Beware of taxes when buying bonus preference shares

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BEYOND THE TAX BOOK

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Sell bonus preference shares before maturity to avoid tax on redemption

Very often, one may find certain preference shares being traded in the stock markets at fairly attractive yields and given the depressed yields in the debt markets, one may be tempted to buy these. Even with the dividends now being taxable, on holding to maturity, one may feel that the post-tax yield is far better than the yields available on debt instruments of similar maturity. But if you are an investor with taxable income in the higher brackets, you will need to do a little more homework and check your potential tax liability.

If the preference shares have been issued by the company at an issue price through subscription, there should be no difficulty, and you can go ahead with your purchase decision on the basis of the post-tax internal rate of return (IRR) based on your normal simple computation. However, if these preference shares have been issued by the company to its equity shareholders by way of bonus, you need to pause and do the math again.

This is on account of the fact that the redemption proceeds of bonus preference shares amounts to dividend, which is now taxable in your hands, along with the dividend on the preference shares. Your calculation, therefore, goes haywire on account of the tax.

The definition of dividend refers to the distribution of accumulated profits by a company, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company.

Way back in 1964, the Gujarat high court analysed a case of redemption of bonus preference shares and held that, when bonus preference shares were issued, it did not amount to dividend as there was no release of assets of the company. However, the Gujarat high court held that, at the time of redemption, there was a release of assets by the company, resulting in taxation as dividend. This decision of the Gujarat high court under the 1922 Income Tax Act, has been also affirmed by the Authority of Advance Ruling in a ruling in 2005, where it confirmed that the position was the same even under the current Income Tax Act.

Consider a simple example. You have bought a preference share with face value of ₹100, bearing a 6% dividend, and maturing after one year. If the share is available at ₹90, you would presume that your post-tax yield to maturity would be about 14.5%, factoring in a long-term capital gains tax of 10% on the appreciation of ₹10, and the tax on dividend at about 33% of ₹6.

However, if the entire redemption proceeds are taxable as dividend, then after factoring in a tax of about 33% on the entire ₹106, you are left with only ₹71, giving you a negative yield—of about -21%. You are, therefore, actually out of pocket.

The first reaction of an investor normally is—I have purchased those shares subsequent to issue as bonus shares. How can this be treated as a dividend in my hands?

In the Gujarat high court matter, the bonus preference shares had been purchased by the taxpayer. The high court had yet held that it made no difference as to whether the shares were purchased subsequently by the investor, and not received as part of the issue by the company.

The next question that arises is whether the investor can claim the purchase cost of the shares as a deduction from the redemption amount taxed as dividend. This issue was expressly considered by the Gujarat high court, which rejected the claim. Besides, the amended law as it now stands is clear—against dividend income, you can claim only interest as an expense, and that too only to the extent of 20% of dividend income. Therefore, the gross redemption proceeds would be taxed as dividends, without deduction of the purchase cost incurred.

Can you claim the capital cost of the shares as a capital loss? This seems to be possible since redemption amounts to a transfer of the security, and there is a redemption amount, which is however taxed under a different head of income.

Conversely, if you are an original allottee of the bonus preference shares and if you sell these before redemption, the entire sales proceeds would be taxed as a capital gain,and not as a dividend. The cost of acquisition would be taken as nil, as in the case of bonus equity shares.

As an investor, if you are holding such bonus preference shares, you should sell these shares before maturity to avoid such tax on redemption.

Alternatively, you can gift them before maturity to such family members whose income is not required to be clubbed with yours, and whose income, even after factoring in such maturity proceeds, would not be taxable.

Otherwise, don’t be surprised to find that the company has deducted tax at source even on the redemption proceeds. As the saying goes, what seems too good to be true is too good to be true.

Gautam Nayak is partner at CNK & Associates LLP.