Buyback tax of 20% on listed companies: Is it fair?

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Buyback tax of 20% on listed companies: Is it fair?

The views are divided, but the larger part of the industry feels the move will discourage the practice of avoiding Dividend Distribution Tax through buyback of shares by listed companies.

Vartika Rawat • ETCFO • July 06, 2019, 15:02 IST

The union budget 2019, tabled by the new FM Nirmala Sitaraman, mentioned under the head 'Preventing tax abuse' few lines on taxing buyback of shares at 20 per cent for listed companies. Earlier this was only applicable to the unlisted companies. This amendment will take effect from 5th July, 2019.

"Now it will take away tax arbitrage available to listed companies," said Alok Mundra, Partner, M&A and PE tax, KPMG India. Many believe that this provision comes in the backdrop of multiple buybacks by listed IT companies in the previous fiscal.

The budget explained the move stating that, "to discourage the practice of avoiding DDT through buyback of shares by listed companies, it is proposed to provide that listed companies shall also be liable to pay additional tax at 20 per cent in case of buyback of shares, as is the case currently for unlisted companies."

Difference between dividend distribution and buyback of shares

Buyback of shares is the repurchase by a company of its own stock. The difference between dividends and buybacks is that a dividend payment is a definite return in that will be taxed, whereas a buyback represents an uncertain future return on which tax is deferred until the shares are sold.

Therefore, the government wants to ensure that such instrument (buyback) is not abused to avoid tax. "Taxing buybacks at 20 per cent will close a loophole to avoid DDT; Dividend distribution may now be at par with buybacks and minority shareholders will be happier to receive dividends rather than being asked to participate in buybacks," said Dhiraj Relli, MD & CEO, HDFC Securities.

But, is it fair?

"No tax is ever fair," said a tax expert in a lighter tone.

Sunil Sayal, CFO of Noikia Seimens, however, felt that it was unfair to listed companies and would act as a deterrent.

Therefore, some companies maybe overcapitalised and genuinely use this to reduce their equity capital ratio.

"It's a legitimate tool and the public at large should not be deprived of (good returns) on the same (tool) just because few companies can use this for tax reduction only," shared Sayal.

Suggesting the same, SR Patnaik, Partner & Head-Taxation of the law firm, Cyri Amarchand Mangaldas expressed, "It may dissuade a number of listed companies from avoiding this mechanism of returning money to the shareholders because of the extra tax."

Another expert commented that this is a way for government to collect tax wherever it can.

That was one side to the story.

Jairaj Purandare, Chairman of tax advisory firm, JMP Advisors discussed the futility of buyback tax on listed companies as compared to unlisted companies. Listed companies do buyback following all regulatory guidelines prescribed by SEBI -- when you do buy back; upto what amount of capital and reserves you can do buy back; it also imposes a gap (12 month) between two buybacks. Thus, "when precautions are there to not misuse the tool of buyback of shares, is it appropriate for the tax authorities to go and now tax buyback as well?"

He justified that unlisted companies may not have such restriction, but listed companies do, hence there was no dire need of it.

However, PK Ghose, Former Finance Director, Tata Chemicals and currently member of CFO Board, a body which intends to act as a bridge between industry and government feels that it is rather fair. He said, "Corporates were earlier doing buybacks, among other reasons, avoiding to have to pay DDT if they were paid out as dividends instead."

Even though he suggests, buybacks if fixed should be treated in the same way as dividends and allowed a set off to avoid double tax."

What does this mean for CFOs?

Purandare explained that earlier the listed company paid no tax on money received when a person gave up the shares. The amount received by the person giving up his shares was subject to tax but only on the gains (deducted amount). "Thus, the effective rate was on a small portion, now the companies have to pay 20 per cent, which is significant," he stated.

The evaluation that CFOs have to carry now, from a tax perspective, will be, as Purandare explained, "Can cash flow be consideration? They now have to evaluate if it is better to pay out dividend where there will be a DDT and compare that with the buyback which is now going to be taxed for listed companies. Now, the individual recipients will not be taxed."

Patnaik gave a practical view for CFOs, accepting the fact that now companies have to pay this tax, he suggested, "CFOs will have to budget for the extra amount towards payment of this extra tax payable on the funds being distributed to the shareholders."

He further explained it with an example, assuming additional tax is 20 per cent and the total amount the company intends to distribute to its shareholders is ₹1,000 crore. Either the CFO will have to budget for ₹830 crore (approx) towards the shareholder and the remainder amount goes towards payment of this tax. Alternatively, the CFO may decide to pay ₹1,000 crore to the shareholders and will have to organise another extra ₹200 crore towards taxes.

"This is an issue that the CFO will have to decide and take appropriate action," he left things up to the finance chiefs.

What problem does it solve?

It increases the tax revenues for the government and blocks the taxpayers from avoiding tax. "Companies may now not be willing to share a bigger portion of their distributable surplus with their shareholders," said Relli of HDFC Securities.

"This will provide an additional amount of tax and will help resource mobilisation for the Government." added Patnaik.

The only concern of the industry is to not paint with the same color taxpayers who want to avoid tax and genuine taxpayers. Yes, tax has been never fair, as the famous saying goes, when the best things in life are free, the government finds a way to tax them.