REVAMPING THE TAX REGIME FOR STOCK REPURCHASES IN INDIA: ECONOMIC EQUIVALENCE AS THE WAY FORWARD

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In November 2022, the Securities and Exchange Board of India ('SEBI') undertook a comprehensive review of the regulatory regime relating to buybacks or stock repurchases through the Consultation Paper on Review of SEBI (Buyback of Securities) Regulations, 2018. For the most part, SEBI was quite clear about what it envisions for India's buyback regime. However, one aspect that lacked clarity was the approach India would take towards the taxation of buybacks. SEBI recognised the problem that exists in the Indian regime wherein the company itself has to bear the tax burden for existing shareholders. To address this issue, SEBI argued that it was 'desirable' to 'realign' the regime and tailor it to shift the tax burden on existing shareholders. Ultimately, SEBI left the decision to the Ministry of Finance. Surprisingly, the 2023 Budget did not account for SEBI's discussion at all and neither did the Finance Act, 2023. This paper undertakes a detailed analysis of the buyback taxation regime in India and examines its lacunae. It does so by examining the traditional rationale behind the buyback of shares, comparing the taxation of buybacks with dividends and undertaking a comparative jurisdictional analysis with respect to the policy surrounding buybacks. Ultimately, this paper proposes a course of action for the Ministry of Finance to ensure that neither buybacks nor dividends are preferred for tax reasons. It concludes by proposing certain amendments to the Income Tax, 1961. The proposed amendments have their edifice in an idea put forward in 1967 – the economic equivalence of buybacks and dividends.

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I. INTRODUCTION

Buybacks and dividends are two methods by which companies distribute profits to their shareholders. In a buyback or a stock repurchase, the company uses its profits to buy shares from its shareholders.[1] On the other hand, when dividends are distributed, they are distributed at a fixed rate on shares.[2] The distributed amount therefore, is proportionate to the paid-up share capital of each shareholder.[3]

Since the 1980s, stock repurchases have been viewed as a suitable means of distributing profits to the shareholders of a company.[4] Studies indicate

[1] Benjamin Curry & John Schmidt, *Stock Buybacks: How Companies Create Value for Shareholders*, Forbes Advisor, June 14, 2023, available at https://www.forbes.com/advisor/investing/stock-buyback/ (Last visited on September 22, 2023); *See also* The Companies Act, 2013, §68(1).

[2] The Companies Act, 2013, §123.

[3] *Id.*, §51.

[4] Dorothy Neufeld, *Charted: The Rise of Stock Buybacks Over 20 Years*, Advisor, December 1, 2022, available at https://advisor.visualcapitalist.com/rise-of-stock-buybacks/ (Last visited on September 21, 2023).

that over the past two decades, the number of companies that repurchase their stock and the amount for which their stocks are repurchased have risen considerably in the United States of America ('USA').[5] Between 1972 and 2000, the percentage of companies that indulged in buybacks increased from twenty-seven percent to more than eighty-four percent.[6] Distribution of profits through dividends on the other hand became less popular. This is evidenced from the fact that the percentage of companies distributing profits through dividends dropped from sixty percent to twenty percent in the same timeframe.[7] This trend of stock repurchases overshadowing dividends as the preferred mode of profit distribution in the USA has continued in the twenty-first century as well.[8]

In India, over the past five financial years, the popularity of buybacks has been mixed. Between the 2017 and 2019 financial years, the buyback to dividend ratio was quite stable.[9] However, a sudden fiscal policy shift caused buyback numbers to slump in the 2020 financial year.[10] Though statistics from 2021 and 2022 indicate that buybacks are making a comeback. Data comparisons between 2021 and 2022 show that the number of buybacks in 2022 shot up from forty-two to fifty-eight and the value of buybacks almost tripled.[11] Additionally, the share of buybacks in the total profit distribution rose from 8.3 percent to twenty-one percent in the 2021 financial year.[12] While dividends are currently the most popular method of corporate redistributions, recent trends indicate that buybacks may soon go toe to toe with dividends as a profit distribution method.

The rapid rise of buybacks as a mode of corporate redistributions has evoked concern in foreign jurisdictions because of the debate regarding the possible impact that buybacks could have on economies. These include reduced investment and innovation, disproportionate enrichment of corporate executives and the possibility of debt-financed payouts bringing economies to the ground.[13] Such events occur because by using the profits to buy one's own shares, the funds that are put into research and development or other company projects reduces, thereby

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5 *Id.*

6 *See* ALVIN CHEN & OLGA A. OBIZHAEVA, STOCK BUYBACK MOTIVATIONS AND CONSEQUENCES – A LITERATURE REVIEW, 7 (CFA Institute, 2022) (where the authors provide statistics on the proportion of companies buying back their own shares with the study including over 15,000 companies).

7 *Id.*

8 *Id.*, 8.

9 Samie Modak, *Buybacks make a Comeback*, PRIME DATABASE available at http://www.primedatabasegroup.com/newsroom/M603.pdf (Last visited on September 21, 2023).

10 *Id.*

11 Narayanan V., *Shoring Up. Share Buybacks Recover in 2022, Surge to Rs. 38,735 crore*, THE HINDU BUSINESS LINE, December 28, 2022, available at https://www.thehindubusinessline.com/markets/share-buybacks-record-a-steep-jump-in-2022/article66313903.ece (Last visited on September 21, 2023).

12 Modak, *supra* note 9.

13 Jane G. Gravelle, *The 1% Excise Tax on Stock Repurchases (Buybacks)*, CONGRESSIONAL RESEARCH SERVICE, 4-5, February 15, 2023, available at https://crsreports.congress.gov/product/pdf/R/R47397#:~:text=The%20new%20provision%20imposes%20a,repurchases%20after%20December%2031%2C%202022 (Last visited on September 21, 2023).

reducing innovation and making no 'productive contributions' to the company.[14] The price of shares, however, tends to increase after a buyback because of changes in the earnings per share, and investor faith in the strength of the company, which could sometimes unjustly cause enrichment to corporate executives.[15]

To combat the possibility of such detrimental consequences, governments in the USA and Canada have taken various steps towards ensuring that stock repurchases are not incentivised. Most jurisdictions have taken to revamping their system of taxing stock repurchases. For instance, the USA under the Inflation Reduction Act of 2022,[16] brought in a one percent excise tax for stock repurchases by public corporations.[17] This new taxation rate will be applicable to all stock repurchases that take place after December 2022.[18] Similarly, in Canada, the 2022 Fall Economic Statement brought in a two percent tax on the net value of all buybacks that take place from January 1, 2024.[19]

In November 2022, the ('SEBI') followed suit and took its first step towards revamping the Indian buyback regime.[20] In its Consultation Paper on Review of SEBI (Buyback of Securities) Regulations, 2018 ('the Consultation Paper'), SEB I sought public comments to completely revamp the current stock repurchase regime which included doing away with open market buybacks through stock exchanges by April 2025.[21] The Consultation Paper also recognises an issue with the burden of taxation in the current buyback taxation regime. The burden of tax is on the shareholders who choose to remain with the company rather than on the shareholders who exit the company.[22] On this note, the Consultation Paper states that it would be 'desirable' for there to be parity between tax incidence on dividends and buybacks.[23] The proposal was for SEBI to consult the Ministry of

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[14] Lazonick et al., *infra* note 105.

[15] William Lazonick, *The Curse of Stock Buybacks*, The American Prospect, June 25, 2018, available at https://prospect.org/power/curse-stock-buybacks/ (Last visited September 21, 2023); *See also* Sarah Keohane Williamson et al., *The Dangers of Buybacks: Mitigating Common Pitfalls*, Harvard Law School Forum on Corporate Governance, October 23, 2020, available at https://corpgov.law.harvard.edu/2020/10/23/the-dangers-of-buybacks-mitigating-common-pitfalls/ (Last visited September 21, 2023).

[16] The Inflation Reduction Act, 2022, §4501.

[17] Gravelle, *supra* note 13.

[18] Internal Revenue Service, *Initial Guidance Regarding the Application of the Excise Tax on Repurchases of Corporate Stock under Section 4501 of the Internal Revenue Code*, available at https://www.irs.gov/pub/irs-drop/n-23-02.pdf (Last visited on September 21, 2023); *See also* effective date in the Internal Revenue Code, 2018, §4501.

[19] Léa Duval, *2% Share Buyback Tax: What to Expect?*, Andersen Global, January 5, 2023, available at https://ca.andersen.com/blog/2-share-buyback-tax-what-to-expect/ (Last visited on September 21, 2023).

[20] The Securities and Exchange Board of India, *Consultation Paper on Review of SEBI (Buyback of Securities) Regulations*, 2018, available at https://www.sebi.gov.in/reports-and-statistics/reports/nov-2022/review-of-sebi-buyback-of-securities-regulations-2018_65136.html (Last visited on September 21, 2023) ('Consultation Paper on Buybacks').

[21] *See id*., Chs.2, 8 (where the glide path mechanism is laid out).

[22] *Id*., 28-29.

[23] *Id*., 28.

Finance seeking recommendations on how tax laws should be amended to account for the fact that "the tax burden of the existing shareholders was being borne by the remaining shareholders".[24]

This paper argues that SEBI's approach in its Consultation Paper is inappropriate. It argues that the focus ought to shift from attempting to redistribute the tax burden in buybacks to ensuring that buybacks and dividends are treated identically by the tax regime because of their economic equivalence. Part II of this paper delves into the buybacks versus dividends debate and explains their economic equivalence. Part III examines the non-tax reasons for the popularity of buybacks.[25] The possible tax reasons for the popularity of buybacks in India are examined under Part IV.

The paper, under Part V, draws on the experience of the USA to show that SEBI's policy decisions were largely influenced by the American economy and the approach of the current Biden administration. Part VI highlights the problems with India's current buyback taxation system. Part VII puts forward a solution to problem statement in the Consultation Paper and lays out a step-by-step amendment process for the Ministry of Finance which is grounded in the 'economic equivalence' of buybacks and dividends. The paper proposes that while implementing the proposed model, the Ministry of Finance will have to reconsider tax rates on buybacks and dividends to account for the competing objectives of attracting foreign investment and reducing wealth concentration. Part VIII of the paper offers concluding remarks.

II. BUYBACKS VERSUS DIVIDENDS

Generally, when companies make profits, they have two courses of action available to them. They can either reinvest these profits to expand their business ventures or they can choose to distribute these profits to their shareholders. Traditionally, profit distribution takes two forms: dividends and buybacks.[26] The difference between these two methods of profit distribution is that buybacks cause the number of shares to reduce, while with dividends, the number of shares remains the same.[27]

Buybacks and dividends can achieve identical results from an economic perspective for the corporation and its shareholders.[28] In a scenario where dividends are used to distribute profits, the share value drops from its post-profit value to its pre-profit value. With buybacks on the other hand, although the share

[24] *Id.*, 29.

[25] *See* Daniel J. Hemel & Gregg D. Polsky, *Taxing Buybacks*, Vol. 38, YALE J. ON REG., 252 (2021) (where the authors examine the non-tax reasons for buybacks).

[26] Dividends can take the form of bonus shares which are called stock dividends.

[27] Hemel & Polsky, *supra* note 25, 246-252.

[28] *See id.*, where the authors argue that tax lawyers have considered the two to be 'essentially equivalent' or that they 'can be'. They go on to argue that any changes involved are 'cosmetic'.

value remains at post-profit levels, shareholders possess a lower number of shares than they would if the company distributed dividends instead.

As an illustration, consider a company X that has two shareholders A and B who hold 100 shares each. The price of each share is Re. 1. If the company earns Rs. 200 in profits then the price of each share would go up to Rs. 2. If the profits are distributed as dividends, then A and B would continue to hold 100 shares worth Re. 1 each and would receive dividends worth Rs. 100 each. However, if X chooses to repurchase its shares, and A chooses to redeem them, then A will receive Rs. 200 while B will hold 100 shares worth Rs. 2 each. In either scenario, the corporation pays Rs. 200 and the shareholders each hold Rs. 200 in some form.[29]

Hence, on a theoretical understanding of buybacks and dividends, there is no economic reason for companies or shareholders to favour one form of profit distribution over the other. However, when tax laws treat both these forms of profit distribution differently, corporations and shareholders would prefer the method of profit distribution that would cause them the least impact from a tax perspective. In addition there also exist several non-tax perspectives to prefer buybacks over dividends. The paper first explores the non-tax perspective and thereafter deals with the tax perspective for favouring buybacks.

III. WHY BUYBACKS ARE PREFERRED OVER DIVIDENDS: A NON-TAX PERSPECTIVE

Both the stakeholders involved in profit distribution namely, the corporation and the shareholders, could have their reasons to prefer buybacks over dividends. Broadly, the relative popularity of buybacks over dividends can be attributed to several reasons that can be placed in two categories: tax and non-tax reasons. This part deals with the non-tax reasons for buybacks which have been put forward by existing literature.

Corporations prefer buybacks over dividends for six reasons.[30] *First*, in the case of listed entities, the stock exchange may require the share price of the company to remain above a certain threshold to remain listed. *Second*, it may be beneficial for the corporation to repurchase its shares if it has issued shares to its employees as part of an employee stock option plan or scheme. *Third*, if the leadership of a corporation believe that its shares are undervalued. *Fourth*, to enable a defense against a takeover. *Fifth*, to improve the earnings per share ('EPS') value.[31] *Sixth*, to improve the capital structure of the corporation.[32]

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[29] For a simpler example, *see id.*, and compare example one with example two.

[30] Hemel & Polsky, *supra* note 25, 254-257.

[31] Marvin A. Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, Vol. 78, Yale L.J., 741-742 (1969).

[32] *Id.*, 742.

A. AVOIDING COMPULSORY DELISTING OR ENABLING VOLUNTARY DELISTING

In jurisdictions such as the USA, buybacks may occur because there is a compulsory price at which the company's shares must remain, without which, it would not meet the listing eligibility criteria on the stock exchange. For example, the New York Stock Exchange requires a company's share price to be at least USD 4 for it to be listed and traded.[33] Similarly, NASDAQ requires companies to maintain their share prices above USD 1.[34] Such a requirement is not very popular.[35] Euronext, the London Stock Exchange, the Hong Kong Stock Exchange (Main Board) and other major stock exchanges do not have a minimum trading price requirement.[36]

In India, delisting can be voluntary or mandatory. Mandatory delisting is governed by the Securities Contracts (Regulation) Rules, 1957.[37] Rule 21 lays down several criteria for compulsory delisting, some of which include negative net worth, infrequently trades shares,amongst others.[38] However, it does not lay down a minimum trading price that a company's shares will have to meet for it to remain listed. Therefore, stock repurchases to meet listing requirements are not a relevant reason for buybacks in the Indian context.

Voluntary delisting on the other hand involves shares being bought by the acquirer, which is either a person who makes an offer to procure the shares of the company or the promoters and the promoter group.[39] The purpose of delisting is to provide an exit opportunity to public shareholders, and not to distribute profits.[40] Nonetheless, a buyback could be the precursor to a company's eventual delisting plan.[41] It reduces the number of shares and increases the value of these

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[33] Kat Tretina, *The New York Stock Exchange (NYSE)*, Forbes Advisor, March 27, 2023, available at https://www.forbes.com/advisor/investing/nyse-new-york-stock-exchange/#:~:text=NYSE%20Listing%20Requirements&text=Its%20share%20price%20must%20be,over%20the%20past%20three%20years (Last visited on September 21, 2023); *See also*, *Cross-Border Listings Guide – New York Stock Exchange*, Baker Mckenzie, available at https://resourcehub.bakermckenzie.com/en/resources/cross-border-listings-handbook/north-america/new-york-stock-exchange/topics/principal-listing-and-maintenance-requirements-and-procedures (Last visited on September 21, 2023).

[34] The NASDAQ Marketplace Rules, Rule 4310(c)(4).

[35] Hemel & Polsky, *supra* note 25 at 254.

[36] Baker McKenzie, *Cross-Border Listings Guide*, 2022, available at https://resourcehub.bakermckenzie.com/en/resources/cross-border-listings-handbook (Last visited on September 21, 2023).

[37] The Securities Contracts (Regulation) Rules, 1957.

[38] *Id.*, Rule 21.

[39] The Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2021, Regulation 2(b).

[40] *Id.*, Regulation 7.

[41] DNHS, *Target Buybacks and Delisting to make Money in Shares*, Deccan Herald, October 16, 2011, available at https://www.deccanherald.com/business/economy-business/war-on-inflation-not-over-el-nino-factor-may-play-out-rbi-governor-1221654.html (Last visited on September 21, 2023).

shares, thereby increasing the likelihood of public shareholders participating in the offer made during the delisting process.

Hence, buybacks may be preferred over dividends in order to avoid delisting and enable voluntary delisting.

B. THE NEXUS BETWEEN BUYBACKS AND EMPLOYEE STOCK OPTIONS

Under the Companies Act, 2013, employee stock options plans ('ESOP') are defined as benefits or rights that can be exercised by employees, directors or officers of a company to purchase or subscribe to shares of the company in the future, at a pre-determined price.[42] Since the management of the company has a big role to play in determining the profit distribution mechanism,[43] companies which have handed out employee stock options are more likely to have a management that favours buybacks over the distribution of dividends.

The management of a company that has issued employee stock options is more likely to favour buybacks since they cause the share price to remain at post-profit levels. Hence, in a scenario where employees can redeem shares of a hypothetical company for Rs. 11, and the price of the shares went up to Rs. 15, they would prefer a buyback since they can exercise their option and redeem shares at a lower price.[44] However, if dividends are distributed the share could fall below the price at which they can exercise their option, and this would not be beneficial for employees.

A recent trend that has taken over the Indian market is ESOP buybacks. In 2022, several startups repurchased ESOPs that were issued to their employees.[45] Razorpay, Pine Labs, Rebel Foods and other unicorn companies have repurchased stock worth close to USD 200 million in 2022 making it extremely profitable for employees.[46]

C. BUYING BACK UNDERVALUED SHARES

If the management of a corporation believe that the shares of the company are being undervalued by the market, they can choose not to redeem their shares when the buyback takes place. Functionally, this allows certain

[42] The Companies Act, 2013, §2(37).
[43] *Id.*, §68.
[44] Hemel & Polsky, *supra* note 25, 254.
[45] Jaspreet Kaur, *ESOPs Galore: Indian Startup Employees Made Over $196 Mn Through Buybacks in 2022*, INC 42 January 5, 2023, available at https://inc42.com/buzz/esops-galore-indian-startup-employees-have-made-over-159-mn-through-buybacks-in-2022/ (Last visited on September 21, 2023).
[46] *Id.*

shareholders, and the management to buy shares of a company for what they believe is a lower price than the actual value of the shares.

Historically, buybacks have resulted in the price of the company's shares increasing, with most companies gaining billions of dollars in shareholder value.[47] Studies have found that companies which repurchase their stock have performed better than their 'peers' in the long run.[48] In addition to increasing the earnings per share, the message that a stock repurchase programme sends to investors is that the best investment the company can make at the time is in its own shares, indicating that the management is confident in its policies and ability to deliver in the future.[49]

However, buybacks may not always reward the company with a rise in share price.[50] It is contingent on the ability of the management to identify situations where the shares of the company are being undervalued,[51] and sending the right message to investors through the company's conduct.[52] Hewlett Packard, for instance, attempted to repurchase its shares at what the management believed were a bargain. Subsequent company conduct such as business restructuring and pulling the plug on an acquisition, coupled with dipping financials, resulted in investor confidence in the buyback dissipating.[53] By 2000, Packard's shares were traded for about half the price the company paid per share during the buyback.[54]

Even if the management correctly identifies situations in which the company's shares are undervalued and company conduct does not send mixed signals, empirical studies indicate that the rise in share price is negligible for the

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[47] Justin Pettit, *Is a Share Buyback Right for your Company?*, Harvard Business Review, April, 2001, available at https://hbr.org/2001/04/is-a-share-buyback-right-for-your-company (Last visited on September 21, 2023) (referring to buybacks in the USA); However, this trend is reflected in recent occurrences in India as well, for instance *see* Asit Manohar, *Wipro Share Price Jumps as IT company's Board to Consider Buyback of Shares Soon*, LiveMint, April 24, 2023, available at https://www.livemint.com/market/stock-market-news/wipro-share-price-jumps-as-it-company-mulls-to-consider-buyback-of-shares-soon-11682317302618.html (Last visited on September 21, 2023); *See also* Livemint, *Welspun India Share up 15% Post Buyback Announcement, Q4 Earnings*, LiveMint, May 2, 2023, available at https://www.livemint.com/market/stock-market-news/welspun-share-up-15-post-buyback-announcement-q4-earnings-11683018200918.html (Last visited on September 21, 2023).

[48] Alex Edmans, *Do Share Buybacks Really Destroy Long-Term Value?*, Harvard Law School Forum on Corporate Governance, October 22, 2020, available at https://corpgov.law.harvard.edu/2020/10/22/do-share-buybacks-really-destroy-long-term-value/#:~:text=Not%20always.,conservatory%2C%20and%20refurbish%20his%20kitchen (Last visited on September 21, 2023).

[49] Pettit, *supra* note 47.

[50] Michael Roberts, *Making Sense of Stock Buybacks*, Knowledge at Wharton, March 7, 2023, available at https://knowledge.wharton.upenn.edu/article/making-sense-of-stock-buybacks/ (Last visited on September 21, 2023).

[51] *Id*.

[52] Pettit, *supra* note 47.

[53] *Id*.

[54] *Id*.

first few months.[55] In many cases, the company's share price rises only years after the stock repurchase takes place.

From the Indian standpoint, the number of empirical studies conducted on the effect buybacks have on share price are not very large. Results from these studies indicate prices of shares generally tend to go up as soon as a buyback is announced in accordance with the signaling theory.[56] Recent occurrences with Wipro and Welspun India and their share prices strengthen the claims of these studies.[57] While the long-term consequences of the buyback are not as well documented, one cannot ignore share undervaluation as an economic reason for companies to conduct buybacks.

D. DEFENSIVE BUYBACKS

One of the easiest ways to prevent a company from being the subject of a takeover is to repurchase stock. By repurchasing its stock, a company reduces its equity share capital and ensures that the ownership of non-redeeming shareholders increases. The non-redeeming shareholders are usually those who have an interest in ensuring that control of the company remains with a specific group of people.[58] They are usually the management of the company or 'management loyalist'.[59] Additionally, since the repurchase also ensures that company's share price remains high, it disincentivises potential takeover bids.

Debt-financed stock repurchases are also a popular takeover defense in certain jurisdictions.[60] By financing the repurchase through debt, the shares of

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[55] Leonce Bageron & Michael Farrell, *The Price Effect of Stock Repurchases: Evidence from Dual Class Firms*, available at https://pubsonline.informs.org/doi/epdf/10.1287/mnsc.2021.4066 (Last visited on September 21, 2023).

[56] *See* S. K. Pradhan & R. Kasilingam, *Buyback Announcement and its Impact on Shareholders' Wealth: A Study on Bombay Stock Exchange*, Vol. 14(3-4), Asia-Pacific Journal of Management Research and Innovation, 111 (2019); *See also* Milan S. Shah, *Share Buyback in India: Performance Evaluation of Share Price of Selected Companies*, Vol. 12, Turkish Online Journal of Qualitative Inquiry, 6332 (2021); A detailed analysis of the signaling theory is beyond the scope of this paper.

[57] Nishant Kumar, *Multibagger Stick in Making? Welspun India Shares Surge 69% in One Month; Is it Still Buy-Worthy?*, LiveMint, May 4, 2023, available at https://www.livemint.com/market/stock-market-news/multibagger-stock-in-making-welspun-india-shares-surge-69-in-one-month-is-it-still-buyworthy-11683170029269.html (Last visited on September 21, 2023); Money Control News, *Wipro Shares Tick Higher After Company Announces Buyback Date*, June 30, 2023, available at https://www.moneycontrol.com/news/business/stocks/wipro-shares-tick-higher-after-company-announces-buyback-date-10824521.html (Last visited on September 21, 2023).

[58] Hemel & Polsky, *supra* note 25, 255.

[59] Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases*, Vol. 99, Harv. L. Rev., 1377 (1986).

[60] Sidharth Sinha, *Share Repurchase as a Takeover Defense*, Vol. 26, The Journal of Fin. & Quant. Analysis, 233 (1991).

the corporation become less attractive for a potential takeover bid because of a less favourable debt-equity ratio and a lower share price.[61]

E. IMPROVING EARNINGS PER SHARE

On many occasions, investors rely on the EPS of a company to make investment decisions.[62] EPS is a financial measure that gives shareholders and prospective investors a fair idea of the company's profitability.[63] It is defined as the ratio between the net income of the company (post tax) and the total number of outstanding shares.[64]

A big reason that companies frequently indulge in buybacks is that the investment opportunities available to the company do not promise sufficient returns.[65] Since the management is aware of the intricacies of their own company, they prefer stock repurchases rather than acquiring stakes in other corporations.[66]

A popular notion is that the company's EPS will increase because of the reduction in the number of outstanding shares (denominator of the ratio).[67] However, that is not always the case.[68] Hemel and Polsky argue "it is far from automatic" that buybacks will always yield a positive outcome because they affect the numerator (net income) and denominator (number of outstanding shares) of the EPS ratio.[69]

Yet, using this method of profit distribution is preferred to dividends because it is more 'neutral' towards EPS as opposed to dividends, which could artificially deflate EPS.[70] Unless buybacks are an available option, corporations will be encouraged to make inefficient investment decisions that offer marginal but largely immaterial increases in EPS to inspire market confidence in the company.[71]

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[61] *Id.*; Debt-financed buybacks are prohibited in India by Rule 17(10(e) of the Companies (Share Capital and Debentures) Rules, 2014, which states that companies cannot buy back their shares utilising money borrowed from banks and financial institutions. One could of course argue that financial institutions as defined by the Reserve Bank of India Act, 1934, under §45-I(f) do not include institutions that carry out their business in agricultural operations, the industrial sector, buying and selling of goods and services and the purchase, construction or sale of immoveable property.

[62] *What is 'Earnings Per Share (EPS)'*, Economic Times, available at https://economictimes.indiatimes.com/definition/earnings-per-share-eps (Last visited on September 21, 2023).

[63] *Id.*

[64] *Id.*

[65] Chirelstein, *supra* note 31, 741.

[66] *Id.*

[67] *Id.*

[68] Hemel & Polsky, *supra* note 25, 291.

[69] *See id.*, for a detailed explanation with examples. The authors conclude that buybacks need not always increase EPS when compared to reinvestment decisions.

[70] *Id.*, 292.

[71] *Id.*, footnote 151.

F. IMPROVING CAPITAL STRUCTURE

A company's 'optimal' capital structure is the ideal mix of debt and equity to finance its ventures. Debts form an extremely important part of capital structure because of their reduced costs,[72] and tax deductibility.[73] With respect to the cost element, debts do not have any hidden costs since holders of debt securities are neither given a share in the profits the company makes like equity shareholders, nor are they given any decision-making powers or control in the company.[74] Additionally, interest payments on debts are not taxed.[75]§36(1)(iii) of the Income Tax Act, 1961 ('the 1961 Act') considers interest payments on capital borrowed for 'business purposes' as a permissible deduction which means that it is deducted from the taxable income of the company.[76]

A stock repurchase reduces equity and increases a company's reliance on debt. It also brings down the weighted average cost of capital thereby increasing the company's profitability. In some cases, even if the optimal debt-equity ratio has been achieved, a company may choose to repurchase its shares because it is threatened by the rapid rise in earnings.[77] Hence, it is convenient for companies to reduce their equity share shareholding and increase reliance on debt capital.

IV. THE RELATIVE FAVOUR ABILITY OF BUYBACKS ON THE TAX FRONT

Having discussed the non-tax reasons behind shareholders and corporations preferring buybacks over dividends in India, the paper will now delve into the tax reasons for buybacks with references to the 1961 Act.

A. DIFFERENTIAL TREATMENT OF BUYBACKS AND DIVIDENDS BY THE INDIAN TAX REGIME

Despite their economic equivalence, there is a stark difference in how buybacks and dividends have been treated under the 1961 Act. According to §10(34A) of the 1961 Act, any income that accrues to an assessee who is a

[72] Travis Meyer, *What's Cheaper: Raising Debt Or Surrendering Equity?*, Forbes, October 2, 2022, available at https://www.forbes.com/sites/forbesbusinesscouncil/2022/10/03/whats-cheaper-raising-debt-or-surrendering-equity/?sh=4af0e1de16e4 (Last visited on September 21, 2023).

[73] The Income Tax Act, 1961, §36(1)(iii).

[74] Money Control, *Why is Debt Cheaper Than Equity?*, Money Control, July 9, 2023, available at https://www.moneycontrol.com/news/mcminis/business/why-is-debt-cheaper-than-equity-7149681.html#:~:text=Indeed%2C%20debt%20has%20a%20real,its%20post%2Dtax%20cost%20further (Last visited on September 21, 2023).

[75] This is the general rule followed across jurisdictions. Our focus is on the Indian position on taxing debt.

[76] The Income Tax Act, 1961, §36(1)(iii) (note however that interest payments are not permissible deductions when the capital is borrowed to acquire another capital asset).

[77] Chirelstein, *supra* note 31, 742.

shareholder of a company, by virtue of a buyback is not considered a part of 'income' for the previous year.[78]

Presently, dividend-based income is considered a part of "income from other sources" under §56 of the 1961 Act.[79] Hence, dividends would form a part of a person's income and,[80] the existing rates under either the new tax regime or the old tax regime, as per the choice of the individual would prevail.[81] Interestingly, the dividend amount will also be taxed in the hands of the company. §194 provides that the company will have to pay a ten percent tax on the amount that will be distributing to shareholders as dividend.[82]

The position on dividends and buybacks, therefore, is quite clear. Since buybacks are completely exempt from taxation in the hands of a shareholder while dividends are taxed as a part of an assessee's total income, it is unsurprising that shareholders prefer buybacks over dividends from a tax perspective.

B. THE 'MARK ZUCKERBERG' PROBLEM

The founders of extremely successful companies sometimes engage in zero-dividend policies to benefit from the 'step-up in basis' rule.[83] The step-up in basis rule changes the cost basis of an inherited asset to the fair market value of that asset when it is inherited.[84] In the USA, §1014 of the Internal Revenue Code, 1986, lays down this rule.[85] The effect of this rule is that the sale of inherited shares will be subject to lower capital gains tax.[86]

In such a scenario, companies which have zero-dividend policy, where profit distribution takes place through buybacks, non-redeeming shareholders do not pay any tax and retain their shares until their death.[87] Their heirs are then able to dispose these shares without incurring any tax liability.[88] This has been described as the 'Mark Zuckerberg' problem because tax policy generally

[78] The Income Tax Act, 1961, §10(34A).
[79] *Id.*, §56.
[80] *Id.*, §8(a).
[81] *See Id.*, §115BAC(1) (where the words, "at the option of such person" allow individuals to choose the tax regime that would be applicable to them).
[82] *See Id.*, §194 (which prescribes a tax deduction at the source. The Income Tax Act, 1961, allows assesses to claim this amount at a later stage by filling forms in accordance with §197 of the Act and the Income Tax Rules).
[83] Hemel & Polsky, *supra* note 25, Part III(D).
[84] Internal Revenue Code, 1986, §1014 (the "cost basis" is essentially the "cost of acquisition" or the base cost on which capital gains are calculated).
[85] *Id.*
[86] Hemel & Polsky, *supra* note 25, 260-261 (this is because capital gains tax is computed as a certain percentage of the difference between the consideration received for the asset and the cost basis).
[87] *Id.*
[88] *Id.*

requires trigger events for income to be taxable.[89] A shareholder who does not receive dividends or cash out on their shares will not have to pay any tax.[90] Professor Kleinbard argues that this should be thought of as the Mark Zuckerberg problem because successful entrepreneurs who live modestly and do not demand large distributions can live a tax-free life.[91]

Fortunately, the Mark Zuckerberg problem is not an issue that plagues India as much as the USA. §49 of the 1961 Act states that the cost of acquisition of a capital asset received through inheritance would be the cost at which the previous owner acquired it plus the costs borne by the previous owner or the assessee to make improvements to the asset.[92] Hence, even in scenarios where a person holds shares until their death, their heirs cannot avoid tax if they dispose of the asset.

However, there could still be some situations where a company has a zero-dividend policy and the founders and their heirs avoid paying tax by choosing not to redeem their shares at any point.[93] While this is unlikely with all companies, it still remains a possibility for a few. The problem with such a regime is that it allows certain shareholders to 'buy/borrow/die', which is borrow money with their shares as collateral and live a tax-free life.[94] Professor McCaffrey notes that the problem does not lie in the fact that the buy/borrow/diestrategy may not be used, rather, the issue is that we have a regime that allows it to occur.[95]

V. THE AMERICAN INFLUENCE ON THE CONSULTATION PAPER

Two major issues that the Indian economy can face because of excessive buybacks are the prioritisation of executive interests over shareholder interests, and repercussions for companies when the economy slumps. The same are discussed in the following sub-parts.

89 Edward D. Kleinbard, *The Right Tax at the Right Time*, Vol. 21, Florida Tax Review, 298-299 (2017).

90 *See generally id.*

91 *Id.*, at 298-299.

92 The Income Tax Act, 1961, §49.

93 The popular example is that of Mark Zuckerberg, who can avail loans with his stock and avoid paying taxes on the stock because of a hypothetical zero-dividend policy. Wealthy founders of companies can adopt such a strategy.

94 *See* Hemel & Polsky, *supra* note 25, 300 (discussing Edward J. McCaffery, *Taxing Wealth Seriously*, Vol. 70, Tax Law Review, 321 (2017).

95 *See generally* Edward J. McCaffery, *Taxing Wealth Seriously*, Vol. 70, Tax Law Review, 306 (2017).

A. PRIORITISATION OF EXECUTIVE INTERESTS OVER THE INTEREST OF SHAREHOLDERS

In 2021, USA Senator Elizabeth Warren came down heavily on buy-backs and labeled them as "nothing but paper manipulation".[96] Buybacks are often conducted by executives of companies because their payouts are often based on company performance which is reflected by its share price and its EPS ratio.[97] Additionally, executives sometimes have a stake in the company and dispose of their shares immediately after a buyback takes place because of the price rise.[98] In essence, a select group of shareholders that are able to redeem their shares benefit from the buyback while the others are left empty-handed.

To prevent executives from using buybacks to benefit at the expense of shareholders, the Biden administration brought in a one percent tax on buy-backs which came into effect in January, 2023.[99] However, this tax measure did not have the desired effect.[100] Despite the new tax rates, Chevron announced a USD seventy-five billion share buyback program in early 2023.[101] In furtherance of its policy of clamping down on buybacks and encouraging companies to re-ward all shareholders by either paying dividends or investing in business ven-tures, the Biden administration is now contemplating quadrupling the tax rate on buybacks.[102]

India's capital market regulator seems to have been influenced by these developments in the USA and Canada as predicted by Michael Mackenzie.[103]

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[96] Thomas Franck, *Elizabeth Warren Rips Stock Buybacks as 'Nothing but Paper Manipulation'*, CNBC, March 2, 2021, available at https://www.cnbc.com/2021/03/02/elizabeth-warren-rips-stock-buybacks-as-nothing-but-paper-manipulation.html (Last visited on September 21, 2023).

[97] As will be discussed below, buybacks automatically increase the EPS ratio, thereby changing the share price as well.

[98] Lenore Palladino, *Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities and Investors*, Harvard Law School Forum on Corporate Governance, October 22, 2019, available at https://corpgov.law.harvard.edu/2019/10/22/examining-corporate-priorities-the-impact-of-stock-buybacks-on-workers-communities-and-investors/ (Last visited on September 21, 2023).

[99] The Inflation Reduction Act, 2022, §4501.

[100] Jennifer Williams-Alvarez, *The 1% Stock-Buyback Tax Hasn't Slowed Repurchases. A Proposed 4% Tax Might.*, The Wall Street Journal, March 2, 2023, available at https://www.wsj.com/articles/the-1-stock-buyback-tax-hasnt-slowed-repurchases-a-proposed-4-tax-might-f87044eb (Last visited on September 21, 2023).

[101] Jeff Carlson, *Proposed 4% Tax on Stock Buybacks Faces Hurdles*, Thomson Reuters, June 2, 2023, available at https://tax.thomsonreuters.com/news/proposed-4-percent-tax-on-stock-buybacks-faces-hurdles/ (Last visited on September 21, 2023).

[102] Williams-Alvarez, *supra* note 100; *See also* Richard Rubin, *Biden to Urge Quadrupling New 1% Tax on Stock Buybacks*, The Wall Street Journal, February 6, 2023, available at https://www.wsj.com/articles/biden-to-urge-quadrupling-new-1-tax-on-stock-buybacks-11675723035?mod=article_inline (Last visited on September 21, 2023).

[103] Michael Mackenzie, *Why US Politicians are Missing the Point on Share Buybacks*, Financial Times, February 3, 2019, available at https://www.ft.com/content/466e1050-350c-11e9-bd3a-8b2a211d90d5 (Last visited on September 21, 2023).

In 2019, he stated, "Should Washington follow through on one proposal of taxing buybacks at a higher rate,or veer left and ban them unless a company bolsters pay for its employees, the outcome will resonate globally".[104] The Consultation Paper indicates that SEBI's intention is to take measures through taxation that ensure parity between dividends and buybacks as profit distribution mechanisms and this may have been influenced by North American policies.

B. PHASING OUT OPEN MARKET REPURCHASES

When an economy is on the rise, one may find it difficult to worry about the potential consequences that excessive stock buybacks may have. Studies show that major companies in the USA tend to conduct buybacks during a bull market to inflate prices even further, thereby making them financially fragile during economic downturns.[105] By reacquiring their own shares in a stable or rising economy, companies deprive themselves of a liquidity source during a potential economic downturn.[106]

Lazonick, Sakinc & Hopkins argue that buybacks in general "undermine the quest for stable and equitable growth".[107] Amounts that are used to buyback shares can be used to offer more benefits to employees of the company, improve existing safety standards and invest in other forms of capital.[108]

Professor Lazonick argues that open market repurchases ought to be banned since it gives senior executives of a company, hedge fund managers and other people who are involved in transactions on a regular basis an unfair advantage over retail investors who often make investments through funds and cannot react to open market repurchases as quickly.[109] Such a position seems to gathering support in the Congress as well. In October 2022, certain Democrat Representatives reintroduced a bill to enact the Reward Work Act, 2018, which seeks to completely ban open market repurchases and provide greater employee representation on company boards.[110]

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[104] *Id.*

[105] William Lazonick et al., *Why Stock Buybacks Are Dangerous for the Economy*, Harvard Business Review, January 7, 2020 available at https://hbr.org/2020/01/why-stock-buybacks-are-dangerous-for-the-economy#:~:text=Stock%20buybacks%20made%20as%20open,pay%20of%20the%20labor%20force (Last visited on September 21, 2023).

[106] *Id.*

[107] *Id.*

[108] Chelsey Cox, *House Democrats Reintroduce Bill Targeting Stock Buybacks*, CNBC, May 25, 2023, available at https://www.cnbc.com/2023/05/25/house-democrats-reintroduce-bill-targeting-stock-buybacks.html (Last visited on September 21, 2023).

[109] William Lazonick, *Banning Buybacks*, Institute for New Economic Thinking, available at https://www.ineteconomics.org/perspectives/videos/banning-buybacks (Last visited on September 21, 2023).

[110] Press Release, *Representatives Garcia, DeFazio, and Khanna Reintroduce Legislation Increase Worker Power and Rein in Harmful Stock Buybacks*, October 7, 2022, available at https://chuygarcia.house.gov/media/press-releases/representatives-garcia-defazio-and-khanna-reintroduce-legislation-increase-worker-power-and-rein-in-harmful-stock-buybacks#:~:text=the%20

The Consultation Paper seems to draw a great deal of inspiration from the USA's approach. It proposes to phase out open market repurchases through the stock exchange by 2025 through a glide path mechanism.[111] The glide path mechanism was introduced because of the inequitable nature of open market repurchases and the possibility of the entirety of the buyback benefitting a single shareholder.[112] Other reasons include the variable price of shares during an open market repurchase and, the lack of representation for retail investors.[113] Comparing these with the developments in the USA, one can reasonably infer that SEBI's decision-making is largely in line with the rationale put forward by experts in the USA.

VI. THE PROBLEMS ASSOCIATED WITH INDIA'S BUYBACK TAX REGIME

Chapter VII of the Consultation Paper deals with taxation matters and provides a background, a problem statement and an analysis.[114] In the problem statement, SEBI states that the current buyback regime favours shareholders who redeem their shares and exit the company while negatively impacting shareholders who do not participate in the buyback, focusing on the problem described above in Part IV(A).[115]

SEBI, in its analysis goes on to provide data on the number of buyback exercises conducted in 2020 and concludes that in all buyback exercises, the tax under §115QA of the 1961 Act has been paid by the company from its free reserves "on behalf of the existing shareholders and promoters at the cost of continuing shareholders".[116]

Based on such an analysis, the Consultation Paper states that "buybacks are taxed in the hand of the company rather than the shareholders who have tendered their shares and earned profit thereon".[117] Hence, the sub-group recommends making a reference to the Ministry of Finance to shift the tax burden from the company to shareholders and to amend existing laws to that effect.[118]

U.S.%20economy.-,The%20Reward%20Work%20Act%20reins%20in%20stock%20buybacks%20and%20corporate,are%20subject%20to%20greater%20disclosure (Last visited on September 21, 2023); For the text of the Bill *see* Chuy Garcia, *A Bill*, available at https://chuygarcia.house.gov/sites/evo-subsites/chuygarcia.house.gov/files/evo-media-document/117th_congress_rewardworkact.pdf (Last visited on September 21, 2023).

[111] Consultation Paper on Buybacks, *supra* note 20, 8.

[112] *Id*., 8, ¶2.

[113] CNBCTV18.com, *Explained |Why Share Buybacks Via Open Markets are Often Considered Bad*, October 14, 2022, available at https://www.cnbctv18.com/market/infosys-share-buyback-open-market-explained-advantages-disadvantages-14947221.htm (Last visited on September 21, 2023).

[114] Consultation Paper on Buybacks, *supra* note 20, Chapter VII.

[115] *Id*., Chapter VII, Problem Statement.

[116] *Id*., 28-29.

[117] *Id*., 29.

[118] *Id*., 29.

Despite SEBI flagging concerns with the current system of taxation,[119] and there being much talk of the Budget 2023 accounting for the deficits in the system,[120] neither the Finance Bill, 2023, nor the Finance Act, 2023 revamped the tax system with respect to buybacks and dividends. The Ministry of Finance's inaction is quite surprising given the fact that exiting shareholders are often promoters who are High-Net Worth Individuals ('HNWI') seeking to plan taxes and shift majority of their tax burden to public shareholders who remain with the company.[121] This has been described as a 'tax leak' which is unjust to small shareholders.[122]

The concept behind the solution to this tax leak problem interestingly may lie in the previous tax regime on both buybacks and dividends. While the previous tax regime came with its own fair share of problems, the most effective move may be to introduce a uniform system that treats both buybacks and dividends the same rather than shift the burden to existing shareholders. This part examines the previous tax system and highlights its shortcomings.

A. TAX TREATMENT OF DIVIDENDS – BRIEF HISTORY

The position regarding dividends is a conundrum. Earlier, under §10(34) of the 1961 Act, dividends were not taxable in the hands of the shareholder.[123] It was only the company that would have to pay a twenty percent tax on the distributed income.[124] These provisions are applicable to dividends distributed between April 1, 2003, and March 31, 2020.[125]

The position changed significantly after the Finance Act, 2020, came into force.[126] For resident shareholders, the tax regime took a classical outlook where dividends are taxed in the hands of the shareholder at prevailing tax rates.[127] Income from dividends would be considered a part of income from other sources

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119 *Id.*

120 Naveen Wadhwa & Rachit Sharma, *Budget 2023 Buybacks Should be Taxable in the Hands of Exiting Shareholders*, Money Control, January 30, 2023, available at https://www.moneycontrol.com/news/business/personal-finance/budget-2023-how-buybacks-should-be-taxed-9959311.html (Last visited on September 21, 2023); Varun Gakhar, *Budget 2023: Indian Corporates Seek Relook At Buyback Tax*, BQPrime, January 19, 2023, available at https://www.bqprime.com/budget-2023/budget-2023-indian-corporates-seek-a-relook-at-buyback-tax (Last visited on September 21, 2023); Surabhi, *Budget May Shift Buyback Tax from Firms to Shareholders*, Financial Express, January 3, 2023, available at https://www.financialexpress.com/economy/budget-may-shift-buy-back-tax-from-firms-to-shareholders/2934614/ (Last visited on September 21, 2023).

121 Gakhar, *supra* note 120.

122 *Id.*

123 The Income Tax Act, 1961, §10(34).

124 *Id.*, §115-O.

125 *Id.*

126 Income Tax Department, *Tax Treatment of Dividend Received from Company*, 1, available at https://incometaxindia.gov.in/tutorials/tax%20treatment%20of%20dividend%20received.pdf (Last visited on September 21, 2023).

127 *Id.*

and taxed accordingly.[128] Notably, the company will have to deduct ten percent as tax at the source in cases where the dividend being distributed is more than Rs. 5000 and, it is being paid in cash.[129]

With non-resident shareholders, the law is slightly complex. According to §195 of the 1961 Act, the company will have to deduct twenty percent of the dividend amount as tax at the source, before distribution takes place.[130] In addition to this, the shareholder will have to pay taxes according to the laws of their country of residence.[131] In India, the tax rate will be the same as that prescribed by agreements entered into by India wherever they are available.[132]

Another important part of dividend income that is seldom discussed is the cascading effect of corporations using the dividends they receive from other corporations to pay their own dividends. In such cases, it would not be desirable for the same income to be taxed twice. Hence, §80M of the Finance Act, 2021, removes the cascading effect by making inter-corporate dividends that are used to pay dividends a permissible deduction.[133]

B. TAX TREATMENT OF BUYBACKS

Presently, buybacks are taxed exclusively in the hands of the company. §115QA of the 1961 Act states that all companies would have to pay a tax at a rate of twenty percent when a buyback is conducted.[134] However, this was not always the case.

1. Buybacks Until the Finance Act, 2013 – The Problem With Capital Gains Tax

Earlier, the system took the approach of taxing shareholders for income that they received for buybacks as capital gains.[135] The Finance Act, 1999, inserted a new §46A into the 1961 Act which ensured that shareholders who exit the company and make profits pay capital gains tax on such profits.[136]

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[128] *Id.*, 2.

[129] The Income Tax Act, 1961, §194.

[130] *Id.*, §195 (note that the twenty percent rate does not apply to all shares and the provision itself carves out certain exceptions).

[131] Income Tax Department, *supra* note 126.

[132] *Id.*

[133] The Finance Act, 2021, §80M.

[134] The Income Tax Act, 1961, §115QA.

[135] *Id.*, §46A.

[136] ET Bureau, *It's Double Taxation: Share Buyback Tax Should go like DDT says TV Mohandas Pai in a BCIC Report*, December 17, 2021, available at https://economictimes.indiatimes.com/news/economy/policy/its-double-taxation-share-buy-back-tax-should-go-like-ddt-says-tv-mohandas-pai-in-a-bcic-report/articleshow/88332271.cms (Last visited September 21, 2023).

Tax on income received from buybacks had to be calculated on the difference between the cost of acquisition and the value of consideration received, which will be considered as capital gains.[137] Notably, amounts up to Rs. 1 lakh in capital gains were exempt from taxation when they involved gains from the sale of equity shares. Depending on the duration that the shares were held and the nature of the company (listed or unlisted),[138] the amount received could either be taxed at fifteen or ten percent.[139]

The two illustrations below provide a clear idea on how the nature of the company (listed and unlisted) and the time for which the shares are held affect the amount of tax that will have to be paid.

Illustration 1: Company ABC Ltd. (listed company) allows shareholders to subscribe to its shares at Rs. 100000 per share. X and Y buy 5 shares for Rs. 500000 each. If A makes profits of Rs. 1000000 and decides to engage in a buyback, it will have to buy back shares at Rs. 200000 each (the share price has gone up to Rs. 200000 per share in lieu of the profits ABC Ltd. made). If X tenders all their shares in the buyback, then two possible scenarios could arise for X.

Scenario 1: In a situation where X has held the shares for more than one year, X will be taxed at the rate for long-term capital gains, i.e. ten percent.[140]

Capital gains = Consideration received for sale – Cost of acquisition

= Rs. 10,00,000 – Rs. 5,00,000

= Rs. 5,00,000

Tax on capital gains = Ten percent of Rs. 5,00,000

= Rs. 50,000

[137] The Income Tax Act, 1961, §46A.

[138] *See id.*, §2(42A) (which defines a short-term capital asset as a capital asset held by an assessee for a duration of less than thirty-six months before its transfer); For a definition of long-term capital assets, *see id.*, §2(29AA); Note that in the case of equity shares held in private companies, they are considered short-term capital assets if held for a period of less than two years and long-term capital assets if they are held for a longer duration. For public companies, equity shares are considered short-term capital assets if held for a period of less than one year, and long-term capital assets if held for longer periods.

[139] The Income Tax Act, 1961, §111A (short-term capital gains) and §112, §112A (long-term capital gains).

[140] *Id.*, §112A (which exempts capital gains from equity shares upto Rs.1 lakh and imposes a ten percent tax on gains above Rs. 1 lakh).

Note: These calculations are conservative because they do not take into account the indexed cost of acquisition based on inflation.[141] The indexed cost of acquisition will be higher the longer the shareholder holds on to the share.[142] In all likelihood, the tax that will be paid will be a lot lower than Rs. 50,000 because the cost of acquisition will increase as time goes by.[143]

Scenario 2: In a situation where X has held the shares for less than one year, X will be taxed at the rate for short-term capital gains, i.e. fifteen percent.

Capital gains = Consideration received for sale – Cost of acquisition

= Rs. 10,00,000 – Rs. 5,00,000

= Rs. 5,00,000

Tax on capital gains = Fifteen percent of Rs. 5,00,000

= Rs. 75,000

Illustration 2: Company ABC Pvt. Ltd. allows shareholders to subscribe to its shares at Rs. 100000 per share. X and Y buy 5 shares for Rs. 500000 each. If ABC makes profits of Rs. 1000000 and decides to engage in a buyback, it will have to buy back shares at Rs. 200000 each (the share price has gone up to Rs. 200000 per share in lieu of the profits ABC Pvt. Ltd. made) when it comes to shareholders, the law treats them differently than in Illustration 1. They will have to hold shares for two years or more for Scenario 1 to apply and less than two years for Scenario 2 to apply.[144] Note that this illustration is relevant for public unlisted companies as well because the 1961 Act makes a distinction between listed and unlisted companies to determine whether the shares are long-term or short-term capital assets.

One of the major issues with the system of taxing buybacks as capital gains however was recognised by the Supreme Court in the case of *Genpact India Pvt. Ltd.* v. *Deputy Commissioner of Income Tax*.[145] The court noted that Article 13 of the India-Mauritius Double Taxation Avoidance Agreement operated against §46A. It provides that capital gains arising from the transfer of shares to Mauritius Residents would be taxable in their country and this would mean that

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[141] The Income Tax Act, 1961, §48 Explanations (iii), (iv) & (v); For the cost inflation index for the 2023-2024 financial year, *see* Ministry of Finance, Income Tax, S.O. 1692 (E) (Notified on April 10, 2023).

[142] *Id*.

[143] *Id*.

[144] *See id*., §2(42A) read with the illustrations provided below.

[145] Genpact India Pvt. Ltd. v. Deputy Commissioner of Income Tax, 2019 (16) SCALE 667.

the transaction would be tax free.[146] Consequently, this could reduce the tax base since Indian subsidiaries could distribute income to Mauritius-based companies and avoid tax on the gains that were made.[147]

2. §10 (34a) and §115qa – Filling in the Gaps of §46a

To address the issue of the transaction escaping tax in its entirety, the Finance Act, 2013, introduced §115QA into the 1961 Act.[148] §115QA sates that distributed income of a company on buyback of shares will be taxed at a rate of twenty percent.§115QA was inserted to ensure that companies could not avoid dividend distribution tax by conducting a buyback and, that buybacks are taxed as a transaction irrespective of who benefits from the buyback.[149] It states that any income distributed for the purpose of buying back shares shall be subject to additional income tax at the rate of twenty-percent.[150]

Notably, §10(34A) was also inserted through the Finance Act, 2013.[151] This provision exempts income from buybacks from being taxed in the hands of shareholders. Therefore, the implication of the amendments is that income distributed as a buyback is taxed exclusively in the hands of the company.

The amendments however, have also brought in confusion regarding the interplay between §10(34A), §46A and §115QA. Since §46A has not been repealed, a question that evokes concern is whether §46A and §115QA will operate simultaneously. Confusion arises regarding whether the amount redistributed through the buyback would be taxed at twenty percent in the hands of the company and as capital gain in the hands of the shareholder. A report by the Bangalore Chamber of Industry and Commerce confirms this.[152] It states that income distributed for buyback exercises is taxed twice and such double taxation ought to be abolished.[153] The said report goes on to recommend the withdrawal of the buyback distribution tax.[154]

This issue could be clarified by *first*, assuming that the later amendment would override the earlier one which means that the 2013 amendment would

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[146] *Id.*, at ¶3(g) (note however that the current treaty taxes the income in the country where the capital gain itself accrues or the source country).

[147] *Id.*

[148] *Id.*

[149] The Income Tax Act, 1961, §115QA.

[150] *Id.*

[151] The Income Tax Act, 1961, §10(34A).

[152] Bangalore Chamber of Industry and Commerce, *Representation to Finance Minister on Measures of Prevention of Disputes, Suggestions for Improving Faceless Assessment and other Matters and Suggestions for Improvement of Capital Gains Tax Regime in India*, available at https://bcic.in/pdf/BCIC%20Report%20on%20Direct%20Tax%20Administration%20and%20Capital%20Gains%20Tax%20Regime%20(2)%20(1).pdf (Last visited September 21, 2023).

[153] *Id.*, 39-40.

[154] *Id.*, 40.

automatically negate the effect of §46A, and *second*, examining the provisions of the 1961 Act.§10 clearly states that the incomes that fall under it are not considered a part of the 'total income' for the previous year.[155] §5 makes it clear that income arising from capital gains form a part of total income which means that the question of double taxation should not arise.[156] Since total income includes capital gains and §10(34A) falls under the chapeau of §10 which exempts income from total income, the exemption of buybacks from taxation would operate as opposed to §46A. Therefore, the Bangalore Chamber of Industry and Commerce could be misguided in its understanding of §10(34A), §46A and §115QA of the 1961 Act.

3. The Current Regime's Contribution to Increased Wealth Concentration

In effect, the introduction of §10(34A) and §115QA by the government results in the tax regime giving preferential treatment to Indian shareholders despite the Supreme Court recognising that the issue arose only with respect to non-residents who were covered by a Double-Taxation Avoidance Agreement.

While the government's move guarantees tax revenue from buybacks, it does not account for the very real possibility that such a system could result in further concentration of wealth. In India, various reports have indicated that the upper echelons of society have a massive proportion of the wealth of the country.[157] One report stated that taxing the richest 100 billionaires in India at 2.5 percent would be sufficient to bring all children in the country to school.[158] The exemption in §10(34A) contributes to greater wealth concentration because it makes buybacks a much more attractive prospect for wealthy investors since they will not have to pay any tax on the amount they receive. The Consultation Paper supports this proposition. It clearly showcased how the promoter participation in the buyback exercises was the greatest.[159]

In fact, Annexure B of the Consultation Paper indicates that out of the nineteen companies on which the study was conducted, the total tax paid by the companies was Rs. 2988.62 crores.[160] The tax paid on promoter buybacks was Rs. 2724.04 crores which is about 91.14 percent of the total tax paid.[161] If the tax on

[155] The Income Tax Act, 1961, §10.

[156] *Id*., §5.

[157] Meryl Sebastian, *Richest 1% own 40.5% of India's Wealth, Says New Oxfam Report*, BBC News, January 16, 2023, available at https://www.bbc.com/news/world-asia-india-64286673 (Last visited September 21, 2023); *See also* Express News Service, *In India, 5% Own More than 60% of Country's Wealth: Oxfam Report*, Indian Express, January 16, 2023, available at https://indianexpress.com/article/business/economy/indias-richest-1-own-more-than-40-of-total-wealth-oxfam-8384156/ (Last visited September 21, 2023).

[158] *Id*.

[159] Consultation Paper on Buybacks, *supra* note 20, 30.

[160] *Id*.

[161] *Id*.

promoter shares was only twenty percent of the total amount, the amount received by the promoters in total was about Rs. 10,896 crores from just these nineteen companies. Such an amount would escape tax completely in the hands of the promoters, who are usually HNWIs and ultra-HNWIs, thereby contributing to greater wealth concentration.

VII. SOLVING THE CONCENTRATION OF WEALTH PROBLEM THROUGH ECONOMIC EQUIVALENCE

The solution to the problem presented by SEBI in the Consultation Paper would be to simply shift tax liability to existing shareholders and remove the system put in place by the Finance Act, 2013. However, shifting liability back to the existing shareholders will bring back the question of how buybacks should be taxed.

There are broadly two approaches that the Ministry of Finance can adopt to ensure that buybacks are taxed appropriately. *First*, to take into account the recommendation of the Bangalore Chamber of Industry and Commerce and remove the buyback distribution tax, bringing back the earlier system of capital gains taxation.[162] *Second*, to bring in a system that taxes dividends and buybacks at the same rate in the hands of shareholders. This paper argues that the second approach is more appropriate and lays down a system that ensures that the problems associated with the previous regime and those identified by SEBI are addressed.

A. DISCARDING BUYBACK DISTRIBUTION TAX

If the Ministry of Finance were to take the BCIC Report's suggestion into account, then the discussion in Part VI(B)(1) becomes relevant. The tax on buybacks under the previous regime may still make stock repurchases more attractive. This is because dividend tax in the hands of those who receive it is dependent on the income bracket, they fall in. Hence, existing rates under either the new tax regime or the old tax regime, as per the choice of the individual would prevail.[163]

Income inequality in India,[164] coupled with the fact that investments in the stock market are largely made by a concentrated group of people,[165] makes buyback tax even at twenty percent much more attractive than dividend tax which could go all the way up to thirty percent.[166]

[162] Bangalore Chamber of Industry and Commerce, *supra* note 152.

[163] The Income Tax Act, 1961, §115BAC (1) (where the words, "at the option of such person" allow individuals to choose the tax regime that would be applicable to them).

[164] Sebastian, *supra* note 157.

[165] Team Mint Genie, *Percentage of Population Investing in Stock Markets: India* v. *Rest of the World*, Live Mint, February 4, 2022, available at https://mintgenie.livemint.com/news/infographics/percent-of-population-investing-in-stock-markets-india-vs-rest-of-the-world-151643871616428 (Last visited September 21, 2023).

[166] The Income Tax Act, 1961, §115BAC(1).

As was discussed in Part V (A), buybacks are considered paper manipulation and could be used to prioritise the interests of executives of the company over the interests of the company's objectives and shareholders. If tax benefits are added to these issues, buybacks become an attractive prospect for promoters. To remove the incentives associated with buybacks as a mode of corporate redistributions, the way forward is to ensure that the tax regime treats both of these profit redistribution methods identically for shareholders.

B. A TAX REGIME GROUNDED IN 'ECONOMIC EQUIVALENCE'

To prevent the possibilities of paper manipulation and the prioritisation of executive interests, the Ministry of Finance will have to ensure that the tax regime does not incentivise buybacks for shareholders or companies. The ideal system would be one that taxes the distributed amount in the hands of the shareholder while also ensuring that the company pays tax on the distributed income. The new system must also tax buybacks at the same rate as dividends and, ensure that the government makes the same revenue as it presently does with §115QA in operation. The Finance Ministry will have to give legal recognition to the economic equivalence of buybacks and dividends by taxing them at the same rate in the hands of the shareholders and the hands of the company. Such an approach has support in jurisprudence and international practice.

1. The Aar's Ruling in Otis Elevators

In 2012, the Authority on Advanced Rulings in the *Otis Elevators*[167] case reclassified capital gains arising from a buyback as dividends by using the 'substance over form' doctrine.[168] The authority concluded that the buyback was conducted to circumvent §115-O of the 1961 Act and to prevent this, the buyback would be considered akin to dividends for the purpose of the law.[169] Although the authority did not directly go into the economic equivalence of buybacks and dividends, the use of the doctrine of substance over form supports the discussion above in Part III.

2. Practice in Sweden

When a company chooses to distribute profits, tax laws play a significant role in the approach they adopt. If a system taxes dividends at higher rates, shareholders and companies would be more likely to engage in stock buybacks. Therefore, whatever system of tax is adopted, there will have to be

[167] A.A.R. No. P of 2010.

[168] *Id.*, ¶3, ¶12; Rustam Singh Thakur, *India AAR Re-Characterizes Capital Gains Arising on Buyback of Shares as Dividends*, April 17, 2012, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2055719 (Last visited September 21, 2023).

[169] *Id.*, ¶15.

'synchronisation' of dividend and stock repurchase tax rates at the shareholder level and,[170] a reasonable tax rate at the company level.

Sweden's tax system seems to account for the shareholder preferences best.[171] It has a single tax rate for both dividends and capital gains, ensuring that there is no bias against dividends.[172] By virtue of the Swedish Tax Reform in 1991, there is a flat 'investment' tax of thirty percent on dividends and capital gains.[173] In India, such a system would ensure that shareholders do not pass resolutions in favour of buybacks purely for tax reasons.[174] However, India occupies a unique position in the global economy. Hence, it cannot, in all likelihood have a tax rate exceeding that of developed countries. Replicating Sweden's thirty percent investment tax as is may cause problems for the Indian economy by making it a less attractive investment destination and due to the systemic differences between the tax regimes of the two jurisdictions. The second issue on systemic differences however, will not affect the viability of the solution since ensuring parity between dividends and buybacks would guarantee that the managements of companies would not engage in buybacks unless they genuinely believe the company's shares are the best investment at the time. Therefore, any changes to tax rates would only have to account for the nature of the Indian economy to ensure that remains an attractive investment destination.

On the company's side, to ensure that excess capital is distributed only when necessary, retaining a system similar to that present under §115QA is necessary. Currently the government receives about twenty percent (which goes up due to health cess, amongst other factors) and this can be reduced to equalise tax treatment of buybacks and dividends and reduce the burden on shareholders who do not tender their shares during the buyback.

3. Proposed Amendments to the Income Tax Act, 1961

The ideal tax regime would introduce a uniform tax rate on both dividends and buybacks while simultaneously making buybacks less attractive from the company's standpoint because advantages accrue to a restricted group of individuals when a buyback takes place. To achieve these twin objectives, this paper proposes a step-by-step process for the Finance Ministry to follow.

[170] Robert Carroll et al., *Corporate Dividend and Capital Gains Taxation: A Comparison of Sweden to the other Members of the OECD and EU and BRIC Countries*, Ernst & Young, 3, October 2012, https://www.svensktnaringsliv.se/bilder_och_dokument/br5c6q_corporate-dividend-and-capital-gains-taxation-a-comparison-of-swe_1069829.html/Corporate+Dividend+and+Capital+Gains+Taxation+-+A+comparison+of+Sweden+to+other+member+nations+of+the+OECD+and+EU%2C+and+BRIC+countries.pdf (Last visited September 21, 2023).

[171] *Id*.

[172] *Id*.

[173] *Id*. (note that there have been amendments introduced recently but, the tax rate on dividends remains at thirty percent).

[174] The Securities and Exchange Board of India (Buy-Back of Shares) Regulations, 2018, Regulation 5(i)(b).

Step 1: The first step is to remove the exemption granted to buybacks under §10(34A) by repealing the said provision. By doing so, the Finance Ministry would take the first step towards ensuring that exiting shareholders' income from buybacks is being taxed as well. Additionally, to resolve the confusion regarding the interplay between §10 (34A), §46A and §115QA, §46A can be amended. The said provision can prescribe the tax rate on buybacks in the hands of existing shareholders. It can be amended to set the rate discussed in Step 4 below.

Step 2: The second step is to exclude dividends from 'income from other sources',and discard the progressive system of taxation for dividends. Instead, the Ministry of Finance will have to amend the 1961 Act to introduce a uniform rate of tax on dividends received thereby making it independent of income brackets. By doing so, the Ministry can ensure that promoters, who usually fall in the high-income bracket are not incentivised to choose the lower-taxed buybacks route when distributing profits.

Step 3: The third step involves creating a provision to tax buybacks at the same rate as dividends on the shareholders side while also retaining §115QA in form, but not in substance to ensure that the corporations are taxed when they conduct buybacks, but not at the rates under the present regime. The tax rate on dividend income can be set at 11.11 percent. If Step 4 is followed as well and the revenue from the current system ought to be maintained, then, if the corporation pays a ten percent tax, the exiting shareholder will have to pay 11.11 percent of the remaining amount for the effective tax rate to be twenty percent as they are presently under §115QA. For instance, if the profit is Rs. 100, the tax that will be paid under the present regime is Rs. 20 because of §115QA. If the company pays ten percent tax, the distributed income will be Rs. 90. For the total amount gained in tax revenue to be the same, the Rs. 90 distributed would have to be taxed such that the tax revenue from it is Rs. 10. Hence, the tax rate should be fixed at (10/90)*100 = 11.11 percent to retain the current regime in substance.

Step 4: §115QA ought to be amended to reduce the tax rate on corporations to ensure that continuing shareholders have to bear only half of the tax burden and that the remaining tax burden is borne by existing shareholders who tender their shares during the buyback. To facilitate this, either §46A can be amended as discussed in Step 1, or a new provision taxing exiting shareholders at 11.11 percent can be enacted. This would address the issue of existing shareholders avoiding tax on corporate distributions and the company bearing the tax burden for them as well.[175] If Step 4 is enacted with the other steps, the existing shareholders and the company would pay the same amounts in tax.

The implications of such a system could possibly ensure that buybacks are not treated preferentially, in relation to dividends, by shareholders, promoters and companies. The proposed system could also give the market the idea

[175] Consultation Paper on Buybacks, *supra* note 20 at 29.

that the dividends ought to be the preferred mode of profit distribution and buybacks are to be conducted in exceptional circumstances, such as when defending against a takeover.[176]

4. Possible Economic Implications of the Proposed Amendments

The proposed amendments will have serious implications for two categories of persons. *First*, HNWIs and untra-HNWIs who aim to receive tax free income by tendering their shares during the buyback. Since there is no way that corporate redistributions can escape taxation under the proposed regime, the number of HNWIs and untra-HNWIs who actively advocate for one form corporate redistributions of within the company will likely significantly reduce. Buybacks will, in all likelihood, be conducted when absolutely necessary. Such a consequence is seemingly in line with SEBI's objective of gradually phasing out buybacks.[177] Additionally, the government would also be able to raise significantly more in tax revenue from this class of society.

The *second* category is the employees of companies. They could possibly receive significant increases in their remunerations if the company is unable to find projects and investments that could benefit shareholders in the long run.[178] Finally, the general public could benefit massively because companies may start to look for ventures that are less-explored and offer creative solutions to already existing problems.

VIII. CONCLUSION

The Ministry of Finance's failure to account for SEBI's suggestions in its Consultation Paper is quite concerning. Despite the Consultation Paper indicating that companies pay the price for buybacks and promoters benefit from it, there has still been no action with respect to revamping the tax regime.

Ensuring parity between buybacks and dividends on the tax front has been an argument that was put forward decades ago by Professor Chirelstein.[179] Very few countries have such a system in place. India may have to follow a system grounded in economic equivalence to ensure that buybacks do not become a tool that promoters and higher-level executives abuse to worsen the wealth concentration problem. Such a system could also incentivise reinvestment and distribution

[176] The possibility of exploring a tax exemption if the assessee can show that there was a strong takeover threat can be explored. However, this could open up a pandora's box in terms of the number of adjudications that could take place and the number of false takeover threats as well.

[177] *See* the earlier discussion on the glide path mechanism for open market repurchases.

[178] Joe Hughes, *Higher Stock Buyback Tax Would Raise Billions by Tightening Loophole for the Wealthy*, Institution on Taxation and Economic Policy, February 13, 2023, available at https://itep.org/higher-stock-buyback-tax-would-raise-billions-by-tightening-loophole-for-the-wealthy/ (Last visited September 21, 2023).

[179] Chirelstein, *supra* note 31.

of dividends which would ensure that all shareholders benefit from excess capital rather than the benefits accruing to a specific group of persons.

The tax rates on buybacks and dividends are dependent on governmental policy. Developed countries can afford to corporate redistributions at higher rates since they are not looking to attract investments into their country.

Although this paper argued for a system where the revenue from shareholders and the company for buybacks ought to be the same, this need not necessarily be the solution to the larger problems that India faces. In the USA, despite the excise tax rate coming in at one percent and income from buybacks being taxed as well, companies continued to engage in stock repurchases.[180] Such a trend may indicate that the effective tax rate for stock repurchases may have to increase in India.

The Ministry of Finance ought to recognise that India's position is very different from the developed world. It has to balance the competing objectives of incentivising foreign investment, reducing wealth concentration and ensuring that 'paper manipulation' of stock prices by executives comes to a halt. The system best suited to India's needs may be one that incentivises the distribution of dividends over conducting a buyback by taxing both the company and the exiting shareholder during a buyback. Ultimately, the tax regime proposed by this paper attempts to ensure that buybacks take place only when no reinvestment of excess capital is possible and that the company's best investment at the time is its own shares.

[180] Carlson, *supra* note 101.