Is the double taxation on buyback of listed shares still required?

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One of the normal principles followed in tax laws is that there is no double taxation of the same income. One exception to this is in relation to company profits, where most countries follow the classical system of dividend taxation, whereby the company's profits are first taxed in the hands of the company, and the dividends are again taxed in the hands of the shareholders. Till the early 1990s, even partnership profits suffered double taxation, which was eliminated in 1993. Today, besides dividends, there is no double taxation for almost all investment incomes. An exception is the double taxation on buyback of shares of listed companies under the market route.

Earlier, on buyback of shares, the shareholder was subjected to capital gains tax. A buyback tax of 20% was introduced in 2013, payable by an unlisted company on buyback, with the shareholder's capital gains being exempted. This was done primarily to prevent foreign companies claiming tax treaty benefits on capital gains, whereby the investee companies would not declare dividends but buy back shares, resulting in tax-free capital gains for the foreign companies. In July 2019, this provision was extended to buyback by all companies, including listed ones.

In case of listed companies, the buyback could be carried out in two different ways. One is the offer tender route, where the shareholder directly surrenders his shares to the company in response to an offer received from the company at a particular price, and the second is the open market route, where the company makes an announcement and buys its own shares in the open market at rates not exceeding a particular price.

Under the offer tender route, there is no double taxation, as the company pays the buyback tax, and the shareholder would claim exemption from capital gains. The problem arises under the open market route, where the company acquires the shares in the open market at the prevailing market prices (subject to the cap). Since these are market transactions similar to any other, executed through the stock exchange trading platform, the seller of the shares is not aware of the identity of the buyer – whether it is the company, which is buying back its shares, or some investor. The seller of the shares would therefore continue to pay the capital gains tax on the sale of his shares, even though the company would be paying the buyback tax on the shares it has bought back.

The quantum of tax paid by each would of course differ. While the company would pay the tax on the difference between the buyback price and the price at which the shares were issued (irrespective of the cost of shares to the seller, who may have bought them from the market at a very different price), the shareholder would pay capital gains tax on the difference between the sale price (effectively the buyback price) and his actual cost price. There may of course even be situations where a buyback tax is payable by the company, but no capital gains tax is payable by the shareholder because of shares being sold at a loss.

This element of double taxation therefore primarily arises because of the very nature of the open market route, where the buyers and sellers are anonymous. This could perhaps be tackled by a process whereby, after execution of the transaction, the company's brokers mark such transactions on the stock market system as being part of the buyback, and the seller also gets an intimation that his sale is part of the buyback by the company. The seller can then claim exemption accordingly. Many companies still prefer open market route over the open offer route, as it offers greater flexibility and advantages. For the same buyback amount, under the open market route, due to market price fluctuations, a company may be able to buy back a larger number of shares, or the same number of shares at a lesser price.

But the larger question is whether such buyback tax is required at all now? The buyback tax was introduced at a time there were tax exemptions for capital gains under the Mauritius and Singapore tax treaties. These exemptions have since been eliminated. Various anti-treaty shopping measures have been introduced. Therefore, with no exemption for capital gains under the tax treaties, most foreign companies pay tax on their capital gains in India at 10%. Foreign investors would therefore not be interested in trying to repatriate profits of investee companies in the form of capital gains, instead of dividends.

Besides, should Indian investors continue to face possible double taxation due to cross-border tax benefits sought to be obtained by foreign investors? With the tax treaty benefits almost completely eliminated, it is perhaps time that the government seriously consider scrapping the buyback tax and subjecting the investors to the capital gains tax on buyback of shares on their real gains. It would also help simplify an already complex law.