

Instrument Alchemy: Capital Reduction as a Mechanism for Converting Share Capital into Financial Liabilities

Apr 02, 2026



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I. Introduction

Capital reduction under Section 66 of the Companies Act, 2013 has long been understood as a mechanism for writing off accumulated losses or returning surplus capital to shareholders in cash. That understanding, while not incorrect, is incomplete. A recent line of NCLT and NCLAT decisions has confirmed that the words "in any manner" in Section 66 accommodate a fundamentally different use of capital reduction: the conversion of share capital into financial liabilities, including interest-bearing loans, non-convertible debentures, and perpetual instruments.

The NCLAT, in a decision involving an infrastructure SPV, reversed an NCLT order that had rejected a proposal to convert cancelled equity shares into an unsecured loan repayable over time. The appellate tribunal held that Section 66 gives the company discretion to reduce its share capital in any manner, the conversion into a loan being a domestic affair requiring only shareholder approval and NCLT sanction.

The corporate law position is fairly settled: the consideration for capital reduction can be cash, property, financial instruments, or the creation of a liability. This article examines three distinct transaction structures that deploy this principle for different commercial objectives, and analyses the income-tax and accounting implications that arise when the consideration for capital reduction is a financial instrument rather than cash.

II. The Three Case Studies

A. Case 1: Equity to Interest-Bearing Loan

Consider an infrastructure company with consistent operational cash flows but negative net worth, the latter driven by depreciation on heavy capital expenditure rather than by genuine commercial distress. The company has been funded substantially through equity, and its shareholders wish to receive a periodic return without the regulatory constraints that attach to buyback (the 25% cap, the cooling-off period, the free reserves requirement). A capital reduction could be proposed under which a portion of the equity shares are cancelled and, in consideration, the company records an interest-bearing unsecured loan payable to the shareholders over a defined tenor.

The effect of this structure is to create a periodic income stream to the shareholders through interest payments on the loan, while the principal repayments over the loan tenor achieve a phased return of capital. The company could then claim a deduction on the interest under Section 36(1)(iii) of the Income-tax Act, 1961 (“ITA”), which is unavailable on dividend distributions. From a regulatory standpoint, the repayment of loan principal going forward is not subject to the caps and procedural restrictions that govern buyback. The structure effectively mirrors the economics of an Infrastructure Investment Trust without the rigours of SEBI regulations.

One hard constraint applies: this structure is not available where the company has foreign shareholders. The conversion of a non-debt instrument (equity) into what would constitute an External Commercial Borrowing under FEMA is not permissible under the automatic route, and assured returns on equity instruments are not permitted under FEMA regulations. The structure is therefore confined to purely domestic shareholding patterns.

B. Case 2: Preference Shares to Perpetual Debentures: Capital Loss Engineering

A promoter holds non-convertible redeemable preference shares in a loss-making company, subscribed to over several years as a funding mechanism. The company has accumulated losses, and its net worth has eroded to a point where the fair market value of the preference shares is nominal. The promoter wishes to crystallise a capital loss on these shares while simultaneously ensuring that the company retains repayment capacity on its balance sheet.

The structural solution: the preference shares could be cancelled through a capital reduction, and in consideration, the company issues perpetual non-convertible debentures to the promoter. The conversion is effected at the fair market value of the preference shares, which would be nominal given the eroded net worth. This would crystallise a capital loss for the promoter equal to the difference between the subscription cost of the preference shares and the FMV of the perpetual debentures so issued at the date of conversion. However, the face value of the perpetual debentures would ideally be kept equal to the original face value of the preference shares, preserving the company's par-level repayment obligation and ensuring the debentures carry meaningful coupon-servicing capacity.

The deliberate decoupling between FMV (which drives the tax computation) and face value (which drives the balance sheet and repayment capacity) is the structural core of this transaction. It is defensible because the two serve different purposes: FMV reflects what a willing buyer would pay for the preference shares in their current state, while the face value of the perpetual debentures reflects the contractual obligation the company assumes

towards the debenture holder. The two quantities need not be, and in a distressed company typically will not be, the same.

C. Case 3: Preference Share Cancellation as a Demerger Enabler

A parent company holds both equity shares (say, 70%) and redeemable preference shares (100%) in a subsidiary. The subsidiary intends to demerge its business to a resulting company, with the residual subsidiary subsequently amalgamating into the parent. Tax neutrality requires a demerger qualifying under Section 2(19AA) of the Income-tax Act, 1961 which mandates a "mirror image" condition: the shareholders of the demerged company must hold shares in the resulting company in the same proportion as they held in the demerged company.

The preference shares create a seemingly intractable problem. If left in place, they must either be mirrored in the resulting company (commercially unacceptable, as the resulting company does not want a redemption liability) or they break the proportionality requirement entirely (the parent holds 100% of the preference shares but only 70% of the equity. Conversion of the preference shares into equity would disturb the equity ratio, which is also a constraint.

One plausible solution is to change what the preference shares are before the demerger takes effect. Within a composite scheme of arrangement under Sections 230 to 232, as a step sequenced prior to the demerger effective date, the redeemable preference shares could be cancelled and an unsecured loan of equivalent value is recorded in the subsidiary's books as a liability payable to the parent. The subsidiary's share capital then consists only of equity shares, held in the desired ratio. The demerger proceeds with a clean mirror image on equity alone. The debt stays with the retained undertaking (which is allocated to the residual subsidiary, not to the resulting company), so the resulting company picks up no liability. In the final step, the residual subsidiary amalgamates into the parent, and the intercompany loan extinguishes on merger as the debtor and creditor become the same entity.

III. Income-tax and Accounting Implications

A. Income-tax: Transfer, Consideration, and Capital Loss

The cancellation of shares on capital reduction constitutes a "transfer" within Section 2(47) of the ITA through the extinguishment of rights in a capital asset. Where the consideration for the cancellation is a financial instrument, the central computational question is the determination of the "full value of consideration" under Section 48 of the ITA.

Where the consideration is a loan, the full value of consideration should logically be the principal amount of the loan. Where it equals the cost of acquisition, no capital gain or loss should arise. Where the consideration is a perpetual debenture, the position is more nuanced. The full value of consideration should be the fair market value of the debenture at the date of allotment, not its face value. In a company with eroded net worth, the FMV of a perpetual debenture will typically be significantly lower than the face value, particularly where the issuer's ability to service the coupon is uncertain. This is precisely the mechanism that allows the capital loss to crystallise: the shareholder receives an

instrument whose FMV is nominal (driving a capital loss equal to cost of acquisition minus FMV) while the instrument's face value (which drives the contractual repayment obligation) remains at par.

A question arises on the interaction with Section 50CA of the ITA, which deems the fair market value of unquoted shares to be the full value of consideration where the actual consideration received or accruing is less than such FMV (i.e., adjusted net book value for unlisted equity shares, or the actual FMV for other kinds of shares and securities). Where the consideration for capital reduction is a financial instrument rather than cash, the threshold question is how the 'consideration received or accruing' is itself to be valued. The consideration is the instrument received by the shareholder, and its value must be determined before the comparison with the FMV of the cancelled shares can be undertaken. If the instrument is a perpetual debenture issued by a company with eroded net worth, the fair value of that debenture may itself be nominal, in which case the comparison under Section 50CA is between the FMV of the shares on one hand and the fair value of the instrument received on the other. Both values are independently computed, both reflect the same underlying net worth of the issuer, and in a distressed company both are likely to converge at a nominal quantum. The real analytical point is that the 'consideration received' is not the face value of the instrument but its fair value at the date of receipt, and once that principle is accepted, the Section 50CA comparison proceeds on its own terms without necessarily triggering the deeming provision, because the fair value of the instrument and the FMV of the cancelled shares are likely to be proximate where both derive from the same underlying enterprise value.

Where the company has accumulated profits, the distribution to that extent is deemed dividend under Section 2(22)(d) of the ITA; in loss-making companies, accumulated profits are nil, so the entire consideration falls within the capital gains computation. Post-conversion, the tax efficiency improves structurally: interest paid by the company on the loan or debenture is deductible, whereas dividend on preference shares was not. For the shareholder, interest income is taxable at the applicable rate.

B. Accounting: Reclassification from Equity to Financial Liability

Under Ind AS 32, redeemable preference shares with a mandatory redemption obligation are already classified as financial liabilities in the company's financial statements, regardless of their characterisation as 'share capital' under the Companies Act. The conversion into a loan or debenture through capital reduction makes this reclassification explicit in the legal form as well. For perpetual debentures, the classification depends on whether the coupon obligation is mandatory or discretionary: perpetual instruments with mandatory coupon payments are financial liabilities under Ind AS 32, while those with purely discretionary coupons may qualify as equity.

The more consequential accounting question arises in the shareholder's books under Ind AS 109 read with Appendix D. Appendix D to Ind AS 109 addresses the scenario where the transaction price of a financial instrument on initial recognition diverges from its fair value determined under Ind AS 113. . Where the face value of the perpetual debenture (say ₹30,00,000) exceeds its Day 1 fair value (say ₹1,50,000), the difference of ₹28,50,000 must be accounted for at inception as a debit to the profit and loss account, unless the shareholder had subscribed to the instrument in its capacity as a promoter-shareholder, in

which case no loss would be recognised.

This accounting treatment has a direct bearing on the income-tax analysis. The Day 1 fair value of the instrument under Ind AS 113, computed by reference to the issuer's creditworthiness and the present value of expected cash flows, provides an independent, accounting-standards-compliant measure of what the instrument is worth at the date of receipt, and should support the premise of availability of capital loss, discussed earlier.

For the issuing company, the balance sheet impact of the reclassification is material. The debt-to-equity ratio deteriorates (capital has moved from the equity side to the liability side), interest payments now hit the income statement (whereas dividends on equity instruments did not), and the resulting increase in reported leverage may trigger lender covenant thresholds or affect credit ratings. This is the commercial cost of the conversion, and it is the trade-off that must be evaluated, unless the instrument being issued, such as perpetual debenture, is classified as equity).

IV. The Big Picture

Capital reduction has historically been understood as either a loss write-off mechanism or a surplus return mechanism. The structures examined in this article reveal a third dimension: capital reduction as an instrument conversion mechanism, one that transforms the character of a shareholder's claim from equity to debt without requiring a fresh subscription, a buyback, or a third-party intermediation.

This matters for at least three reasons. First, the equity-to-loan conversion provides a structural alternative to buyback for companies wishing to return capital to shareholders on a periodic basis, without the regulatory caps, cooling-off periods, or shareholder-level buyback taxation that constrain that route. Second, the preference-share-to-perpetual-debenture conversion enables capital loss crystallisation in group restructurings by exploiting the divergence between the fair market value of the cancelled instrument and the face value of the replacement instrument. Third, the cancellation of preference shares and their conversion into debt can dissolve structural impediments in composite schemes of arrangement, including the mirror-image requirement in tax-neutral demergers, that would otherwise require far more complex and costly solutions.

The corporate law position, following the NCLAT's affirmation that Section 66 permits capital reduction 'in any manner,' is fairly settled. The accounting framework, while well-established in its general principles, provides the critical analytical bridge: it is the Ind AS 113 fair value determination read with Appendix D to Ind AS 109 that supplies the independent, standards-compliant measure of what the replacement instrument is worth on Day 1, and it is this measure that anchors the income-tax 'full value of consideration' argument. The deliberate decoupling of face value and fair value, where the former preserves the company's contractual repayment capacity and the latter drives the tax computation, is defensible precisely because the two quantities serve different purposes and are governed by different frameworks. The income-tax framework, however, has not yet caught up. Neither the legislature nor the judiciary has addressed the specific question of how consideration is to be valued when it takes the form of a financial instrument, or whether the Section 50CA comparison should be undertaken on the basis of face value or

fair value of the instrument received.