, 1961 ('the Act').

Background

- The **AAR in the case of A, In re^[1]** held that where a Mauritian shareholder of Indian company, accepted offer of buy-back of shares given by Indian company, the amount received would be taxable in India as dividend which is liable to withholding tax under section 195 since the tax payers were taking benefit of some tax treaties and avoiding payment of Capital Gains Tax.
- The **Finance Act, 2013** brought in a prospective amendment in the Act **to tax the distributed income of domestic company on account of buy back of shares** by inserting a new Chapter XII-DA comprising of sections 115QA to 115QC w.e.f. 1st June 2013, to negate the avoidance of payment of tax by way of DDT particularly where the capital gains arising to the shareholders are either not chargeable to tax or are taxable at a lower rate.

The term "**Distributed Income**" was defined by way of Explanation to sub-section (1) of section 115QA which is reproduced below:

(ii) "distributed income" means the consideration paid by the company on buy-back of shares as reduced by the amount which was received by the company for issue of such shares.

However, there was an ambiguity on the determination of consideration received by a company at the time of issue of shares being bought back by the company which would have lead to avoidable disputes and also presented a tax arbitrage opportunity of scaling up of consideration particularly under a tax neutral business reorganisation followed by buyback of shares. Following are the situations where shares may have been issued by the company^[2]:

- in tranches,
- for different considerations, at different point of time or
- May have been issued in lieu of existing shares of another company under amalgamation, merger or demerger.

- To carve out the above, the **Finance Act, 2016** made an additional amendment in clause (ii) of the Explanation to section 115QA (1) of the Act to standardise the manner and to lay the criteria for determining the consideration received by a company. The same is reproduced below:
 - (ii) “distributed income” means the consideration paid by the company on buy-back of shares as reduced, by the amount which was received by the company for issue of such shares, ***determined in the manner as may be prescribed.*** (words in bold and italics were inserted w.e.f. 1st June 2016)
- To put the above amendment swiftly in place, the CBDT vide Letter F.NO.370133/30/2016-TPL on **25th July 2016** issued draft rules (***comprising of eight different scenarios***) for determining the amount received by the company on issue of its shares bought back and invited public comments thereon.
- Based on the feedback received, the CBDT, in exercise of the powers conferred by section 115QA read with section 295 of the Act, recently issued final rules dated **17th October 2016** prescribing the computation mechanism for determining **amount received** on issue of shares comprising of ***twelve different scenarios.***

The final rules were released by way of insertion of Rule 40BB in the Income-tax Rules, 1962 particularly for the purpose of clause (ii) of the Explanation to the section 115QA(1) of the Act as amended by Finance Act, 2016.

- These rules will be applicable from 1st June 2016.

The salient features of Rule 40BB are as under:

Sub - Rule	Manner of issue of shares to be bought back	Manner of determination of “amount received”
2	Shares issued by way of subscription	Amount actually received including share premium
3	Where at any time prior to buy-back, company had returned any sum out of the amount received at the time of issue	Amount actually received as reduced by the sum so returned. However, if Dividend Distribution Tax was paid on the amount so returned, then that amount shall not be reduced.
4	Shares issued under an employees’ stock option plan or as sweat equity shares	Fair market value (‘FMV’) as per Rule 3(8) [i.e. FMV as determined by a merchant banker on the date of exercising the option or any other earlier date not being more than 180 days earlier], to the extent credited to the share capital and share premium account. For the purpose of this sub-rule “sweat equity shares” shall have the meaning assigned to it in clause b of the explanation of section 17(2)(vi) of the Act. ^[3]
5	Shares issued by amalgamated company in lieu of share or shares of an amalgamating Company	Amount received by the amalgamating company in respect of such share or shares determined in accordance with this Rule shall be deemed to be the

Sub - Rule	Manner of issue of shares to be bought back	Manner of determination of "amount received"
		amount received by the amalgamated company in respect of the share so issued by it.
6	Shares issued by resulting company in a scheme of demerger	Amount received by the demerged company in respect of its original shares determined in accordance with these rules, in the proportion of net book value of assets transferred in a demerger to the net worth of the demerged company immediately before demerger
7	Original shares in demerged company	Amount received by the demerged company in respect of its original shares as reduced by amount determined for shares issued by resulting company in such demerger (sub-rule 6 above)
8	Shares issued or allotted by the company as part of consideration for acquisition of any asset or settlement of any liability	<p>Amount received = A/B, where A = Lower of (a) or (b)</p> <p>a. the amount which bears to the fair market value (FMV) of the asset or the liability, as determined by a merchant banker, the same proportion as the part of consideration being paid by issue of shares to total consideration</p> <p>b. amount of consideration for acquisition of the asset or settlement of the liability to be paid in the form of shares, to the extent credited to the share capital and share premium account by the company</p> <p>B = Number of shares issued by the company as part of consideration</p>
9	<p>Shares issued or allotted by a company as the case may be;</p> <ul style="list-style-type: none"> - on succession or conversion of a firm into the company or - - succession of sole proprietary concern by the company 	<p>Amount received = (A - B)/C, where</p> <p>A= Book value of assets (ignoring revaluation) shown in the balance-sheet as reduced by</p> <p>(i) TDS/ TCS/ Advance tax (as reduced by tax amount claimed as refund); and</p> <p>(ii) any amount which does not represent value of any asset(including the unamortized amount of deferred expenditure)</p> <p>B= Book value of liabilities shown in the balance- sheet (excluding capital, reserve and surplus, adjusted provision for tax, provisions for unascertained liabilities and contingent liabilities)</p> <p>C= Number of shares issued on conversion or succession</p>

Sub - Rule	Manner of issue of shares to be bought back	Manner of determination of “amount received”
10	Shares issued or allotted, without any consideration on the basis of existing shareholding in the company (Bonus Shares).	NIL
11	Shares issued on conversion of preference shares or bond or debenture, debenture-stock or deposit certificate in any form, or warrants or any other security	Amount received by the company in respect of the instrument converted
12	Shares held in dematerialized form and not distinctly identifiable	To be determined in accordance with these Rules on FIFO basis.
13	Any other case	Face value of the share shall be deemed to be the amount received by the company for issue of shares

BCAS' Comments

The much awaited clarity towards what constitutes “**amount received**” particularly for non-cash transactions is a great relief and it leads to a stable tax regime.

However, in principle, it is a generally accepted view that section 56(2)(viiia) of the Act should not be made applicable to buy-back transaction for the following reasons:

- there is no transfer of shares as the shares would be cancelled on buy-back and no asset would continue to exist.
- the Section presupposes involvement of three parties viz. the transferor, the recipient and the company whose shares are the subject matter of the transaction. In case of a buy-back, the transaction only involves two parties.

Source: Notification No.94/2016 [F.No.370133/30/2016-TPL]/ G.S.R. 982(E) dated 17th October 2016.

^[1] 343 ITR 455 (2012)

^[2] Explanatory memorandum to Finance Bill, 2016

^[3] “sweat equity shares” means – equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called
