

EY Tax Alert

Delhi Tribunal rules that court-approved capital reduction cannot be re-characterized as buy-back

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Executive summary

This Tax Alert summarizes a recent ruling of the Delhi Income-tax Appellate Tribunal (Tribunal) in case of Seaview Developers Pvt. Ltd. (Taxpayer) v DCIT¹ on the issue of characterization of a court-approved reduction of share capital undertaken by an unlisted company. The key issue before the Tribunal was whether a reduction of share capital implemented pursuant to a scheme sanctioned by the Bombay High Court could be recharacterized as a buy-back of shares and subjected to the buy-back tax regime which trigger levy in the hands of the company while the income in the hands of shareholders is exempt.

The tax authority had held that the transaction, though structured as a reduction of capital, effectively resulted in extinguishment of shares and distribution of funds to the shareholder and was therefore triggering buy-back tax.

¹ [TS-1036-ITAT-2026-DEL]



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The Tribunal ruled in favor of the Taxpayer and held that reduction of share capital and buy-back are distinct corporate law mechanisms operating in separate statutory fields and cannot be treated as interchangeable merely because they may result in similar economic outcomes. The Tribunal observed that a capital reduction undertaken under a court-sanctioned scheme does not amount to a purchase of shares by the company and, therefore, cannot be recharacterized as a buy-back in the absence of a specific statutory provision. The Tribunal also noted that the legislative framework has historically maintained separate tax treatment for reduction of capital and buy-back transactions. Tribunal also held that where transaction of capital reduction is subjected to dividend distribution tax (DDT) as well as capital reduction and again subjecting the transaction to buy-back tax results in double taxation.

The Tribunal also allowed deduction of interest on borrowings used for capital reduction, holding that rationalization of capital structure constitutes a measure of commercial expediency undertaken for business purposes.

Background of the statutory provisions

- In the context of capital restructuring, where a company undertakes a capital reduction, the Income-tax Law (ITL) creates a deeming fiction whereby the distribution made to shareholders on such capital reduction is characterized as dividend to the extent of the company possesses accumulated profits².
- On capital reduction, any excess amount received by a shareholder (holding the shares as a capital asset), over and above the accumulated profits which is characterized as dividend, is regarded as consideration for transfer of shares and is subjected to tax under the head "Capital Gains".
- Historically, up to tax year 2019-20, dividends distributed by domestic companies, (including deemed dividends arising pursuant to a capital reduction), were subject to DDT at the company level³. Consequently, such dividend income was exempt in the hands of the shareholders⁴.
- Upon the introduction of the buy-back provisions under the Company Law, the ITL was correspondingly amended to provide a distinct tax regime for buy-back transactions. Specifically, where shares constituted a capital asset in the hands of the shareholder, consideration received

pursuant to a buy-back was brought within the ambit of the capital gains provisions⁵.

Additionally, the definition of dividend was amended to provide that the amount received on buy-back will not be characterized as dividend income⁶.

- Finance Act, 2013 introduced a separate taxation regime applicable to buy-back of shares by unlisted companies⁷. Under this regime, tax liability was imposed on the distributed income in the hands of the company carrying out buy-back of its own shares. The distributed income was the difference between the consideration paid by the company for purchase of its shares and the amount originally received by the company on issuance of such shares (buy-back tax).
- Finance Act, 2016 expanded the scope of definition of 'buy-back' for the purpose of buy-back tax applicability from 'purchase by a company of its own shares in accordance with provisions of section 77A of Company Law, 2016' to 'purchase by a company of its own shares in accordance with any law for the time being in force relating to companies'.
- There were statutory rules issued by Central Board of Direct Taxes (CBDT) for determining the amount received by company on buy-back of its own shares⁸. One of the said rules provides that where company has returned any amount to the shareholders before carrying out buy-back, such amount shall be reduced from the amount received by company on issuance of shares. However, a carve out is created providing that where the amount returned by the company has suffered DDT, such amount shall not be reduced from the amount received by company on issuance of shares.

Facts:

- The Taxpayer was engaged in the business of development and leasing of commercial real estate assets in India. The Taxpayer was a wholly owned subsidiary of BREP India Office Holdings IV Pte. Ltd (BREP IV), a company incorporated and resident of Singapore.
- During tax year 2016-17, the Taxpayer undertook a capital reduction exercise with the objective of reducing its share capital in accordance with sections 100 to 104 and other applicable provisions of the Company Law, 1956. Pursuant to a board resolution and a subsequent resolution passed by the shareholders at an extraordinary general meeting, the Taxpayer proposed reduction of up to 53,000 equity shares held by BREP IV.
- The scheme of capital reduction was filed before the Hon'ble Bombay High Court and, after obtaining

² Section 2(22)(d) of ITL 1961

³ Section 115-O of ITL 1961

⁴ Section 10(34) of ITL 1961

⁵ Section 46A of ITL 1961

⁶ Section 2(22)(iv) of ITL 1961

⁷ Section 115QA of ITL 1961

⁸ Rule 40BB

the requisite regulatory clearances and in the absence of any objections from the regulatory authorities, received the Court's approval.

- The capital reduction was supported by an independent valuation report prepared by SSPA & Co., under which the fair value of each equity share was determined at INR 129,185.76 using the Discounted Cash Flow (DCF) method.
- Following approval of the scheme, the Taxpayer cancelled 36,768 equity shares and distributed an aggregate consideration of approximately INR 4,749m to BREP IV. The consideration was funded partly from reserves and surplus of approximately INR 1,193m and partly through borrowings aggregating approximately INR 3,336m⁹.
- The above facts are summarized in a chronological order:

Date	Particulars	Amount
Start of the tax year 2016-17	Equity share capital of the Taxpayer. The Taxpayer was a wholly owned subsidiary of BREP India Office Holdings IV Pte. Ltd (BREP IV), a Singapore entity.	INR 0.68m ¹⁰
3 June 2016	Board Resolution passed for capital reduction, up to 53,000 shares	-
6 June 2016	Extra ordinary general meeting held	-
27 June 2016	Filed an application with before the Bombay HC along with share valuation report	INR 4,749m ¹¹
8 September 2016	Capital reduction scheme was approved (no objection from the regulatory was received)	

- For income-tax purposes, the Taxpayer treated the portion of the distribution attributable to accumulated profits as deemed dividend arising on capital reduction and accordingly discharged DDT of approximately INR 278m. The balance consideration, after reducing the deemed dividend component, was treated by BREP IV as consideration giving rise to short-term capital gains and was offered to tax in India. The return of income filed by BREP IV was subsequently processed and accepted by way of intimation dated 3 March 2018.
- The Taxpayer claimed deduction of interest expenditure amounting to approximately INR 260m on borrowings used to finance the consideration distributed to shareholders under the court-approved reduction of share capital scheme.

- During the course of assessment proceedings, the tax authority disputed the taxpayer's characterization of the transaction as a capital reduction. Tax authority contended that the transaction resulted in extinguishment and cancellation of shares coupled with payment of consideration to the shareholder and, therefore, was in substance a buy-back of shares. On this basis, the tax authority held that the transaction attracted the buy-back tax provisions along with interest on delay in payment¹². Tax authority further alleged that the capital reduction mechanism had been adopted as a colorable device to avoid the incidence of buy-back tax.
- Additionally, the tax authority disallowed the deduction of interest expenditure of approximately INR 260m, holding that the borrowings had been utilized for effecting the capital reduction and, accordingly, the resultant interest expenditure assumed the character of capital expenditure rather than deductible business expenditure.
- Aggrieved by the order of the tax authority, the Taxpayer filed an appeal before First Appellate Authority (FAA). FAA upheld the order of tax authority. While doing so, the FAA observed that:
 - The approval granted by the Hon'ble Bombay High Court to the capital reduction scheme did not determine the tax treatment of the transaction under the ITL.
 - The transaction was not simple capital reduction since it involved extinguishment, cancellation and return of capital.
 - Following the legislative amendment in 2016 expanding the scope of the buy-back tax provisions, the relevant inquiry was the effect of the transaction involving distribution to shareholders and extinguishment of shares, rather than the specific provisions of Company Law under which the transaction had been undertaken.
 - In respect of buy-back tax, Double Taxation Avoidance Agreement (DTAA) benefit cannot be claimed as the liability falls on company and not shareholder.
- FAA upheld the disallowance of interest expenditure on the borrowed funds for effective capital reduction on the ground that borrowed funds have been used for capital purpose which has enduring benefit to the Taxpayer's business.
- Aggrieved by the order of FAA, Taxpayer filed an appeal before Income-tax Appellate Tribunal (Tribunal).

⁹ It may be noted that the sum of money used from reserves and borrowing does not add up to the amount discharged on capital reduction

¹⁰ 68,489 shares of INR 10 per share

¹¹ 36,768 shares @ INR 129,185.76 per share

¹² Section 115QB of ITL 1961

Taxpayer's contentions before Tribunal:

- Capital reduction was strictly in accordance with statutory provisions and had been sanctioned by the Bombay High Court. Once a scheme is approved under sections 100 to 104 of the Company Law, the legal character of the transaction is that of capital reduction. Tax authority cannot, merely by invoking substance, convert such transaction into buy-back in the absence of a specific charging or deeming provision.
- Under the Company Law, capital reduction and buy-back operate in different fields. Prior to insertion of provisions relating to buy back of shares in 1999, buy-back was not permitted, and reduction of share capital could be undertaken only through a court-approved mechanism. Introduction of buy-back provisions under Company Law diluted the general prohibition of company buying its own securities. Buy-back was introduced as a separate statutory mechanism and was never intended to subsume capital reduction.
- Taxpayer pointed to practical and legal distinctions between the two mechanisms of buy-back of shares vis-à-vis capital reduction:
 - Capital reduction requires approval of the High Court or National Company Law Tribunal (NCLT), while buy-back does not.
 - In capital reduction, once the scheme is sanctioned, the shareholder is bound by the order and has no option in the matter; whereas in buy-back, the shareholder may choose whether to offer shares and the company may accept or reject the offer.
 - Buy-back is subject to statutory restrictions, such as the restriction on further issue of the same kind of shares for a specified period, whereas such restrictions do not apply to capital reduction.
 - Capital reduction can be undertaken even if there are no reserves available and by contrast, buy-back can be undertaken only out of free reserves, securities premium account or proceeds of fresh issue of specified securities.
- Capital reduction involves direct cancellation of shares without actual acquisition of those shares by the company. In such a case, the shares do not exist in the hands of the company and cannot be said to have been "re-purchased" or "bought back". In buy-back, the company acquires the shares, either physically or in its demat account, before the shares are extinguished. Thus, buy-back is a

repurchase of shares, whereas capital reduction is not.

- Statutory scheme of taxation under ITL provides that on capital reduction, to the extent the distributing company possesses accumulated profits, there is dividend taxation. When buy-back provisions were inserted under Company Law, a special provision was inserted under ITL to provide that income arising from buy-back is taxable as capital gains income. In addition, the definition of dividend was specifically provided that amount received on buy-back shall not be considered as dividend income. This demonstrated that the legislature consciously maintained different tax regimes for capital reduction and buy-back.
- 2016 amendment expanding the provision of buy-back tax was not intended to bring capital reduction within buy-back tax. The Memorandum explaining the Finance Bill, 2016 referred to doubts concerning buy-back undertaken under different provisions of the Company Law and provisions was expanded to cover any buy-back of unlisted shares undertaken under Company Law. 2016 amendment did not state that capital reduction would be treated as buy-back.

In this regard, reliance was placed on *Cognizant Technology Solutions India Pvt. Ltd. v. ACIT*¹³, where the Chennai Tribunal recognized that the 2016 amendment to expand scope of buy-back tax was brought to clarify that buy-back covered by any provisions of Company Law including those carried out through the scheme of arrangement. Capital reduction for which separate scheme of taxation is provided under ITL will be governed by the specific law.

- Reliance was placed on *Capgemini India (P.) Ltd.*¹⁴, where the Bombay High Court held that merely because a company opted for buy-back and not capital reduction, or vice versa, the tax authority could not infer tax evasion simply because the transaction did not attract tax in the manner desired by the tax authority.
- Reliance was also placed on *Chetan G. Cholera v. Rockwool (India) Ltd.*¹⁵, where it was observed that every reduction of share capital does not amount to buy-back of shares, though every buy-back would involve reduction of share capital.
- Reliance was also placed on *Goldman Sachs (India) Securities (P.) Ltd v. ITO*¹⁶ which recognized the distinction between the two concepts of capital reduction and buy-back of shares.
- On the allegation of colorable device, the Taxpayer submitted that the tax authority itself accepted DDT paid on the capital reduction and thereby accepting that the transaction involved a deemed dividend component arising on capital reduction. Additionally, tax authority also accepted the BREP IV's return in which the balance amount was offered as capital gains. Therefore, when the

¹³ [2023] 108 ITR(T) 492 (Chennai Trib.)

¹⁴ [2016] 67 taxmann.com 1 (Bombay)

¹⁵ [2010] 102 SCL 93 (Andhra Pradesh)

¹⁶ [2016] 70 taxmann.com 46 (Mumbai-Trib.)

transaction was viewed as a whole, there was no tax avoidance or colourable device.

Tax authority's contentions before Tribunal:

- The tax authority supported the orders of the tax authority and the FAA.
- The transaction, though described as capital reduction, had the effect of extinguishment of shares and distribution of money to the shareholder and therefore should be regarded as a buy-back for purposes of buy-back tax.
- Post 2016 amendment, what mattered was the effect of buy-back being in the nature of distribution of income and not the particular provision of the Company Law under which the transaction was undertaken.
- The order of the Bombay High Court approving capital reduction did not adjudicate the taxability of the transaction and therefore did not preclude the tax authority from examining the transaction under the ITL.

Tribunal ruling:

The Tribunal quashed tax authority's re-characterization of the Taxpayer's Court-sanctioned capital reduction scheme as a buy-back of shares. Tribunal held that capital reduction and buy-back under Company Law are legally and conceptually distinct transactions that cannot be substituted for one another by a deeming fiction or by piecemeal analysis. Additionally, Tribunal allowed deduction of interest on borrowings raised for capital reduction, holding that rationalization of capital structure constitutes expenditure incurred for the purposes of business.

As regards the re-characterization of transaction of capital reduction as buy-back:

Rejection of the "colorable device" allegation on a holistic reading of the transaction:

- While alleging the capital reduction was a colorable device, Tribunal noted that tax authority itself accepted the payment of DDT of approximately INR 278m on the deemed dividend component. This was as an implicit acceptance that part of the transaction was genuinely a capital reduction attracting deemed dividend treatment and not a buy-back.
- The consideration over and above dividend was accepted in the hands of shareholder as short-term capital gains. Basis this, Tribunal held that prima facie, there was no substance in allegation that arrangement was a colorable device.
- Tribunal invoked the "look at" principle as laid down by Vodafone International Holdings B.V.¹⁷,

emphasizing that the tax authority cannot start with the question as to whether the impugned transaction is a tax deferment or saving device but must ascertain the transaction's true legal nature by looking at it as a whole and not through a dissecting, piecemeal approach.

Structural and legal distinction between "capital reduction" and "buy-back"

- In capital reduction, shares are directly cancelled without the property in the shares passing to distributing company. Shares are extinguished by operation of the court-sanctioned scheme and never come in the company's hands. Consequently, shares cannot be said to have been "re-purchased" or "bought back." By contrast, in a buy-back, the company must take physical delivery of shares or demat credit before extinguishment.
- The term "buy-back" is defined in ITL as "purchase by a company of its own shares." Since no "sale" occurred from BREP IV to the Taxpayer, the transaction fell outside this definition.
- Capital reduction mandatorily requires High Court or NCLT sanction whereas buy-back requires no such court/tribunal approval. Once the scheme of capital reduction is sanctioned, the shareholder is bound by the court order with no option in the matter, whereas in a buy-back the shareholder retains the option to tender shares, and the company has the option to accept or reject the offer.
- Capital reduction permits repayment of capital even if there are no reserves available with the company, whereas buy-back can only be funded from free reserves, the securities premium account, or a fresh issue of securities.
- Buy-back carries statutory restrictions such as no further issue of the same kind of shares within six months of buy-back that do not apply to capital reduction, reinforcing that the two regimes serve different regulatory purposes.
- Tribunal noted that dividend definition specifically excludes payments made on buy-back of shares. Tribunal also noted that on insertion of provisions of buy-back of shares under Company Law, there was insertion of special provision in ITL to provide that transfer of shares will give rise to capital gains taxation. The Tribunal held this legislative architecture demonstrates that the legislature deliberately amended the definition of dividend and inserted special provision into ITL to bring to tax payment received for buy-back of shares as capital gain. However, the distribution to shareholders in case of capital reduction scheme, continued to be taxed as dividend to the extent of accumulated profits.

¹⁷ [2012] 34 ITR 1 (SC)

Legislative history and intent behind the Finance Act 2016 amendment to section 115QA

The Tribunal examined the Memorandum to Finance Bill 2016 which clarified that the amendment addressed doubts about the effect of buy-backs undertaken by the company under different provisions of the Company Law. The Tribunal held that the intention behind this amendment was to cover "buy-back" of shares undertaken under other sections such as buy-back under a Court or NCLT approved Scheme. In this regard, reliance was placed on Chennai Tribunal's decision in Cognizant Technology Solutions India (P.) Ltd. (*supra*) which held that the amendment to buy-back tax provision was brought in to clarify that the provisions would apply to buy-back under all the provisions of Company Law including under Court scheme.

Reliance on judicial precedent supporting the distinction between capital reduction and buy-back

- Reliance was placed on Bombay HC ruling in case of Capgemini India (P.) Ltd (*supra*) wherein it was held that merely because a company opts for buy-back rather than capital reduction (or vice versa), tax authority cannot presume tax evasion merely because the chosen route did not attract income-tax.
- Reliance was placed on Andhra Pradesh HC ruling in case of Chetan G. Cholera (*supra*) wherein it was held that every reduction of share capital does not amount to buy-back, though every buy-back exercise would necessarily involve reduction of share capital establishing buy-back as a subset, not a synonym, of capital reduction.

Purposive distinction:

- Capital reduction is at the volition of the company, for the benefit of the company to service a lower capital in future. A buy-back, though at the volition of the company, is for the benefit of the shareholder to provide exit at a reasonable price.
- Treating capital reduction as akin to buy-back would be in direct contradiction to the legislative intent behind introduction of the 'buy-back' provisions, which, were introduced to allow company to buy its own securities without the interference of the court.
- As ITL does not contain any charging provision empowering tax authority to deem a transaction recognized under a different statute (the Company Law) to be substantively a different transaction, the tax authority's act of rechristening the Bombay High Court-approved capital reduction scheme as a "Buy-back" was beyond the scope of ITL.
- As capital reduction distribution was already taxed as deemed dividend and subjected to DDT, levy of additional tax under buy-back tax provision on the

same transaction would result in double taxation, which does not seem to be the intent of the law.

As regards deduction of interest expenditure on borrowing utilized for capital reduction:

- The Tribunal deleted the disallowance of interest expenditure incurred on borrowings utilized for implementing the capital reduction scheme and held that the borrowing satisfied the test of commercial expediency and was incurred for the purposes of the Taxpayer's business.
- The Tribunal observed that the purpose of borrowing and the subsequent utilization of borrowed funds are distinct considerations and that the relevant enquiry under the interest deduction provisions is whether the borrowing itself was undertaken for business purposes. The Tribunal noted that the borrowings were raised to facilitate implementation of a High Court-approved capital reduction scheme aimed at rationalizing the Taxpayer's capital structure.
- Tribunal relied upon the Supreme Court's decision in CIT v. Malayalam Plantations Ltd¹⁸, wherein it was held that the expression "for the purpose of business" is of wide import and extends beyond expenditure incurred for earning profits to include measures undertaken for preservation, protection and rationalization of the business.
- Reliance was also placed on the Supreme Court's decision in S.A. Builders Ltd. v. CIT¹⁹, wherein it was held that expenditure incurred on grounds of commercial expediency may be allowable notwithstanding the absence of a legal obligation to incur such expenditure.
- The Tribunal accepted that replacement of equity capital with lower-cost borrowed funds could constitute a legitimate commercial decision undertaken to optimize capital structure, reduce the cost of capital and improve shareholder returns and, therefore, fell within the scope of business expenditure.
- Tribunal held that the interest expenditure incurred in connection with the capital reduction did not result in the creation of any capital asset or enhancement of the taxpayer's profit-making apparatus. The expenditure was incurred in the course of reorganizing the capital structure of the business and, therefore, retained the character of revenue expenditure. Reliance was placed on Mumbai Tribunal in the case of Colgate-Palmolive (India) Ltd. v. ACIT²⁰ wherein it was held that expenditure incurred for implementing the capital reduction scheme is not capital expenditure.

¹⁸ [1964] 53 ITR 140 (SC)

¹⁹ [2007] 288 ITR 1 (SC)

²⁰ [2020] 118 taxmann.com 399 (Mumbai - Trib.)

Comments

The Tribunal's ruling is a welcome development as it provides much-needed clarity on the distinction between a reduction of share capital and a buy-back of shares, reaffirming that the two represent separate and distinct corporate law mechanisms with different legal and tax consequences.

Tribunal ruling reinforces the principle that a transaction validly undertaken under a recognized corporate framework and sanctioned by High Court cannot be disregarded or re-characterized merely on the basis of economic effect.

Tribunal ruling reaffirms 'look at' principles of taxation in absence of invocation of General Anti-Avoidance Rules.

Taxpayers undertaking similar transaction may or in litigation may usefully rely on the ratio laid down by Tribunal.

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