Capital Reduction - Regulatory & Tax Issues: Part 2

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IMPLICATIONS UNDER INCOME TAX ACT, 1961 (IT Act)

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Â· Amounts distributed by the company on capital reduction to the extent of its accumulated profits will be considered as deemed dividend under section 2(22)(d) of the IT Act and the company will have to pay dividend distribution tax on the same under section 115-O of the IT Act; and

Â· Distribution over and above the accumulated profits, in excess of original cost of acquisition of shares would be chargeable to capital gains tax in the hands of the shareholders.

Dividend Distribution Tax Accumulated profits

It is important to determine as to what would be covered by the term â€œaccumulated profits. The term â€œaccumulated profits is not defined in the IT Act and the courts have interpreted the term in various judicial precedents.

The Supreme Court of India in case of *P.K. Badiani vs. CI*T[6] held that accumulated profits are profits made by the company in the real and true sense and not merely assessable or profits liable to tax as a company distributes dividend out of its business profits and not out of its assessable income. Further, the explanation to section 2(22) of the IT Act provides that accumulated profits up to the date of distribution or payment should be considered.

In the case of CIT vs. G. Narasimhan and Others[7], it has been held that the amount distributed by a company on account of capital reduction includes distribution attributable to accumulated profits and distribution attributable to capital. Any distribution over and above the accumulated profits would be chargeable to capital gains tax in the hands of the shareholders.

Capital gains related

As explained above, the distribution to shareholders over and above the accumulated profits would be chargeable to capital gains tax in the hands of the shareholders since it amounts to â€œtransfer. However, this matter has been the subject matter of controversy and some judicial precedents are given below in this context.

The Honble Supreme Court of India in the case of *Kartikeya V. Sarabhai vs. CIT*[8] has held that reduction of share capital would result in extinguishment of rights of the shareholders resulting in a taxable event under section 45 of the IT Act. Further, in another decision in case of *G. Narasimhan (Supra)*, the Supreme Court of India again held that even though the shareholder remained a shareholder even after the reduction of share capital, his right as a holder of those shares stood reduced with the reduction in the share capital, which amounted to a transfer. Accordingly, when any company undertakes a reduction of share capital under the Companies Act, 2013, by way of paying off part of the share capital, it amounts to extinguishment of the rights of the shareholders to the extent of reduction of share capital. Therefore, it is regarded as transfer under section 2(47) of the IT Act and would accordingly be chargeable to tax to the extent of the amounts distributed over and above the accumulated profits, as explained above.

From the shareholders perspective, the impact of section 50CA of the IT Act would also need to be considered. Section 50CA applies only where some consideration is received or accrued. Hence, in case of capital reduction without pay-out, section 50CA of IT Act should not be applicable, as there is no consideration received or accrued. Further, when the distribution does not exceed accumulated profits, relying on the principles of the Supreme Court of India in the case of G. Narasimhan (Supra), again there should be no tax implications under section 50CA of IT Act as this section is only for the purpose of calculating capital gains under section 48 of the IT Act.

Capital loss in hands of shareholders on account of reduction of share capital

The other issue that arises is whether in absence of any consideration or consideration lesser than investment amount being received by the shareholder on account of reduction of share capital, loss under the head Capital Gains can be claimed.

In this regard, the Special Bench of the Mumbai ITAT in *Bennett Coleman vs. ACIT*[9] had disallowed a shareholder's claim for capital loss on reduction of share capital since the shareholder's percentage of shareholding, immediately before reduction of share capital and immediately after such reduction, remained the same. Also, there was no consideration received by the shareholder in lieu of reduction of share capital and hence, the Tribunal termed the shareholder's claim as merely a notional loss which was not allowed.

The Bangalore ITAT in the case of *M/s Jupiter Capital Pvt. Ltd. vs. ACIT (dated 29 November 2018)* allowed the claim for capital loss on account of reduction in share capital of the company. However, in this case, it is pertinent to note that the assessee received some consideration on account of capital reduction, which is a different fact pattern, as compared to the *Bennett Coleman case (Supra)* wherein no consideration was received. It seems that even in the Bennett Coleman case, there should have been a deduction allowed, since clearly there has been a loss incurred even more so, since nothing is received. Take the other view which the Bombay Tribunal did, puts the shareholders at a substantial disadvantage from a commercial stand point also.

ACCOUNTING

Section 66(3) proviso mentions that no application for reduction of share capital shall be sanctioned by the NCLT unless the accounting treatment proposed by the company is in conformity with the accounting standards specified in Section 133 / other provisions of the Companies Act and the certificate to that effect by the companies auditor is filed with the Tribunal.

As such, there are two aspects from an accounting stand point i.e. for the company doing the capital reduction (scheme company) and for the shareholders. In the context of the scheme company, the accounting treatment will depend on whether the capital reduction is with pay out or without pay out. Incidentally, under Scheme III of the Companies Act, 2013, there are some disclosure requirements for a period of 5 years in the Balance sheet of the scheme company.

In the context of the shareholders (assuming it is a company) such shareholder company will account in its books depending on whether the capital reduction is with or without pay out. If it is with pay out, the holding cost will reduce of course, and if it is without pay out, the description will alter, but the holding cost will remain the same, unless the capital reduction is also converging with an impairment (which test has to be undertaken anyway for a potential write down in the books of the shareholder company).

FEMA / RBI Regulations

RBIs general permission is available for payment pursuant to payment on capital reduction[10]; the consideration cannot exceed the cap prescribed under the RBI pricing guidelines[11]. If the price on capital reduction is exceeding the cap, RBI approval would be required. A remittance abroad would be possible assuming the shares are held on repatriation basis and a tax NOC or a CA certificate has been obtained as required u/s 195 of the Income Tax Act.

SUMMING UP

It would be seen that capital reduction has got multiple dimensions i.e. corporate law provisions, accounting issues, FEMA aspects and tax, and a company intending to embark on this route needs to clearly define its objectives and consider the implications of the Companies Act, 2013 as also the possibility of a regulatory roadblock. One key aspect therein is that Section 66 is wide enough for the NCLT to approve a scheme with or without a pay out, even if it is a selective capital reduction scheme.

(This article has been co-authored by Aseeim Agarwal)

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[6] 1977 AIR 560

[7] 236 ITR 327 / [TS-5067-SC-1998-O]

[8] 228 ITR 163 / [TS-24-SC-1997-O]

[9] TS-580-ITAT-2011

[10] AP DIR Circular No. 10 dated 30 Aug 2015

[11] AP Dir Circular No. 4 dated 15 July 2014