Tax Hotline

May 31, 2021

AAR DENIES PARENT-SUBSIDIARY CAPITAL GAINS EXEMPTION IN BUYBACK, UPHOLDS TAXABILITY UNDER SECTION 46A

- Buyback in case of wholly owned subsidiary held taxable under section 46A of the Income Tax Act, 1961, being a special provision that overrides a general exemption under section 47
- Since buyback involves extinguishment of underlying shares, upholding exemption under section 47 would render provisions under sections 47A, 49 and 155 otiose.

In a ruling passed in October 2019, the Mumbai bench of the Authority for Advance Rulings ("**AAR**") denied the exemption from capital gains for parent-subsidiary transfers under section 47(iv) of the Income-tax Act, 1961 ("**ITA**") to PQR Gmbh ("**Taxpayer**"). The AAR held that the parent–subsidiary exemption would not be available in cases of buyback as exemptions under section 47 are 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 section 46A - the specific capital gains deeming provision applicable to buyback of shares or other specified securities.

BACKGROUND

The Taxpayer is a company incorporated under the laws of Germany. It has a subsidiary in India, PQR India ("**Subsidiary**"), which is a private limited company incorporated under the Indian Companies Act, 1956 ("**Companies Act**"). More than 99.99% of the Subsidiary's shareholding was held by the Taxpayer, with the remaining shareholding being held by PQR International Gmbh, as a nominee of the Taxpayer.

The Subsidiary, during the year under consideration, proposed a buyback of its shares under section 77A of the Companies Act owing to surplus funds. The Taxpayer thereafter filed an application before the AAR ("**Application**") for a ruling on whether the buyback would be exempt from tax in the hands of the Taxpayer in light of section 47(iv) of the ITA, as the transaction was a mere transfer of a capital asset by a parent to its subsidiary. Two additional questions regarding applicability of Minimum Alternative Tax ("**MAT**") provisions and withholding tax liability were also raised in the Application.

ARGUMENTS OF THE PARTIES

The Taxpayer contended that:

- The buyback should be exempt 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 Taxpayer is a company as per section 2(17) of ITA (ii) the Taxpayer along with its nominee held whole of the share capital of the Subsidiary; and (iii) the Subsidiary company is an Indian company as per section 2(26) of ITA being formed and registered under the Companies Act.
- Section 47(iv) and 47(v) of the ITA deal with the peculiar situation of transfers between parent and wholly owned subsidiaries. Being provisions, which are beneficial in nature, they should be interpreted liberally.
- Section 46A of the ITA was introduced to clarify that gains arising from buyback of shares should be deemed to be capital gains and should not be treated as dividend, hence section 46A of the ITA is not a charging section itself but should be read with section 45, which itself is subject to section 47.

The Revenue argued that:

- The Taxpayer was not covered under the parent – subsidiary exemption, but section 46A of the ITA should be applicable. Section 46A was brought into the ITA at the same time when section 77A was introduced in the Companies Act, with the specific intent to tax capital gains arising out of a buyback.
- Section 46A of the ITA is an exclusive clause deeming the difference between cost of acquisition of shares and the value of consideration received by the shareholder in pursuance of buyback, as capital gains, and hence it should be treated as a special clause; whereas section 47 should be treated as a general clause for this purpose.
- Further, reliance was also placed on *In re RST*[1] where it was held that in case of a buyback of shares, section 46A of the ITA would alone be attracted and not section 45.

RULING OF THE AAR

The AAR held that the parent subsidiary exemption under section 47(iv) of the ITA would not be available to the Taxpayer on the following grounds-

- Section 46A of the ITA is a specific provision brought in with a specific objective to tax buybacks as capital gains and not as deemed dividend. If the legislature intended it to be subject to section 45 and section 47 of the ITA, it would have provided so expressly.

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- If the parent-subsidiary exemption is read into section 46A of the ITA, then the object of taxing capital gains from buybacks would be vitiated. On the other hand, if the section 46A is not read to be subject to section 47(iv), then it would not make section 47(iv) any less effective as the parent-subsidiary exemption would be available in numerous other circumstances such as transfer of land, machinery, share of other entities etc.
- Buybacks result in extinguishment of rights that the shares represent, as the company undertaking the buyback is statutorily required to destroy the shares so bought back.[2] However, section 47A(1) read with sections 49 and 155(7B) of the ITA provide for a scheme of taxation where the exemption under section 47(iv) of the ITA could be withdrawn, and contemplates the survival of the asset transferred by the parent to the subsidiary. Since in a buyback, the capital asset itself ceases to exist, sections 47A, 49 and 155 of the ITA would be rendered otiose.
- Following *In re RST,* it was held that section 47 of the ITA began with the words "*Nothing contained in section 45 shall apply to the following transfers*", hence it did not override section 46A. By virtue of section 47 of ITA, it is not that a transfer ceases to be a 'transfer' for purposes of the ITA, , but is only an exempted transfer. Section 46A was considered plain and clear, only subject to section 48 of the ITA.

ANALYSIS

The AAR's reading of section 46A of the ITA should be subject to a deeper study. In the AAR's view, section 46A, a specific provision addressing share buyback, would prevail over the general provision of section 45 read with section 47(iv) of the ITA. The AAR relied upon *In re RST* that held that section 46A is an *independent charging provision,*[3] however it should be noted that section 46A nowhere uses the phrase "*shall be chargeable to tax*" and includes a deeming provision that necessarily would relate the provision back to section 45 for the charge of 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 or machinery 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.*[4] wherein 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 language alone.[5] Even in the present ruling, the revenue itself had contended that the capital gains arising out of a buyback *is chargeable to tax under section 45 of the Act, read with section 46A of the Income Tax Act, 1961.*

The AAR held that section 46A should not be subject to section 47 read with section 45 of the Act as it would significantly reduce the scope of section 46A. However, it needs to be noted that the parent-subsidiary exemption is available only in limited circumstances i.e. when the *parent company or its nominee* ***hold the entire share capital*** *of the subsidiary* and would not apply to buybacks where the underlying company is not a wholly owned subsidiary.

Since the Finance Act, 2013, the taxation of buyback is governed by section 115QA, which shifts the incidence of tax entirely on to the underlying company undertaking the buyback. Hence, for buybacks undertaken after April 1, 2013 that are subject to section 115QA, income in the hands of the shareholder would be exempt per section 10(34A), and section 46A would not apply at all. However, the above discussion continues to be relevant for buybacks not subject to section 115QA or entered prior to the amendment, and it would be interesting to see where higher courts in India land on the interaction of section 46A and the exemption under section 47(iv) of the ITA, both of which in different contexts can be regarded as special provisions.

– Vibhore Batwara & Varsha Bhattacharya
You can direct your queries or comments to the authors

[1] AAR No. 1067 of 2011

[2] Section 77A(7) of the Companies Act, 1956

[3] Even in *In re RST* the AAR did not directly hold that section 46A is a charging provision. It merely states that - *"There appears to be no reason to go into an enquiry as to whether it is a charging section or not and whether we can only understand Sec 45 as the charging section. The section says what the capital gains is, arising out of such a transaction and mandates resort to Sec 48. Sec 48 only deals with the mode of computation and Sec 46A having determined the capital gains, the tax needs alone to be computed as provided for therein."*

[4] [1999] 240 ITR 451 (Mad)

[5] Please refer to our previous hotline.

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