

Preference Shares: Structural Savoir-Faire Across Various Use Cases

May 29, 2026



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Background

Preference shares sit at an interesting intersection. The Companies Act treats them as share capital (Section 43), but requires mandatory redemption within a defined time frame. Ind AS 32 looks past the legal form and asks whether the issuer has an unconditional obligation to deliver cash; if it does, the instrument is a financial liability, regardless of the "share" label. FEMA recognises only compulsorily convertible preference shares (CCPS) as equity instruments under the Non-debt Instruments Rules; optionally convertible or redeemable variants fall under the ECB framework. Under the IBC, preference shareholders rank below financial and operational creditors in the Section 53 waterfall, but above equity shareholders.

The same instrument, therefore, wears a different hat under each framework. And the structuring question, in each of the use cases that follow, is which hat is being relied on for the commercial outcome, and whether the other hats leave the structure intact.

Use Case 1: Merger Consideration Without Cash Outflow, with a Put Option Exit

The Commercial Problem

An acquirer intends to acquire a target company. A direct share purchase would require either upfront cash consideration, which the acquirer does not wish to deploy, or a deferred consideration structure, where the seller is taxed on the full sale consideration in the year of transfer regardless of when the cash is actually received. An amalgamation is a potential option, but allotting equity shares of the acquirer to the target's shareholders does not solve the problem either, because equity carries no defined exit i.e., the target's shareholders end up participating in the acquirer's equity risk indefinitely, without a pre-determined redemption price or a pre-determined exit window. The commercial need is a mechanism that defers the actual cash outflow, provides the target's shareholders with a defined exit at a defined price, and does not leave them holding an open-ended equity position in a company.

Why Preference Shares Work

The merger route can be looked at where the target company is merged with the acquirer company, against issuance of redeemable preference shares (RPS) or optionally convertible redeemable preference shares (OCRPS) to the target's shareholders as merger

consideration, in lieu of equity shares. Where the instrument is structured as OCRPS, the holder retains the optionality to convert into equity if the acquirer's business performs well, while the redemption feature provides a floor exit at a pre-determined price. Where the instrument is structured as RPS without a conversion feature, the exit is purely through redemption at a defined price after a defined period. In either case, the structure achieves the commercial objective: the acquirer avoids an immediate cash outflow at the point of merger, the target's shareholders receive an instrument with a defined exit rather than an open-ended equity position, and the acquirer's equity shareholding in the merged entity is not diluted. Further, since redemption can only be out of the profits of the company or proceeds from fresh issuance of shares at the time of redemption, a put option, where the seller has the right to sell the preference shares to the shareholders of the acquirer company can mitigate the risk of redemption due to inadequacy of profits or non-receipt of fresh proceeds against issuance of shares.

Regulatory and Tax Mapping

The merger itself is tax-neutral and the allotment of RPS or OCRPS as merger consideration should qualify for the amalgamation exemption, since the income-tax law does not distinguish between the kind of share capital issued. The subsequent redemption or put option exercise would be taxable as capital gains, with cost of acquisition and period of holding being grandfathered, thereby linking the tax outflow to the actual cash inflow, rather than an upfront tax outflow which would be so in case of deferred consideration mechanism.

From an accounting perspective, under Ind AS 32, RPS with mandatory redemption or OCRPS with a holder put option are classified as a financial liability, impacting reported leverage post-merger, and dividends being recorded as interest expense, impacting the profitability. Under FEMA, this structure would not work under the automatic route since preference shares (other than CCPS) are considered as debt instruments, and would require prior RBI approval.

Use Case 2: Family Arrangements and Succession Structuring

The Commercial Problem

Two branches of a promoter family, Family A and Family B, hold equal shareholding in two group companies, Company A and Company B. As a part of the family arrangement, the objective is that Family A takes full ownership of Company A's business, and Family B takes full ownership of Company B's business, with each family exiting the other's company. A direct conversion of one family's equity into preference shares within each company would amount to a capital reduction, triggering an upfront dividend tax/ capital gains tax liability. A conversion into plain debt would impact existing lender covenants and create a defined repayment obligation on the balance sheet, and again trigger taxation as a capital reduction. A cash buyout of one family by the other would require the availability of funds. The commercial need is a structure that separates the two businesses between the two families in a tax-neutral manner, while providing each exiting family with a defined exit from the other's company.

Why Preference Shares Work

The structure uses a cross-demerger within a composite scheme of arrangement. In the

first leg, the business of Company A is demerged into Company B, with the scheme providing for the issuance of equity shares in Company B to Family A (who will continue to own this business) and redeemable preference shares in Company B to Family B (who are exiting this business). Simultaneously, as a second leg, the business of Company B is demerged into Company A, with the scheme providing for the issuance of equity shares in Company A to Family B (who will continue to own this business) and redeemable preference shares in Company A to Family A (who are exiting this business).

The net result is that each family ends up holding equity in the company whose business it intends to operate, and preference shares in the other company, with the preference shares providing a defined exit through redemption at a pre-determined price. The businesses are effectively swapped in a tax-neutral manner under a composite scheme, without either family needing to deploy cash upfront. The commercial risk of inadequacy of profits at the time of redemption (given the Section 55 constraint that redemption can only be out of profits or fresh issuance proceeds) can be mitigated through a put option, where the exiting family has the right to sell the preference shares to the continuing family's shareholders.

Regulatory and Tax Mapping

The demerger route is tax-neutral and the allotment of preference shares as part of the demerger consideration within an NCLT-sanctioned scheme avoids the need for capital reduction characterisation and the upfront dividend tax/ capital gains tax trigger that a direct equity-to-preference conversion would attract. Capital gains arise only when the preference shares are actually redeemed, linking the tax outflow to the cash inflow.

Fiscal considerations including stamp duty on the transfer of business undertakings, continuity of licences, registrations, and contracts, and the impact on existing lender arrangements would need to be assessed on a case-specific basis.

Under Ind AS 32, the preference shares with mandatory redemption would be classified as a financial liability in the hands of each issuing company, and the dividend would be recorded as an interest expense rather than a distribution. However, as a result of this, the main objective of family arrangement could be achieved i.e., each family ends up with equity control over the business it operates and a defined economic exit from the business it does not.

Use Case 3: Net Worth Augmentation for Regulatory and Bidding Eligibility

The Commercial Problem

Several regulatory and commercial contexts require a company to demonstrate a minimum net worth. EPC companies need to meet net worth thresholds to qualify for government infrastructure tenders. NBFCs must maintain minimum net owned fund under the RBI framework. Insurance companies must maintain prescribed solvency margins. Companies making overseas direct investments are subject to the 400% of net worth limit for total financial commitment under the FEM (Overseas Investment) Rules, 2022. In each case, the applicable net worth definition determines which instruments count, and plain debt does not contribute. The commercial need is to augment net worth without raising external equity or promoter equity, and without altering the existing shareholding pattern.

Why Preference Shares Work

The definition of "net worth" under Section 2(57) of the Companies Act includes paid-up share capital, which encompasses preference shares regardless of their Ind AS classification. This means that even where a redeemable preference share is classified as a financial liability under Ind AS 32 (on account of the mandatory redemption obligation), it continues to form part of paid-up share capital under the Companies Act and therefore counts towards the Section 2(57) net worth. For EPC tender eligibility, the statutory auditor's net worth certificate includes paid-up preference share capital, which means the issuance of preference shares to a promoter or group entity directly augments the reported net worth for bidding purposes. For outbound investment, the augmented net worth expands the 400% ceiling for financial commitment under the overseas investment framework. For regulated sectors such as NBFCs and insurance, depending on the specific regulatory definition, preference shares may count towards regulatory capital, though the form of preference shares variant would be driven by the definitions under each regulation.

Regulatory and Tax Mapping

The structuring choice must align with the specific regulatory definition being targeted. A promoter augmenting the net worth of an NBFC must issue CCPS to count towards owned fund, but the same promoter augmenting an EPC company's net worth for tender eligibility or expanding the ODI headroom can issue redeemable preference shares, which count under Section 2(57) and also carry a contractual exit through redemption. The Ind AS classification as a financial liability does not disturb the Companies Act net worth computation, which is a form-over-substance outcome that works in the issuer's favour in this specific context. The dividend on preference shares, post the abolition of DDT, is taxable in the hands of the shareholder and not deductible in the hands of the company, a cost asymmetry compared to debt instruments where interest is deductible under Section 36(1)(iii).

The Big Picture

The common thread across the three use cases is the deployment of a single instrument to address fundamentally different commercial problems, by calibrating the terms to produce the desired characterisation under each applicable framework. The merger scenario defers cash outflow while providing a defined exit. The family arrangement separates economics from control through a cross-demerger without triggering an upfront tax event. The net worth scenario exploits the gap between the Companies Act definition of share capital and the Ind AS classification of the same instrument as a financial liability.

The tension that runs through the preference share toolkit is the interplay between the Companies Act, which requires redeemability, and Ind AS 32, which treats mandatory redemption as a financial liability. Unlike perpetual debentures, which can achieve equity classification under Ind AS by making coupon and redemption entirely discretionary, preference shares are structurally constrained from pure equity treatment because the Companies Act itself imposes redeemability. That constraint, however, is not always a disadvantage. In the merger scenario, the financial liability classification is the feature, not the bug, because it is the mandatory redemption that gives the target's shareholders their defined exit. In the family arrangement, the financial liability classification could be accepted as the cost of achieving the separation without an upfront tax trigger. In the net worth scenario, the Ind AS classification is simply irrelevant, because the Companies Act definition of net worth looks at legal form, not accounting substance. The right question, in each case, is which hat the commercial purpose requires, and whether the other hats leave the structure intact.