

Instrument Alchemy: Capital Reduction

*Converting Share Capital into
Financial Liabilities under Section 66*

Equity to Loan | Preference to Perpetual Debenture | Demerger Enabler

Case 1

Equity to interest-bearing
loan

Case 2

Preference shares to
perpetual debentures

Case 3

Preference cancellation as
demerger enabler



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SECTION 66 'IN ANY MANNER'

Capital Reduction. An Instrument Conversion Mechanism.

Infrastructure SPV: NCLAT Ruling

THE NCLAT RULING

Cancelled equity shares converted into an unsecured loan repayable over time. Section 66 gives the company discretion to reduce share capital in any manner; conversion into a loan is a domestic affair.

Cash, Property, Instrument, Liability

FORMS OF CONSIDERATION

Consideration for capital reduction is not confined to cash. It can take the form of property, financial instruments, or the creation of a liability such as an unsecured loan, debenture, or perpetual instrument.

Special Resolution Plus NCLT Sanction

PROCEDURAL THRESHOLD

The route is straightforward. A special resolution under Section 66, followed by NCLT sanction. No third-party intermediation, no fresh subscription, no buyback procedural overlay.

FEMA: Domestic Shareholding Only

HARD CONSTRAINT

Conversion of equity into a debt instrument is barred where the company has foreign shareholders. ECB route blocked, and assured returns on equity are not permitted under FEMA.

The Conversion Mandate

Section 66 permits capital reduction in any manner. The consideration can be cash, property, a financial instrument, or the creation of a liability.



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CASE 1 : EQUITY TO LOAN

Buyback Without the Buyback Cage.

Cashflow Rich, Net Worth Negative

THE SETUP

Infrastructure company with consistent operating cashflows but negative net worth driven by depreciation, not distress. Equity-funded. Shareholders want a periodic return without the buyback regulatory cage.

Equity Cancelled. Loan Recorded.

THE STRUCTURE

Capital reduction cancels a portion of equity. In consideration, the company records an interest-bearing unsecured loan payable to shareholders over a defined tenor. Periodic interest plus phased principal repayments.

Section 36(1)(iii) Deduction Available

TAX ECONOMICS

Interest paid by the company is deductible under Section 36(1)(iii), unavailable on dividends.

Domestic Shareholders Only

THE CARVE-OUT

Conversion of equity into a debt instrument runs into FEMA's bar on automatic-route ECB and the prohibition on assured returns on equity. The structure is therefore confined to purely domestic shareholding.

The InvIT Without the Trust

The structure mirrors the economics of an InvIT of interest-deductible, periodic return without SEBI rigour. No 25% cap, no cooling-off period, no free reserves test.



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CASE 2 : P R E F T O P E R P E T U A L N C D

Decouple Fair Value From Face Value. Crystallise the Loss.

Promoter Stuck With Eroded Preference Shares

THE SETUP

Promoter holds NCRPS in a loss-making company. Net worth eroded, FMV of preference shares nominal. Promoter wants to crystallise capital loss while preserving the company's repayment capacity.

Cancellation at FMV. Issuance at Face Value.

THE STRUCTURE

Preference shares cancelled through capital reduction. In consideration, perpetual NCDs issued at FMV (nominal) for tax computation, but with face value retained at par level for contractual repayment capacity.

Two Quantities, Two Frameworks

THE CORE INSIGHT

FMV reflects what a willing buyer would pay today. Face value reflects the contractual obligation the company assumes. They serve different purposes and need not coincide. In a distressed company, they typically will not.

Capital Loss Crystallised. Repayment Preserved.

THE OUTCOME

Capital loss equals subscription cost minus FMV of debentures issued. Face value carries the contractual coupon-servicing obligation forward. Loss recognised, repayment capacity preserved at par.

Capital Loss Engineering, Without Magic

*FMV drives the tax computation, face value drives the balance sheet.
The deliberate decoupling is the structural core of the transaction.*



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CASE 3 : DEMERGER ENABLER

Mirror Image Demands. Preference Shares Won't Mirror. Cancel Them First.

THE PROBLEM

Parent holds 70% equity and 100% redeemable preference shares in a subsidiary. Subsidiary intends to demerge a business; residual subsidiary will then amalgamate into the parent.

Tax neutral demerger requires a mirror-image: shareholders of the demerged company must hold the resulting company in the same proportion. The preference shares break this. Mirror them across, the resulting company picks up an unwanted redemption liability.

Convert preference to equity, the equity ratio breaks (parent holds 100% pref but only 70% equity). Either path collapses tax neutrality. The structural impasse is real.

THE SOLUTION

Within a composite Section 230-232 scheme, sequence a step prior to the demerger effective date: cancel the redeemable preference shares, record an unsecured loan of equivalent value as a liability payable to the parent.

Subsidiary's share capital then consists only of equity shares, held in the desired ratio. Demerger proceeds with a clean mirror image on equity alone. The debt stays with the retained undertaking, allocated to the residual subsidiary, not to the resulting company. The mirror-image bind dissolves before the demerger effective date, no fresh consideration is required, and the structural impasse becomes a sequencing question.

The Loop That Closes Itself

On the final amalgamation of residual subsidiary into parent, debtor and creditor merge into the same entity. The intercompany loan extinguishes by operation of law.



The Takeaway

Capital reduction transforms the character of a shareholder's claim from equity to debt, without fresh subscription, buyback, or third-party intermediation.

Case 1

Equity to interest-bearing loan: A buyback alternative without the 25% cap, the cooling-off, or the free reserves test. Domestic shareholding only, FEMA bars the structure for foreign holders.

Case 2

Preference shares to perpetual debentures: Decouple FMV (drives tax) from face value (drives balance sheet). Capital loss crystallised, repayment capacity preserved at par.

Case 3

Preference cancellation as demerger enabler: Within a composite Section 230-232 scheme, cancel preference shares pre-demerger to clean up the mirror-image. Loan extinguishes on final amalgamation.

The Bridge

FMV under IndAS 113 read with IndAS 109 (Appendix D) anchors the full value of consideration under the income-tax law.

