Taxation of shares and securities

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Prologue

An attempt has been made to analyse the tax implications of various modes of funding and diverse instruments issued by Indian companies. A case of Start-Up company has been considered to bring out various facets. Start-up for presentation means any company which is raising funds. Tax implications depend upon the terms of the instrument. Accordingly, comments and illustrations are generic in nature.

Seed stage

Seed stage

This is the stage where the entrepreneur has an idea and is working on bringing it to life. At this stage, the amount of funds needed is usually small. Additionally, at the initial stage in the start-up lifecycle, there are very limited and mostly informal channels available for raising funds.

Seed funding

Bootstrapping/Self-financing

- Personal savings, gifts and loans from relatives
- Sale of personal assets
- Government and private institution grants

Tax and regulatory implications

- Section 54GB provides a capital exemption from the transfer of residential house owned by an individual or HUF if:
  - Net consideration is subscribed in equity shares of eligible start up
  - Amount is utilised for purchase of new asset within one year from date of subscription in equity shares

Seed funding

Bootstrapping/Self-financing

- Personal savings, gifts and loans from relatives
- Sale of personal assets
- Government and private institution grants

Tax and regulatory implications

- Loan - Beware of section 68 implications !!
- Grants:
  - Generally taxable as business income
  - Exp 10 to section 43(1) – reduction from cost of acquisition if cost is met directly or indirectly by any person

Seed funding

Angel investor

- Angel investors are individuals who invest their money into high-potential start-ups in return for equity.
- They provide valuable guidance and mentor start-ups
- E.g. Sharks of Shark Tank India

Tax and regulatory implications

- **Investor**
  - Section 56(2)(x) – Difference between Rule 11UA value and actual consideration taxed in hands of recipient
  - Technically, the provision should not apply to fresh issues of shares
  - Advisable to obtain Rule 11UA valuation
  - Disclosure in ITR

Seed funding

Angel investor

- Angel investors are individuals who invest their money into high-potential start-ups in return for equity.
- They provide valuable guidance and mentor start-ups
- E.g. Sharks of Shark Tank India

Tax and regulatory implications

- **Company**
  - Section 56(2)(viib) – The difference between consideration for share issue and FMV is taxed as other sources
  - Start-up registered with DPIIT and satisfying specified condition exempt
  - Need to obtain valuation report from SEBI Registered Merchant Banker
  - Valuation typically challenged by tax authorities

Seed funding

Incubators

Provides the following assistance

- Access to financial capital through relationships with financial partners
- Access to experienced business consultants and management-level executives
- Access to physical location space and business hardware or software

- They may charge a fee or pick up equity stake

Tax and regulatory implications

- Section 28(iv) – Benefit of perquisite arising in the course of business or profession is chargeable to tax
- Nominal fees charged by Government funded incubators
    - Section 194R Circular considers FMV as yardstick of benefit/prerequisite
    - Whether difference chargeable to tax?
- TDS on equity given as consideration for services

Growth stage

Growth stage

Startup’s products or services have been launched in the market. Funds are raised at this stage to further grow the user base, product offerings, expand to new geographies, attract and retain talent, build infrastructure etc.

Venture Capital, AIFs, Private Equity, HNI’s family offices are key investors. Investment instrument depends upon valuation, existing investors, exit option, maturity of start-up.

Equity shares and DVRs

Equity shares result in the distribution of ownership. Traditional equity shares attach themselves with 1:1 voting rights. Section 43(2) of the Companies Act, 2013 read with the Companies (Share Capital and Debentures) Rules, 2014 permits the Company to issue shares with differential voting rights (DVR). This opens up the possibility to structure transactions wherein attributes of founders are protected, and investors can get a larger slice in the cake.

Alternative to DVRs is amendment in AOA wherein voting rights per Board seat can be higher vis-à-vis other Board members [e.g. Razor pay amended AOA to give founders 2 votes per Board seat comprising of 5 members. Similarly, Ola amended AOA which restricts maximum shareholding by the investor. Further transfer of shares cannot happen without consent of the founders].

Equity shares

Advantages

- No repayment obligation. Funds can be freely used
- May step up valuation-making foray for next round of funding
- Investors may mentor start-ups by providing management guidance
- Quick recognition – media coverage, tech platform

Disadvantages

- Shareholders may insist on shareholders agreement restricting the operational freedom of founders
- Part dilution of equity. Multiple rounds may reduce founder to minority
- In series of funding, early entrants may benefit from lower valuation
- Decision making may get polarised reducing horizontal freedom to inorganic growth

Key Tax Implications

Company

- Section 56(2)(viib) – The difference between consideration for share issue and FMV is taxed as other sources
- Start-up registered with DPIIT and satisfying specified condition exempt from section 56(2)(viib)
- Need to obtain valuation report from SEBI Registered Merchant Banker
- Valuation typically challenged by tax authorities. Thus, it is necessary to appropriately document key assumptions at the time of issuance of shares

Shares with DVR

DVR Shares

Shares	Comments
Shares without voting rights	• These types of shares are issued to individuals who want to invest in the company's profitability and success without the benefit of voting rights or having a say in the management or control of the company. • e.g. – Shares to employees who can enjoy the upside in valuation and at the same time stay out of management

Shares with DVR

DVR Shares

Shares	Comments
Shares with superior voting rights e.g. 1:100 votes – 100 votes per share	• Higher votes per share vis-à-vis other shareholders • Founders have larger say in business decision • Prevents hostile takeovers, forced mergers, and investors activism • SEBI LODR Regulators – Superior shares need to be converted into ordinary shares after 5 years of listing on stock exchange • E.g. – Zomato, Paytm, Policybazaar

Shares with DVR

DVR Shares

Shares	Comments
Shares with superior dividend rights	• Higher rights to dividend per share • Shareholders gain an advantage in terms of the distribution of profits and are at par when it comes to voting. • Investor can be assured of a minimum return on a periodic basis

Shares with DVR

DVR Shares

Shares	Comments

Shares with Liquidation preference	• A liquidation preference is the formula that defines who is paid first and who gets how much money when the start-up gets acquired or liquidated, or when the startup's substantial assets are sold
	• Some common liquidation preferences
	    • Single or multiple return (1x or 2x etc)
	    • Participating (including upper caps) or non-participating
	    • Seniority structure – Exit waterfall in LIFO, Paripasu, tiered

Key Tax Implications

Company

- Section 56(2)(viib) deals with consideration for issuance of shares
  - Equity shares, shares with DVR, CCPS all are at par
- Explanation (a) to section 56(2)(viib) provides following definition of FMV
  - Rule 11UA(2) (3) :
  - As may be substantiated by company to the satisfaction of AO based on the value of its assets including specified intangible

  Whichever is higher
- Valuation date is date of Mercant Banker valuation report provided it is obtained within 90 days
- 10% floor level exemption in case of difference between FMV and issue price

Key Tax Implications

Company

- Explanation (a) to section 56(2)(viib) provides following definition of FMV
  - Rule 11UA(2):

    Resident investor

    - Book value method subject to adjustment
    - FMV of unquoted equity shares determined by merchant banker as per DCF method
    - Special rules for issuance of shares by venture capital undertaking
    - Special rules for issuance of shares to notified class of investor

Key Tax Implications

Company

- Explanation (a) to section 56(2)(viib) provides following definition of FMV
  - Rule 11UA(2):

    Non - Resident investor

    - Book value method subject to adjustment
    - FMV of unquoted equity shares determined by merchant banker as per DCF method
    - Special rules for issuance of shares by venture capital undertaking
    - Comparable company multiple method, probability weighted expected return method, option pricing method, milestone analysis method, replacement cost method
    - Special rules for issuance of shares to notified class of investor

Key Tax Implications

Company

- Methods to value start up
  - Berkus Approach
  - Cost to duplicate
  - Scorecard Valuation method
  - Venture capital method
  - DCF approach
- Since shares are having DVRs, the value of shares will differ. The difficulty will arise if shares are issued at same time or nearly same time
- Logic of excluding one method for resident investor?

Key Tax Implications

Company

- Rule 11UA prescribes DCF-based or asset-based valuation for resident and prescribed method for non-resident. To this extent, rules are rigid and provide limited flexibility
- Following decision supports that limitations attached to shares should be factored into the valuation:
  - DCIT v BPL Ltd [2022] 143 taxmann.com 222 (SC) – Shares with lock in period cannot be valued as quoted shares.
  - Ahmed G.H. Ariff v. CWT [1966] 59 ITR 230 (Cal)

Compulsorily Convertible Debentures

Section 71(1) of the Companies Act, 2013 authorizes a company to issue a CCD. They are hybrid securities as they get converted from a debt (debenture) to an equity share and thus possess qualities of both. Since the initial stages of a start-up are not stable, there is usually a lack of assets and cash flow among the entrepreneurs. This makes it difficult to arrive at an accurate valuation of the company, which is an essential prerequisite for investors who pool in their resources. If the start-up venture fails to deliver, the investors are still secured as they are bound to receive interest with the possibility to convert into equity shares. For founders, there is no need to pay the debt. Further, with appropriate conversion terms, investors can get better value vis-à-vis subsequent series of investments.

Compulsory Convertible Debenture

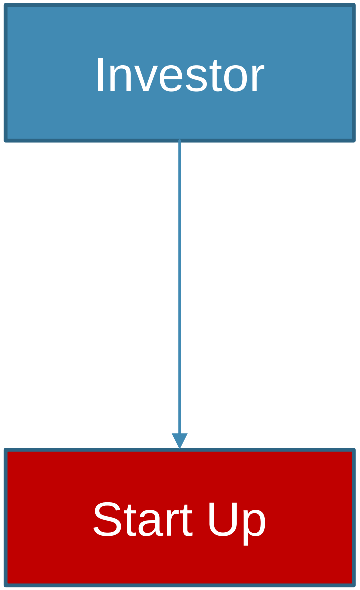
Advantages

- No repayment obligation except interest which can be linked to milestone
- Bridge round of funding can take place via CCDs because founders don't want a certain valuation number to affect the larger round valuation
- Start up can issue shares when they get better valuation

Disadvantages

- Skewed CCDs ratio may impact future valuation and ability of the Company to raise funds
- Valuation report required for compliance under various laws [e.g. Income Tax, FEMA, SEBI rules]

CS 1 - CCD



Facts

- Investor subscribes to CCD of Start up
  - 5% interest payable on receipt of Series A
  - Conversion ratio – 20% discount to price per share in case of Series A funding
- Tax Issues:
  - Interest deductibility and year in which interest is deductible
  - Tax implication on conversion of CCD into equity
  - Section 56(2)(viib) and section 56(2)(x) implication

Key Tax Implications

- **Interest deduction**
  - CCDs are debt until converted into equity shares.
  - Year of deduction of actual interest paid / payable
    - Discount on issue of the debenture to be amortized over the tenure of debenture [Madras Industrial Corporation v. CIT [1997] 255 ITR 802 (SC)]
    - Bullet payment of interest at inception of the debt instrument for 5 years – the entire amount allowed in year 1 [2015] 372 ITR 605 (SC)
  - Section 43B covers specified lenders e.g. Banks, Financial Institutions, NBFC etc. VCs or private investors are not covered

Key Tax Implications

- **Section 56(2)(viib)**
  - Section 56(2)(viib) applies where the company receives in any previous year from a resident person any consideration for the issue of shares
  - SC in the case of Narendra Kumar Maheshwari v. Union of India ((1989) AIR SC 2138) held that "any instrument which is compulsorily convertible into shares is ultimately regarded as equity and not as a loan or debt".
  - Section 56(2)(viib) applies only when consideration is higher than FMV
  - Valuation for Series A can be considered as base. Since the conversion price is 20% less than Series A value, section 56(2)(viib) is not applicable

Key Tax Implications

- **Section 56(2)(viib)**
  - Kol Tribunal decision in Milk Mantra Dairy (P.) Ltd v DCIT [2022] 140 taxmann.com 163 (Kolkata - Trib.)
    - CCDs were issued prior to section 56(2)(viib) introduction. It was argued that provision are not applicable on conversion into equity shares
    - ITAT held that the term "consideration", is a term of wider import when compared with words "amounts" or "money". Receipt of money is one of the several modes for having a consideration in a transaction. Consideration can partake in many forms viz. tangible or intangible, pecuniary or non-pecuniary, direct or indirect.
    - Section 56(2)(viib) contains the words "receives any consideration" which encompasses consideration in all forms and is not limited to only the receipt of money.

Key Tax Implications

- **Section 56(2)(x) – in hands of investor**
  - Section 56(2)(x) applies to shares and securities
  - Section 56(2)(x) applies where any person receives in any previous year shares and securities
  - CCDs are securities. Rule 11UA(1)(c)(c) provides that FMV shall be estimated to be price it would fetch if sold in the open market on the valuation date
  - Receipt of equity shares on conversion is built into the price of CCD and accordingly there is no separate event giving rise to taxation

Key Tax Implications

- **Section 269T**
  - It is merely a book entry and not repayment in cash
    - CIT v. Adinath Builders (P.) Ltd [2019] 102 taxmann.com 57 (SC) (SLP dismissed)
    - CIT v. Ajitnath Hi-Tech Builders (P.) Ltd. [2018] 92 taxmann.com 228 (Bombay HC)
- **Conversion of CCD into equity**
  - Section 47(x) - any transfer by way of conversion of debentures into shares of the company is not regarded as a transfer and thus no capital gain liability arises in the hands of the individual holding shares of the company.

Compulsory Convertible Preference Shares

Advantages

- **Anti-dilution** - Promotors can keep their equity stake intake when the Company issues equity shares to new investors. The Promoters may convert their CCPS which was taken at the time of the Lower valuation of shares when new investors bring the money at a higher valuation thereby promoters can increase their stake without bringing money at a higher valuation

Disadvantages

- Subsequent investors will factor CCPS and value the company on post dilution basis
- Subsequent investors may insist on CCPS to protect its valuation attributes

Compulsory Convertible Preference Shares

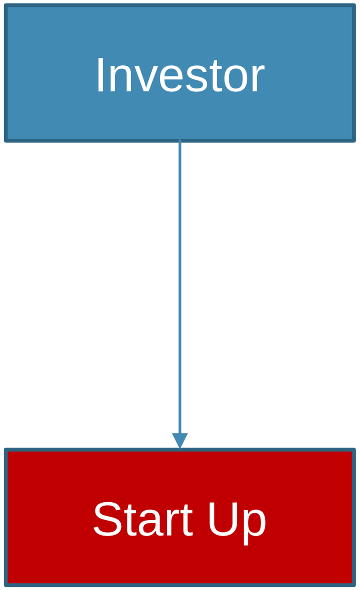
Advantages

- **Avoid valuation gap** - CCPS are also benefited to PE Investors. The investors may link the time of conversion to Company's performance. This essentially means that the shares get converted only after the company achieves the promised growth. If the milestones are not achieved, then the PE firm reserves its right to increase the stake.

Disadvantages

- Higher conversion ratio in the event milestone is not received may demotivate founders

CS 2 - CCPS



Facts

- Investor subscribes to CCPS of Start up
  - 0.01% dividend payable on receipt of Series A
  - Conversion ratio – 20% discount to price per share in case of Series A funding
- Tax Issues:
  - Tax implication on conversion of CCPS into equity
  - Section 56(2)(viib) and section 56(2)(x) implication

Key Tax Implications

- **Section 56(2)(viib)**
  - Section 56(2)(viib) applies where the company receives in any previous year from a resident person any consideration for the issue of shares
  - CCPS are shares and accordingly section 56(2)(viib) applies
  - SC in the case of Narendra Kumar Maheshwari v. Union of India ((1989) AIR SC 2138) held that "any instrument which is compulsorily convertible into shares is ultimately regarded as equity and not as a loan or debt".
  - CCPS needs to be valued as per Rule 11UA(1)(c)(c) - FMV shall be estimated to be price it would fetch if sold in the open market on the valuation date

Key Tax Implications

- **Section 56(2)(viib)**
  - CCPS needs to be valued as per Rule 11UA(2)(B)
    - in accordance with the provisions of sub-clause (b), sub-clause (c), or sub-clause (e) of clause (A), at the option of the assessee, or based on the fair market value of unquoted equity shares determined in accordance with sub-clause (a), sub-clause (b), sub-clause (c), or sub-clause (e) of clause (A), at the option of the assessee, where such consideration is received from a resident
    - in accordance with the provisions of sub-clauses (b) to (e) of clause (A), at the option of the assessee, or based on the fair market value of unquoted equity shares determined in accordance with sub-clauses (a) to (e) of clause (A), at the option of the assessee, where such consideration is received from a non-resident.
  - Option to value CCPS based on its own term or based on unquoted equity shares – indicates valuation should be based on factors existing on the date of issue of CCPS

Key Tax Implications

- **Section 56(2)(x) – in hands of investor**
  - Section 56(2)(x) applies to shares and securities
  - Section 56(2)(x) applies where any person receives in any previous year shares and securities
  - CCPS are securities. Rule 11UA(1)(c)(c) provides that FMV shall be estimated to be price it would fetch if sold in the open market on the valuation date
    - No parallel amendment made in Rule 11UA(1) as one done for section 56(2)(viib)
  - Receipt of equity shares on conversion is built into the price of CCD and accordingly there is no separate event giving rise to taxation

Venture Debt

Venture debt enters into a start-up when they have achieved certain maturity in terms of product-market fit and a scale. There are two elements in venture debt returns. One is the pure fixed income returns in the form of interest, while the other component is equity upside opportunity. Unlike conventional debt financing methods (like senior/secured lending), venture debt does not necessarily require specific, tangible, underlying collateral security.The collaterals for these firms are generally in the form of receivables, IP rights, etc.

Venture Debt

Advantages	Disadvantages
• Money raised through venture debt is less dilutive and can optimize the capital structure. • Companies also benefit by getting additional runway before they raise the next round of equity • As a debt instrument, venture debt has a higher liquidation priority than equity. • Reduces the risk as there is return on capital and ability to block future funding	• Upside is protected through share warrants. Warrants may be useless if start-up is not able to raise funds at higher valuation • Liquidation preference in venture debt may act as a barrier to future funding. Subsequent investor may consider them as senior debt reducing its probability to get return of capital

Key Tax Implications

- **On receipt of debt**
    - Section 68 requires borrower to explain source of source of funding
    - Section not applicable to venture capital fund or a venture capital company as referred to in clause (23FB) of section 10
    - Other regulated entities like Bank, NBFC, AIFs are not covered
    - Necessary to include protective covenants in terms sheet
- **Issuance of share warrant**
    - Share warrants are not shares and accordingly section 56(2)(viib) is not applicable
    - Typically, share warrants are converted at less than FMV. Thus, the provision not applicable

Key Tax Implications

- **Receipt of share warrant –in hands of the investor**
  - Share warrants are securities
  - Thus, warrant needs to be valued at FMV by obtaining accountant certificate [Rule 11UA(1)(c)(c)].
  - Receipt of shares pursuant to conversion is not a new receipt but forms part of warrants itself

Key Tax Implications

- **Conversion of share warrants into share**
  - Once share warrants are issued, the warrant holder works upon its entitlement and converts the share warrants into equity shares. There is no transfer. Refer following:
    - Circular F. No. 12/1/84-IT(AI) dated 12.05.1964
    - ITO vs. Vijay M. Merchant, [1986] 19 ITD 510.
    - PeriarTrading Company (P.) Ltd. v ITO [2018] 100 taxmann.com 263 (Mumbai - Trib.)

Key Tax Implications

- **Lapse of Share warrant**
  - Warrant holder eligible to claim capital loss. Section 50CA not applicable as share warrants cannot be considered as shares

Exit Stage

Initial Public Offering – Exit as OFS

- **Sale as OFS**
  - IPO clause included in term sheet where Company undertakes to come out with IPO on best effort basis
  - Investor can offer part of shares as an Offer for Sale
  - Broad Mechanics
    - Shareholders consent to the inclusion of its holding in OFS
    - Consideration is determined based on the market price
    - Generally, tax certificate from the investors consultant is asked to determine WHT obligation in case of NR shareholder.
    - Cost incurred for IPO is claimed as a deduction based on the CA certificate
    - STT is paid on the sale of shares
- E.g - Paytm , Zomato, Nykaa, Sula Vineyards

Does OFS trigger CG?

- Section 112A brings to tax income arising from the transfer of shares of a listed company

- Section 55(2)(ac) provides:

  in relation to a long-term capital asset, being an equity share in a company referred to in section 112A, acquired before the 1st day of February, 2018, shall be higher of—

  (i) the cost of acquisition of such asset; and

  (ii) lower of—

  (A) the fair market value of such asset; and

  (B) the full value of consideration received or accruing as a result of the transfer of the capital asset.

Does OFS trigger CG?

- fair market value" means,—

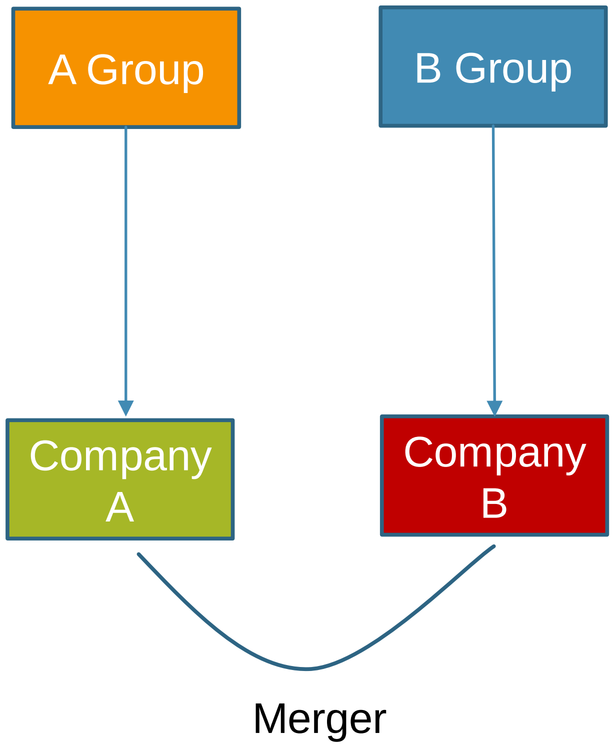
Provision	Comment
(i) in a case where the capital asset is listed on any recognised stock exchange as on the 31st day of January, 2018, the highest price of the capital asset quoted on such exchange on the said date:	Shares are not listed on 31 Jan 2018
in a case where the capital asset is an equity share in a company which is— (A) not listed on a recognised stock exchange as on the 31st day of January, 2018 but listed on such exchange on the date of transfer; indexed cost of acquisition up to F.Y. 2017-18	When the equity shares are transferred under an OFS, such shares are unlisted and are listed on a recognized stock exchange only subsequent to the transfer

Whether computation mechanism fails?

Cost of listed securities

- **Cost of acquisition in following situations**
  - Bonus shares issued prior to 1 Feb 2018
    - Favourable – Heinrich de Fries Gmbh – Mumbai Tribunal
    - Negative – Zash Traders v ACIT (ITA 747/Bang/2023)
  - Bonus shares issued after 1 Feb 2018
  - Shares received under inheritance
  - Debentures or preference shares issued prior to 1 Feb 2018 but converted into shares after 1 Feb 2018
  - Merger/demerger – see subsequent slides

Merger



Transaction

- Company A mergers with Company B
- A group are issued shares of Company B
- Merger is in compliance with section 2(1B)

Issue – Cost of acquisition

Sr No	Company A	Company B
1	Listed	Listed
2	Unlisted	Listed

Provisions

- Section 49(1) - Where the capital asset became the property of the assessee—
  - under any such transfer as is referred to in clause (vii) of section 47

  the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it

- Section 55(2)(ac) provides:

  in relation to a long-term capital asset, being an equity share in a company referred to in section 112A, acquired before the 1st day of February, 2018, shall be higher of—

  (i) the cost of acquisition of such asset; and

  (ii) lower of—

  (A) the fair market value of such asset; and

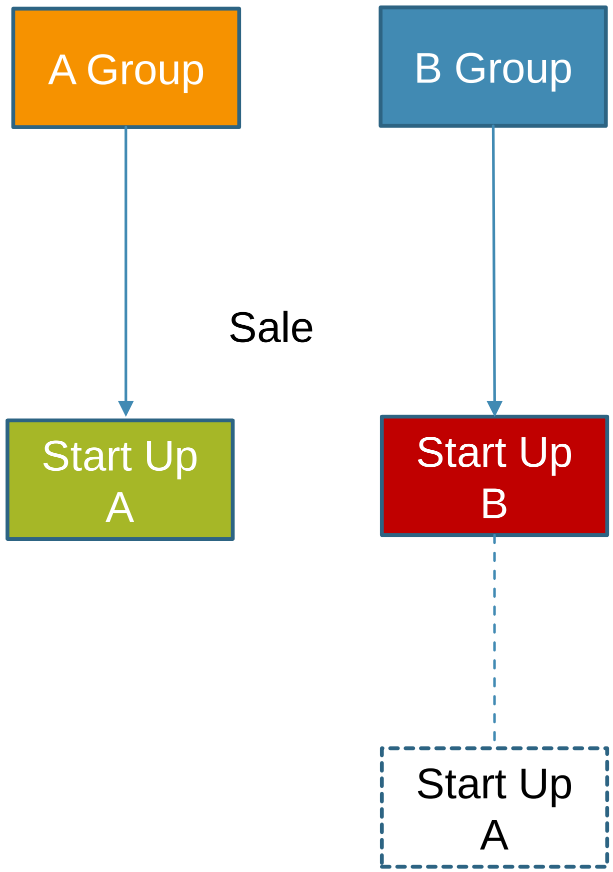
  (B) the full value of consideration received or accruing as a result of the transfer of the capital asset.

Provisions

- fair market value" means,—

Provision
(i) in a case where the capital asset is listed on any recognised stock exchange as on the 31st day of January, 2018, the highest price of the capital asset quoted on such exchange on the said date:
in a case where the capital asset is an equity share in a company which is— (A) not listed on a recognised stock exchange as on the 31st day of January, 2018 but listed on such exchange on the date of transfer; indexed cost of acquisition up to F.Y. 2017-18

Private Sale



Facts

- B Group acquires all shares from A Group at the following values per share
  - Common Stock – Rs 69
  - Shares with liquidation preference – Rs 150
  - Shares with only Dividend rights – Rs 40
  - Shares with Superior Voting rights – Rs 100
  - Founder shares with non-compete clause – Rs 80
- Rule 11UA value - Rs 70

Tax Implication

- Evaluate tax implication under section 50CA and section 56(2)(x)

Tax implications – section 50CA

Section 50CA

Where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being share of a company other than a quoted share, is less than the fair market value of such share determined in such manner as may be prescribed, the value so determined shall, for the purposes of section 48, be deemed to be the full value of the consideration received or accruing as a result of such transfer

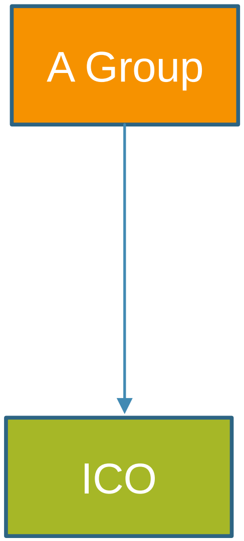
Rule 11UAA

For the purposes of section 50CA, the fair market value of the share of a company other than a quoted share, shall be determined in the manner provided in sub-clause (b) or sub-clause (c),as the case may be, of clause (c) of sub-rule (1) of rule 11UA and for this purpose the reference to valuation date in the rule 11U and rule 11UA shall mean the date on which the capital asset, being share of a company other than a quoted share, referred to in section 50CA, is transferred.

Tax implication – section 50CA and section 56(2)(x)

- Section 50CA applies to transfer of shares of the company other than quoted shares
  - Scope is wide enough to cover all shares
- Clause (b) of Rule 11UA(1)(c) provides Book Value based formula for unquoted equity shares
- Clause (c) of Rule 11UA(1)(c) states value unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date
- Can it be said that shares with DVR needs to be valued under clause (c)? Can it be said that clause (b) deals with traditional equity shares i.e. class of shares which does not enjoy any additional rights
- There is no safe habour limit in section 50CA and section 56(2)(x)
  - Section 50C provides 10% safe harbour limit

Buy Back



Commercial Imperatives

- Investors would have infused equity with a put option
- Exit may be provided by promoters or the Investee Company
- ICo obtains debt funding to undertake Buyback of shares
- Investor is AE – assume TP provision applies

Tax Implication

- Deductibility of interest
- Buy back tax
- Section 56(2)(x) in hands of ICO
- Applicability of TP provision

Key Tax Implications

- **Interest deduction**
  - Interest on loan taken to purchase shares is tax deductible [See Eastern Investments Ltd v CIT [1951] 20 ITR 1 (SC)]
- **Buy back tax**
  - Limit of Buy back governed by Cos Act 2013
  - Section 115QA – Tax at 23.30% in hands of domestic company on distributed income on buy back
    - Effective tax rate 18.9% (23.30/123.30)
  - Section 10(34A) - any income arising to an assessee, being a shareholder, on account of buy back of shares by the company as referred to in section 115QA
  - Section 50CA not applicable as income is exempt in hand of shareholder

Key Tax Implications

- **Section 56(2)(x) in hands of ICO**
  - Section 56(2)(x) not applicable to buy-back [Vora Financial Services (P.) Ltd v ACIT [2018] 96 taxmann.com 88 (Mumbai - Trib.); VITP (P.) Ltd. v. Dy. CIT [2022] 143 taxmann.com 304; Dy. CIT v. Venture Lighting India Ltd. [2023] 150 taxmann.com 523; DCIT v Globe Capital Market Ltd [2023] 156 taxmann.com 620 (Delhi - Trib.)]
  - Section 115QA start with Non obstante clause – Notwithstanding anything contained in any other provision of this Act. 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
  - In absence of specific provision in section 115QA itself, consideration paid cannot be changed

Key Tax Implications

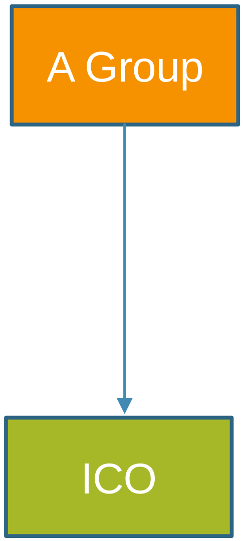
- **Applicability of TP Provision**
  - Section 115QA start with Non obstante clause – Notwithstanding anything contained in any other provision of this Act. distributed income'' means the consideration paid by the company on buy-back of shares as reduced by the amount, which was received by the company for the issue of such shares
  - As per one view, in absence of a specific provision in section 115QA itself, consideration paid cannot be changed
  - Refer Van Oord India Private Ltd. vs. ACIT where it is held that TP provisions are not applicable to Assessee opting for a tonnage tax scheme
  - Matter is prone to high litigation and other view is equally possible

Other issues in buy back

- **Applicability of section 115QA to redemption on preference shares**
  - "buy-back" means purchase by a company of its own shares in accordance with the provisions of any law for the time being in force relating to companies
  - Is redemption purchase by a company of its own shares?
  - SC in Anarkali Sarabhai v CIT [1997] 224 ITR 422 (SC)

"This section clearly implies that redemption of its preference shares by a company would have come within the bar of purchasing its own shares by a company. This specific provision of sub-section (5) was necessary to get over the bar. The company redeemed its preference shares only by paying the preference shareholders the value of the shares and taking back the preference shares. In effect, the company has bought back the preference shares from the shareholders."

Capital Reduction



Commercial Imperatives

- Cancellation of shares through NCLT process
- Widely used in IBC takeover. Erstwhile promoter's shares are canceled without payment of any consideration

Tax Implication

- Section 56(2)(x) in hands of ICO
- Applicability of section 50CA in hands of promoter
- Can promoter claim loss?

Key Tax Implications

- **Section 56(2)(x) in hands of ICO**
  - Section 56(2)(x) applies to receipt of shares of other companies [Vora Financial Services (P.) Ltd v ACIT [2018] 96 taxmann.com 88 (Mumbai - Trib.)]
  - In case of capital reduction, shares are cancelled and thus there is no receipt by ICO
- **Section 50CA in hands of Promoters**
  - Section 50CA applies to where the consideration received or accruing as a result of the transfer by an assessee
  - Received is a factual event and accruing means the right to receive consideration
  - In the absence of 'receipt' or 'accrual' of consideration, arguably, section 50CA is not applicable

Key Tax Implications

- **CG Loss in hands of promoter**
  - Capital reduction amounts to transfer in the hands of shareholder [Kartikeya V. Sarabhai v. CIT [1997] 228 ITR 163 (SC)]
  - In absence of consideration computation mechanism fails [Bennett Coleman & Co. Ltd. v. ACIT [2011] 12 ITR(T) 97 (Mumbai SB)] contra : Tata Sons Ltd v CIT [2024] 158 taxmann.com 601 (Mumbai - Trib.)
  - Matter pending before Bombay High Court

Thank You

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