

MCA Tax Alert

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“From Company’s Coffers to Shareholder’s Pockets – The New Buyback Tax Paradigm”

Introduction

The announcement of Infosys’ largest-ever share buyback has renewed discussions on the taxation of buybacks under the amended Income-tax provisions. With the recent legislative shift effective from **1st October 2024**, the taxation landscape of buybacks has undergone a fundamental transformation—moving the tax burden from the company’s end to the shareholder’s hands.

This change mirrors the earlier transition seen in the treatment of dividends, where the erstwhile **Dividend Distribution Tax (DDT)** was abolished, and dividends became taxable in the hands of shareholders. The current buyback taxation reform follows a similar philosophy, aiming to streamline corporate taxation and align shareholder-level taxation mechanisms.

The Pre-Amendment Regime

Before the amendment (i.e., up to 30th September 2024), buybacks were governed by **Section 115QA** of the Income-tax Act, 1961. Under this regime:

- The **domestic company** undertaking a buyback of shares (whether listed or unlisted) was liable to pay **buyback distribution tax (BBT)** at an effective rate of approximately **23.296%** on the distributed income (the difference between buyback price and issue price) within 14 days from the date of distribution.
- The **shareholder** was **exempt** from tax on such income under **Section 10(34A)**.

This mechanism made buybacks an attractive and tax-efficient route for profit distribution, as shareholders received tax-free income while companies paid tax at a concessional rate, often lower than the maximum marginal rate applicable to individuals.

Parallel with the Dividend Taxation Shift

Historically, dividends too enjoyed exemption in shareholders’ hands when DDT was applicable. However, the Finance Act, 2020 abolished DDT, making dividends taxable in the hands of shareholders. The government’s rationale was to eliminate double taxation and bring parity among different forms of income.

Similarly, to ensure consistency and avoid arbitrage between dividend and buyback routes of distribution, the government has now phased out the company-level tax on buybacks under **Section 115QA** and shifted the incidence to shareholders.

The Post-Amendment Regime (Effective 1 October 2024)

Under the amended framework, the **amount received by a shareholder** on buyback of shares is deemed as a **dividend** under **Section 2(22)(f)** of the Income-tax Act. Consequently:

- The entire consideration received is taxable under **“Income from Other Sources”** in the year in which it is distributed/paid by company"
- Tax is levied on the **gross amount received**, not merely on the differential or profit component.
- No deduction is allowed under **Section 57** for any expense or cost incurred in relation to such income.

However, buyback is regarded as an extinguishment of rights; hence, capital gains provisions under Section 46A apply in the hands of the shareholders. As per Section 46A, the value of consideration received by the shareholder is deemed to be **nil**, resulting in a **capital loss** under the head *“Capital Gains.”*

- If the shares are held for more than 12 months (in the case of listed equity) or more than 24 months (in the case of unlisted equity), the resulting loss is classified as a **Long-Term Capital Loss (LTCL)**.
- If the shares are held for 12 months or less (for listed equity) or 24 months or less (for unlisted equity), the resulting loss is classified as a **Short-Term Capital Loss (STCL)**.

The **set-off and carry-forward rules** then apply:

- **STCL** can be set off against both long-term and short-term capital gains in the same year.
- **LTCL** can be set off only against long-term capital gains.
- Both types of losses can be carried forward for **eight assessment years**.

In the case of **bonus shares** with a nil cost of acquisition, no capital loss would arise, as both sale consideration and cost would effectively be nil.

Illustrative Impact

Consider a shareholder who tenders shares in a buyback at ₹1,000 per share, originally issued at ₹300.

Under the earlier regime:

- The company paid BBT at ~23.296% on ₹700 (the distributed income).
- The shareholder's income was tax-exempt.

Under the new regime:

- The entire ₹1,000 received is taxable as “Income from Other Sources” at the shareholder’s applicable slab rate (up to 30% for individuals).
- The cost of ₹300 becomes a capital loss (₹300 STCL or LTCL), adjustable only against future capital gains.

Thus, the **effective tax incidence increases sharply**, especially for individuals in higher tax brackets, and the timing of benefit (through set-off) may be deferred to future years.

Key Tax Considerations

1. Timing Mismatch:

The tax on the buyback amount is immediate, but the capital loss benefit may only be realized when future capital gains arise. This creates a timing gap and cash-flow disadvantage.

2. Rate Differential:

The buyback income is taxed at slab rates (up to 30%), whereas capital gains on market sales would have been taxed at 12.5% (long-term) or at slab rates (short-term). Hence, even after set-off, the mismatch in tax rates leads to inefficiency.

3. Loss of Grandfathering Benefit:

Shares held since before 31 January 2018 are eligible for grandfathering for long-term capital gains computation under Section 112A. However, in a buyback, the entire consideration is taxed as “other income,” denying this grandfathering benefit.

4. Impact on Investor Behaviour:

For retail and high-net-worth investors, the new regime could substantially reduce post-tax returns from buyback participation, potentially dampening enthusiasm for future offers.

Strategic Implications for Companies

From the company’s perspective, buybacks were historically used as a shareholder-friendly capital allocation tool, especially when surplus cash existed, and dividend distribution was tax-inefficient.

Under the new regime:

- The **overall tax cost** (considering both company and shareholder levels) may increase significantly.
- The attractiveness of buybacks as a capital-return strategy may decline.

- Companies may need to **reassess capital distribution strategies**, balancing between dividend payouts, bonus issues, and share repurchases based on shareholder composition and tax efficiency.

Key Tax Strategies:

1. Interest on borrowed capital used to purchase shares bought back by a company—though the buy-back proceeds are deemed as dividend—is not deductible under section 57(i). However, since such interest cannot be claimed as a deduction, it may be capitalized as part of the cost of acquisition of the shares (to the extent not already claimed), thereby increasing the capital loss on buy-back, provided there is no double deduction.
2. Judicial principles establish that the real nature of income, not its assessed head, determines the right to set-off. Applying this reasoning, the deemed dividend from a buy-back and the related capital loss arise from the same transaction. Therefore, one may contend that even if taxed under different heads, the capital loss should, in substance, be adjustable against the deemed dividend, since substance should prevail over form or classification.
3. Further, Section 80M should likewise apply to buy-back dividends deemed under section 2(22)(f), provided such dividend forms part of the total income of the recipient domestic company. Consequently, where the company redistributes this income as dividend to its own shareholders within the time prescribed under section 139(1), it may claim the corresponding deduction under section 80M, thereby neutralising the tax impact of the buy-back dividend.

Conclusion

The post-October 2024 regime marks a **fundamental policy shift**—from taxing companies on buybacks to taxing shareholders on receipt. While the move enhances tax neutrality between dividends and buybacks, it imposes heavier immediate tax liability on investors and may reduce the overall appeal of buybacks.

In effect, the **entire buyback consideration**—and not merely the income component—is now subject to taxation at rates up to 30%, with limited ability for immediate relief through capital loss adjustment. Unless companies factor in these implications while pricing their buybacks, the investor response may turn muted once the market fully comprehends the tax impact.

The new framework isn't just a simple rule change — it marks a major shift in the way Indian companies plan and share their profits after the removal of Dividend Distribution Tax (DDT).

This tax alert is brought to you by MCA's Direct Tax Quality & Training Committee. Do write to us on dtqtc@mca.co.in if you have any queries relating to this tax alert.