Corporate Financing: Debt vs. Equity and Buy-backs

Session By: CS DIVYA BAJPAI

Practicing Company Secretary, Trademark Attorney, Author and Educator

Coverage Under Debt Vs. Equity

- Debt Financing and its advantages.
- Equity Financing and its advantages.
- Advantages of Debt compared to Equity.
- Disadvantages of Debt compared to Equity.
- Debt Vs. Equity based on Risk, Cost and Control Comparative Approach and General Approach.

Categories of Corporate Financing

Corporate Finance divided into two categories

Debt	Equity
Debt is acquired through the borrowing of funds to be repaid at a later date.	Equity is a contribution to capital. Typically, an investment in exchange for a stake in the company.

Most companies use a combination of debt and equity financing.

Debt Financing

- Debt financing involves the borrowing of money and paying it back with interest.

- The creditors look favourably upon a relatively low debt-to-equity ratio, which benefits the company if it needs to access additional debt financing in the future.

- Debt Equity Ratio = $\dfrac{\text{Debt}}{\text{Equity}}$

The higher the debt over , the higher the Debt- Equity Ratio.

Example: XYZ Ltd. having mix of equity-debt financing. The Debt amounting to INR 1,00,000 and equity amounting INR 2,00,000.
Thus, Debt Equity Ratio = INR 1,00,000/ 2,00,000 = 0.50

Debt Financing

Problem: The financials of two companies ABC Ltd. and XYZ Ltd. given as below:

Sources of Finance	Company ABC Ltd.	Company XYZ Ltd.
Equity	INR 2,00,000	INR 20,000
Debt	INR 1,00,000	INR 1,00,000

Based on the given data, advise amongst two companies which is favourable as per creditors that benefits the company if it needs to access additional debt financing in the future.

Solution: The creditors look favourably upon relatively low debt-equity ratio which benefits the company if it needs additional debt financing in the future. Thus, the Debt- Equity Ratio of two companies are computed as below: Debt / Equity.

Company ABC Ltd.	Company XYZ Ltd.
INR 1,00,000/2,00,000 = 0.50	INR 1,00,000/20,000 = 5

Thus, ABC Ltd. with relatively low debt-equity ratio is favourable as per creditors that benefits the company if it needs to access additional debt financing in the future.

Advantages of Debt Financing

- The lender has no control over the business. Once the loan is paid back, relationship with the financier ends.
- Easy to forecast expenses because loan payments do not fluctuate.
- The interest paid is tax deductible.

Example: *Mr. Ram given loan of INR 10,00,000 to ABC Ltd. @ 10% per annum. ABC Ltd. repaid the loan along with interest after one year. The relationship between Mr. Ram and ABC Ltd. ended once the loan along with interest paid by ABC Ltd. Also, the interest paid is tax deductible.*

Equity Financing

Equity financing involves selling a portion of a company's equity in return for capital.

Example: *The owner of XYZ Ltd. might need to raise capital to fund business expansion. The owner decides to give up 10% of ownership in the company and sell it to an investor in return for capital. That investor now owns 10% of the company and has a voice in all business decisions going forward.*

Advantages of Equity Financing

- There is no obligation to repay the money acquired through it.
- The company's owners provide the equity investors with a good return on their investment but no additional interest charges required to be paid.

Advantages of Debt Compared to Equity

1) Debt Financing does not dilute the owner's ownership interest in the company.

2) A lender is entitled only to repayment of the agreed-upon principal of the loan plus interest, and has no direct claim on future profits of the business.

3) The principal and interest obligations are known amounts which can be forecasted and planned for (except in the case of variable rate loans).

4) Interest on the debt can be deducted on the company's tax return.

5) The company holding only debt finance is not required to send periodic mailings to large numbers of investors, hold periodic meetings of shareholders, and seek the vote of shareholders before taking certain actions.

Disadvantages of Debt Compared to Equity

1) Debt must be repaid.

2) High interest costs during difficult financial periods can increase the risk of insolvency.

3) Cash flow is required for both principal and interest payments and must be budgeted for.

4) The company is usually required to pledge assets of the company to the lender as collateral, and owners of the company are in some cases required to personally guarantee repayment of the loan.

Debt Vs. Equity - Based on Risk, Cost and Control Approach

Based on Risk, Cost and Control Approach, the comparative analysis of the Debt and Equity in tabular form are as follows:

APPROACH	DEBT	EQUITY
RISK	**High Risk** *As Capital and Interest should be paid irrespective of profits.*	**Low Risk** *No question of repayment of capital except in case of liquidation.*
COST	**Comparatively Cheaper** *As prevailing interest rates are considered. Also, interests are tax-deductible*	**Most Expensive** *As dividend expectations of shareholders are higher than interest rate on debt. Also, dividends are not tax-deductible.*
CONTROL	**No Dilution of Control**	**Dilution of Control** *As capital base might be expanded and new shareholders/public are involved.*

Debt Vs. Equity – Based on General Approach

Basis of Distinction	Debt	Equity
Management Influence	None. Unless agreed upon especially.	All shareholders have voting rights that influence management.
Repayment	Debt required to be repaid till maturity date.	Stock has no such maturity date for repayment.
Yearly Obligations	Obligation of payment of interest .	Not legally liable to pay dividends. Not obligatory payment.
Tax Benefits	Interest is tax deductible. Since payments made to repay a loan can be counted as business expenses, they are tax-deductible. This reduce net tax obligation at the end of the year.	Dividends are not tax deductible.

Example of Debt Vs. Equity

The Company ABC Ltd. need funds of INR 10,00,000. ABC Ltd. raised INR 5,00,000 by way of debt financing at the rate of 10% and remaining INR 5,00, 000 by way of equity financing of 50,000 equity shares of INR 10 each.

Debt of INR 5,00,000	Equity of INR 5,00,000
▪INR 5,00,000 raised through debt financing considered as borrowed fund. ▪ The pre0determined interest are required to be paid along with borrowed fund. ▪ Generally, the lenders of borrowed funds not participate in decisions of the company. In exceptional cases of loan from financial institutions; financial institutions nominate their representative as director on the board of the Company to control actions and decisions of the companies.	▪The holder of 50,000 equity shares are owners of the Company. ▪The shareholders will get return on capital and dividend income. ▪The shareholders can participate in decisions of the companies through shareholders' meetings.

Summary- Debt Vs. Equity

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Coverage under Buy-Backs

- Meaning of Buy-back.
- Reasons for Buy-back.
- Important Terms.

- Overview of Statutory Provisions for Buy-back
- Sources of Buy- back.
- Conditions for Buy-back.
- Methods of Buy-back.
- Restrictions on Buy-back.
- Norms to be complied by the private companies and unlisted public companies for buy-back of their securities.

- Capital Gains on Buyback of Shares or Other Securities .
- Special Provisions Relating to Tax on Distributed Income of Domestic Company for Buy-Back of Shares.

Meaning of Buy-back

- A buyback of shares is buying back of own shares by a company that was issued earlier.

- It is a corporate action event wherein a company makes a public announcement for the buy-back offer to acquire the shares from existing shareholders within a given time period.

- Generally, the company announces an offer price for the buy-back that is generally higher than the current market price.

Reasons for Buy-back

- To improve earning per share;

  Earning Per Share = Earnings/ No. of Equity Shares.

- To use ideal cash;
- To give confidence to the shareholders at the time of falling price;
- To increase promoters shareholding to reduce the chances of takeover;
- To return surplus cash to the shareholders.

Important Terms

<u>As per Explanation of Section 68 of the Companies Act, 2013</u>:

- **“Specified securities"** includes employees' stock option or other securities as may be notified by the Central Government from time to time.

- **“Free reserves"** includes securities premium account.

Overview of Statutory Provisions of Buy-back

Statutory Provisions For Buy-back
Section 68 of the Companies Act, 2013: Power of company to purchase its own securities.
Section 70 of the Companies Act, 2013: Prohibition for buy-back in certain circumstances.
Rule - 17 of Companies (Share Capital and Debentures) Amendment Rules, 2016: Norms to be complied by the private companies and unlisted public companies for buy-back of their securities.
Securities and Exchange Board of India (Buy - Back of Securities) Regulations, 2018: These regulations shall be applicable to buy - back of shares or other specified securities of a company in accordance with the applicable provisions of the Companies Act.

Sources of Buy- back

As per provisions of Section 68(1) of Companies Act, 2013:

A Company can purchase its own shares and other specified securities out of –

- its free reserve; or
- the securities premium account; or
- the proceeds of the issue of any shares or other specified securities.

However, buy-back of any kind of shares or other specified securities cannot be made out of the proceeds of the earlier issue of same kind of shares or same kind of other specified securities.

Methods of Buy-back

Methods of Buy- back [As per Section 68 sub-section (5) of the Companies Act, 2013]
from the existing shareholders or security holders on a proportionate basis
from the open market;
by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

Conditions for Buy-back

As per provision of Section 68(2) of Companies Act, 2013, following condition required to be fulfilled:

Authorization for Buy-Back	Articles of Association(AOA) of the company should authorize Buy-Back. If no provision in AOA then first alter the AOA.
Special Resolution/ Board Resolution	A special resolution has been passed at a general meeting of the company authorising the buy-back. A Board Resolution required to be passed at a Board Meeting of the company when buy-back is up to 10% of the total paid-up equity capital and free reserves of the company;

Conditions for Buy-back

Approval of Shareholders	When buy-back is up to 25% of the aggregate of paid-up capital and free reserves of the company. However in respect of the buy-back of equity shares in any financial year, the reference to twenty-five per cent shall be construed with respect to its total paid-up equity capital in that financial year.

Debt-equity Ratio In Post Buy-back	In post buy-back scenario; debt-equity ratio cannot exceed 2:1. However, the Central Government may, by order, notify-a higher ratio of the debt to capital and free reserves for a class or classes of companies.

Conditions for Buy-back

Fully paid-up shares/ other specified securities	All the shares or other specified securities for buy-back are fully paid-up.
Completion within One Year	The buy-back should be completed within a period of one year from the date of passing of Special Resolution or Board Resolution, as the case may be.
In accordance with SEBI Regulations and prescribed rules	**In case of listed shares and or other specified securities:** In accordance with the regulations made by the Securities and Exchange Board in this behalf. **In case of unlisted listed shares and or other specified securities:** In accordance with specified rules under Companies Act, 2013.

Conditions for Buy-back

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No offer for buy-back within one year from the closure of preceding offer of buy-back	No offer of buy-back shall be made within a period of one year from the date of the closure of the preceding offer of buy-back, if any.

Restrictions on Buy-back

As per provisions of Section 70 of the Companies Act, 2013:

No company shall directly or indirectly purchase its own shares or other specified securities—

- through any subsidiary company including its own subsidiary companies;
- through any investment company or group of investment companies; or
- If company has defaulted in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company.

However, the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

Restrictions on Buy-back

No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of :

- **Section 92:** Filing of Annual Return,
- **Section 123:** Declaration of Dividend ,
- **Section 127**: Payment of Dividend ,
- **Section 129:** Financial Statement.

Norms to be complied by the private companies and unlisted public companies for buy-back of their securities

1. Convene the meeting of the Board of Directors of the Company.

2. Sending Notice of General Meeting at which special resolution to be passed accompanied by Explanatory statement containing disclosures as per Rule 17(1) of the Companies.

<u>List of above mentioned disclosures (the list is not complete):</u>

- ❑ the date of the board meeting at which the proposal for buy-back was approved by the board of directors of the company;
- ❑ the class of shares or other securities intended to be purchased under the buy-back;
- ❑ the number of securities that the company proposes to buy-back;
- ❑ the method to be adopted for the buy-back;
- ❑ the price at which the buy-back of shares or other securities shall be made;
- ❑ the time-limit for the completion of buy-back;
- ❑ Other disclosures as per Rule 17(1) of the Companies (Share Capital and Debentures) Amendment Rules, 2016.

Link to Check Explanatory statement for buy back:
https://www1.nseindia.com/corporate/MAJESCO_09102020192021_EGMnotice09102020.pdf .

Norms to be complied by the private companies and unlisted public companies for buy-back of their securities

3. Letter of Offer (Form SH-8): The company which has been authorized by a special resolution shall, before the buy-back of shares, file with the Registrar of Companies a letter of offer in **Form No. SH.8.**
However, that such letter of offer shall be dated and signed on behalf of the Board of directors of the company by not less than two directors of the company, one of whom shall be the managing director, where there is one.

The letter of offer shall be dispatched to the shareholders or security holders immediately after filing the same with the Registrar of Companies but not later than twenty days from its filing with the Registrar of Companies.

4. Offer Period: The offer for buy back shall remain open for a minimum period of 15 days but not more than 30 days from the date of dispatch of letter of offer. (Period may be less than 15 days, if all the members agree.)

Norms to be complied by the private companies and unlisted public companies for buy-back of their securities

5. Declaration of Solvency (Form SH-9): The company shall file with the Registrar of Companies, along with the letter of offer, a declaration of solvency in e-Form SH-9 and verified by affidavit.

6. Acceptance of Offer: In case the number of shares offered by the shareholders is more than the total number of shares to be bought back by the company, the acceptance per shareholder shall be on proportionate basis out of the total shares offered for being bought back.

7. Separate Bank Account: After the closure of the buy-back offer, the company shall immediately open a separate bank account and deposit therein, such sum, as required for the entire sum due and payable as consideration for the shares tendered for buy-back.

Norms to be complied by the private companies and unlisted public companies for buy-back of their securities

8. The company shall complete the verifications of the offers received within fifteen days from the date of closure of the offer.

9. Payment of consideration made within 7 days from the date of verification of the offers to those shareholders whose shares has been accepted and return the share certificate to those whose shares are not accepted.

10. Submission of Return of buy-back in Form SH-11 annexed with Compliance Certificate in Form SH-15 signed by 2 Directors out of which One must be a Managing Director, if any.

11. Maintenance of Register of Buy-Back in Form SH-10.

Capital Gains on Buyback of Shares or Other Securities [Section 46A of Income Tax Act, 1961]

In case of specified securities other than shares	In case of shares (whether listed or unlisted)
• Any consideration received by a holder of specified securities (other than shares) from any company on purchase of its specified securities is chargeable to tax in the hands of the holder of specified securities. •The difference between the cost of acquisition and the value of consideration received by the holder of securities is chargeable to tax as capital gains in his hands. ***Note: The cost of acquisition is the amount at which shares were purchased by the shareholder and sale consideration is the amount given by the company to Shareholder on buy-back of shares.***	• **Taxability in Hands of Companies:** In case of buyback of shares (whether listed or unlisted) by domestic companies, additional income-tax @ 20% (plus surcharge @ 12% and cess @ 4%) is levied in the hands of the company under section 115QA of Income Tax Act, 1961. (i.e. equal to @23.30%).

Capital Gains on Buyback of Shares or Other Securities [Section 46A of Income Tax Act, 1961]

In case of specified securities other than shares	In case of shares (whether listed or unlisted)
• The computation of capital gains shall be made in accordance with the provisions of section 48. of Income Tax Act, 1961 • Such capital gains shall be chargeable in the year in which such securities were purchased by the company.	• **Taxability in the hands of Shareholders:** The income arising to the shareholders in respect of such buy-back of shares by the domestic company would be exempt under section 10(34A) of Income Tax Act, 1961, since the domestic company is liable to pay additional income-tax on the buy-back of shares.

Summarized Taxation provisions in respect of buy-back

Taxability in the hands of	Buy-back of shares by domestic companies	Buy-back of shares by a company other than a domestic company	Buy-back of specified securities by any company
Company	Subject to additional income-tax @23.30%.	Not subject to tax in the hands of the company.	Not subject to tax in the hands of the company.
Shareholder / holder of specified securities	Income arising to shareholders exempt under section 10(34A) of IT Act, 1961.	Income arising to shareholder taxable as Capital Gains u/s 46A.	Income arising to holder of specified securities taxable as capital gains u/s 46A.

Special Provisions Relating to Tax on Distributed Income of Domestic Company for Buy-Back of Shares

Tax on distributed income to shareholders [Section 115QA]:

Notwithstanding anything contained in any other provision of this Act, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount of distributed income by the company on buy-back of shares (not being shares listed on a recognised stock exchange) from a shareholder shall be charged to tax and such company shall be liable to pay additional income-tax at the rate of twenty per cent on the distributed income.

Important Terms Used
In Section 115QA of Income Tax, 1961

- ***"buy-back"*** *means purchase by a company of its own shares in accordance with the provisions of section 77A of the Companies Act, 1956 (corresponding to Section 68 of the Companies Act, 2013);*

- ***"distributed income"*** *means the consideration paid by the company on buy-back of shares as reduced by the amount which was received by the company for issue of such shares.*

Tax on distributed income to shareholders [Section 115Q A of Income Tax Act, 1961]

- When no income-tax is payable by a domestic company on its total income computed in accordance with the provisions of Income Tax Act, the tax on the distributed income as discussed above shall be payable by such company.

- **Liability to Pay Tax to the credit of CG within 14 days from the date of payment of any consideration to the shareholder on buy-back of shares:** The principal officer of the domestic company and the company shall be liable to pay the tax to the credit of the Central Government within fourteen days from the date of payment of any consideration to the shareholder on buy-back of shares.

Tax on distributed income to shareholders [Section 115QA of Income Tax Act, 1961]

- The tax on the distributed income by the company shall be treated as the final payment of tax in respect of the said income and no further credit there for shall be claimed by the company or by any other person in respect of the amount of tax so paid.

- No deduction under any other provision of this Act shall be allowed to the company or a shareholder in respect of the income which has been charged to tax or the tax thereon.

Interest payable for non-payment of tax by company [Section 115QB of Income Tax Act, 1961]

Where the principal officer of the domestic company and the company fails to pay the whole or any part of the tax on the distributed income of section 115QA(1), within the time allowed under section 115QA(3), he or it shall be liable to pay simple interest at the rate of one percent for every month or part thereof on the amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

Company is deemed to be assessee in default
[Section 115QC of Income Tax Act, 1961]

If any principal officer of a domestic company and the company does not pay tax on distributed income in accordance with the provisions of section 115QA OF Income Tax Act,1961 then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of this Act for the collection and recovery of income-tax shall apply.

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Practical Questions On Buy-backs

Question 1:

Mr. Arun, a resident individual held 30% equity shares of Mohan Limited, an Indian company.

The Company's paid-up share capital as on March 31, 2021 was Rs. 10,00,000 divided into 1,00,000 Equity Shares of Rs. 10 each and issued at premium of Rs. 20. The shares were allotted to shareholders in October, 2014.

The company paid Rs. 60 per share on buy back of shares.

Explain and compute the tax effect in the hand of Mohan Ltd., and Mr. Arun in below mentioned situations:

Situation 1: Shares of Mohan Ltd. are listed on recognized stock exchange; and

Situation 2: Shares of Mohan Ltd. are not listed on recognized stock exchange.

Practical Question Solution 1

Solution 1:

As per Section 115QA of Income Tax Act, 1961: A domestic company distributing its income through buy back of shares have to pay income tax/ distribution tax @ 20% (surcharge @ 12% and education cess @ 4%) i.e. equal to @ 23.30%.

Since tax on buy back of shares will be payable by the company buying the shares and hence to avoid double taxation of the same income, income in the hand of shareholders is exempted.

In both the cases, whether shares of Mohan Ltd., are listed on stock exchange or not, income arising in the hands of shareholders (Mr. Arun) is exempted by provisions of Section 10(34A) of the Income Tax Act, 1961.

Practical Question Solution 1

<u>Calculation of tax in hands of Mohan Ltd. on buy back of shares</u>

Particulars	Amount (INR)
Amount paid by Mohan Ltd. at the time of buy back of shares: (INR 60 x 30,000)	18,00,000
Less: Amount received at the time of allotment of shares: (INR 30 x 30,000)	9,00,000
Distributed Profit *[consideration paid by the company on buy-back of shares less (-) amount which was received by the company for issue of such shares]*	9,00,000
Tax on Distributed Profit @ 23.30% including income-tax @ 20% (plus surcharge @ 12% and cess @ 4%)	2,09,700
Tax Liability of Mohan Ltd. under Section 115QA of Income Tax Act, 1961	**2,09,700**

Practical Questions On Buy-backs

Question 2:

Mr. Manish, a resident individual held 10% equity shares of XYZ Limited, an Indian company.

The Company's paid-up share capital as on March 31, 2021 was Rs. 5,00,000 divided into 50,000 Equity Shares of Rs. 10 each and issued at premium of Rs. 10. The shares were allotted to shareholders in August, 2015.

The company paid Rs. 40 per share on buy back of shares.

Explain and compute the tax effect in the hand of XYZ Ltd., and Mr. Manish in below mentioned situations:

Situation 1: Shares are listed on recognized stock exchange; and

Situation 2: Shares are not listed on recognized stock exchange.

If no income-tax is payable by XYZ Limited on its total income computed in accordance with the provisions of Income Tax Act, then computation of tax is required or not under Section 115QA of the Income Tax Act, 1961?

Practical Question Solution 2

Solution 2:

As per Section 115QA of Income Tax Act, 1961: A domestic company distributing its income through buy back of shares have to pay income tax/ distribution tax @ 20% (surcharge @ 12% and education cess @ 4%) i.e. equal to @ 23.30%.

Since tax on buy back of shares will be payable by the company buying the shares and hence to avoid double taxation of the same income, income in the hand of shareholders is exempted.

In both the cases, whether shares of XYZ Ltd., are listed on stock exchange or not, income arising in the hands of shareholders (Mr. Manish) is exempted by provisions of Section 10(34A) of the Income Tax Act, 1961.

Practical Question Solution 2

<u>Calculation of tax in hands of XYZ Ltd. on buy back of shares</u>

Particulars	Amount (INR)
Amount paid by XYZ Ltd. at the time of buy back of shares: (INR 40 x 5,000)	2,00,000
Less: Amount received at the time of allotment of shares: (INR 10 x 5,000)	50,000
Distributed Profit *[consideration paid by the company on buy-back of shares less (-) amount which was received by the company for issue of such shares]*	1,50,000
Tax on Distributed Profit @ 23.30% including income-tax @ 20% (plus surcharge @ 12% and cess @ 4%)	34,950
Tax Liability of XYZ Ltd. under Section 115QA of Income Tax Act, 1961	**34,950**

Practical Question Solution 2

Even if no income-tax is payable by XYZ Limited on its total income computed in accordance with the provisions of Income Tax Act, XYZ Limited is liable to pay the tax on Distributed Profit @ 23.30% under Section 115QA of Income Tax Act, 1961.

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THANK YOU

(For more clarification; you can write me on: divyabajpaidb@gmail.com)