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Impact of Buyback Regulations on Shareholder Value

SARGAM GUPTA[1]

ABSTRACT

This paper examines the impact of buyback regulations on shareholder value in the Indian context, highlighting how share repurchases serve as a strategic tool for companies to distribute surplus cash, enhance earnings per share (EPS), and signal undervaluation. Buybacks reduce outstanding shares, thereby increasing individual stakes, boosting returns on dividends, and acting as a defense against hostile takeovers. The analysis establishes a direct link between buybacks and shareholder value, influenced by factors like capital structure changes, investor confidence, and efficient capital allocation. Focusing on key Indian regulations under the Companies Act, 2013, and SEBI (Buy-Back of Securities) Regulations, 2018, the paper outlines restrictions such as the 25% limit on paid-up capital and free reserves, debt-equity ratios, and funding sources. Through case studies, it contrasts the Finance Bill 2016, which spurred buybacks by making them tax-efficient (leading to a surge in offers totaling Rs 26,353 crore), with the Union Budget 2024, which reclassifies buyback proceeds as dividend income taxable on shareholders, potentially deterring participation while encouraging reinvestment in growth opportunities. The author advocates for a balanced regulatory framework to optimize buybacks for long-term shareholder value alignment with broader economic goals.

I. INTRODUCTION

The economic significance of buyback mechanisms employed by the companies range from immediate short-term distribution of cash funds to long-term increment in the shareholder value of the company. Notably, the shareholder value, which is the financial worth of a company's shares to its owners, or shareholders and a measure of how much a company's investment value changes over time[2]- is directly affected by the buyback regulations brought about by national legislations. While national legislations may bring these regulations to achieve the financial goals, these are fraught with direct and indirect consequences over the shareholders' value of a company.

This Paper aims to analyse the impact of buyback regulations on a company's capacity and

[1] Author is a Student at O.P. Jindal Global Law School, Sonipat, India.

[2] 'Shareholder Value' (*Corporate Finance Institute)* <https://corporatefinanceinstitute.com/resources/management/shareholder-value/> accessed 04 November 2024.

scope to carry out share repurchases, or buybacks and its consequential impact on the company's shareholder value. The first section shall establish the concept of buybacks and the purpose they are used for. The second section shall analyse the relationship of buyback programmes and shareholder value of a company. Moving further, the third section shall outline the major Indian regulations in place for regulating the buyback mechanisms of the companies. The last section highlights two case studies in the Indian capital market landscape to understand the relationship between changes in the buyback regulations and the shareholder value in practicality. By assessing these sections, the author contends that a balanced regulatory approach is essential for an environment where companies can use buybacks as a tool for enhancing shareholder value, while also aligning with broader economic and market objectives of the legislation.

II. THE CONCEPT OF BUYBACKS

Buyback is a process by which a company purchases its own shares from the market. Under the share buyback, a company can cancel its shares and ultimately reduce the share capital.[3] A company purchases shares of stock on the secondary market from any and all investors that want to sell. Shareholders are under no obligation to sell their stock back to the company.[4]

When share buybacks are done by a company, it results in reduction of total shares in circulation within the market. In this way, each shareholder gerd both a larger stake in the company and a higher return on the future dividends.[5] Here, the company's overall value remains the same but the supply decreases, thereby increasing the share price and consequently the shareholder value. This is also called Earnings-per-Share (*hereinafter* ''EPS'). This also gives the shareholders a greater stake in the company's profits.[6]

This can be substantiated with a simple example. Where a listed company with 100 shares of 1 rupee each, and 15 of them are held by one shareholder. The company initiates a buy-back and purchases 25 shares. The total share capital was reduced to 75 shares. The shareholder here, who initially had a 15% stake now has a 20% stake.

Furthermore, in an environment where the threat of hostile takeovers has become real, share buyback acts as a defense mechanism for an entity by increasing promoter's holdings.[7]

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[3] 'Share Buybacks and Why They Are Important to Shareholders' (*Santander,* 02 September 2024) <https://www.santander.com/en/stories/share-buyback> accessed 04 November 2024.

[4] Benjamin Curry, 'Stock Buybacks: How Companies Create Value For Shareholders' (*Forbes,* 30 July 2024) <https://www.forbes.com/advisor/investing/stock-buyback/> accessed 04 November 2024.

[5] *supra* note 3.

[6] *supra* note 4.

[7] Kotak Securities Team, 'SEBI Regulations & Guidelines on Share Buyback' (*Kotak Securities,* 31 October 2023) <https://www.kotaksecurities.com/investing-guide/share-market/sebi-regulations-and-guidelines-on-

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Moreover, in the process of mergers and acquisitions, companies also make use of share buybacks without increasing their capital.[8]

III. RELATIONSHIP OF BUYBACKS AND SHAREHOLDER VALUE

The main objective of every business is to increase its shareholder and stakeholder value.[9] Shareholder value has gained increasing acceptance as a measure of a company's performance in competitive global markets.[10] Shareholder value is impacted by the decisions concerning the net present value of the cash to shareholders and potential investors. The relevant factors that impact the shareholder value are *inter alia* cost of capital and investment, economic value of a business and expected future and present cash flow. The shareholder value of a company is also affected by the value creation/degradation, management and business plans as well as priority investment plans of companies to achieve their full potential.[11] Therefore, how and when a company seeks to implement buyback programmes for its investors is directly related to all these factors and ultimately to the shareholder value of a company.

Companies opting for share repurchase are more likely to enhance their EPS significantly and therefore attract investors rapidly.[12] When companies buy their own shares, it sends a signal in the market that its shares are currently undervalued. Such companies appear to be a better income-generating avenue with enhanced growth potential. Further, where a company is capable enough to repurchase its shares, the financial position of the company appears to be positive and strong creating a worthy image for the potential investors, thereby increasing the shareholder value.

When a capital buyback is financed by a debt-issue, buybacks can significantly change a company's capital structure, increasing its reliance on debt and decreasing the reliance on equity.[13]

Furthermore, where companies have excess cash and limited avenues for growth, they usually prefer to give back the cash to their shareholders by way of dividends and buybacks. This reduces the risk that the management will misuse the excess cash into value-destroying investments and overpriced acquisitions,[14] therefore creates trust and confidence amongst the

buyback-of-shares/> accessed 04 November 2024.

[8] *ibid.*

[9] Dr. Megha Pandey and Deeksha Arora, 'Shareholder Value Analysis: A Review' (2013) IJSR 2129.

[10] *ibid.*

[11] *supra* note 9.

[12] Icici direct

[13] Justin Pettit, 'Is a share buyback right for your company' (*Harvard Business Review,* 2001) <https://hbr.org/2001/04/is-a-share-buyback-right-for-your-company> accessed 04 November 2024.

[14] Alfred Rappaport, 'Ten Ways to Create Shareholder Value' (*Harvard Business Review)*

shareholders of a company. Therefore, by implementing a well-planned share buyback, a company can give a fair valuation of its stock price and improve key return ratios like return on net-worth, return on assets etc. This improves the market perception and thereby creates a long-term value for shareholders.[15]

IV. Major regulations governing share buybacks

The Companies Act, 2013 (*hereinafter* "the Act") and the SEBI (Buy-Back of Securities) Regulations, 2018 are the two major regulations governing the buyback programmes of companies in India. Section 67 the Act prohibits the purchase of its own securities by a Company for the protection of creditors. However, Section 68 is an exception to this general rule; laying down several conditions and restrictions for the companies undertaking a buy-back of its shares.

Moreover, SEBI has prescribed elaborate regulations for the buy-back of shares of listed entities under the SEBI (Buy-Back of Securities) Regulations, 2018. SEBI guidelines impose several regulations on share buybacks. The maximum limit for a buyback is set at 25% of the company's paid-up capital and free reserves, which includes funds obtained from shareholders and freely distributable reserves. Additionally, SEBI requires that a company's debt-to-equity ratio remains within 2:1 post-buyback, meaning that the total secured and unsecured debt should not exceed twice the paid-up capital and free reserves. Only fully paid-up shares are eligible for buybacks, ensuring that there are no partially paid shares involved.

To reduce share capital through a buyback, companies must comply with Section 67 of the Companies Act, 2013. Buybacks can be funded from free reserves, where a sum equal to the nominal value of the shares repurchased must be transferred to the Capital Redemption Reserve; from the securities premium account, which contains funds from selling shares above fair value; or from any source other than the proceeds of an earlier issue of similar shares or securities. However, SEBI restricts companies from buying back shares through subsidiary or investment companies and prohibits buybacks for companies with unresolved financial obligations, such as unpaid fixed deposits, debentures, term loans, or interest on these obligations.

V. Case studies

The Indian capital market saw significant change in the tax laws and buyback regulations

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<https://hbr.org/2006/09/ten-ways-to-create-shareholder-value> accessed 04 November 2024.

[15] 'Buy back of shares Key considerations' (*Deloitte,* May 2020) <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-presentation-buyback-of-shares-noexp.pdf> accessed 04 November 2024.

under the Finance Bill 2016.[16] The Bill levied an additional income tax of 10% on dividends above INR 10 Lakhs without changing the existing zero capital gains tax policy on share buybacks made by firms, thus making buybacks a tax efficient means of surplus cash distribution amongst the shareholders to create a long-term value.

Companies with low debt, high inside shareholding and low institutional shareholding significantly influenced cash payout decisions post-Finance 2016 Bill.[17] Buybacks became more appealing as they had the available capital without the need to borrow, thus avoiding higher interest expenses. High inside shareholding encouraged decisions that boosted share value, as insiders benefited directly from price appreciation due to reduced share supply in buybacks. Low institutional shareholding also meant fewer pressures for immediate dividends, allowing management flexibility in choosing buybacks over dividends to enhance long-term shareholder value.

Under the Finance Bill of 2016, a listed company attracted a tax of only 0.1% in the form of Securities Transaction Tax. Moreover, there was an exemption from long-term capital gains tax on the transfers of shares held for more than a year. Consequently, a company paid no tax on the repurchase of its shares, leading to a phenomenal rise in share repurchases.[18] Between April and October, 19 buyback offers were made - the highest in the last two fiscal years - according to Prime Database. The amount raised through buybacks was Rs 26,353 crore, the highest in over a decade.[19]

However, eight years down the line, the circumstances of the Indian capital market have changed drastically, inviting our attention to the second case study. The Union Budget of 2024, under the proposed Section 2(22)(f), proceeds from buybacks have been classified as "dividend" income rather than earlier classification of "capital gains", significantly altering the tax liabilities under buyback transactions. Under the new rules, the tax liability will be shifted on the shareholders receiving income from the buyback as opposed to the earlier regulation under which the company had the liability to pay the tax. Buyback proceeds will be treated as deemed dividend, which will be taxed at shareholder's income tax slab rates rather than the company paying the 23.92% buyback tax under Section 115QA of the Income

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[16] The Finance Bill, 2016 (As announced in Lok Sabha).

[17] Charu Banga and Amitabh Gupta, "Analysing the Effect of Share Repurchases on Liquidity" (2022) 60 (1) Quarterly Journal of Finance and Accounting <https://www.jstor.org/stable/10.2307/27224935> accessed 04 November 2024.

[18] *ibid.*

[19] Niti Kiran, 'Share Buybacks on the Rise' (*Business Today, 18 December 2016)* <https://www.businesstoday.in/magazine/focus/story/buyback-issues-has-risen-driven-by-psus-66223-2016-11-26> accessed 04 November 2024.

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Tax Act, 1961. Companies will be required to deduct this tax at source (TDS) at a rate of 10% for the resident individuals and 20% for the non-resident individuals. The cost of shares brought back can be claimed as capital loss, offsetting gains from other share sales.The Ministry outlined that the adjustment aims to level the playing field between dividends and buybacks in order to create a more equitable tax system.[20]

However, shareholders may face higher tax liabilities potentially and will also affect capital allocation of a company. The recent Budget provisions have effectively increased the tax burden on shareholders participating in share buybacks, which has led to a marked disincentive for such transactions. This tax escalation discourages shareholders from capitalizing on buyback offers, thereby reducing the attractiveness of buybacks as a strategy for returning value to shareholders. As a result, companies may find buybacks less viable for optimizing capital structure, potentially limiting a key method for returning surplus funds to shareholders and impacting overall shareholder empowerment.

The increased tax burden on shareholders directly affects the shareholder value and therefore may deter companies from using buybacks as a primary capital return method. Sensing the impending change that the Budget might bring, numerous companies rushed to complete their buybacks before the new rules took effect in October 2024. As per the latest data available, out of 39 share buybacks so far, 46% came following the Union Budget announcement.[21]

When the treatment for both the share buyback income and dividend income is being purported to be brought on a level playing field, it disincentivizes the investors to sell their shares during the buyback programmes. A buyback was earlier preferred by a promoter since it attracted only a 23.3% tax liability for the company undertaking the buyback while the dividends could be taxes upto 35.88% for the promoter investors.[22]

Furthermore, this may discourage the shareholders from tendering their shares during buyback offers, potentially lowering the success rate and ultimately impacting the company's ability to

[20] 'Union Budget: Amount paid on share buyback to be treated as dividend and taxed in hands of shareholders, says Nirmala Sitharaman' (*The Hindu,* 23 July 2024) <https://www.thehindu.com/business/budget/union-budget-amount-paid-on-share-buyback-to-be-treated-as-dividend-and-taxed-in-hands-of-shareholders-says-nirmala-sitharaman/article68436778.ece/amp/> accessed 04 November 2024.

[21] Mayur Bhalerao, ' New Share Buyback Rules to Kick-in, Say hello or Goodbye?' (*Live Mint,* 30 September 2024) <https://www.livemint.com/market/stock-market-news/new-share-buyback-tax-rules-companies-shareholders-investors-dividend-income-taxation-capital-gains-taxable-profits-11727680827871.html> accessed 04 November 2024.

[22] 'Redefining Buy-back: Tax Implications under Finance Act (No. 2), 2024' (*S & R Associates,* 23 August 2024) <https://www.snrlaw.in/redefining-buy-back-tax-implications-under-finance-act-no-2-2024/> accessed 04 November 2024.

repurchase shares at favourable prices.[23]

Even if the companies do not have potential deployment areas for their surplus cash, they may prefer to retain the cash within the company rather than issuing buyback programms, which can significantly reduce effective returns on the shareholder value.[24] Similarly, this can also reduce the shareholder's return on equity investment since they shall hold the liability to pay tax on the entire buyback amount rather than the earlier taxation on net-gain.

However, this will also lead to some marked advantages. The companies can now potentially look for other areas to reinvest the surplus cash which ultimately can enhance a company's financial position. The improved financial standing may lead to reduced borrowing costs, thereby benefiting the company in a longer run.[25] Companies can now direct funds that were previously kept for buybacks to a more effective utilisation expansion, acquisition and development opportunities.[26] Resources may potentially be diverted to other beneficial endeavors such as research and product development that can benefit the long-term goals of a company and significantly improve its overall performance, thereby increasing the shareholder value of a company.

VI. Conclusion

In India, dividends were a taxable income for shareholders until 2003. The legislative change in the form of Dividend Distribution Tax was imposed on the company on these dividends in 2003.This, over the years, increased to a whopping 23% of liability. It is in this context that the government aimed to shift the tax burden from the companies to the shareholders in an equitable manner. The case studies cited in the preceding section therefore invite the readers to contemplate on the far-reaching impact of the buyback regulations specifically on the shareholder values. While contemporary legislations in Europe focus on maximising the stakeholder value rather than the shareholder value,[27] Indian companies still aim to enhance the shareholder value consistently. Therefore, the lessons from the changes in regulations

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[23] *supra* note 22.

[24] Bijal Ajinkya and Viraj Doshi, 'New share buyback rules from October 1, 2024: A higher tax for many, but these people will gain' (*Economic Times,* 13 August 2024) <https://economictimes.indiatimes.com/wealth/tax/new-share-buyback-rules-from-october-1-2024-a-higher-tax-for-many-but-these-people-will-gain/articleshow/112485147.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst> accessed 04 November 2024.

[25] 'Share buyback tax rules: How the new rules will affect capital allocation strategies?' (*Business Today)* <https://www.businesstoday.in/personal-finance/tax/story/share-buyback-tax-rules-how-the-new-rules-will-affect-capital-allocation-strategies-447937-2024-09-28> accessed 04 November 2024.

[26] *ibid.*

[27] P. Raghavendra Rau and Theo Vermaelen, 'Regulation, Taxes, and Share Repurchases in the United Kingdom' (2002) 75 (2) <https://www.jstor.org/stable/10.1086/338703> accessed 04 November 2024.

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need to be taken from the Indian financial landscape. While the impact of Finance Bill 2016 can be assessed to bring about contemporary regulations, it is only later that the potential impact of the Union Budget 2024 in the light of changed buyback regulations will become apparent. As Indian companies navigate these changes, it will be essential to assess the long-term implications on shareholder value and the overall effectiveness of buyback mechanisms in this new tax landscape.

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