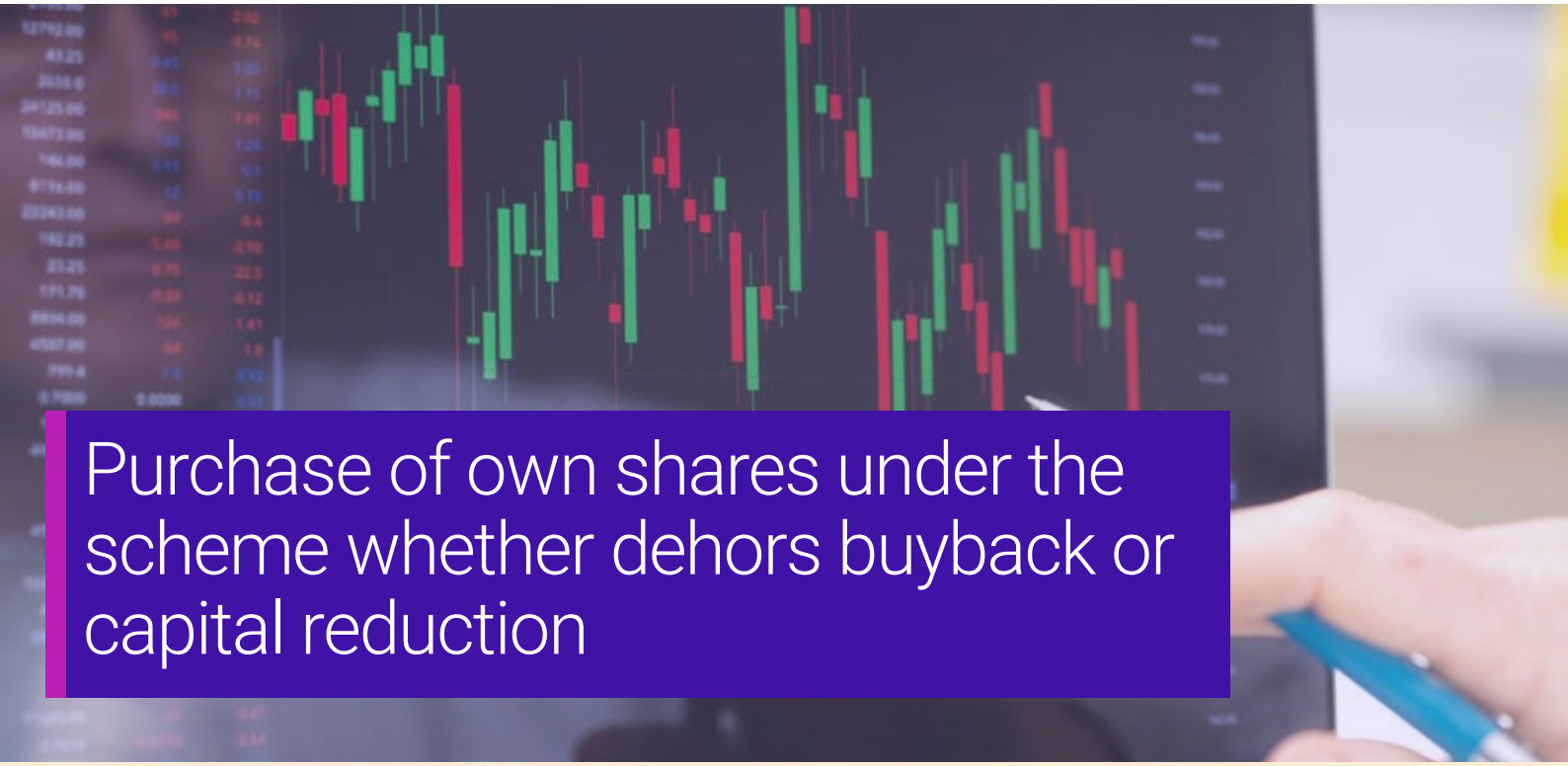

Purchase of own shares under the scheme whether dehors buyback or capital reduction

Recently, the Chennai Income-tax Appellate Tribunal (ITAT) in the case of Cognizant Technology Solutions India Pvt. Ltd [TS-531-ITAT-2023(CHNY)] (the Company) recharacterized the Scheme of Arrangement (scheme) for the purchase of shares by the Company from its shareholders under Scheme 391 to 393 of the erstwhile Companies Act 1956 (1956 Act) as a capital reduction and ruled in favor of the revenue from taxation perspective.

Interestingly, the contention of the Company was that the scheme was neither a buy-back under Section 77A nor capital reduction under Section 100-104 of the 1956 Act (as it was applicable then).

Our article titled "**Chennai ITAT Ruling in Cognizant's Shares Buyback - A Panoramic Analysis**", which delved into the taxation aspects of the issues involved has been separately published on Taxsutra portal.

In this article, we have attempted to analyze the company law issues that the aforesaid ruling has touched upon.

The brief facts are as under

- The Scheme under Section 391-393 of the 1956 Act was approved by the Madras High Court (High Court) on 18 April 2016, pursuant to that the company purchased 94,00,534 equity shares (representing 54.70% of the outstanding number of equity shares) from its shareholders for a total consideration of INR 190802.6 million.
- The scheme provided for the purchase by the Company of its own shares from the shareholders under the contractual arrangement. The scheme stipulated that it is neither a buy-back of its shares under Section 77A nor the capital reduction under Section 100 of the 1956 Act.
- The tax department, during the assessment, challenged the Company's contention and sought to charge distribution of money to the shareholders as the deemed dividend under Section 2(22) of the Income Tax Act, 1961, by characterizing it as nothing but the scheme of capital reduction.

The Company's submissions on the company law provisions are summarised as follows

- The Company submitted that the power of the Hon'ble High Court under section 391 to 393 of the 1956 Act to sanction a scheme for the purchase of own shares has been held to be complete 'code in itself' and the Court can sanction, inter alia, scheme of arrangement for purchase by the company of its own shares from the shareholders. Such powers are independent and de hors Section 77 of the 1956 Act.
- The Company submitted that the Sections 77A and 100 of the 1956 Act are not the only Sections that enable the purchase of the Company's own shares from the shareholders. Section 391-393 of the 1956 Act are wide enough to cover the said scheme for the purchase of its own shares by the Company from its shareholders.
- The Company argued that Section 230(1) of the Companies Act, 2013, notified w.e.f. 15 December 2016, specified that a company cannot buyback/purchase of its own shares under a 'Scheme of Arrangement & Compromise' unless buy-back/purchase of its own shares is in accordance with Section 68 of the Companies Act, 2013 (corresponding to Sec.77A of the 1956 Act). Therefore, from the aforesaid, it follows that prior to 15 December 2016, there was no restriction on the powers of the Hon'ble High Court to sanction the scheme for the purchase of its own shares under Section 391 of the 1956 Act, independent and de horse of Section 77A of the 1956 Act.
- The Company further argued that the scheme for the purchase of shares cannot be said to be a scheme for the reduction of capital under Section 100-104/402 of the 1956 Act. It emphasized that a consequent reduction of capital cannot be said to be a causa causansor (proximate/direct cause) of the payment to the shareholder, but causa sine qua non since the extinguishment/cancellation of shares is a consequence of the purchase of own shares. Thus, the reduction of capital and the purchase of one's own shares are distinct and separate legal concepts and cannot be construed as being synonymous with one another.
- The Company also submitted that once the company acquired its shares from the shareholders under a completed contract for the purchase/sale of shares, the company thereafter had to necessarily extinguish the shares in view of the bar in law. The payment to the shareholders was made in pursuance of the contract for the purchase of the shares and not on account of the extinguishment of the shares.
- In short, the Company's contention was that the purchase of its own shares amounts to buyback but not under Section 77 of the 1956 Act. It is a sui generis buy-back, which is facilitated through Section 391-393 of the 1956 Act.
- The company further argued that since the scheme had the approval of the Madras High Court after inviting objections from the Central Government, it operates as a judgment in 'rem' and is binding on all stakeholders. Therefore, once having furnished 'no objection' from the Regional Director, the Central Government, including the Assessing Officer (AO), cannot change the nature of the scheme approved by the Court.

Having considered the submissions of the Company and the income tax department, the ITAT's ruling on the company law issues is summarized as follows

- The ITAT stated that the term 'buyback' is not used anywhere in the scheme. The transaction is always described only as the purchase of equity shares. However, from the facts, it is clear that there is a capital reduction of the shares and distribution out of accumulated profits of the Company to its shareholders.
- The ITAT, on an operation of Hon'ble High order 'in rem', held that the order sanctioning the scheme itself clearly provides that the sanction shall not grant immunity to the assessee from payment of taxes under any law for the time being in force. Further, the role of the High Court in approving the scheme is very limited. The Company Court will look at the scheme and act as an umpire to just verify whether the requisite meetings under Section 391(1)(a) of the 1956 Act have been complied with and further, it has a requisite majority. The Hon'ble Court will also look into the scheme if it is fair to all members and reasonable to a prudent man. Therefore, the Hon'ble Court, while sanctioning the scheme, will merely look at the commercial wisdom of the creditors and approve the same if it is just and fair and there are no illegalities. The tax consequences and otherwise would be for the AO to look into the scheme in light of the relevant provision of the Income tax Act, 1961.
- The ITAT stated that if we go by the arguments of the Company that, once the scheme is approved by the Hon'ble High Court, it operates in 'rem' and binding on the Revenue, then the AO would be rendered functus officio, and the assessment itself would be finalized under the scheme. Further, as alleged by the Company, the tax department is not re-characterizing the scheme. The AO is fully empowered to analyze the effects of the scheme and to determine whether they attract the provisions of the Income Tax Act, 1961 or not.
- The ITAT also held that the provisions of Section 77 of the 1956 Act prohibit a company from purchasing its own shares except by way of actual reduction in capital in accordance with Section 100-104 or Section 402 of the 1956 Act. The only exception to this is the newly introduced non-obstinate clause under Section 77A of the 1956 Act, for buy-back of its own shares. The provisions of Sec.391-393 are only a single window scheme through which various actions are undertaken. Therefore, the purchase of own shares will still have to relate back to either Section 77 r.w.s.100 or Section 77A. There cannot be any purchase of own shares just under Section 391-393 without relate back to Section 77 r.w.s.100-104 or Section 77A.
- In a nutshell, the ITAT held that there cannot be sui generis buyback that is possible under Section 391-393 de hors reference to any other provision of the 1956 Act. A purchase of own shares by the Company involving reduction of share capital can only be made under Section 391-393 r.w.s.77 and Section 100 of the 1956 Act.

Reference to judicial precedents on the scheme under Section 391-393 of the 1956 Act (now 230 of the Companies Act, 2013)

There are a plethora of judicial precedents under Section 391-393 of the 1956 Act, which established a single window system to approve the scheme and also confirmed the wide powers conferred on the High Courts (now NCLT) in sanctioning the scheme subject to meeting the conditions laid down in said Sections. However, judicial precedents presented before the Hon'ble ITAT in the present case on company law provisions are summarised herein below:

- **Capgemini India Private Limited (Company Scheme Petition No. 434 of 2014):** The Hon'ble Bombay High Court held that the company may either follow procedure under Section 391 read with Sections 100-104 of the 1956 Act or procedure under Section 77A of the 1956 Act.
- **PMP Automation reported in [1991] 4 Bom CR 387 and Hognas India Ltd. 148 Comp CAS 70:** The purchase of own shares will still have to relate back to either Section 77A or Section 77 read with Section 100-104 of the 1956 Act. There cannot be any purchase of own shares effected just under Section 391-393 of the 1956 Act.
- **Miheer H. Mafatlal v. Mafatlal Industries Ltd (1997) 1 SCC 579:** Merely the Hon'ble High Court, approving the scheme does not mean that other consequences, including tax implications, will not apply to the assessee at all.
- **SEBI v. Sterlite Industries Ltd., reported in 113 Comp. 273 (Bom):** Any purchase of its own shares under Section 391-393 of the 1956 Act has to be read along with Section 77 and Sections 100-104 of the 1956 Act. Furthermore, the buyback of shares under Section 391-393 of the 1956 Act always refers to Section 100-104 of the 1956 Act. Therefore, Section 391-394 cannot be read separately in isolation with Section 100-104 for the purpose of the purchase of own shares involving capital reduction.
- **M/s. Reckitt Benckiser (India) Ltd. Company case No.228/2010:** The Hon'ble Delhi High Court stated that the conditions provided in Section 77A are applicable only to the buy-back of shares under Section 77A. The conditions applicable to Sections 100-104 and Section 391 cannot be imported into or made applicable to a buy-back under the Section. Similarly, the conditions for a buy-back under Section 77A cannot be applied to a scheme under Sections 100-104 and Section 391.

Our Comments

The contentious issue in the case is that the scheme providing the purchase of its own shares by the Company from its shareholders through the contract under Section 391-393 of the 1956 Act is independent and dehors Sections 77A and 100 of the 1956 Act. The novelty of the scheme is that, it states that the purchase of the shares neither amounts to buy-back nor the capital reduction. It is the purchase of shares from its shareholders under a contract through the scheme. The thrust of the Company's submission is that the Company can purchase its own shares through the scheme under Section 391 of the 1956 Act, which is a single window system to effect the same and does not require reference to any other Section. The purchase of own shares is sui generis buy-back, and it is not necessary to always read Section 391 along with Sections 77A or 100. Merely that the shares are canceled after its purchase doesn't ipso facto result in the reduction of capital, the act of cancellation of shares after its purchase is consequential action since under law it is not permissible for the Company to continue to hold the shares so purchased. In essence, the argument is that the company has the option to purchase its own shares through the scheme and the Hon'ble High Court has inherent jurisdiction to sanction such scheme. Furthermore, once the scheme is sanctioned, it assumes statutory recognition and is binding on all stakeholders.

Whereas the ITAT's ruling concluded that the Company can purchase its own shares pursuant to the scheme under Section 391 either as buyback under Section 77A or capital reduction under Section 100 of the 1956 Act. The Company has no power to purchase its own shares without resorting to Sections 77A or 100 along with Section 391 of the 1956 Act. ITAT also stated that Section 77 of the 1956 Act (now 67 of the Companies Act, 2013) prohibits the Company from buying its own shares unless the consequent reduction of share capital is effected under the provisions of the Act.

While the ITAT's ruling seems well reasoned, however, it will be interesting to see how the appellate authority considers the nuances of it given that the Hon'ble High Court has sanctioned the scheme. Moreso, whether the characterization of the scheme is possible when the scheme assumes the statutory force once it is sanctioned by the court.

It is pertinent to note that sub-section (10) of Section 230 of the Companies Act, 2013 now stipulates that no compromise or arrangement in respect of any buy-back of securities under said Section shall be sanctioned by NCLT unless such buy-back is in accordance with the provisions of Section 68 (dealing with conditions and manner of buy-back of shares). There was no corresponding provision under the 1956 Act. Hence, the legislature has either plowed the loophole or may have clarified the position but the Company has taken a stand that the aforesaid express provision means that earlier there was no bar to purchase shares through the scheme under Section 391 of the 1956 Act. This aspect needs to be considered in greater to see if that would change the dynamics of the case.

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