

Income-Tax Implications of Capital Reduction

*Transfer, Capital Asset,
Computation and Section 50CA*

Unit of Analysis | Ascertaining Consideration | Zero-Payout

Modes

Reduction of face value,
cancellation of shares

Computation

Bifurcation into deemed
dividend and capital gains

Zero Payout

Implications of capital
reduction without payout



Swipe →

01



CAPITAL REDUCTION AS 'TRANSFER'

Face Value Reduced.

Shares Cancelled.

Is it a Transfer?

Kartikeya Sarabhai – Supreme Court

REDUCTION OF FACE VALUE

Reduction of face value against payment of consideration is a transfer under S. 2(47). Extinguishment of rights in a capital asset is independently sufficient.

Bennett Coleman – Mumbai ITAT

DIVERGENCE

Face value halved, then consolidated, without consideration. Held: not a transfer. Proportionate shareholding unchanged, computation under S. 48 fails.

Jupiter Capital – Supreme Court

CANCELLATION OF SHARES

Cancellation of shares is a transfer, irrespective of the fact that proportionate shareholding remains unchanged. Receipt of consideration is not a precondition.

Grace Collis – Supreme Court

REINFORCED

Extinguishment of shareholder rights in amalgamation is a transfer. Principle applies with equal force to capital reduction.

The Transfer Question

Supreme Court judgements consider reduction of face value and share cancellation as transfers. Consideration is not a pre-condition.



02



THE SHARE AS UNIT OF ANALYSIS

Individual Share. Not Proportionate Holding.

Share as the unit of analysis

THE CLAIM

Even where a proportionate reduction of share capital leaves the shareholder's percentage unchanged, the cancellation of individual shares constitutes a transfer of capital assets.

Carestream Health – Mumbai ITAT

THE RULING

Indian subsidiary halved its share capital; parent continued to hold 100%. Tribunal rejected the proportionate-interest test. The capital asset is the 'share' itself, not the 'percentage of shareholding'.

Each Share is Independent

IMPLICATION

Each share is an independent capital asset and its cancellation is an independent extinguishment event. Percentage of shareholding is a derivative measure, not the asset itself.

Bennett Coleman: Effectively Overruled

CONSEQUENCE

Even where proportionate reduction leaves percentage unchanged, cancellation of individual shares constitutes a transfer of capital assets.

The Individual Share

*The capital asset is the share. Not the proportionate shareholding interest.
Carestream Health resolves the unit-of-analysis question definitively.*



03



COMPUTATION OF GAINS AND LOSSES

Bifurcate the Payout.

Zero Payout: Real Loss.

S. 48 Operates.

Bifurcation

WITH PAYOUT

To the extent distribution is from accumulated profits: deemed dividend under S. 2(22)(d).
The balance, being return of capital: capital gains under S. 48. Approach laid down by Supreme Court in G. Narasimhan.

The Zero Payout Problem

ZERO PAYOUT

In zero-payout reduction, consideration is ascertainable but happens to be NIL. S. 48 proceeds normally, results in a capital loss.

Tata Sons – Mumbai ITAT

DISTINCTION

Company cancels half its share capital without any payout to Tata Sons. Tribunal held: The resulting loss is a real capital loss, not notional. The shareholder's investment has been genuinely eroded.

Capital Loss Claimable

RESULT

Shareholder whose shares are cancelled in a zero-payout reduction can claim capital loss equal to the cost of acquisition.

Computation of Capital Gains

Consideration bifurcates into deemed dividend and capital gains.

NIL consideration is ascertainable consideration, results in a capital loss.



04



APPLICABILITY OF SECTION 50CA

With Payout: Applies.

Without Payout: Strong Case It Does Not.

Face Value: Untested.

WITH PAYOUT

S. 50CA applies on a plain reading for unquoted shares where consideration is less than FMV (net book value adjusted for fair value of investments and properties).

Difficulty: where payout is partly deemed dividend under S. 2(22)(d), S. 50CA deems the entire FMV as consideration. Double taxation risk to the extent FMV reflects accumulated profits embedded in net worth.

Better view: S. 50CA should operate only on the capital gains component, not the deemed dividend portion. Awaits judicial clarification.

WITHOUT PAYOUT

Strong argument S. 50CA does not apply. Trigger requires 'consideration received or accruing' to be less than FMV. No consideration means the comparative mechanism has nothing to operate on.

Deeming fictions are to be construed strictly. 'Transfer' in S. 50CA need not carry the same expansive meaning as in S. 2(47).

Section 50CA: Design vs. Deployment

An anti-avoidance provision designed for private bilateral transfers. Its application to NCLT-sanctioned capital reductions raises questions if capital reduction is with payout.



05



RESIDUAL ISSUES AND THE BIG PICTURE

Bennett Coleman's Status. Set-off Constraints. Commercial Deployment.

Bennett Coleman: Narrow Residual

STATUS

Face value reduction followed by consolidation without consideration has not been directly addressed by the SC. Kartikeya Sarabhai involved payment. Residual uncertainty persists in this narrow configuration only.

Set-off and Carry Forward

S. 70/71/74

LTCL set off only against LTCG. Eight-year carry forward window. In group restructurings, availability of LTCG within this window is a relevant structuring consideration.

Capital Reduction: The New Versatility

COMMERCIAL

Deployed across minority squeeze-outs (Bharti Telecom), surplus distribution as alternative to buyback, balance sheet rehabilitation, and PE/JV clean exits through selective reduction of a specific class or series of shares.

Face Value Reduction and S. 50CA

OPEN

S. 50CA speaks of transfer of a 'share'. In face value reduction, no complete share is transferred. FMV substitution mechanism may not operate. Untested in reported decisions.

The Big Picture: Expanding Commercial Use

Capital reduction has evolved from a loss write-off tool to a versatile restructuring Mechanism: Minority Squeeze Out, Surplus Distribution, Balance Sheet Liposuction, PE Exits, JV Unwinding



The Takeaway

The tax framework accommodates each commercial application of capital reduction. The unresolved questions are the remaining friction points.

Transfer

Capital reduction is a transfer under S. 2(47). Jupiter Capital settles this. Consideration is not a precondition.

Capital Asset

The individual share, not proportionate shareholding, is the capital asset. Carestream Health resolves the unit-of-analysis question.

Computation

G. Narasimhan bifurcation for payouts. Zero payout: capital loss claimable. NIL is ascertainable, not unascertainable.

Section 50CA

Applies with payout (double taxation risk on deemed dividend overlap). Strong case it does not apply without payout. Face value reduction: untested.

*Published in The Chamber's Journal, April 2026
Special Feature on Company Payouts to Shareholders*

