

Tax Implication on Redemption of Preference Shares - A 360 Degree View : Part 1

Oct 09, 2019



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Under the Income Tax Act, 1961 ('the ITA'), taxability on redemption and conversion of preference shares has always been a matter of litigation/ debate. The Finance Act 2017 addressed the issue pertaining to conversion of preference shares by inserting that conversion of preference shares to equity would not be regarded as transfer.

With respect to redemption of preference shares, the point of debate has been whether redemption of preference shares will be treated as capital gains and/ or deemed dividend under Section ('u/s') 2(22) of the ITA. With amendment in Section 115QA of the ITA, the matter of debate extended to whether redemption of preference share be considered as "**purchase of shares**" and be liable to buyback tax ('BBT').

This article intends to analyze the issues pertaining to taxation, deduction and accounting implications and provisions of Companies Act 2013 ('CA 2013') pertaining to issue and redemption of preference shares.

Summary

Sr. No.	Particulars	Our Comments
1.	Whether redemption of preference shares could be equated with buyback and be liable to buyback tax, i.e. tax u/s 115QA of the ITA?	Redemption of preference shares amounts to purchase by a company of its own shares. BBT will be payable on the redemption

2.	<p>Whether redemption of preference shares is considered as dividend?</p> <p>Will it be considered as dividend under Section 2(22)(a) of the ITA?</p> <p>Will it be considered as dividend under Section 2(22)(d) of the ITA?</p>	<p>surplus, if any.</p> <p><i>Redemption at par</i></p> <p>1. When shares are redeemed at par, it is nothing but the fulfilment of obligation and repayment of debt. Therefore, it is not considered as deemed dividend.</p> <p><i>Redemption at premium</i></p> <p>2. Redemption of preference shares doesn't amount to reduction of capital; Hence, the same does not fall u/s 2(22)(d) of the ITA. Further, there is a specific exemption for non-participating preference shares issued for full cash consideration.</p> <p>3. Since the redemption gains are already taxed u/s 115QA of the ITA, there is no additional distribution of accumulated profits. Hence, the same will not fall u/s 2(22)(a) of the ITA.</p>
3.	<p>Whether redemption of preference shares is liable to capital gain tax?</p>	<p>On redeeming preference shares, the shareholders' rights gets relinquished, and that amounts to transfer. Hence, the same is liable to Capital Gains.</p> <p>Since the same amount cannot be taxed twice, there is a possibility of claiming capital loss on redemption considering the Mumbai ITAT decision of Raptakos Brett & Co. Ltd^[1].</p>

Whether redemption of preference shares could be equated with buyback and be liable to buyback tax under the provisions of section 115QA of the ITA?

With a view to bring all the transaction within the sweep of the ITA, Finance Act, 2016 expanded the scope of buyback transaction by changing the definition. This has raised concerns on the applicability of buyback on redemption of preference shares.

Section 115QA of the ITA reads as under:

" (1)..... in addition to the income-tax chargeable in respect of the total income of a `domestic company for any assessment year, any amount of distributed income by the company on buy-back of shares from a shareholder shall be charged to tax and such company shall be liable to pay additional income-tax at the rate of twenty per cent on the distributed income.

Explanation. —For the purposes of this section, —

(i) "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;

(ii) "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, determined in the manner as may be prescribed”

View 1

It can be argued that redemption of preference share is compulsory acquisition or discharge of contractual commitment by the company and is not a voluntary purchase and sale. Hence, this doesn't fall within the definition of purchase.

Further, referring to the Explanatory memorandum of Finance Bill, 2013 pertaining to the amendment in section 115QA of the ITA it states that the objective of the new regime was to target those unlisted companies which resorted to buyback mechanism in order to avoid the payment of Dividend Distribution Tax (“DDT”). Earlier, Section 115QA of the ITA dealt only with buyback u/s 68 of the CA 2013. Hence, companies used to resort to buyback under a capital reduction scheme u/s 66 of the CA 2013 to avoid falling u/s 115QA of the ITA. So, the amendment was brought in and Section 115QA's scope was widened. However, it was never the intention to tax transactions relating to preference shares which are redeemed. Based on such purposive interpretation, it can be considered that redemption doesn't fall u/s 115QA of the ITA.

View 2

Buyback has been defined as purchase by a company of its own shares. Hence, 'purchase' and not 'buyback' has been given importance. For a transaction to fall u/s 115QA of the ITA, it should amount to a purchase by a company of its own shares. So, the question is not whether redemption of preference shares amounts to buyback of shares by a company but whether it amounts to purchase of its own shares.

Does buyback redemption amount to purchase and sale?

Issuance of preference shares is a contract between two parties with a right to purchase and right to sale at a specified price or a formula and in a specified period. This is similar to exercise of a call option in case of purchase of shares. Just like share transfer on exercise of call option leads to purchase and sale, redemption should also amount to purchase. Additionally, Section 67 of the CA 2013 talks about restrictions on purchase by company of its shares. Section 67(4) of the CA 2013 specifically provides that the section does not apply to redemption of preference shares. Such exception would not have been necessary in case redemption doesn't amount to purchase. Hence, it can be inferred that the redemption of preference shares u/s 55 of the CA 2013 amounts to purchase.

The same view has been echoed by the Hon'ble Supreme Court (SC) in case of Anarkali Sarabhai^[2]. The relevant extract of the said judgement has been produced hereunder:

*“Moreover, a reading of sections 77, 80 and 85 of the CA, 1956 makes it clear that when a preference share is redeemed by a company, **what a shareholder does in effect is to sell the share to the company. Such a transaction is nothing but sale of the preference shares by the shareholder to the company.** That is why after specifically laying down in section 77(1) that no company shall have the power to buy its own shares, it was necessary to specify in sub-section (5) thereof that this provision shall not affect the right of a company to redeem any shares issued under section 80. If redemption of preference shares did not amount to sale, it would not have been necessary to specifically provide that the restriction imposed upon a company in respect of buying its own shares will not apply to redemption of shares issued under section 80. Therefore, redemption of preference shares by the company will squarely come within the phrase 'sale, exchange or relinquishment of the asset'.”*

Therefore, based on the common law, the provisions of the CA 2013 as well as the decision of the SC, one can consider that redemption of preference shares is nothing but purchase of its own shares by the company and hence, would fall within the ambit of section 115QA of the ITA.

Our view

According to us, View 2, i.e. redemption falls u/s 115QA of the ITA is a better view as compared to View 1.

As discussed, the question is whether redemption amounts to purchase, and according to us, redemption is a transaction of sale and purchase, which has also been subscribed by the SC in Anarkali Sarabhai.

Amount taxable u/s 115QA of the ITA

Amount chargeable to tax u/s 115QA of the ITA is the consideration amount, less the initial amount paid up. In case of the shares have been issued for non-cash consideration, like issue of bonus shares, or issue in a demerger process, etc., the amount paid up is to be determined under rule 40BB of the Income Tax Rules, 1962. Hence, it is to be noted that it is not necessary that redemption will be chargeable to tax only when it is redeemed at a premium. Even redemption at par may result in taxability u/s 115QA of the ITA, if the amount paid up is computed to be lesser than the redemption amount. Example: Issue of bonus preference shares.

Whether redemption of preference shares is liable to capital gain tax?

For a gain to be charged under the head “capital gains” there should be “transfer” of “capital asset”. In case of redemption of preference shares, preference share is a capital asset covered within the definition of capital asset under Section 2(14) of the ITA.

Section 2(47) of the ITA defines the term “transfer” which includes “sale, exchange or relinquishment of the asset”. The meaning of the word “relinquish” as given in Webster's comprehensive dictionary is to give over, surrender, to stop holding, abandon, to let go or to renounce. On redemption of preference shares, the shareholders have to give up or surrender or abandon the shares held by them and would receive in lieu thereof a sum of money.

Accordingly, the gains arising from transfer would therefore be covered under the definition of transfer and will be liable to capital gains.

We have already discussed above that redemption leads to purchase/sale of shares, which is nothing but a transfer. The same has been held by the SC in case of Anarkali Sarabhai (cited above), holding that *redemption of preference shares by the company will squarely come within the phrase 'sale, exchange or relinquishment of the asset'.* Considering the SC's view, redemption of preference shares amounts to transfer, and will be subject to capital gains tax.

Reliance could be placed on following case laws where it has been held that redemption of preference shares is transfer and liable to capital gain tax:

- o Parle Biscuits Private Limited^[3]
- o Enam Securities Private Limited^[4]

Amount of capital gains tax post insertion of Section 115QA of the ITA

As discussed, the redemption gains is likely to be taxed u/s 115QA of the ITA in the hands of the issuer company. The transaction is exempted in the hands of the shareholders u/s 10(34A) of the ITA. However, considering the decision of the Mumbai ITAT in Raptakos Brett & Co. Ltd, it can be argued that capital loss on account of redemption is allowable. Further, considering the SC's decision in case of G Narasimhan^[5], no income can be taxed twice, and if an income has faced taxation under one head, the same should be excluded while taxing under another head.

Computation of loss in this case will be as follows:

Redemption amount	120
Less: Amount taxable u/s 115QA	20
Less: Indexed cost of acquisition	$(100 \times 289 / 240) = 120$
Capital gains	-20 (i.e. a long-term loss of 20)

However, this position is untested and should be evaluated in detail. Further, we have provided the unfavourable arguments for reference, as follows:

Unfavourable arguments:

The ITAT in case of Raptakos Brett & Co. Ltd (cited above) dealt with transaction u/s 10(38) of the ITA where the court held that the entire source is not exempt but rather a specific transaction which fulfils conditions u/s 10(38) of the ITA is exempt. It is difficult to take the same stand u/s 10(34A) of the ITA. Further, there is no computation mechanism for computing capital gains by excluding the amount taxable u/s 115QA of the ITA.

Conclusion:

Redemption of preference shares amounts to transfer, which is subject to capital gains. However, considering section 115QA of the ITA, it is unlikely that there will be any capital gains. Further, it is possible to argue that the loss on such transfer will be allowable.

Whether redemption of preference shares be considered as deemed dividend under Section 2(22)(d) of the ITA?

Section 2(22) of the ITA defines the term “dividend”. Section 2(22)(d) of the ITA reads as under:

“any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not”

In case of reduction of capital, Section 2(22)(d) of the ITA gets invoked. So, the question is whether redemption amounts to reduction of capital. The statutory requirements pertaining to the reduction of capital have been laid down u/s 66 of the CA 2013. It may be argued that the provisions of section 2(22)(d) refers to the reduction of share capital as contemplated u/s 66 of the CA 2013. It does not provide for any conditions pertaining to reduction of preference shares and hence the provisions of section 2(22)(d) of the ITA cannot be invoked in case of redemption of preference shares.

Further, section 55 of the CA, 2013 specifies that redemption of preference shares shall not be considered as reduction in share capital of the company. Placing reliance on the similar provisions of the CA 1956, it was held by the Hon'ble Mumbai Tribunal in case of Parle Biscuits Private Limited (cited above) that redemption of preference shares cannot be treated as deemed dividend.

Moreover, depending on the facts of the case, exclusion in clause (i) to section 2(22) of the ITA may apply. This exclusion specifies the circumstances in which distribution under section 2(22)(d) of the ITA will not be considered as “deemed dividend”. The conditions are:

1. Preference shares were issued for full cash consideration
2. The preference shareholder is not entitled to participate in surplus assets in liquidation.

Considering the above, redemption of preference shares (at par or at premium) will not amount to dividend u/s 2(22)(d) of the ITA.

Whether redemption of preference shares be considered as deemed dividend under Section 2(22)(a) of the ITA?

As per Section 2(22)(a) of the ITA *“any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company”*

Accordingly, for attracting the provisions of section 2(22)(a) of the ITA, the following criteria has to be fulfilled:

1. Distribution of accumulated profits
2. Such distribution entails release of assets

o **Redemption of preference shares at par**

When the preference shares are redeemed at par, it results into repayment of capital sum to the shareholders. This is nothing but fulfilment of obligation of returning the money back to the shareholders as they no longer hold any right in the company.

Thus, when preference shares are redeemed at par, it does not involve any distribution of profits, but it is just settlement of debt availed by the company.

It may be further argued that as per provisions of section 55[6] of the CA 2013 when preference shares are redeemed there is a requirement to transfer a sum equal to the nominal amount of the shares to be redeemed to Capital Redemption Reserve Account (CRR) which is nothing but distribution of accumulated profits. However, creation of CRR is merely a transfer from one reserve to another and hence it does not result into distribution of profits.

Based on the above, it can be concluded that to the extent of redemption of capital sum on preference shares there is no deemed dividend.

o **Redemption of preference shares at premium**

When preference shares are redeemed at premium, the premium amount on redemption may be considered as dividend under section 2(22)(a) of the ITA. The said treatment would depend upon the sources of funds utilized for payment of premium.

If the premium on redemption of such shares is provided out of securities premium account[7], it may be possible to contend that distribution of accumulated profits as securities premium does not form part of accumulated profits.

Thus, payment of premium out of securities premium shall not be considered as distribution of accumulated profits of the company.

In case the premium has been paid out of profits (other than security premium) of the company, the amount of premium will be taxed u/s 115QA of the ITA. Section 115QA of the ITA is a specific section dealing with purchase by a company of its own shares, whereas Section 2(22)(a) of the ITA deals with distribution of accumulated profits which can be done in various ways. Considering the same, the amount will be taxable u/s 115QA of the ITA and not u/s 115-O of the ITA. It is a cardinal principle of taxation that same income cannot be subject to tax more than once, and hence, since the income is already assessed under section 115QA r.w.s. 10(34A) of the ITA, capital gains shall not be levied in the hands of either the company or the shareholder.

Note that pre-115QA of the ITA, it may be possible to argue that section 2(22)(a) of the ITA gets attracted on the distribution of profits on redemption of preference shares. This is considering the observation made by the Hon'ble Mumbai Tribunal in the case of Parle Biscuits Private Limited:

"We are of the opinion that the redemption of preference shares at face value without any premium or discount does not result in any amount to be considered as deemed dividend and assessee's claim of loss by way of computation prescribed by the Act is correct."

However, considering the wide scope of Section 115QA of the ITA, we feel that there will not be any dividend implications in case of redemption of preference shares.

[1] [2015] / [\[TS-6042-ITAT-2015\(MUMBAI\)-O\]](#)

[2] [1997] (SC)/[1997] 224 ITR 422 (SC)/[1997] 138 CTR 253 (SC) / [\[TS-1-SC-1997-O\]](#)

[3] ITA Nos. 5318 & 5319/Mum/2006 & 447/Mum/2009 / [\[TS-477-ITAT-2011\(Mum\)\]](#)

[4] ITA No..5372 OF 2010 / [\[TS-324-HC-2012\(BOM\)-O\]](#)

[5] [1999] (SC) / [\[TS-5067-SC-1998-O\]](#)

[6] As per the provisions of Section 55 of the CA 2013:

“(a) no such shares shall be redeemed except out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of such redemption;

(b)....

(c) where such shares are proposed to be redeemed out of the profits of the company, there shall, out of such profits, be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve, to be called the Capital Redemption Reserve Account, and the provisions of this Act relating to reduction of share capital of a company shall, except as provided in this section, apply as if the Capital Redemption Reserve Account were paid-up share capital of the company; and

[7] Section 52 of the CA 2013 provides for various restrictions on the use of securities premium account. Some of the purposes for which securities premium account can be utilized are as under:

“(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.”