India:
AAR rules buy-back of shares by wholly owned subsidiary is subject to capital gains tax

India’s Authority for Advance Rulings (AAR) ruled on 27 February 2012 that specific taxing provisions found in section 46A of India’s Income Tax Act, 1961 (ITA) preempt the general exemption in section 47 in the case of a buy-back of shares by a wholly owned subsidiary (thus making the transaction subject to capital gains tax) on the grounds that section 46A was specifically introduced to deal with such a buy-back.

Background

Section 45 provides that the transfer of a capital asset is subject to tax under the head “capital gains.” The term “capital asset” includes shares and transfers of shares subject to tax under section 45. Section 47, however, treats certain transactions as non-transfers, overriding section 45 so that such transactions that are not treated as transfers are exempt from capital gains tax.

More specifically, section 47(iv) provides that a transfer of a capital asset by a company to its wholly owned subsidiary is a transaction that is not treated as a transfer provided the parent company (or its nominees) holds all of the share capital of the subsidiary and the subsidiary is an Indian company. A number of taxpayers have taken the position that a holding company may claim a tax exemption on the buy-back of shares by the wholly owned Indian subsidiary on the premise that section 47(iv) applies to the buy-back.

Ruling

According to the AAR, section 46A plainly and clearly provides that a shareholder receiving consideration from a company on buy-back has a capital gain taxable under section 46A on the difference between the cost of acquisition and the value of consideration received by the shareholder. According to the AAR, section 45 is a general provision dealing with the transfer of all capital assets other than the buy-back of shares, which is covered under a special provision (i.e. section 46A). The AAR further ruled that the provisions of section 46A are not subject to section 47, making section 47 inapplicable to the buy-back of shares.

Accordingly, the AAR ruled that the buy-back of shares by a wholly owned subsidiary from its holding company is subject to tax and is not eligible for the exemption under section 47(iv).

Conclusion

The AAR ruling has the potential to significantly impact the buy-back of shares, which has become an important tool in corporate restructuring. However, the ruling does not touch upon such critical aspects as the ITA’s definition of “income” or on what basis section 46A can be viewed as a charging section. That is, section 2(24) defines “income” and includes capital gains chargeable under section 45, which, by extension, makes section 45 a charging section. Given that section 2(24) does not make any reference to section 46A, it appears that the AAR views section 46A as a charging section on its own, although such status is not apparent in the text of section 46A and the AAR offered no clarification.

— N.C. Hegde (Mumbai)
  Partner
  Deloitte Haskins & Sells
  nhegde@deloitte.com

  Sheeram Deshpande (Mumbai)
  Manager
  Deloitte Haskins & Sells
  shrdeshpande@deloitte.com