Distribution of accumulated profits to shareholders:

various ways and their corporate law and tax implications

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LEARNING OBJECTIVE: BIRD'S EYE VIEW

01 **Accumulated profits**
What it is and modes of utilization

02 **Capitalization of profits: Bonus issue**
Various aspects: corporate law & tax implications

03 **Buyback of shares**
Various aspects: corporate law & tax implications

04 **Dividend**
Various aspects: corporate law & tax implications

05 **Comparative analysis of various modes under different parameters**

ACCUMULATED PROFIT

- What is accumulated profit?
  - Amount lying to the credit of retained earnings, built through undistributed profits and which forms part of reserves & surplus in B/S

- What are the modes of utilization of accumulated profits?
  - Refer fig. 1

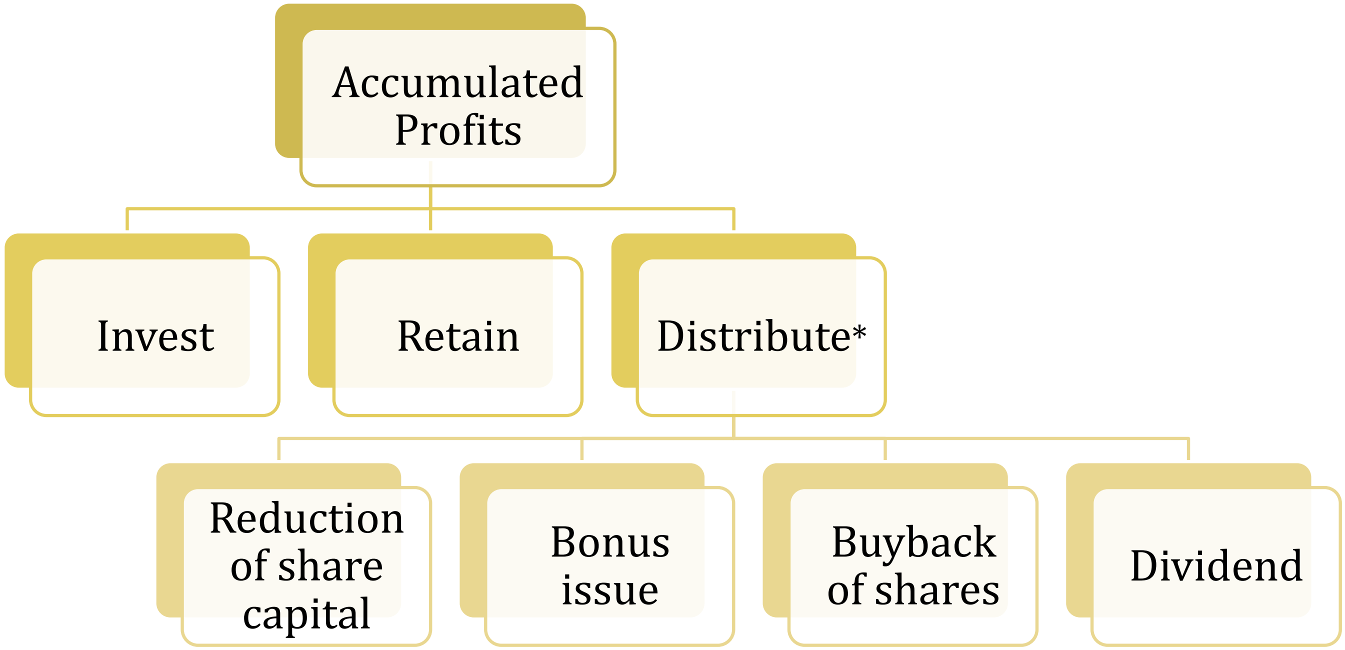


Fig. 1

* Sec 8 companies are strictly prohibited from distributing its accumulated profits.
Our detailed article on "*Utilisation of accumulated surplus by section 8 companies*" can be viewed here

CAPITALIZATION OF RESERVES: BONUS ISSUE

LEGAL FRAMEWORK

Bonus issue

- Sec-63 of Companies Act, 2013
- Rule 14 of the Companies (Share Capital and Debentures) Rules, 2014
- Chap-XI of SEBI (ICDR) Regulations, 2018

SOURCE FOR BONUS ISSUE- SEC 63 OF CA, 2013 & REG. 294 OF SEBI (ICDR) REG., 2018

SOURCES

- Free reserve
- Securities premium
- Capital redemption reserve

NOTE:

- Revaluation reserve created by revaluation of fixed assets cannot be used for the purpose of bonus issue
- Reserves built out of genuine profits can only be used
- Securities premium not collected in cash cannot be utilized

CONDITIONS FOR A BONUS ISSUE

All companies

- Authorized by AoA
- Shareholders approval
- No default in payment of statutory dues of employees
- Partly paid shares, if any made fully paid up
- Bonus issue once announced cannot be withdrawn
- Bonus not in lieu of dividend

Listed companies (ICDR)

- No default in payment of interest or principal in respect of FD or debt sec. issued by it
- Promoter/ director not a fugitive economic offender
- Reservation of equity shares in favor of holders of outstanding CCDs
- Bonus issue on SR shares carries same ratio of voting rights as compared to ordinary shares

TAXATION ASPECTS (1/2)

- Cost of acquisition of bonus shares = nil [Rule 40BB(10)]
- No tax is levied in the hands of shareholder and company at the time of allotment*
- Tax on bonus issue is levied only at the time of disposal of shares

* Sec 2(22)(b) of IT Act, 1961, following shall be deemed dividend:

- distribution by a co. to shareholders of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest; or
- any distribution to pref. shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalised or not

TAXATION ASPECTS (2/2)

TAXATION

Shares are held in demat form

- Sec 45(2A) of IT Act, 1961: Cost of acquisition & period of holding in case of demat shares is determined on the basis of FIFO method.

Illustration: Mr. X holds 100 shares of XYZ Ltd. acquired at Rs. 50/share. The Co. issues bonus shares in the ratio of 1:1 and after the issue, share price falls to Rs. 25/share. Mr. X sells off 100 shares.

- Cost of acquisition of 1st 100 shares= 5,000
- Cost of acquisition of next 100 shares = Nil

So, Capital loss on sale = 100 x (50-25) = Rs. 2,500

Shares are held in physical form

- In case of physical shares, there is no concept of FIFO basis as shares transferred can be easily ascertained. [See *M/s Savyasachi Constructions P. Ltd. v. Assessee*, I.T.A. No. 504/HYD/2014]

Illustration: Mr. X holds 100 shares of ABC Ltd. acquired at Rs. 50/share. The Co. issues bonus shares in the ratio of 1:1 and after the issue, share price falls to Rs. 25/share. Mr. X sells off those100 shares which are received as bonus.

- Capital gain on sale = 100 x 25 = Rs. 2,500

BUYBACK OF SHARES

LEGAL FRAMEWORK

Buyback

- Sec-68, 69 & 70 of Companies Act, 2013
- Rule 17 of the Companies (Share Capital and Debentures) Rules, 2014
- SEBI (Buyback of Securities) Regulations, 2018

SOURCE FOR BUYBACK OF SHARES- SEC 68 OF CA, 2013 & REG. 4 OF SEBI (BUYBACK) REG., 2018

SOURCES

- Free reserve
- Securities premium
- Proceeds of fresh issue

NOTE:

- Buyback cannot be made out of proceeds of earlier issue of same class of securities
- In case the co. buybacks out of free reserve or securities premium, an amount equivalent to nominal value of shares shall be transferred to CRR- Sec 69

LIMITS ON BUYBACK OF SHARES

Board Resolution	• Upto 10% of (paid up equity capital + free reserves)
Special Resolution	• Upto 25% of (paid up capital + free reserves)
Overall limit	• Max. 25% of paid up capital

OTHER CONDITIONS FOR BUYBACK – SEC 68 & RULE 17

- ✓ Authorized by AoA
- ✓ Requisite resolution passed
- ✓ Post buyback debt-equity ratio ≤ 2:1 (6:1 in case of Govt. co. - NBFC)
- ✓ Fully paid up shares
- ✓ No offer of buyback made until expiry of 1 year from closure of previous buyback
- ✓ Buyback complete within 1 year
- ✓ Notice of meeting at which SR is proposed to be passed accompanies with an explanatory statement
- ✓ File letter of offer with RoC in SH-8 & dispatch to shareholders within 20 days
- ✓ File declaration of solvency with RoC & SEBI (in case of listed cos.) in SH-9
- ✓ Immediately upon closure of offer, deposit entire consideration to a separate bank a/c
- ✓ Extinguish & physically destroy the shares bought back within 7 days
- ✓ No further issue for 6 months*
- ✓ Maintain register of buyback in SH-10
- ✓ File a return with RoC & SEBI (in case of listed cos.) within 30 days of completion in SH-11

TAXATION ASPECTS

In the hands of company

- Taxable u/s 115QA of IT Act, 1961 read with Rule 40BB
- Value of tax = 23.296% of distributed income
- Distributed income = consideration paid on buyback – consideration received from issue
- Consideration received also includes premium amount, if any [Rule 40BB(2)]

Illustration:

X Ltd. bought back shares issued at Rs. 20 (including premium of Rs. 5) for Rs. 100 per share.

- Distributed income = 100-20 = 80
- Tax = 23.296% of 80 = Rs. 18.64

In the hands of shareholder

- Sec 46A of IT Act, 1961: in case of buyback, tax shall be payable on (consideration received by shareholder – cost of acquisition) by the shareholder
- Sec 10(34A) of IT Act, 1961: income arising on account of buy-back is not included in the income of the shareholder
- Further, Section 115QA of IT Act, 1961 starts with a non-obstante clause and the tax is borne by the company.

Hence, the only incidence for taxation will be on the company under section 115QA

DISTRIBUTION OF PROFITS BY WAY OF DIVIDEND

LEGAL FRAMEWORK

Dividend

- Chapter VIII of Companies Act, 2013
- The Companies (Declaration and Payment of Dividend) Rules, 2014
- SS-3 Secretarial Standards on Dividend

INTERIM DIVIDEND VS. FINAL DIVIDEND

Basis of distinction	Interim dividend	Final dividend
Authorization	• Board resolution	• Board recommends • Shareholders approve in AGM
Point of time at which it can be declared	• During the financial year; or • After the close of FY but before holding of AGM	• At the time of AGM
Source	• Out of surplus in the profit and loss account • Out of profits for the FY for which interim dividend is sought to be declared • Out of the profits generated in the FY till the quarter preceding the declaration	• Profit of CFY arrived after providing depreciation as per Sch II • Profit of PFY(s) arrived after providing depreciation as per Sch II • Funds provided by CG/SG
In case of inadequacy of profits	• Loss during the CFY up to the end of the quarter immediately preceding the date of declaration of interim dividend, rate of dividend not higher than the average dividends declared by the company during the immediately preceding 3 FYs	• In accordance with the rules (Discussed in detail in later slide)

PAYMENT OF DIVIDEND IN CASE OF INSUFFICIENCY OF PROFITS

Declaration of dividend out of accumulated profits earned in PYs and transferred to free reserve

- Max rate of dividend: Average rate of declared in 3 PFYs
- Max amount that can be drawn from accumulated profits: 10% of (PUSC + free reserves)
- Amount drawn to be first utilized in writing of losses*
- Balance after withdrawal: Not to fall below 15% of PUSC

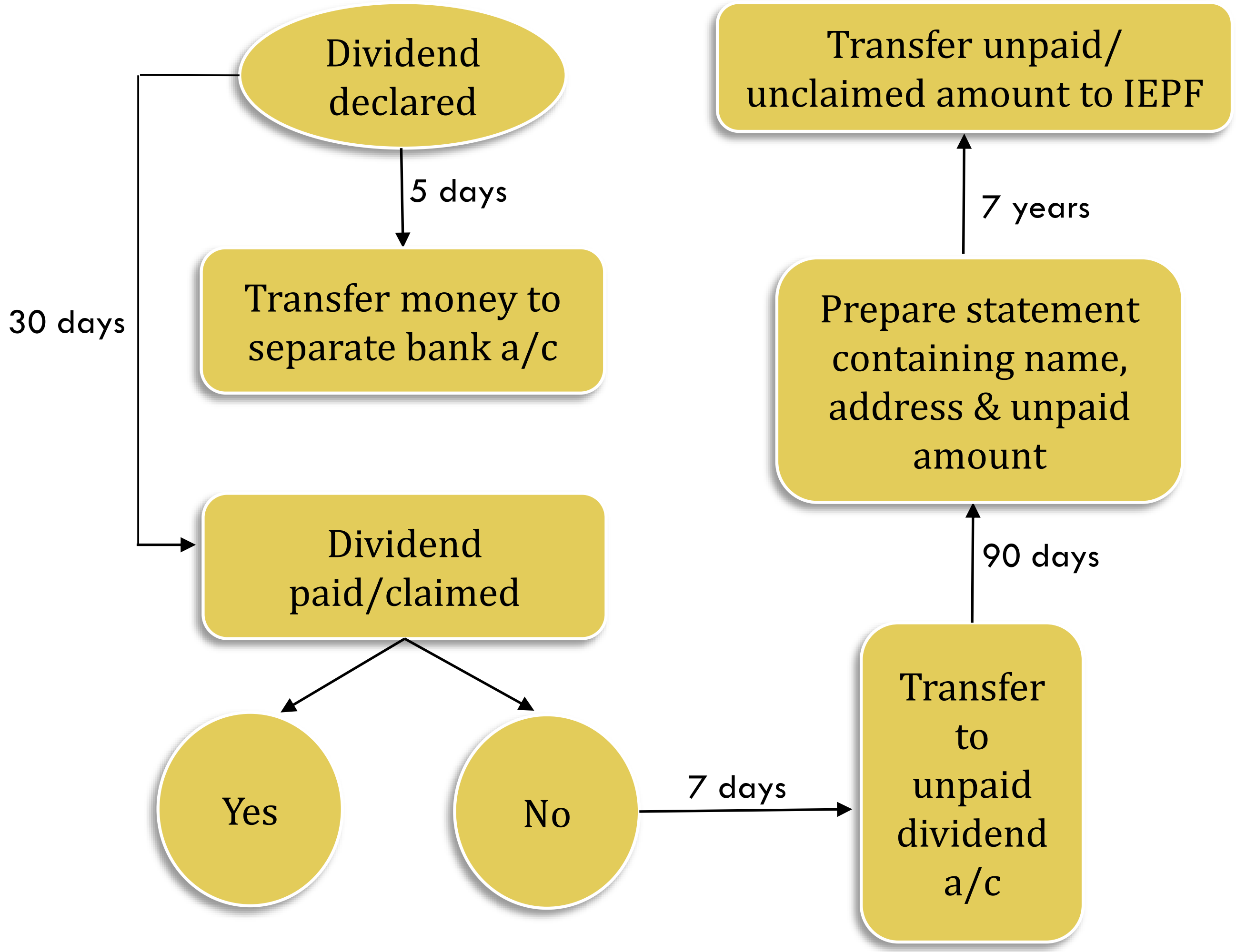
* Rule 3 provides amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared.

Sec 123 provides no company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company for the current year

CONDITIONS FOR DIVIDEND PAYMENT

- ✓ Co. is not a sec 8 company
- ✓ Dividend declared out of profits of the co. after providing depreciation as per Sch. II
- ✓ Unrealized gains, notional gains, revaluation profits/losses excluded
- ✓ In case of inadequacy of profits, dividend cannot be paid except in accordance with rules
- ✓ No dividend can be paid out of reserves except free reserve
- ✓ Dividend declared to be deposited in a separate bank a/c within 5 days of declaration
- ✓ Dividend can be paid only in cash
- ✓ Default u/s 73 & 74, if any, has been made good
- ✓ No subsisting default in redemption of debentures or payment of interest or creation of DRR
- ✓ No subsisting default in redemption of pref. shares or creation of CRR
- ✓ No subsisting default in payment of dividend declared in current or previous FYs
- ✓ No subsisting default in repayment of any term loan from Bank or FIs or interest thereon

DECLARATION & PAYMENT OF DIVIDEND



<u>NOTE:</u>

- If dividend is not paid within 30 days from the date of declaration, (except in case of the exceptions provided u/s 127)
  - Every director who is knowingly a part of default shall be punished with <u>imprisonment up to 2 years AND a min. fine of Rs. 1000/ day</u> during which such default continues
  - Co. shall pay S.I. @ 18% p.a.
- In case of default in transferring money to unpaid dividend account, interest @12% shall apply
- Claimant shall be entitled to claim transfer of shares from IEPF in accordance with Rule 7 of IEPF Rules

TAXATION ASPECTS (1/3)

DIVIDEND TAXATION

Upto 31/03/2020

- Co. liable to pay CDT u/s 115-O of IT Act, 1961. Effective rate of CDT 20.555%
- Dividend exempt in the hands of the shareholders u/s 10(34) subject to sec 115 BBDA of IT Act, 1961.
- Sec 115 BBDA: If dividend amount exceeds 10 lakh, excess portion taxable in the hands of shareholder @ 10%

Wef. 01/04/2020

- Concept of CDT omitted by Finance Act, 2020
- Dividend taxable in the hands of shareholders based on the slab limits
- Co. to deduct TDS @ 10% from dividend distributed to resident shareholders if the amount exceed Rs. 5000

TAXATION ASPECTS (2/3)

IN THE HANDS OF SHAREHOLDER (Other than co.)

Held shares as investment

- Dividend received is taxable under "Income from Other Sources" at normal tax rate
- Sec 57: No deduction of any expenses except interest expense (lower of actual expense or 20% of total dividend)

Held shares as stock-in trade

- Dividend received is taxable under "Income from Other Sources"
- For the purpose of set-off and carry forward of business losses, dividend income deemed to be "Income from PGBP" [See SC ruling in *Western States Trading Co. Pvt. Ltd. v. CIT, 1971 AIR 2274*] [Refer illustration]

Illustration:

- In P.Y. 2021-22, X Ltd. incurred a business loss of Rs. 2,00,000 and earned dividend from shares held as stock in trade Rs. 2,25,000.
- Dividend income of Rs. 2,00,000: income from PGBP
- Dividend income of Rs. 25,000: income from other sources

TAXATION ASPECTS (3/3)

INTER CORPORATE DIVIDEND

Received from domestic company

- Taxable at normal tax rate
- Deduction of interest expense allowed u/s 57
- Sec 80M: Inter-corporate dividend shall be reduced from the total dividend income if the same is further distributed 1 month prior to the due date of return filing

Received from foreign company

Indian co. holds at least 26%

- Sec 115BBD: Taxable @ 15%+ surcharge + HEC
- No deduction of any expenditure
- Deduction u/s 80M available

Indian co. holds less than 26%

- Taxable at normal tax rate
- Deduction of interest exp. allowed
- Deduction u/s 80M available

COMPARATIVE ANALYSIS OF VARIOUS MODES

Parameters	Bonus issue	Buyback	Dividend
Provisions	Sec 63 of CA, 2013 read with the Rules & SEBI (ICDR) Reg.	Sec 68, 69 & 70 of CA, 2013 read with the Rules & SEBI (Buyback) Reg.	Chap-VIII of CA, 2013 read with Rules & SS-3
Shareholders approval	Yes	Yes; if exceeds 10% of (PUEC +FR)	Only in case of final dividend
Outflow of money	No outflow	Yes	Yes
Timeline	Cos Act- no timeline	To be completed within 1 year	To be paid within 30 days of declaration
Taxation	Only at the time of disposal of shares	Only in the hands of company @ 23.296%	In the hands of the shareholder
Debt-equity	NA	Post buyback min. 2:1 is to be maintained	NA
Limits	No limit	Max. 25% of paid up capital	Only in case inadequate profits
Penal provision (Type of offence)	No specific punishment provided. Sec 450 of CA, 2013 should apply	In case of non compliance, punishable with fine (compoundable)	If not paid within 30 days of declaration: Fine & imprisonment (non-compoundable)

THANK YOU