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Selective and Optional Capital Reduction Scheme

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Ketan Dalal
Managing Partner, Katalyst Advisors LLP

Section 66 of the Companies Act, 2013 ("Cos Act") provides that, subject to authorisation by a special resolution and approval of the National Company Law Tribunal ("NCLT") on an application, a company may reduce the share capital "in any manner", including paying-off any share capital "which is in excess of the wants of the company".

1. Introduction

Section 66 of the Companies Act, 2013 ("Cos Act") provides that, subject to authorisation by a special resolution and approval of the National Company Law Tribunal ("NCLT") on an application, a company may reduce the share capital "in any manner", including paying-off any share capital "which is in excess of the wants of the company".

In this context, a question that arises is whether there can be a selective capital reduction and more so, by a Listed Company. Furthermore, could such a selective capital reduction be optional in nature? i.e. public shareholders get an option if they wish to tender their shares or not; usually, in a capital reduction application/is "across the board; and, once approved by the NCLT, it is binding on shareholders and the Company.

Effectively, therefore, an option as envisaged in the preceding para would make capital reduction similar to a buy back, wherein option to tender shares is with the respective shareholder; however, are important key differences like price discovery through a tender process in a share buy-back which, in case of a capital reduction, is proposed by the Company and approved by the NCLT. Tax consequences would also differ as explained in the ensuing paragraphs.

Such a selective capital reduction has been implemented by a few closely held companies, each presumably driven by a different rationale. However, such a capital reduction by a listed company has many nuances. This article focuses on a selective capital reduction by a Listed Company and key aspects around such a reduction.

2. The Contours

In the kind of scenario envisaged above, a listed company could file an application/ petition under section 66 of the Cos Act with the NCLT, providing for public shareholders to tender their shares optionally, at a pre-determined price proposed in the application and in accordance with the prescribed methodology for exercising that option. Any such application/ petition will need to comply with section 66 of Cos Act, NCLT Rules and directives of Securities Exchange Board of India for listed companies, including that the audit committee, the Board of Directors and the shareholders (by special resolution) must approve such application/ petition.

Valuation is an important dimension for the shareholders to consider it attractive enough to tender their shares, if they so choose. Accordingly, one dimension is that, such a reduction of share capital will need

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to be at fair value, for the audit committee or Board to approve this as application/ petition being in interest of the shareholders. For such a process to be successful/ shareholders to tender their shares, the proposed pricing will usually need to be at a premium to quoted price of these shares on stock exchanges.

In terms of Regulation 37 of the Listing Obligation & Disclosure Requirements ('LODR'), a listed entity desirous of undertaking a scheme of arrangement including u/s 230-234 and Section 66 of the Companies Act shall, before filing such scheme with the NCLT, obtain a no objection letter from the Stock Exchange(s). Interestingly, there is no reference to an application which is only u/s 66; however, in practice, even applications which are only u/s 66 are being filed with Stock Exchanges under Regulation 37.

3. Rationale

All stakeholders, be it audit committee, Board of Directors, Shareholders, SEBI, as also, income-tax authorities and, of course, the NCLT would require the rationale to be explained for a Company to undertake such a capital reduction. Each Company may have a different set of reasons for initiating such a capital reduction over any other alternative, but the following reasons may have relevance:

- Price discovery mechanism in share-buyback could be complex vis-à-vis price offered under capital reduction, being at the discretion of the Board, subject to fair valuation/ quoted price.
- Share buy-back will have limitations on quantum as envisaged under Cos Act, whereas capital reduction will not have such statutory limitations.

On the other hand, share buy-back may have simpler process and will also not require approval of external authorities like NCLT or lenders. One could also argue that a capital reduction will provide an exit opportunity to dissenting shareholders, but that may have little relevance in a listed Company scenario where shares are tradeable on daily basis and selling on stock exchanges in tax efficient for the selling shareholder.

As such, the Companies intending to undertake a capital reduction of this nature will need to provide commercial rationale to various stakeholders for such a buyback to be meaningful and to have the desired outcome. Also, as mentioned above, a reasonably high premium to the traded price can be a sweetener for the option to be exercised by a shareholder.

4. Selective Capital Reduction vis-a-vis Companies Act/SEBI Regulations

One issue is whether the promoters can opt-out at inception from the capital reduction scheme; the answer appears to be in the affirmative, given that section 66 is very widely worded and it seems to provide for that possibility.

In a capital reduction where promoters opt-out, the promoter shareholding would indirectly increase, without any amount being spent by the promoters or at the expense of cash outflow from the Company. Such increase in promoter shareholding will need to be in compliance with the Takeover code which provides that Promoters cannot acquire, directly or indirectly, more than 5% shares/ control in the Company, unless such acquisition is pursuant to an exempted transaction or pre-approved by SEBI. In a capital reduction like the one discussed here, the change in promoter holding would be contingent upon number of public shareholders tending their shares and hence would not be known in advance, but there is a possibility that the indirect increase in holding may happen to be more than 5% which is the creeping acquisition limit under Regulation 3(2) of the SEBI (Substantial Acquisition of Shares and Takeover Regulation 2011) (SAST regulation or takeover code), one would presume that the company would approach SEBI for a Takeover Code exemption or restrict the amount of shares that could be tendered by public, such that the indirect increase in shareholding is less than or equal to 5% (it may be noted that the relation of the limit from 5% to 10% is only till 31st March 2021 and only if promoters are issued shares on preferential allotment basis).

It is also important to bear in mind that such a scheme of arrangement would need to comply with SEBI Circular dated 10th March 2017 and the relevant listed entity has to submit quite a few documents to the

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Stock Exchange, including valuation report, report from the Audit Committee recommending draft scheme, fairness of opinion by SEBI's registered merchant banker etc.; there have been further amendments to the said SEBI Circular, vide a recent SEBI Circular dated 3rd November 2020 wherein the following changes have been further brought about as a further tightening of the regulatory framework surrounding schemes of arrangement.

- The Audit Committee while approving the draft scheme should also comment on the rationale and the need for the scheme of arrangement, impact of the scheme on the shareholders and cost - benefit analysis of the scheme.
- A report from the committee of independent directors recommending the draft scheme is also required and the report must take into consideration that the scheme is not detrimental to the interest of the listed entity; incidentally, the law does not technically provide for the committee of independent directors, but Schedule IV of the Companies Act, Para VII(1) provides for the independent directors to meet at least once in a financial year without the presence of non-independent directors and members of management; presumably what is envisaged in the SEBI circular may require separate meeting.

The relevant part of SEBI Circular of 10th November 2020 refers only to schemes of arrangement and not an application u/s 66 for reduction of capital. Accordingly, it seems that the above changes will not apply to applications which are solely u/s 66 of the Companies Act.

5. Tax implications

The reduction of capital would first need to be examined from the perspective of deemed dividend under section 2(22)(a) of the Income Tax Act, 1961, which provides that, to the extent the company possesses "accumulated profits", proceeds of capital reduction would be considered as a deemed dividend. Obviously, under the new dispensation for dividend taxation, such amounts would be taxable in the hands of the shareholders, subject to withholding of taxes by the Company. To the extent that the amount of capital reduction exceeds the amount of accumulated profits, it would be taxable as capital gains in the hands of the shareholders. This was so held by the Supreme Court in G. Narasimhan [[1999] 236 ITR 327 (SC)], i.e. that any distribution over and above the "accumulated profits" would be chargeable to capital gains tax in the hands of the shareholders.

It is important to note that the concept of accumulated profits is not linked with the proportion of value of shares held by the shareholders who accept the offer. For example, let's say the accumulated profits are 200 cr and the value attributable to those shareholders who accept the offer is 25%, and the amount of capital reduction attributable to that 25% is, say, 75 cr; in this situation, since 75 crores is less than 200 cr, the entire 75 cr will be deemed dividend. However, if the accumulated profits are 50 cr, then to the extent of 50 cr, it will be deemed dividend and the balance will be taxed as capital gains in the hands of the shareholder.

One would suppose that the company would need to send some intimation to the shareholders (or at least to those who have exercised the capital reduction option) regarding the quantum of accumulated profits which is treated as dividend, so that they are able to compute tax on the balance, if any, as capital gains, based on the G Narasimhan decision. This obviously adds to the complexity of the scheme, because it is extremely difficult for individual shareholders to decipher these complex issues from their individual tax perspective.

Clearly, taxability of such a capital reduction may not be beneficial to public shareholders who can monetise their shares on stock exchanges at the tax cost of 10% plus surcharge/ cess, unless the Company adjusts this incremental tax cost as premium over the fair value for shareholders. As such, such a capital reduction will result in tax costs as follows:

- Upto the extent such capital reduction is taxable as deemed dividend, at the tax rate of 30% assuming that the shareholder is in the maximum tax bracket plus surcharge/ cess
- The amount taxable as capital gains, will be taxed at 20% plus Surcharge / cess; assuming it is a long-term asset; else 30% plus surcharge /cess.

Given that the transaction will be off-market, the cost base price on 31st January 2018 will not be

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available, and hence, the taxable gain would be higher to that extent.

The above taxability is illustrated as follows:

Taxability	Scenario 1	Scenario 2	Scenario 3
Accumulated Profits	100	100	Nil
Amount of capital reduction amount	75	150	100
Taxable Income			
Deemed Dividend 2(22)(a) @ 30%	75	100	Nil
Capital Gains @ 20% if Long-term/ 30% if Short term	Nil	50	100

In the case of a share buyback the company would have to pay tax at 20% + surcharge/cess on the difference between the buyback price and the amount received towards such shares, as per the provisions of Section 115QA; obviously, the company would factor in this tax element, while considering the overall economics of a buyback scheme.

6. Accounting treatment

Cos Act requires that the Company proposing to undertake a capital reduction will be required to furnish a certificate from its statutory auditor along with the application/ petition to NCLT, certifying that the accounting treatment proposed by the Company is in compliance with prescribed accounting standards under Section 133 of the Cos Act.

Neither the Accounting Standards nor IND AS prescribe any treatment for a capital reduction. Usually, the corresponding effect of cancellation of share-capital will be given to capital reserve as any credit to general reserves/ retained earnings would have an effect of share-capital converted into free distributable reserves.

In a few justifiable situations, statutory auditor may permit transferring the share capital cancelled to general reserves/ free reserves and it would depend purely upon the facts of such case.

7. Summing up

The following generic comparison between capital reduction with share buy-back may be useful.

Parameters	Capital Reduction	Share buy-back
Restrictions on size	No restrictions	Restricted upto 25% of paid-up capital and reserves
Regulatory process/approvals	SEBI, Lenders, NCLT	Board of Directors approval and under section 68 of the Companies Act, the Special Resolution, but subject to limitations of quantum and Compliance with SEBI Regulations

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Income tax	· Upto to the extent it is treated as deemed dividend – max. 30% plus surcharge/cess. · Beyond such deemed dividend, taxable as capital gains at the rate of 20% plus surcharges, if long-term in nature and 15% if short term.	· 20% plus surcharge/cess payable by the company

Flexibility and ease of restructuring is important and section 230 – 232 and section 66 do provide quite a bit of flexibility. A capital reduction scheme, which is optional in nature, is one such important tool, and the consequences have been broadly explained in this article. Of course, in any such initiative, listed entities undertaking such restructurings will need to give appropriate weightage to corporate governance norms.

This article has been co-authored by Abhijeet Shah.

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