Intricacies of Corporate Restructuring

Barsha Dikshit and Neha Malu
Vinod Kothari and Company

Kolkata:
B42, Metropolitan Cooperative Housing Society,
Kolkata 700105
Phone:: 033-45017864/ 23233742
Email: info@vinodkothari.com

New Delhi:
Nukleus, 501 & 501A,
5th Floor, Salcon Rasvilas,
District Centre, Saket,
New Delhi, Delhi 110017
Phone: 011 6551 5340
Email: delhi@vinodkothari.com

Mumbai:
403-406, Shreyas Chambers
175, D N Road, Fort
Mumbai
Phone: 022 2261 4021/ 3044 7498
Email: mumbai@vinodkothari.com

Bengaluru:
4, Union Street,
Infantry Rd, Shivaji Nagar,
Bengaluru, Karnataka 560001
Phone: 022 2261 4021
Email: info@vinodkothari.com

Website: www.vinodkothari.com

Copyright & Disclaimer

- The contents of the presentation are intended solely for the use of the client to whom the same is marked by us.
- No circulation, publication, or unauthorised use of the presentation in any form is allowed, except with our prior written permission.
- No part of this presentation is intended to be professional advice, or solicitation of professional assignment.

About Us

- Vinod Kothari and Company, consultants and advisors
  - Based out of Kolkata, New Delhi, Mumbai and Bengaluru
- We are a team of consultants, advisors & qualified professionals having over 35 years of practice.

Our Organization's Credo:

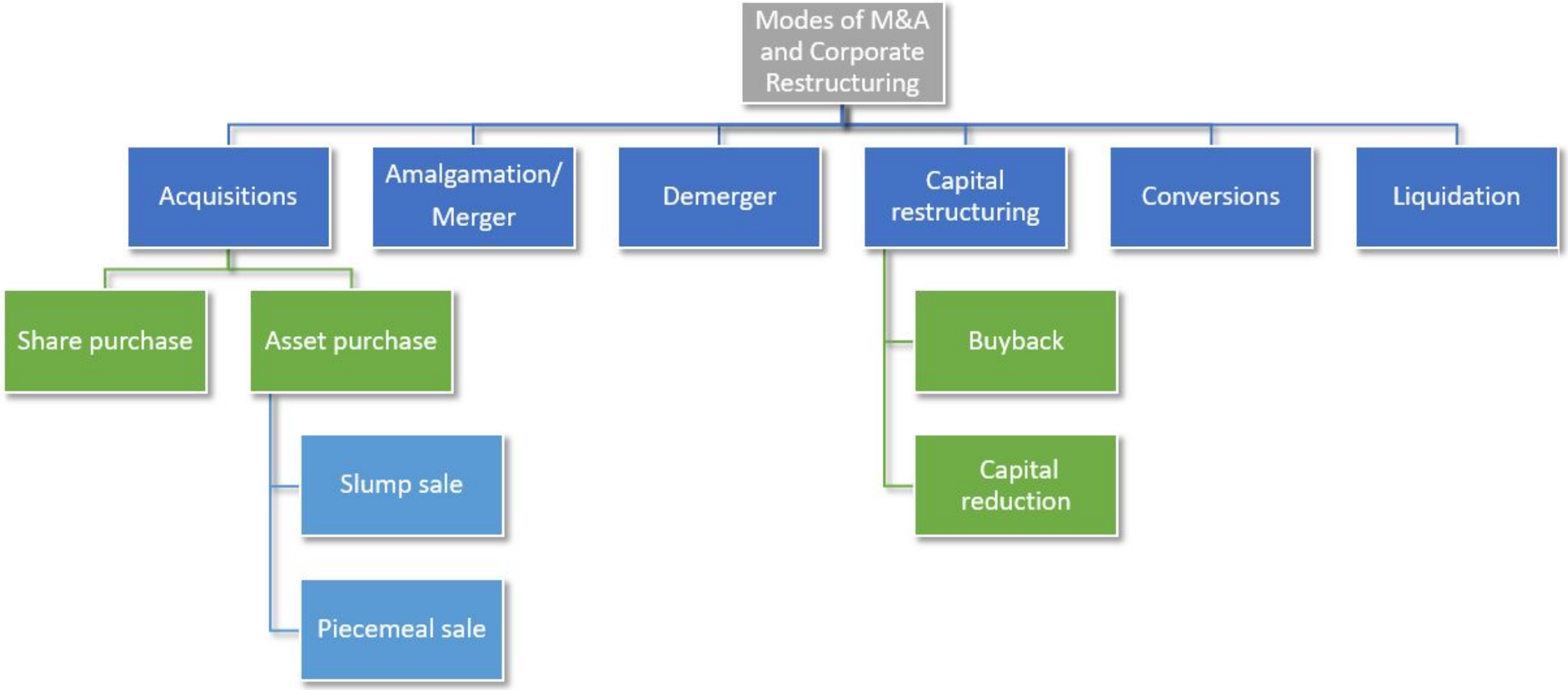
Focus on capabilities; opportunities follow

Outline

- External Corporate Restructuring
  - Merger
  - Demerger
  - Slump sale
  - Sale/exchange of business/entity
- Internal Corporate Restructuring
  - Buyback
  - Reduction of share capital
  - Consolidation of shares
  - Conversion of entity

- Regulatory aspects
- Taxation aspects
- Accounting aspects
- Applicability of Competition Law
- Stamp duty implications

Modes of Corporate Restructuring



Mergers, Demergers and Amalgamations-
An Overview

What Is Merger/ Amalgamation/ Demerger/ Re-construction?

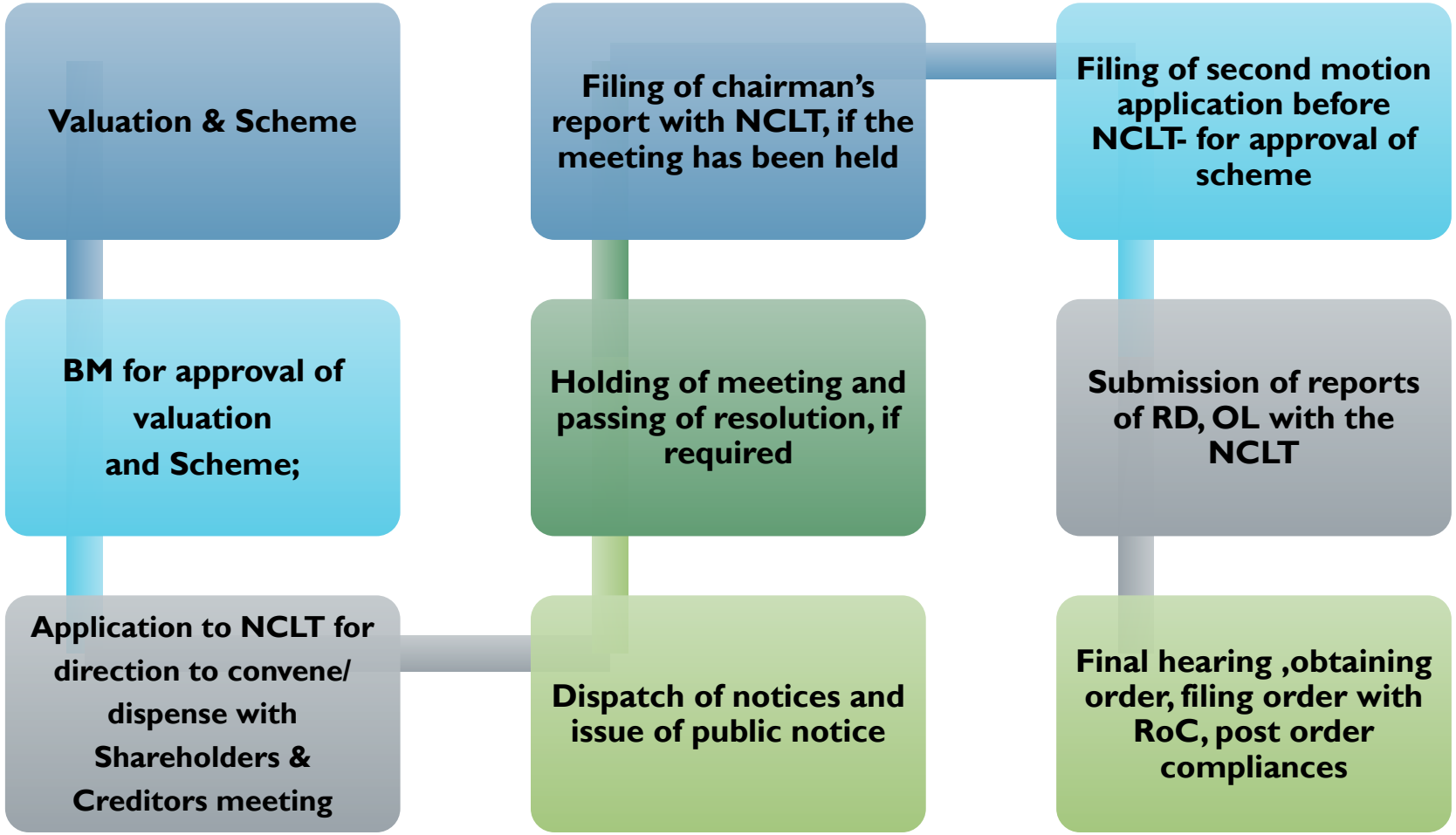
- Not defined under the Companies Act, 1956
- ***What is defined under Companies Act, 2013?***
  - ***Arrangement-*** includes a re-organisation of the share capital of the company by the consolidation of shares of different classes, or by the division of shares into shares of different classes or, by both those methods
- ***What is defined under Income Tax Act?***
  - ***Amalgamation*** *[sec. 2(1B)]*
  - ***Demerger*** *[2(19AA)]*

- **Meaning of the terms in common parlance:**
  - ***Amalgamation*** - combination of two or more independent business corporations into a single enterprise
  - ***Demerger*** – transfer and vesting of an undertaking of a company into another company
  - ***Reconstruction-*** re-organisation of share capital in any manner; varying the rights of shareholders and/or creditors
  - ***Arrangement-*** All modes of reorganizing the share capital, including interference with preferential and other special rights attached to shares

Provisions in the Companies Act, 2013- Compromise or Arrangement

- **Coverage:**
  - Compromise & Arrangement between a company and its creditors or any class of them; or
  - Compromise & Arrangement between a company and its members or any class of them;
- **Who can apply:**
  - company itself
  - creditors
  - members
  - in the case of a company undergoing liquidation under IBC, the liquidator.
- **Approvals and sanctions required from:**
  - Dual criteria for approval from members- more than a special resolution
    - majority of members/creditors, as the case may be, in number
    - representing three-fourth in value
  - Regulatory approval from RD, ROC, OL, CCI, IT
  - Sanction from the National Company Law Tribunal
  - Approval from SEBI, in case of listed companies
  - Approval of RBI, in case of NBFCs

Mergers- Broad Process



Additional Requirements for Listed Companies

Provisions in SEBI (LODR) Regulations, 2015 (1/2)

- **Regulation 11: Scheme of Arrangement**
  - Listed companies to ensure that any scheme of arrangement/ amalgamation/ merger/ reconstruction/ reduction of capital etc. to be presented to any tribunal shall not violate or override or limit the provisions of securities laws or requirements of stock exchange(s).
- **Regulation 37: Draft scheme of Arrangement & Scheme of Arrangement**
  - Listed entities desirous of undertaking scheme of arrangement or involved in scheme of arrangement shall file draft scheme to be filed before any court/ tribunal, with Stock Exchanges for obtaining observation letter or no objection letter, before submitting the Scheme to Court/ tribunal.
  - No scheme shall be filed by the listed entities unless it has obtained observation letter or no objection letter from stock exchange (s)
  - Listed entities shall place observation letter/ no objection letter, before the Court or Tribunal at the time of seeking approval of the scheme.

  Validity of the 'observation letter' or no objection letter shall be 6 month from the date of issuance
  - Upon sanction of the scheme by Court or Tribunal, listed entity shall submit documents to the stock exchanges, as prescribed by the Board or stock exchanges from time to time.
  - Nothing in this section shall apply to draft scheme which solely provides for merger of a WOS with its holding company; provided that draft scheme shall be filed with stock exchanges for the purpose of disclosure.

Provisions in SEBI (LODR) Regulations, 2015 (2/2)

- **Regulation 94: Draft Scheme of arrangement & Scheme of arrangement**
  - The designated stock exchange, upon receipt of the draft scheme and documents prescribed by the Board, shall forward the same to the Board;
  - Stock Exchanges(s) shall issue observation letter/ no objection letter to the listed entity with 7 days of receipt of comments from the Board;
  - Upon sanction of the scheme by the Court or Tribunal, the designated stock exchange shall forward its recommendation to the Board on the documents submitted by the listed entity
  - Stock exchange(s) shall submit to the Board its objection letter/ no objection letter on draft scheme of arrangement after ascertain that the scheme is in compliance with the Securities Law, within 30 days from the date of receipt of draft scheme or with 7 days from the date of receipt of satisfactory reply on clarifications from the listed entity/ opinion from Independent Chartered Accountant, if any, sough by Stock Exchange (e);
  - Stock Exchange(s) shall bring the observation or objection, as the case may be, to the notice of Court or Tribunal at the time of approval of the scheme;

Accounting Standard 14/ Ind- AS 103
Accounting for Amalgamations

Accounting Standard 14 – Types of Merger

- **AS 14 recognizes two types of amalgamation:**
  - ***Amalgamation in the nature of merger*** has been defined to mean an amalgamation which satisfies all the following conditions:
    - All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company
    - Shareholders holding > 90%of the face value of the equity shares of the transferor company become equity shareholders of the transferee company by virtue of the amalgamation
    - The consideration for the amalgamation is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares
    - The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company
    - No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies
  - ***Amalgamation in the nature of purchase*** is an amalgamation which does not satisfy any one or more of the conditions specified above.

Methods of Accounting

The pooling of interests method- for merger method

- The assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (book value)
- Reserves of the transferor company appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company.

The purchase method

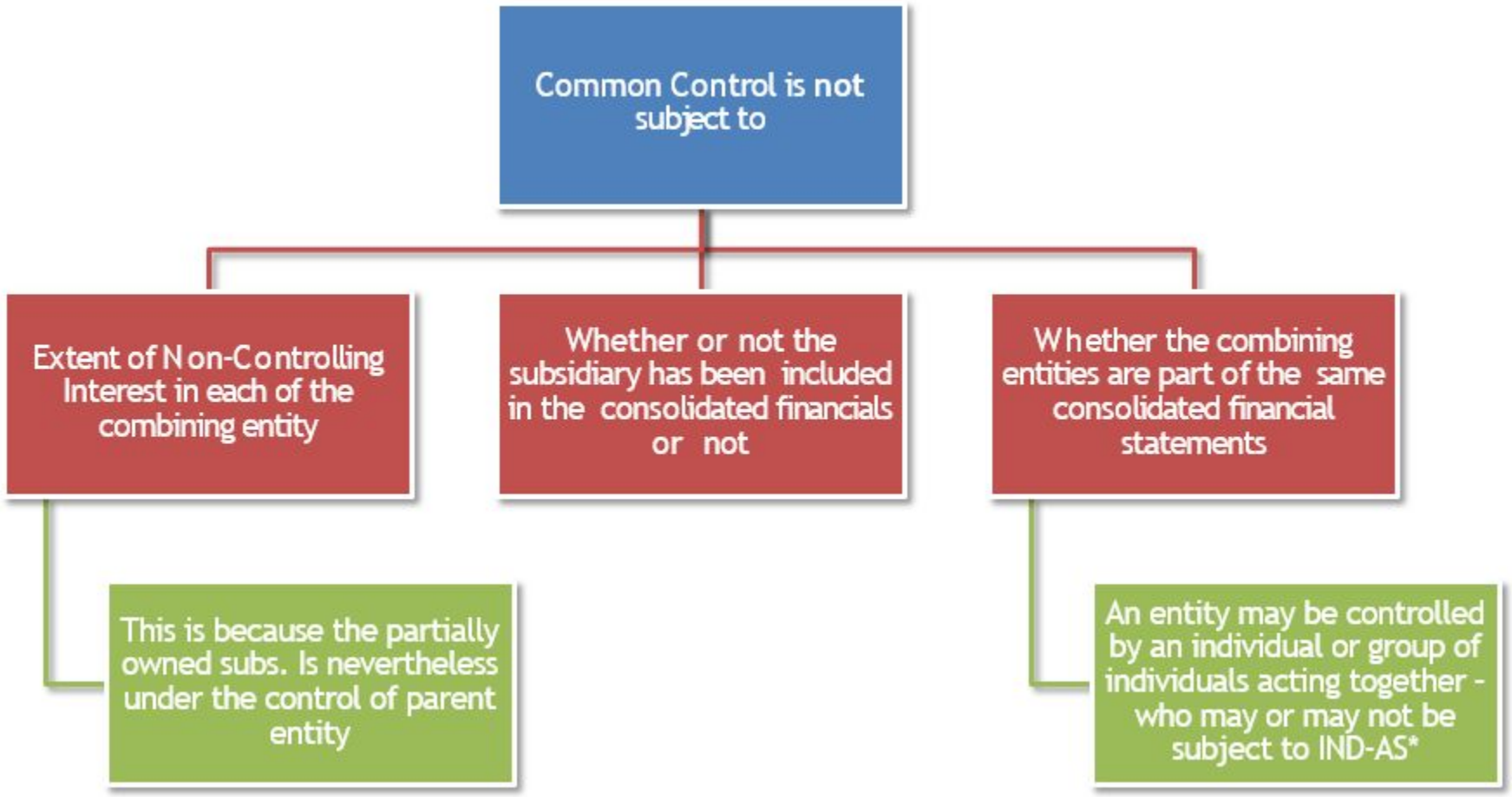
- The transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation
- There is no question of bringing to the books of the transferee the profits/reserves of the transferor
- The amount of the consideration is deducted from the net assets of the transferor company acquired by the transferee company and the difference, if any, is debited to goodwill or credited to Capital Reserve, as the case may be. Goodwill arising on amalgamation is treated as an asset and amortized over a period of five years.

Accounting by Pooling of Interest under Ind-AS 103

- Under Ind AS-103, all assets and liabilities of the TRoR are transferred at **fair value.**
  - Hence, accounting for companies where Ind-AS 103 is applicable, is similar to purchase method under AS-14
- The **only** case where accounting under Pooling of Interest Method is done is **business combinations of entities under "common control"** (Ann. C of Ind-AS 103)

- Common Control business combinations means a business combination
  - Involving entities or businesses
  - In which all combining entities or businesses
  - Are ultimately controlled by the same party or parties
  - both before and after the business combination
  - And that control is not transitory.
- Includes transactions such as transfer of subsidiaries or businesses, between entities within a group

Accounting by Pooling of Interest under Ind-AS 103 (2/2)



* A group of individuals are regarded as controlling an entity when, as a result of contractual arrangements, they collectively have the power to govern its financial and operating policies so as to obtain benefits from its activities, and that ultimate collective power is not transitory

Case Study

Accounting Treatment

Facts of the case

	In the books of transferor (pre-merger)		In the books of transferee (pre-merger)
Particulars	**Book value (Rs. in lacs) [A1]**	**Fair value (Rs. in lacs) [A2]**	**Book value (Rs. in lacs) [B]**
Paid-up capital (FV - Rs. 10)	50	-	70
Reserves **- Securities premium** **- General reserve**	 10 30	-	 30 30
Outside liabilities	20	15	40
Total liabilities	**110**		**170**
Total assets	**110**	**100**	**170**
Net assets acquired		**100-15 = 85**	

Share Exchange ratio = 2:1 (2 shares of transferee company issued against 1 share of transferor each)

Accounting through "pooling of interests" method

In the books of transferee (post-merger)	
Particulars	**Book value (Rs. in lacs) [A1+B]**
Paid-up capital*	170
Reserves - **Securities premium** - **General reserve***	 40 10
Outside liabilities	60
Total liabilities	**280**
Total assets	**280**

- Paid up capital (Post merger)
  - Pre- merger capital of transferee: 70
  - Issued to shareholders of transferor: 100
- Consideration: 100
- Net assets acquired to be adjusted through general reserve: 50
- General reserve (Post merger)
  - Pre-merger general reserve (Transferor): 30
  - Pre-merger general reserve (Transferee): 30
  - Adj. pursuant to merger: (50)

Accounting through "purchase" method

In the books of transferee (post-merger)	
Particulars	**Book value (Rs. in lacs)**
Paid-up capital	170
Reserves - **Securities premium** - **General reserve**	 30 30
Long term borrowings	55
Total liabilities	**285**
Goodwill	15
Other assets	270
Total assets	**285**

- Net assets acquired = 85 lacs
- Consideration paid = 100 lacs
- Difference between consideration paid and assets acquired = Rs. (100-85) lacs = Rs. 15 lacs

Single-Window Clearance System

Single Window Clearance System

When the scheme envisages various incidental proposals as an integral part of the scheme, the procedures prescribed under the Companies Act, need not be separately undertaken.

- **Procedure for change in object clause need not be separately followed-**
  - *PMP Auto Industries Ltd.*, (1994) 80 Com Cases 289 (Bom).
  - *Rangkala Investments Ltd., Re, (1997) 89 Com Cases 754*
  - *Liqui Box India P. Ltd., In re, (2006) 131 Com Cases 645 (P&H).*
- **No need to comply with the provisions of Sec 293 of Act, 1956 (sec 180 of Act, 2013) for sale, lease, etc., of the company's property**
  - *HCL Infosystems Ltd. Re, (2004) 121 Com Case 861 (Del).*
- **The Court can sanction reduction of capital as a part of the scheme.**
  - *Cooper. Cooper and Johnson Ltd., Re, (1902) WN 199*
  - *Stephon Walters & Sons Ltd., (1926) WN 236*
  - *Durairajan (T.) v. Waterfall Estates Ltd., (1972) 42 Com Cases 563 (Mad)*
  - *Asian Investments Ltd., Re, (1992) 73 Com Cases 517, 523 (Mad).*
- **Change of name can be carried out as a part of the Scheme**
  - *Jaypee Cement Ltd. Re, (2004) 122 Com Cases 855 (All) : 2004 CLC 1031*

Other Aspects of Merger

Whether Holding of Meeting Necessary In all Cases?

- In case of amalgamation of the wholly owned subsidiary companies with their holding company, the court dispensed with the requirement of calling meetings
  - *Punjab Chemicals & Crop Protection Ltd., Re*, (2008) 84 CLA 33 (P&H).
  - *Rajasthan Network (P.) Ltd.* v. *Synergy Entrepreneur Solutions (P.) Ltd.* [2007] 80 SCL 13 (Raj)
- Where the concerned shareholders gave their written consent to the proposed scheme, their meeting was dispensed with*
  - *Celica Developers P. Ltd., Re (No. 1),* (2005) 145 Com Cases 154 (Cal).
  - *Dabur Foods Ltd, Re,* (2008) 144 Com Cases 378 (Del)
  - *Balaji Industrial Products Ltd., In re* [2008] 88 SCL 321 (Raj.)
  - *Raj Narain Pratap Narain Rolling Enterprises (P.) Ltd.*, In re [2009] 89 SCL 17 (All.)
  - *C.M. Smith & Sons Ltd.,* In re [2009] 89 SCL 377 (Guj.)

**Such consent must be given by atleast 90% of the creditors in value*

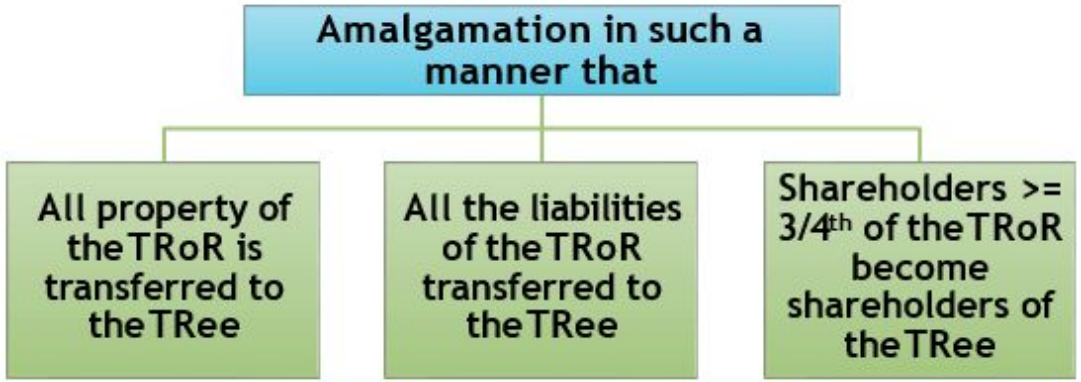
Practical concerns relating to Scheme

- Concept of Appointed date, effective date and closing date;
  - (MCA circular dated 21st August, 2019, where the appointed date is ante-dated beyond a year from the date of filing, proper justification must be given)
- Applicability of SEBI Master Circular
  - Whether applicable on CSE listed companies as well?
  - Whether applicable in case of demerger of WOS?
  - Whether applicable in case of debt listed companies?
- Applicability of Sec 233 dealing with FTM
  - New proposal pursuant to Budget, 2025
- Approval requirements
  - for dispensation
  - for NCLT convened meeting
  - Cut off date for the purpose of seeking approval of shareholders/ creditors
- Can a subsidiary hold shares in parent company pursuant to Scheme of arrangement?
- Can consideration of merger/demerger be paid in cash or securities other than equity shares?
- Applicability of Stamp duty in case of Scheme

Tax Provisions on Mergers & Amalgamations

Definition of Amalgamation

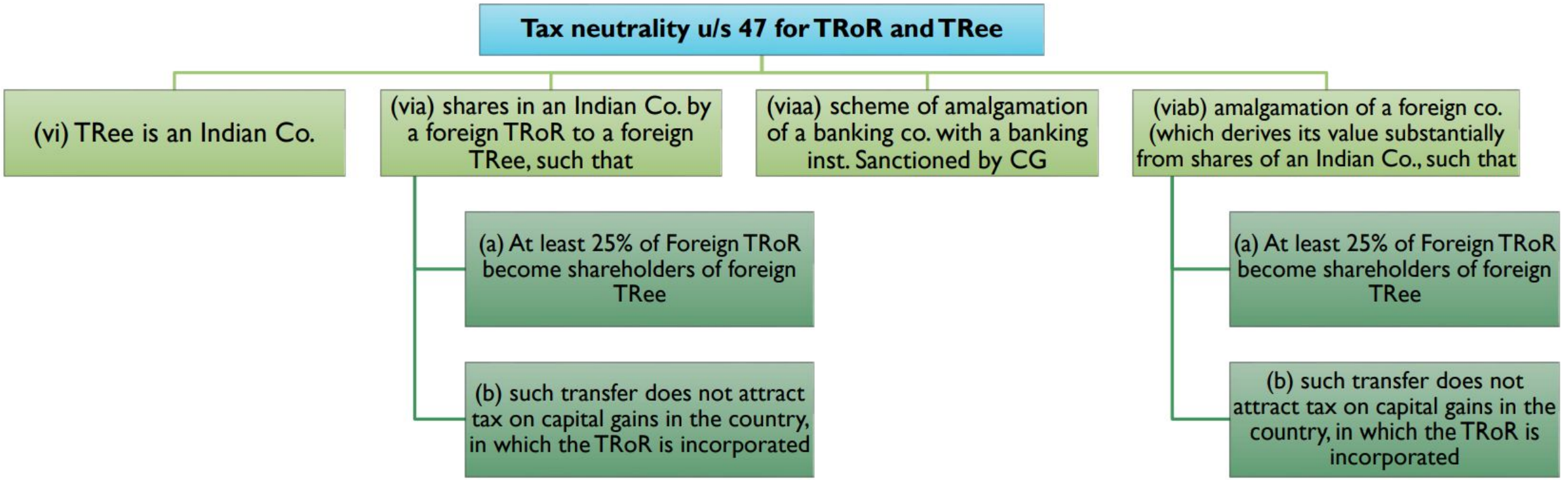
- As per Section 2(1B) of the Income Tax Act, 1961 "amalgamation", in relation to companies, means
  - Merger of one or more companies with another company or
  - Merger of two or more companies to form one company



- Points to note-
  - Merger as a result of acquisition of property by one company shall not tantamount to merger u/s 2 (1B)
  - Merger as a result of distribution of property of one company to the other company after the winding up of the first mentioned company shall not tantamount to merger u/s 2 (1B)
  - W.r.t. the shareholding condition- Shares already held by the TRee co. or its nominees, in the TRoR shall not be included;
  - The definition is only applicable in case of merger of companies;
  - So as to avail tax neutrality, the TRee co. (Amalgamated Co.) must be an Indian Company;
  - The shares allotted to shareholders of TRoR Co. is not subject to any lock-in;
    - A share-swap agreement either pursuant to the Scheme, or otherwise is a common transaction;
  - It is not mandatory that the shareholders of TRoR constitute the same % of holding in the TRee- For eg: if shareholders holding 80% in TRoR become shareholders of TRee- it is not mandatory that they constitute 80% in TRee also.

Tax Neutrality in case of Amalgamation (1/2)

Transfer of any capital asset is subject to capital gains tax in India; However, amalgamation enjoys tax-neutrality with respect to tax on transfer.

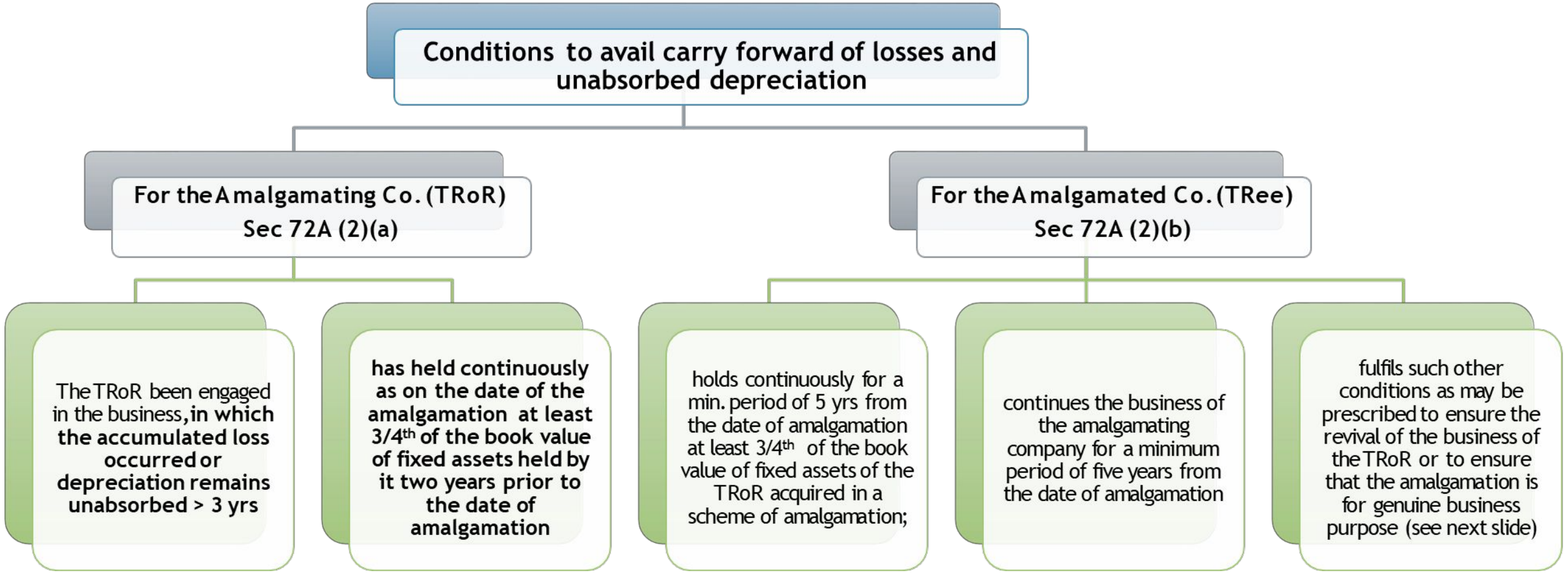


Tax Neutrality in case of Amalgamation (2/2)

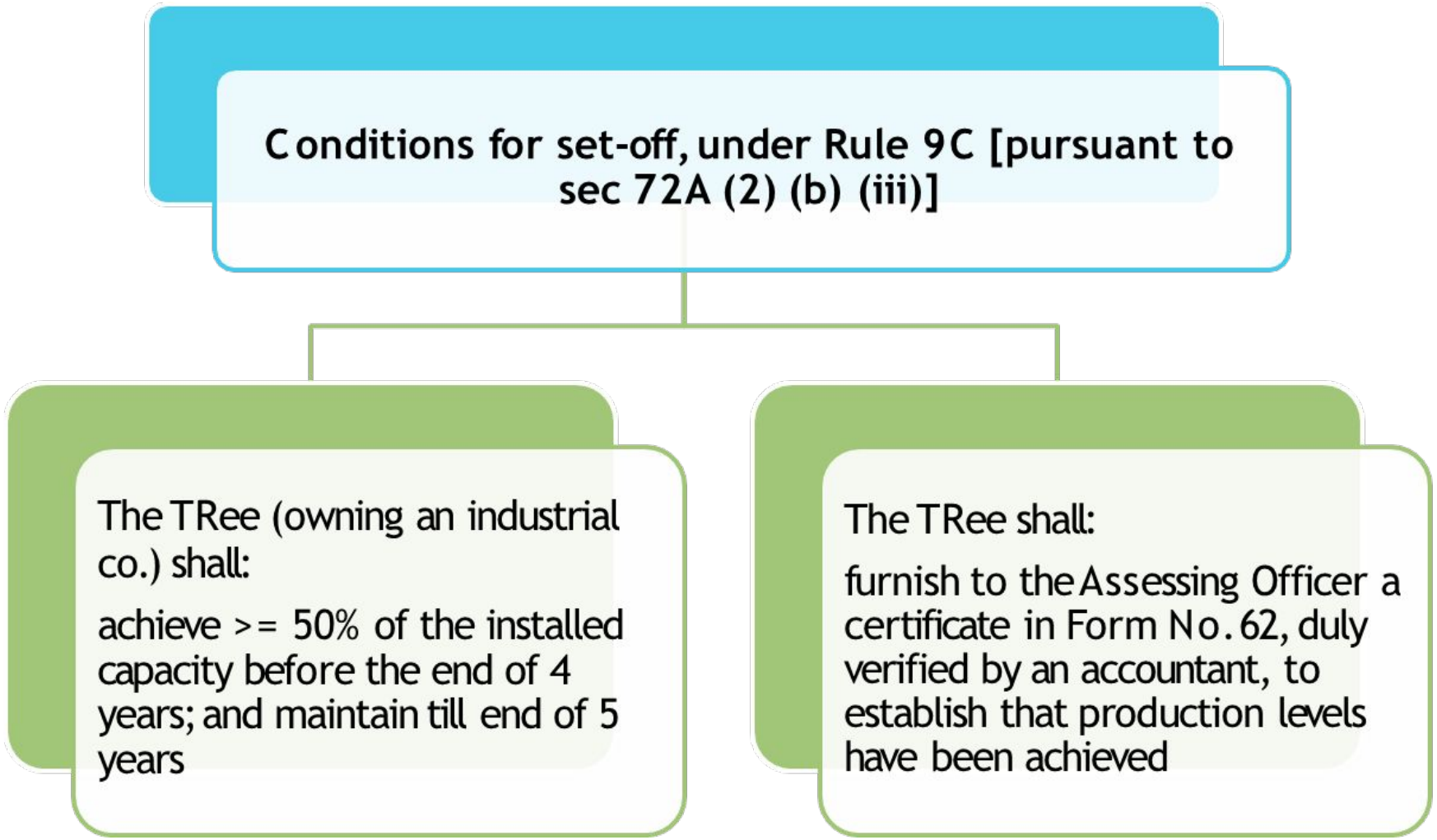
Taxability in the hands of shareholder – Sec 47 (vii) – not regarded as transfer

- any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company, if—
  - the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company except where the shareholder itself is the amalgamated company, and
  - the amalgamated company is an Indian company

Carry Forward of Losses and Unabsorbed Depreciation (1/3)



Carry Forward of Losses and Unabsorbed Depreciation (2/3)



Carry Forward of Losses and Unabsorbed Depreciation (3/3)

- If the conditions mentioned in the previous slide are not fulfilled- [Sec. 72A (3)]
  - The set off of loss or allowance of depreciation made in any previous year in the hands of the TRee Co.
  - Shall be deemed to be the income of the TRee Co. chargeable to tax
  - For the year in which such conditions are not complied with.
- Accumulated loss means loss of the TRoR under the head “Profit and Gains of business or profession” (not being a loss due to speculation business)
- Accumulated losses b/f under the head “house property” or “capital gain” will get lost, and neither co. will be able to avail c/f benefit

Budget 2025: Carry forward and set off of losses in amalgamation

Carry forward of losses not to be permitted beyond 8 AYs immediately succeeding the AY for which such loss was first computed for original predecessor entity.

- **Impact of the change?**
  - Mergers cannot be used for evergreening of losses: benefit of carry forward and set off to be limited 8 years of onset, and not 8 years of merger.
- **What about demerger?**
  - In case of demerger, the existing provision of sec. 72A (4) will continue to apply - note that there is no evergreening here, as the vintage of the loss does not shift to the year of demerger under this provision

- **The provision is applicable from April 1, 2025, as the appointed date or the effective date?**
  - It is a settled principle of law that a scheme becomes effective with effect from the "appointed date". Whereas "effective date" denotes the date on which the amalgamation is completed in all respects after having gone through the formalities involved.
  - Refer to sec. 232 (6) of Companies Act: "The scheme under this section shall clearly indicate an appointed date from which it shall be effective"
  - What does this imply? Can companies come with merger proposals putting appointed date before 1st April 2025?

Current position wrt. set off and carry forward of losses

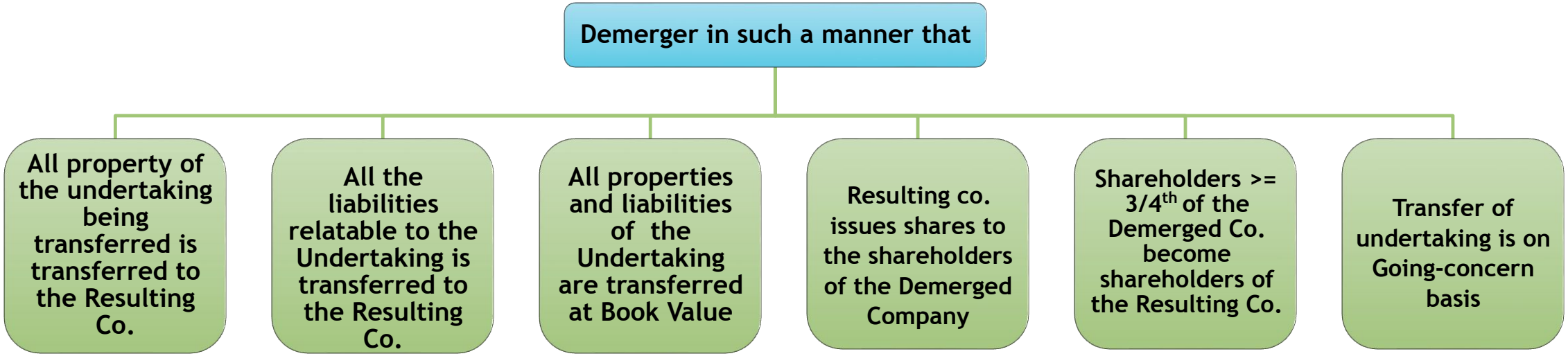
ITAT Mumbai in *Supreme Industries Ltd. v DCIT* held:

> *"Having gone through both the provisions of Sections 72A and 32A, of the Act we are of the view that Section 72A deals with carry forward and set off of accumulated business loss and unabsorbed depreciation allowance in case of amalgamation. According to this Section, accumulated business loss and unabsorbed. depreciation allowance of the amalgamating company shall be deemed to be the loss or as the case may be of the amalgamated company for the previous year in which amalgamation was affected and other provisions of this Act relating to set off of and carry forward of loss allowance for depreciation shall apply accordingly.* ***Meaning thereby the amalgamated company would get the original period for its carry forward and set off.****"*

Tax Implications on Demergers

Definition of Demerger

- As per Section 2(19AA) of the Income Tax Act, 1961 “demerger", in relation to **companies**, means the transfer by a demerged company of its one or more undertakings to any resulting company



- ***Demerged Co. [Sec. 2(19AAA)]-*** *company whose undertaking is transferred, pursuant to a demerger, to a resulting company*
- ***Resulting Co. [Sec. 2(41A)]-*** *company (including a WoS) to which the undertaking of the Demerged Co. is transferred in a demerger and, the Resulting Co. in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company*

Meaning of “Undertaking” (1/2)

- **Explanation 1- Meaning of “Undertaking”-** It includes
  - any part of an undertaking; or
  - a unit or division of an undertaking; or
  - a business activity taken as a whole
  - **But does not include**
    - Individual assets or liabilities
    - Or any combination thereof
    - Not constituting a business activity.

- **Key Considerations**
  - Can assets and liabilities be cherry picked?
  - What does “going-concern” mean?
  - What is business activity?

Meaning of “Undertaking” (2/2)

Cherry-picking of Assets & Liabilities

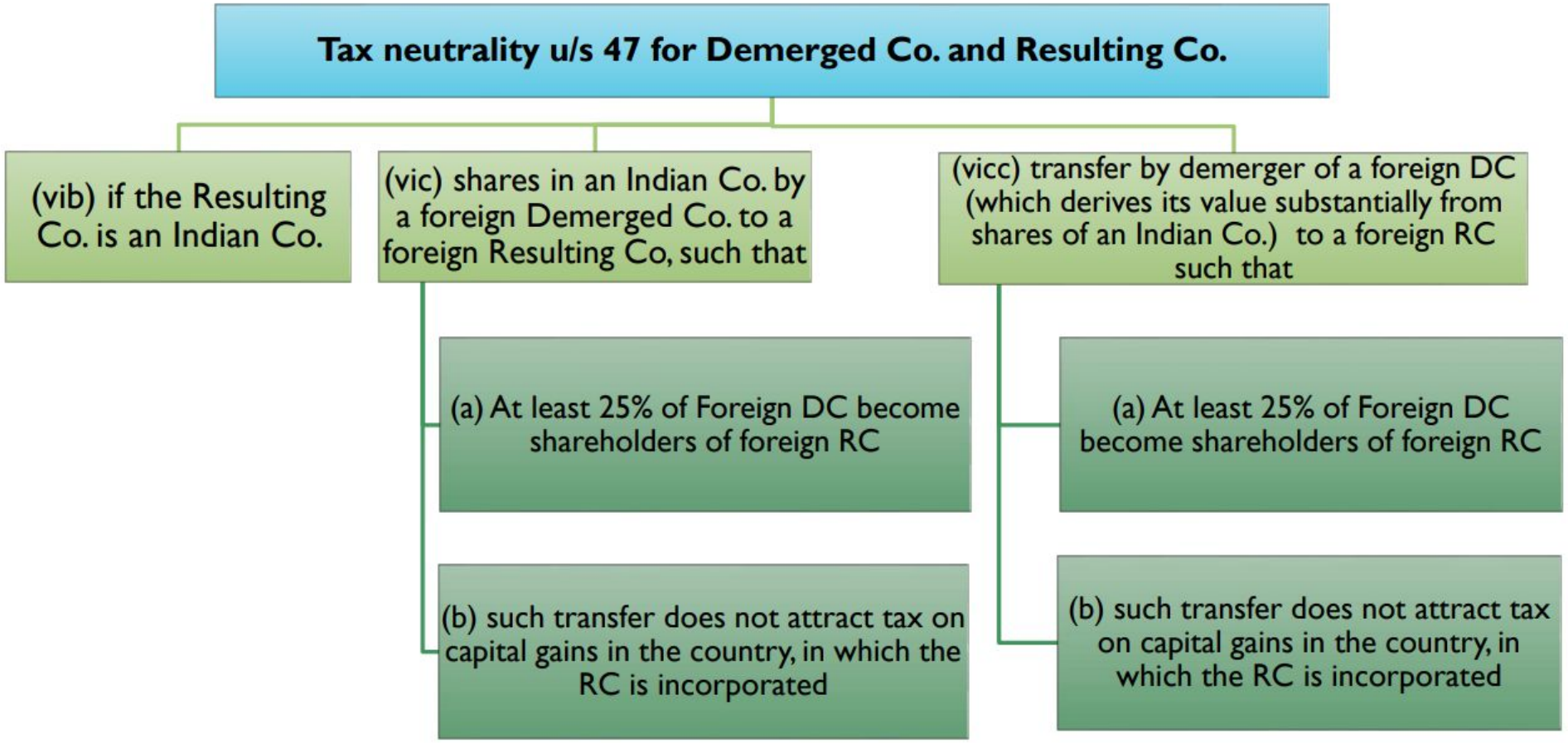
- The Hon’ble Delhi High Court *vide* its judgement in *Indo Rama Textile Ltd* [Co. Petition No. 4 of 2003, Co. Appl. No 762 of 2009, July 23, 2012], held that-

  “in a demerger, transfer of all common assets and/or liabilities relatable to undertaking being demerged is not required ***so long as the assets and liabilities transferred, by themselves, constitutes a running business and the business can be carried on uninterruptedly with such assets and liabilities alone”***

- The Delhi High Court further held that-
  - To ensure that the undertaking has been transferred as a going concern or not, while sanctioning a scheme of arrangement, **the Court can examine whether essential and integral assets like plant, machinery and manpower without which it would not be able to run as an independent unit have been transferred to the resulting company**

Tax Neutrality in case of Demerger (1/2)

Transfer of any capital asset is subject to capital gains tax in India; However, de-merger enjoys tax-neutrality with respect to tax on transfer.



Tax Neutrality in case of Demerger (2/2)

Taxability in the hands of shareholder – Sec 47 (vid)

- any transfer or issue of shares by RC, to the shareholders of the DC if the transfer or issue is made in consideration of demerger of the undertaking
- In case of a demerger, the existing shareholders of the DC will hold:

  (a) Shares in the resulting Co.; and

  (b) Shares in the demerged co.

- **Cost of acquisition will be computed as under-**

  By virtue of Section 49(2D) the COA of shares in the Demerged Company shall be:

  - COA of original shares in the demerged company

    Less: COA of shares in the resulting company as calculated in section 49(2C)

- Cost u/s 49 (2C)=

  CoA f the shares held, in the same proportion as the

  Net Book Value : Net Worth of the DC

Carry Forward of Losses and Unabsorbed Depreciation- Sec 72 (A)(4)

- **Losses and unabsorbed depreciation of the Demerged Co, shall be carried forward-**
  - **where such loss or unabsorbed depreciation**
    - is directly relatable to the undertakings transferred to the resulting company,
    - be allowed to be carried forward and set off in the hands of the resulting company
  - **where such loss or unabsorbed depreciation**
    - is not directly relatable to the undertakings transferred to the resulting company,
    - be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company,
    - and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be

Other Aspects

- By virtue of Section 2(22)(v) there will be no dividend in the hands of shareholders on distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company.
- By virtue of amendment in section 2(42A), for calculating the period for which the shares are received upon demerger are held, the period for which shares were held in the demerged company shall also be considered.
- The Resulting Company must record the cost of assets transferred pursuant to the demerger, as equal to the cost that would have been recorded in the books of the Demerged Co., i.e. **the actual cost:**
  - **However, exception made for companies which have adopted IndAS**

Slump Sale

Introduction to Slump Sale

Provisions

- As per Section 2(42C) slump sale means transfer of business **undertaking** as a going concern for lump sum consideration without values being assigned to individual assets and liabilities.
- As per Section 50B transferor company is liable to short/long term capital gains (holding period 36 months)
  - Capital gains computed by deducting 'net worth' from the sale consideration
- ***Undertaking*** *has same meaning as under Explanation 1 to Sec 2(19AA)*
- Computation of WDV as per sec. 43 (6)

- **Whether Undertaking is a capital asset?**

  The Supreme Court in the case of *R.C. Cooper V. UOI : AIR 1970 SC 564 (610)* held that

  "the undertaking is distinct from the various assets which comprise the undertaking"
- **Undertaking must be a business activity as a whole**
- **Whether in a slump sale some of the assets could be retained by the transferor?**

  If some assets are retained by the transferor / liabilities not taken over by the transferee, the same does not militate against the concept of slump sale.

  [CIT v F.X. Periera and Sons Pvt. Ltd.: 184 ITR 461 (Ker.) ; Premier Automobiles Ltd. v. ITO: 264 ITR 193 (Mum.); ACIT v. Raka Food Products Ltd.]

Key aspects

- Consideration is paid to the Transferor Company, not its shareholders
- Capital gains = Full value of consideration – Net worth of undertaking
  - Net worth = Aggregate value of WDV of the block of assets and book value of other assets of the undertaking – Value of liabilities of undertaking
  - Change in value of assets on revaluation be ignored for computing net worth
  - **Benefit of indexation not available**
  - Revaluation is completely ignored
- If values of individual assets are considered while computing the lumpsum value, or where it is possible to attribute prices to individual assets, the transaction may not amount to slump sale – *CIT vs Artex Manufacturing,* 227 ITR 260 (SC)
- If the net worth of the undertaking is negative, the entire sale consideration is capital gain – *Zuari Industries v CIT* (2006) SOT 563 (Mum.)
- Any business loss/ accumulated depreciation stays with the transferor.
- Slump sale provisions do not provide tax treatment for the purchaser. Hence, purchaser may split the actual consideration paid for the going concern and treat the assets/liabilities accordingly as if acquired in normal course of business
  - In DE Nora India Limited vs CIT (2015) 370 ITR 391 (Del), the transferee's right to allocate values based on valuations was also upheld

Buyback

Buyback of shares

Reasons for Buyback

- Buyback is by far the **only possible avenue for companies to scale down their size**
  - The other ways are reduction of capital, which is fraught with long process
- Buybacks are also **often used to allow exit to particular shareholders**:
  - quite common for VCs or strategic investors to put in a clause for buyback
- Buyback is also the **only way to cashout a compulsorily convertible debenture or a compulsorily convertible preference share**

Conditions for Buyback

- Upto 10% of PUESC+FR: Board approval
- Upto 25% of PUSC+FR: SR
- Max. buyback: 25% of PUSC
- Debt-Equity Ratio post buy back ≤ 2:1

Restrictions

- No buyback offer within 1 year of previous closure
- No further issue of same kind of shares/other securities within 6 months

Sources

- FR, SPR, proceeds of fresh issue

Taxation on Buyback

- Entire consideration included u/s 2(22) of IT Act, and to be taxable as "dividend"
  - Taxable at slab rates as applicable to respective shareholders, with a flat surcharge @ 15%
- Entire cost of acquisition in respect of shares bought back to be booked as "capital loss" [section 46A of IT Act]
  - Such capital loss may be set off against capital gains subsequently
- As per section 74 of IT Act, the set-off is available for a period of 8 AYs immediately after the AY in which loss arise
- No deductions allowed for any type of expense made in connection therewith [Section 57 of IT Act]

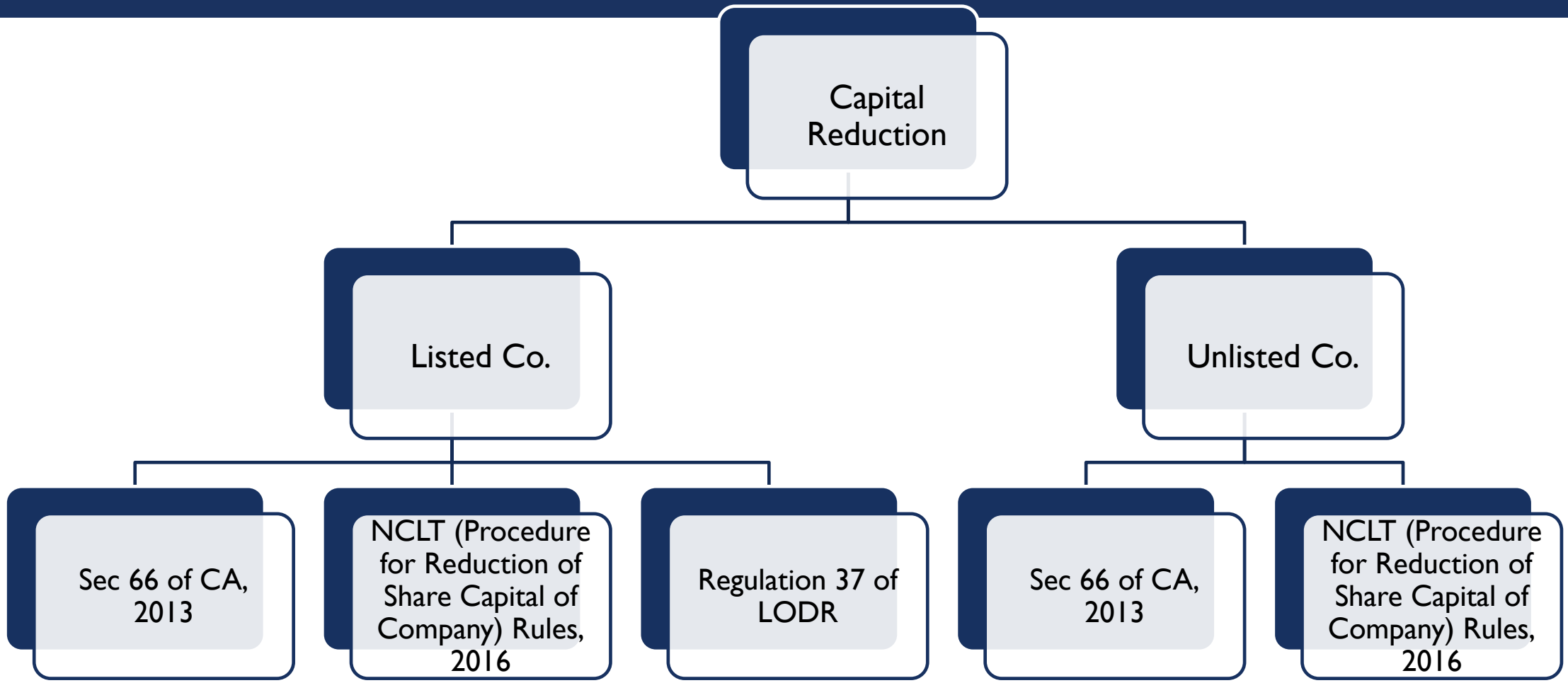
			At a profit		At par		At a loss	
Period	**Particulars**	**No. of shares**	**Price per share**	**Amount (Rs.)**	**Price per share**	**Amount (Rs.)**	**Price per share**	**Amount (Rs.)**
FY 2020	Total cost of acquisition	100	Rs. 50	5,000	Rs. 50	5,000	Rs. 50	5,000
FY 2025	Shares tendered and accepted for buyback	40	Rs. 80	3,200	Rs. 50	2,000	Rs. 40	1,600
AY 2026	Income taxable as deemed dividend (entire buyback consideration)	40	Rs. 80	3,200	Rs. 50	2,000	Rs. 40	1,600
AY 2026	Capital loss (cost of acquisition of bought back shares)	40	Rs. 50	2,000	Rs. 50	2,000	Rs. 50	2,000
AY 2026-2034	Set-off of capital loss against capital gains							

Reduction of share capital

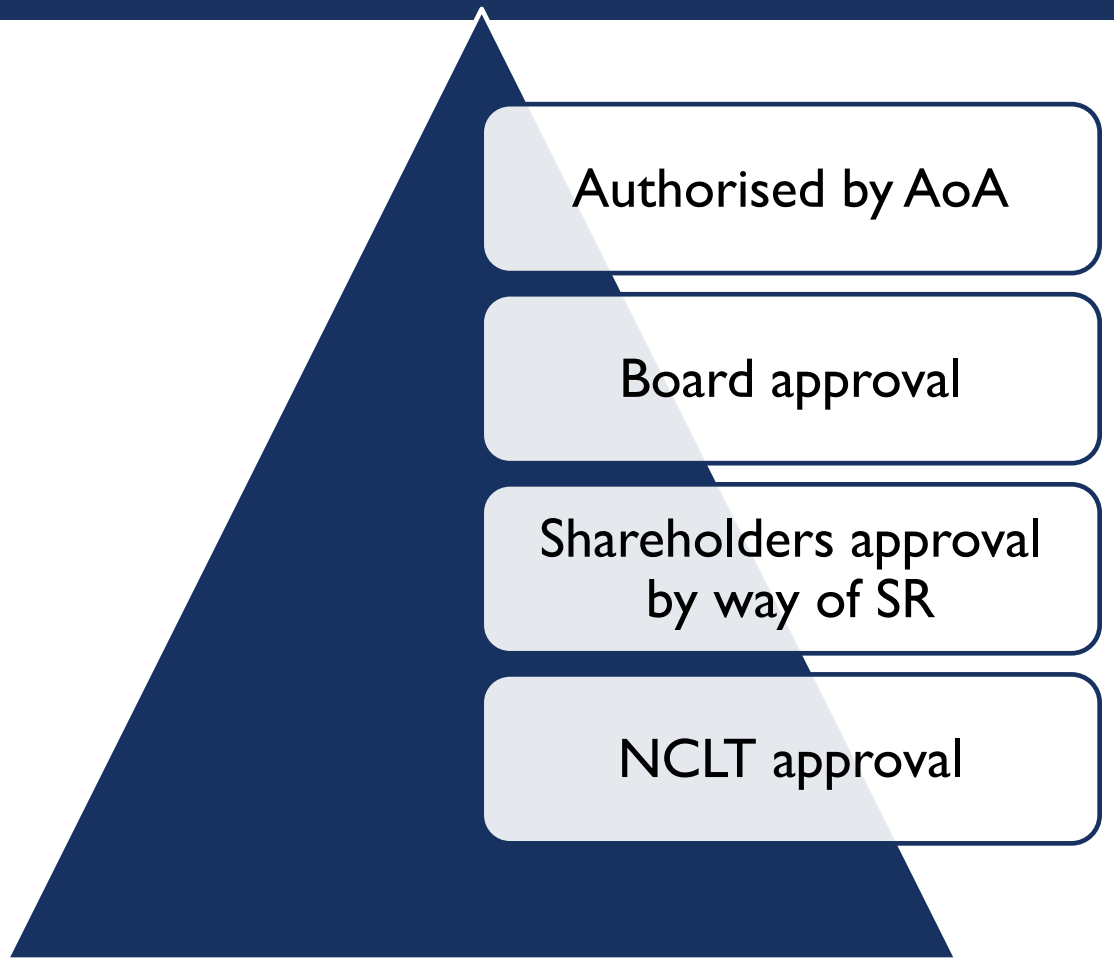
Reasons for Reduction of Capital

- Internal restructuring (as a part of scheme of compromise or arrangement)
- Alteration of capital structure
- Company has surplus funds through which it intends to reduce its share capital
- To set off accumulated losses against share capital/reserves

Provisions dealing with reduction of capital



Approvals required for capital reduction



Notice, in Form RSC-4 in English & Vernacular newspaper within 7 days, and on website, mentioning amount of reduction, time limit for raising objections and place where list of creditor can be inspected

Co. to file affidavit in Form **RSC-5** confirming dispatch and publication of notice within 7 days from date of issue of notice

Board Resolution

Special Resolution

Application filed in NCLT IN Form **RSC-1**

Attachments:
- List of creditors;
- Auditor's Certificate that the list of creditors is correct as per the records of the company verified by the auditor;
- A certificate by the auditor and a director's declaration that the co. is not, in arrears in the repayment/interest of the deposits on the date of filing of the application;
- Auditor's Certificate that Accounting Treatment proposed for reduction of capital is in conformity with the AS;
- Any other relevant documents.

NCLT will notify RD, RoC, SEBI & Creditors

Within 15 days of submitting the application in Form **RSC-2** to RD, ROC and SEBI and to every creditors in Form **RSC-3**

If representation not received within three months of notice

it shall be presumed that they have no objection to the reduction

If representation received within three months of notice

NCLT will satisfy itself that debt or claim of every creditor has been discharged/determined/ secured or consent is obtained

Co. shall send the representation or objections so received along with responses thereto to NCLT within 7 days of expiry of period upto which objections were sought.

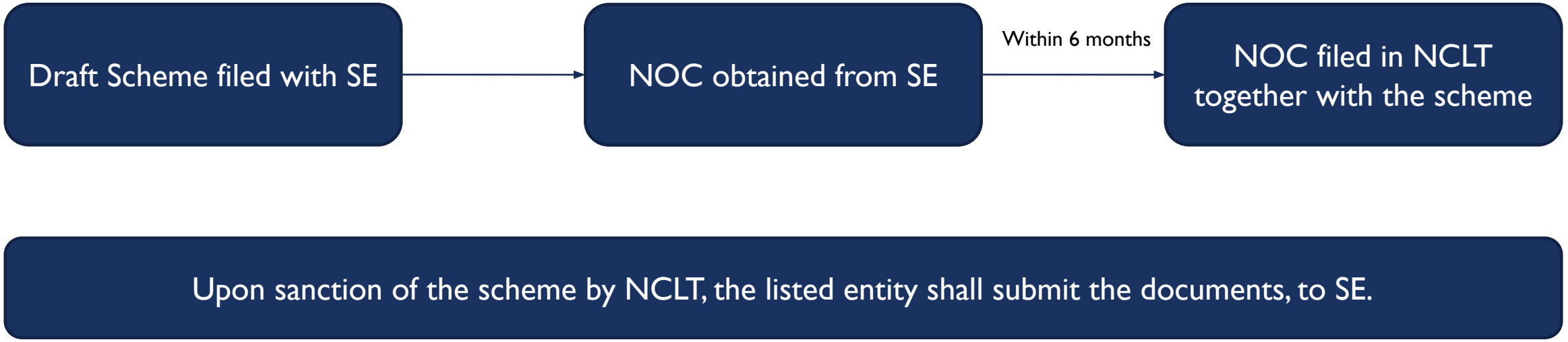
NCLT may hold any enquiry on adjudication of claim and/or give direction for securing the debts of the creditors.

Order confirming reduction of capital in Form **RSC-6** on such terms & conditions as it deem fit

Co. shall deliver a certified copy of the order of NCLT and of minute approved by NCLT to ROC showing—
- the amount of share capital, no. of shares into which it is to be divided, amount of each share and amount, if any, at the date of registration deemed to be paid-up on each share
- file e-form **INC-28** within 30 days of the receipt of order and ROC shall issue a certificate to that effect in Form **RSC-7**.

Additional requirement for a listed company

- Draft scheme to be filed with NCLT shall first be filed with the stock exchange (SE)where securities of the company are listed.
- No-objection letter (NOC) to be received from stock exchange which shall be filed in the NCLT while submitting application
- NOC shall be valid for six months from the date of issuance, within which the draft scheme shall be submitted to the NCLT



Tax on reduction of capital

Tax on capital reduction is levied in two ways

As per section 2(22) (d) of the Income-tax Act, 1961 (IT Act), any distribution of accumulated profits to the shareholders, whether capitalised or not, pursuant to capital reduction, is considered as dividend.

Any distribution over and above the accumulated profits would be chargeable to capital gains tax in the hands of the shareholders. It was also held that reduction in capital will be construed as a transfer within the meaning of section 2(47) of the IT Act

SC in *CIT v. G. Narasimhan*, 1999 (1) SCC 510

Reduction of capital - possible scenarios

Particulars	Consideration	Taxability
Capital reduction at fair value	Fair value > Cost of acquisition	● Distribution from accumulated profits = deemed dividend ● Difference between remaining and Cost of Acquisition = capital gains
	Fair value < Cost of acquisition	● Distribution from accumulated profits = deemed dividend ● Difference between remaining and Cost of Acquisition = capital loss
Capital reduction at face value	Face value = Cost of acquisition	● Deemed dividend = 0 ● Capital gains = 0
	Face value < Cost of acquisition	● Deemed dividend = 0 ● Difference between consideration and cost of acquisition = capital loss
Capital reduction without payment of consideration		● Cost of acquisition = capital loss

Selective reduction of capital (1/2)

- Reduction of capital resulting in compulsory extinguishment of the shares of some shareholders, without affecting the other shareholders of the same class
- Section 66 of the Act says ***"that a company limited by shares or limited by guarantee and having a share capital may reduce its share capital by special resolution in any manner xxxxxx"***
- In re *Philip India Ltd* (19.09.24), NCLT Kolkata examined whether section 66 can be invoked for buying out minority stake
  - answered in negative considering *"...share capital reduction is only incidental to the main objective of buy back of shares…"*
  - Tested against the objectives of capital reduction u/s 66(1)(a) and (b)
  - Currently in appeal before NCLAT
- In re *Bombay Gas Company Ltd* (21.05.24), the Scheme providing selective reduction of capital was approved
  - Reliance made on various rulings, by Petitioner Company, as cited in Regional Director's (Western Region) Report
  - Concluded selective reduction to be permissible since non-promoter shareholders are being paid fair value of their shares. It is nobody's case that the proposed reduction is unfair or inequitable.
- In re *Reliance Retail Ltd* (05.01.24), NCLT Mumbai approved capital reduction scheme stating that
  - it is a settled law that selective capital reduction is permitted under Section 66 of the Companies Act, 2013
  - Reliance placed on NCLAT judgement in *Brillio Technologies Pvt Ltd. vs ROC & RD*
    - *As per Section 66 of the Act, reduction of share capital can be done in 'any manner'. Clause (a) & (b) of Section 66 of the Act, mere illustration and not the only manner in which share capital may be reduced.*
- In *Sandvik Asia Ltd. Vs. Bharat Kumar Padamsi & Ors.* (2009) SCC Online Bom. 541
  - In our opinion, once it is established that non-promoter shareholders are being paid fair value of their shares, at no point of time it is even suggested by them that the amount that is being paid is any way less and that even overwhelming majority of the non-promoters shareholders having voted in favour of the resolution shows that the court will not be justified in withholding its sanction to the resolution.
  - Reference to judgment in the case of *Poole and ors. v/s. National Bank of China Limited*

Selective reduction of capital (2/2)

- In re *Reckitt Benckiser (India) Ltd* 122(2005) DLT612
  - While reducing the share capital company can decide to extinguish some of its shares without dealing in the same manner as with all other shares of the same class. Consequently, it is purely a domestic matter and is to be decided as to whether each member shall have his share proportionately reduced, or whether some members shall retain their shares unreduced, the shares of others being extinguished totally, receiving a just equivalent.
  - Reference to Re. *Denver Hotel Co.,* 1893 (1) Chancery Division 495
  - Also referred to in re *Syngenta India Limited*
- In re *R.S. Live Media Pvt Ltd* (2014) 187 Comp Cas,
  - Selective reduction permitted, reliance on international judgements such as
    - *British and American Trustee and Finance Corpn. v. Couper*, (1894) AC 399
    - *Thomas de La Rue & Co. and Reduced*: (1911) 2 Ch. D 361)
- *British and American Trustee and Finance Corporation v. Couper* (1894), A.C. 399

  If the parties to the transaction come to the conclusion that the bargain is a fair one, why should the Court say that there is a preference on the one side or on the other? If there is nothing unfair or inequitable in the transaction, ***I cannot see that there is any objection to allowing a company limited by shares to extinguish some of its shares without dealing in the same manner with all other shares of the same class. There may be no inequality in the treatment of a class of shareholders, although they are not all paid in the same coin, or in coin of the same denomination****.*
  - Re-affirmed in the matter of *Poole and Others v National Bank of China*, [1907] UKHL 616
- *Westburn Sugar Refineries Ltd.*: (1951) 1 All.E.R. 991 (H.L.)

  "...the general rule is that the prescribed majority of the shareholders is entitled to decide whether there should be a reduction of capital, and, if so, in what manner and to what extent it should be carried into effect."

Wide interpretation of term "in any manner"

- Reduction of capital and payment to shareholders through creation of loan to be repaid over a period of time
  - In Re *Ulundurpet Expressways Private Limited* (NCLT Mumbai - 19.12.2023)
  - NCLT rejected Scheme on the grounds that there is no excess capital to be repaid, and hence, intent of the section is not met

    the scheme of section 66(1)(b)(ii) of the Companies Act, 2013 only enables a company to pay off excess capital to its shareholders, which is considered in excess of wants of the company. The facts of the case clearly shows that such reduced share capital can not be said to be in excess of wants of the company on the date of passing of special resolution. Accordingly, such reduction is not permissible under the terms of Section 66(1)(b)(ii) of the Companies Act, 2013.
  - Further, results in indirect lending by overseas shareholders, attracting compliance with ECB Guidelines
- NCLAT reversed NCLT's order considering that:

  A bare perusal of the above section would show it gives discretion to the appellant company to reduce its share capital "in any manner" subject to special resolution being passed by requisite majority of shareholders.

- Referred to *Tamil Nadu Newsprint & Papers Ltd* (CP No.17 of 1995)
  - Capital reduction through issuance of NCDs
  - *Indian National Press (Indore) Ltd* (1989) 66 Comp Cas 387 (MP)

    The company has the right to determine the extent, the mode and incidence of the reduction of its capital. But the court, before it proceeds to confirm the reduction of capital, must see that the interests of the minority and that of the creditors are adequately protected and there is no unfairness to it, even though it is a domestic matter of the company. The power of confirming or refusing to confirm the special resolution of a company to reduce its capital is conferred on the court in order to enable it to protect the interest of person who dissented or even of persons who did not appear, except on the argument and hearing of the petitioner.
- Petitioner Company also referred to:
  - NCLT Mumbai in *Dewas Bhopal Corridor Private Limited* (10.02.23) - cancellation of shares against loan

What is more tax efficient - Buyback or Capital Reduction?

	Buyback				Capital Reduction			
Period	**Particulars**	**No. of shares**	**Price per share**	**Amount (Rs.)**	**Particulars**	**No. of shares**	**Price per share**	**Amount (Rs.)**
FY 2020	Total proceeds received	50	Rs. 80	4,000	Total proceeds received	50	Rs. 80	4,000
AY 2026	Income taxable as deemed dividend	50	Rs. 80	4,000	Income taxable as deemed dividend (proceeds received to the extent of accumulated profits)*	50	Rs. 30	1,500
	Cost of acquisition	50	Rs. 30	1,500	Cost of acquisition	50	Rs. 30	1,500
AY 2026	Capital loss (cost of acquisition of bought back shares)	50	Rs. 30	1,500	Capital Gains (difference between net consideration not considered as deemed dividend and cost of acquisition)	40	Rs. 20	800
AY 2026-2034 (upto 8 years)	Set-off of capital loss against capital gains							

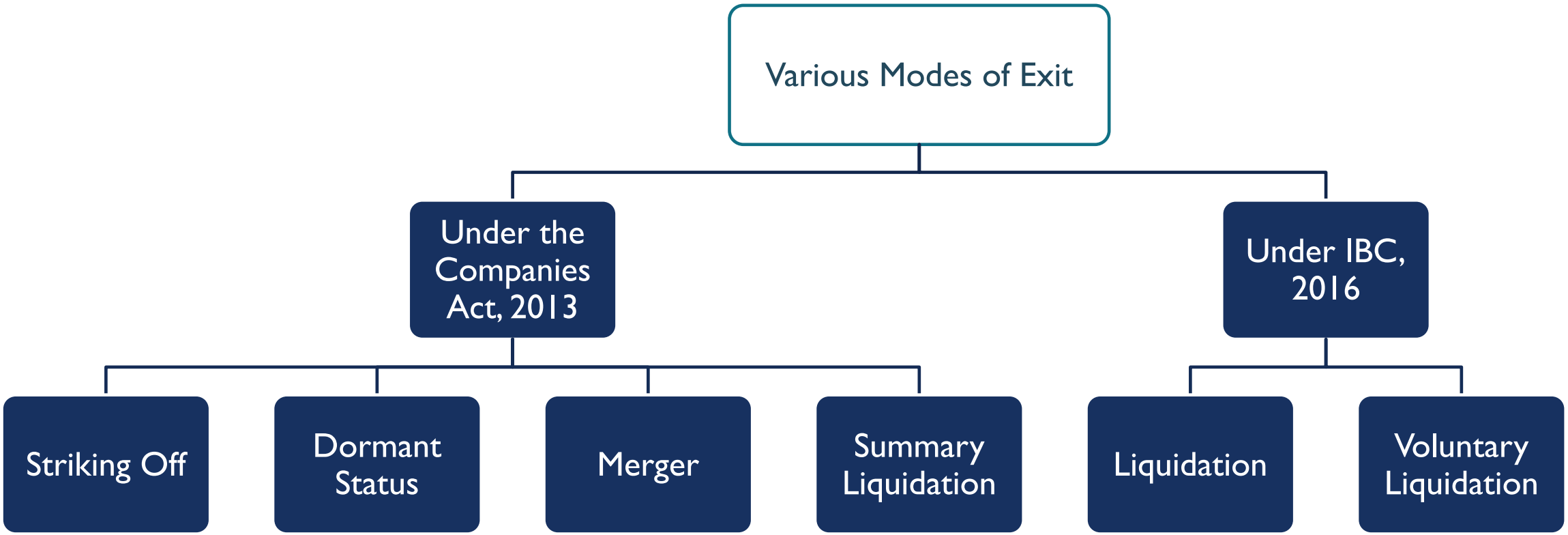
Reduction of capital is concerned with repayment of capital and securities premium. Accordingly, it is unlikely to utilise accumulate profits for the purpose of capital reduction. However, where a part of the consideration is payable through accumulated profits (on account of fair valuation), the same will be taxable as deemed dividend.

Difference between Buyback and Capital Reduction

Particulars	Buyback	Capital Reduction
Maximum amount that can be utilised	The fair value of shares can be paid out; upto 25% of paid up capital and free reserves	No such limits
Source of distribution	Profits, share premium, or proceeds of issue of securities	Not specified
Approvals required	Upto 10% of Net worth: Board Upto 25% of Net worth: special resolution	Board Special Resolution No-objection of creditors NCLT
Impact on the shareholder	To the extent sold back, the holding of the shareholder comes down	
Taxability	Entire amount paid by the company is taxable u/s 2(22)(f)	Entire amount paid by the company to the extent of accumulated profits is taxable u/s 2(22)(d) For remaining part, only capital profits are taxable

Modes of exit

Modes of Exit



THANK YOU