TAX ON REDUCTION OF CAPITAL: HERE'S HOW SHAREHOLDERS WILL GET AFFECTED

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The news of an unlisted subsidiary of a large listed company recently deciding to cancel all the shares held by shareholders, other than its parent firm, created waves in the investor community dealing in unlisted shares. This is on account of the fact that the price at which the capital reduction is planned is around one-fourth the price at which such shares were transferred to investors by existing shareholders (mainly employees who got these shares through stock options), and around one-third of the prevalent rates being quoted till then in the unlisted market.

There is also a tax angle to this. In case of a capital reduction, shareholders whose shares are being cancelled will be taxed. Such taxation is not only as capital gains. The shareholders are first taxed on the amount paid out by way of capital reduction as dividend, to the extent that the company possesses accumulated profits. In calculating such amount taxable as dividend, it is not the proportionate accumulated profits attributable to each share that is to be taxed as dividend, but the entire amount of accumulated profits.

To illustrate with an example, assume that the company has a share capital of 5 billion shares of ₹10 each (total capital of ₹5,000 crore), of which 5 million shares (₹5 crore capital) are held by shareholders other than the parent company. Assuming that the shares are being cancelled at a price of ₹1,000 per share, the total amount being paid out by way of capital reduction would be ₹500 crore. If the company has accumulated profits of more than ₹500 crore (say, for example, ₹20,000 crore), the entire amount of ₹500 crore being paid to the shareholders on cancellation of the shares would be subjected to income tax in the shareholders' hands as dividends. In computing their taxable dividends, they would not be able to claim the amount that they may have paid to acquire the shares—whether by way of allotment by the company, or as purchase price to the selling shareholders from whom they may have purchased the shares.

This is therefore a double whammy for the shareholders. Not only are they getting far less than the amount that they paid to acquire the shares, but also the entire amount that they would be getting would be subjected to tax, and, in most cases, it would be taxed at 35.88%.

Even employees continuing to hold the shares acquired through stock options would suffer such tax on the entire proceeds, though they would already have suffered tax on the value of their stock options exercised at their slab rates of tax. The only consolation for such employees may be that, unlike investors who purchased the shares in the unlisted market, they may be getting almost the same or a higher price for the shares, than that at which they acquired them under the stock options plus the perquisite value on which they paid tax.

The only redeeming factor is that they would be able to claim a capital loss (long term, if the shares are held for more than two years, or otherwise short-term) to the extent of the amount paid by them for acquiring the shares, which they may possibly be able to set off against their other capital gains.

This is in contrast to a situation where, if the company had done a buyback of the shares, the company would have had to pay a buyback tax at 23.296% of the difference between the buyback price and the issue price, the effective rate of tax being less than 20%.

Possibly, the company was driven by other compulsions to resort to a capital reduction rather than a buyback. In case of a buyback, shares of only those shareholders who agree to tender their shares in a buyback would be bought back. Besides, the company would not have been able to issue further shares till expiry of a year after the buyback.

The problem, perhaps, lies in the distinction that the tax laws make between a buyback, a capital reduction and a sale of shares (had shares been sold to the parent company), all 3 of which are treated differently for tax purposes.

It is perhaps time to harmonise the tax treatment of these three types of transactions, since the economic consequences are the same, so that shareholders does not suffer adverse tax consequences merely because a company chooses to compensate them for their shares in a different manner.

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