India; Mauritius; United States

Purchase of Shares from Shareholders Is Capital Reduction (Not Buyback), Subject to Dividend Distribution Tax, Says Indian Court

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The Chennai Income Tax Appellate Tribunal (ITAT), in the case of *Cognizant Technology Solutions India Pvt. Ltd. vs. Assistant Commissioner of Income Tax (ITA No.269/Chny/2022)*, has upheld the order of the lower tax authority and held that the purchase of own shares by the taxpayer was actually a distribution of accumulated profits and reduction of capital to be considered dividend under section 2(22) of the Income Tax Act, 1961 (the Act).

(a) Facts. The taxpayer, an Indian company, purchased its own shares from its shareholders based in the United States and Mauritius, pursuant to a scheme of arrangement approved by the court under the Companies Act, 1956. The taxpayer considered the payments to non-resident shareholders to be capital gains and withheld tax under section 46A of the Act applicable to buyback of shares. No withholding tax was deducted on the payment to the Mauritius shareholder because capital gains on the transfer of equity shares are not taxable in India by virtue of the beneficial provisions under the India-Mauritius Income Tax Treaty (1982) (the Treaty). According to the tax authorities, the payment to shareholders was of the nature of a capital reduction under section 2(22)(d) of the Act and was subject to dividend distribution tax (DDT) under section 115-O of the Act.

(b) Issue. The ITAT examined whether the payments by the taxpayer were of the nature of a buyback or capital reduction under the provisions of the Act as well as the Companies Act.

(c) Decision. The ITAT ruled in favour of the tax authorities with observations set out below.

On the scheme of arrangement

- Considering the dates and events recorded, the scheme was executed in a hurried manner to execute the transaction before introduction of tax on buyback of shares under section 115QA of the Act.
- Based on the shareholding pattern of the taxpayer before and after the arrangement, there was an artificial shift of the shareholding base from the United States to Mauritius, solely to claim Treaty benefits.
- The scheme was a colourable device intended to avoid tax and lacked a commercial purpose. The sole commercial purpose was to shift the profit base to Mauritius so as to get the tax advantage.
- Therefore, the tax authorities opined that it was necessary to "look through" the scheme in light of relevant provisions of the company law and the tax law.

On buyback vs reduction of capital

- The term "buyback" was not used anywhere in the scheme. The transaction was described as a purchase of equity shares. It involved a capital reduction and distribution out of accumulated profit of the taxpayer to its shareholders.
- As the transaction was not a buyback under section 77A of the Companies Act, it would automatically be considered a reduction of capital and distribution of accumulated profits, i.e. deemed dividend under the Act subject to DDT.

On payment being considered as deemed dividend

- The meaning of "dividend" under section 2(22) of the Act is wider than the conventional meaning of dividend to ensure that the taxpayer cannot camouflage payments out of accumulated profits to its shareholders through different channels in order to avoid payment of tax.
- Two essential prerequisites for the payment to be considered dividend under section 2(22)(d) of the Act were met in the case of the taxpayer, i.e. a distribution was made to the shareholders by way of capital reduction and the quantum of amount paid was to the extent of accumulated profits of the taxpayer.
- Assuming that the distribution cannot be treated as a distribution by way of capital reduction, it will automatically fall within the ambit of section 2(22)(a) applicable to a distribution of accumulated profits entailing release of assets to the shareholders.

Accordingly, the ITAT held that there is no error in the reasons given by the tax authorities to treat the transactions as dividend under section 2(22)(a) or 2(22)(d) read in conjunction with section 115-O of the Act, and dismissed the appeal filed by the taxpayer.

The decision was pronounced by the ITAT on 13 September 2023.

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