Tax Hotline

January 15, 2020

BANGALORE TRIBUNAL DENIES CAPITAL GAINS EXEMPTION ON SHARE BUYBACK FROM 99.99% PARENT

- Conditions under section 47(iv) not legally impossible to satisfy under Indian company law
- For the purposes of section 46A, there is no requirement to demonstrate that there had been a transfer of a capital asset
- Parent – subsidiary exemption under section 47 (iv) not applicable where capital gains are chargeable to income-tax under a special charging provision

Recently, in *Acciona Wind Energy Private Limited v. DCIT (IT) Circle 1(1),*[1] the Delhi bench of the Income-tax Appellate Tribunal ("**Tribunal**") denied the benefit of the capital gains exemption available in the case of parent – subsidiary transfers under the Income-tax Act, 1961 ("**ITA**") to a 99.99% parent participating in a buyback announced by its Indian subsidiary, on the basis that the parent company did not hold the "whole of the share capital" of the subsidiary, as required under section 47(iv) of the ITA. The Tribunal also ruled that in any event, the parent – subsidiary exemption would not be available in cases of buyback on account of the finding that the parent – subsidiary exemption is applicable only to transfers falling under section 45 of the ITA i.e., the charging provision for capital gains, and not to transactions covered by the specific capital gains deeming provision applicable on buyback of shares or other specified securities.

BACKGROUND

The taxpayer was a company resident in India. 99.99% of the taxpayer's shareholding was held by Acciona Energia International S.A., ("**AEISA**") a company resident in Spain, with the remaining 0.01% shareholding held by Acciona Energia S.A., ("**AESA**") a different group company resident in Spain.

During the year under consideration (AY 2014-15, corresponding to FY 2013-14), the taxpayer repurchased shares from AEISA at a price in excess of the issue price, but did not withhold taxes on payments made to AEISA pursuant to the repurchase.

In the course of assessment proceedings against the taxpayer, the Commissioner of Income-tax (Appeals) ("**Commissioner**") finalised two orders against the taxpayer: the first, an order under section 201(1) of the ITA deeming the taxpayer to be an assessee in default for failing to withhold taxes on payments made to AEISA pursuant to the repurchase; and the second, a consequent order under section 201(1A) of the ITA imposing simple interest on the taxpayer at 12% per annum on the amount of tax that ought to have been withheld.

Aggrieved, the taxpayer appealed both orders to the Tribunal.

ARGUMENTS OF THE PARTIES

Whether the conditions for the exemption under section 47(iv) are fulfilled

The taxpayer argued that the buyback of shares should be entitled to the benefit of the exemption from capital gains tax under section 47(iv) of the ITA, which exempts any transfer of a capital asset by a parent company to its subsidiary company from the charging provisions under section 45 of the ITA, provided: (i) the parent company or its nominees hold the whole of the share capital of the subsidiary company; and (ii) the subsidiary company is an Indian company. The taxpayer argued that both conditions were satisfied in the present case since AEISA practically held all of the shares of the taxpayer; the one share held by AESA was only in order to comply with the requirement under Indian company law that a private limited company have a minimum of two shareholders. In other words, it was a legal impossibility for a parent company to comply with condition (i) and therefore the exemption under section 47(iv) should be interpreted in a purposive manner. In support of this argument, the taxpayer relied on the decision of the Mumbai bench of the Tribunal in *ACIT v. Papillon Invest. (P.) Ltd.*[2] In that case, the Tribunal had made a distinction between the whole of the share capital of a company being held *by* a holding company, and the whole of the share capital being held *in the name of* the holding company and stated that the latter situation would be a legal impossibility in India.

The Revenue submitted that the conditions for applying section 47(iv) of the ITA were not fulfilled inasmuch as AEISA did not legally hold the 'whole' of the share capital of the taxpayer directly or through its nominees.

Whether a buyback is a transaction to which section 47 (iv) could apply

The Revenue also argued that in any event, section 47 is limited in its application to only those cases covered by the charging provision under section 45 of the ITA.[3] Buybacks, by contrast, were argued to be chargeable to tax under section 46A of the ITA, which is a special provision dealing with the purchase by a company of its shares or other specified securities. As per section 46A of the ITA, the difference between the cost of acquisition and the value of consideration received by the shareholder is deemed to be the capital gains arising to the shareholder in the year in

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which shares are repurchased by the company. Accordingly, it was argued that section 46A, being a special provision applicable to buybacks, should prevail over the general charging provision under section 45, which meant that by consequence, section 47(iv) would have no application. In support of this argument, the Revenue relied on the decision of the Mumbai bench of the Tribunal in *Goldman Sachs (India) Securities (P.) Ltd v. ITO*[4] where the Tribunal had observed that there was no ambiguity that the provisions of section 46A would be applicable to a buyback.[5]

In rejoinder, the taxpayer submitted that section 46A was not an independent charging section; it was section 45 that levied the charge of tax and accordingly, section 47(iv) should remain applicable.

RULING OF THE TRIBUNAL

The Tribunal dismissed both appeals and ruled in favour of the Revenue.

The Tribunal found that for section 47(iv) to apply, there was no requirement for the parent company to hold the entire share capital of the subsidiary company *in its own name*. Condition (i) of section 47(iv) stood satisfied if the whole of share capital of the subsidiary company was held by the parent company *or its nominees*. This meant that condition (i) of section 47(iv) was not legally impossible to perform. In the present case, it was not argued that AESA held shares in the taxpayer *as a nominee of* AEISA. Consequently, condition (i) did not stand satisfied and therefore section 47(iv) could not be invoked in relation to the buyback. The Tribunal also distinguished the co-ordinate decision in *Papillon* on facts, as in that case, the parent company *did* hold the whole of the share capital of the subsidiary company by jointly holding certain shares with a director of the subsidiary company.

While this finding was sufficient to decide both orders on appeal, the Tribunal also ruled on the applicability of section 47(iv) to a transaction covered by section 46A of the ITA. The Tribunal found that section 45 and section 46A operated in different fields. While section 45 was applicable to cases involving transfer of a capital asset, section 46A was specifically applicable to share repurchases. In other words, for section 46A to be attracted, there was no requirement of demonstrating that there had been a *transfer* of a capital asset. Consequently, section 47, which began with the words "*Nothing contained in section 45 shall apply to the following transfers*", would have no applicability in the context of a share repurchase covered by section 46A.

On that basis, the Tribunal affirmed the Commissioner's first order under section 201(1) of the ITA, and consequently, also affirmed the Commissioner's second order under section 201(1A) of the ITA.

ANALYSIS

The strict approach adopted by the Tribunal in construing the exemption under section 47(iv) is consistent with the recent landmark Supreme Court decision in *CC v. Dilip Kumar & Company*.[6] In that case, the Supreme Court had held that any ambiguity in an exemption clause or an exemption notification was to be strictly interpreted in favour of the Revenue, and that the burden of proof would be on the taxpayer to show that his case came within the parameters of the exemption clause or exemption notification. Seen in this light, it is difficult to fault the Tribunal's conclusion that the conditions for invoking section 47(iv) were not satisfied in the present case.

Nevertheless, doubts about the intended scope of section 47(iv) continue to persist. In *Papillon*, the Tribunal had relied on the principle of *ut res magis valeat quam pereat* to draw a distinction between all shares being held by a holding company, and all shares being held in the name of the holding company, with the latter found to a legal impossibility under Indian company law. Should the benefit of that principle have been extended to a case were all shares were *practically* held by the holding company through another group company, although not through a nominated shareholder? Such shareholding structures are common in the Indian corporate landscape, necessitated as they are by commercial requirements (including ease of offshore financing and exit), regulatory arbitrage, and other operational considerations.

The Tribunal's interpretation of section 46A of the ITA also requires deeper appreciation. In the Tribunal's view, section 46A, a specific provision addressing share repurchases, operated in a different field from section 45, the general provision charging capital gains to income-tax. This implies section 46A to be an *independent charging provision* – a finding that appears legally dubious, considering that unlike a charging provision, section 46A nowhere uses the phrase "*shall be chargeable to tax*".

Section 46A merely dispenses with the three-fold requirement under section 45 of establishing: (i) the existence of a capital asset; (ii) the transfer of that capital asset; and (ii) profits and gains arising from the transfer, by deeming the spread between the buyback price and the cost of the shares to be capital gains arising to the shareholder (and not the capital gains *chargeable to income-tax*). In this analysis, section 46A is more appropriately categorised as a *computation provision*, which must necessarily be read with section 45 to perfect the charge of income-tax. This interpretation is consonance with the decision of Madras High Court in *CIT v. N Bhagavathy Ammal and Ors*.[7] In that case, the High Court had found section 46(2) of the ITA (which in fact contains the phrase "*chargeable to tax*") to be an independent charging provision based on its bare language alone.

The Tribunal's reliance on *Goldman Sachs* in support of its finding on the independent applicability of section 46A is misplaced. In that case, the Mumbai bench of the Tribunal did not discuss the scope or independent application of section 46A; it merely observed that section 46A would be applicable to a scheme for buyback of shares.

The Tribunal's treatment of section 46A in the present case is therefore unsatisfactory. Since the applicability of section 47(iv) to a scheme of buyback turns on the applicability of sections 45 and 46A, it is hoped that a higher forum provides the requisite clarity soon.

– Anandu Unnikrishnan & Shipra Padhi
You can direct your queries or comments to the authors

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[1] Order dated 20.12.2019 in ITA Nos. 1783 and 1784/Bang/2018 for AY 2014-15.

[2] [2005] 4 SOT 304 (Mumbai), affirmed by the Bombay High Court in *CIT v. Papilion Investments (P.) Ltd.*, [2012] 206 Taxman 142 (Bombay) (MAG.).

[3] On the basis that section 47 begins with the words "*Nothing contained in section 45 shall apply to the following transfers (…)*."

[4] [2016] 70 taxmann.com 46 (Mumbai – Trib.).

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[5] It should be noted that in coming to this conclusion, the Tribunal did not comment on whether section 46A was an independent charging provision. Instead, the Tribunal merely observed that such distributions should be taxable under the head "capital gains" and not as dividend.

[6] [2018] 361 ELT 577 (SC).

[7] [1999] 240 ITR 451 (Mad).

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