Article

Bonus Debentures: Having the cake and giving shareholders to eat

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Introduction

The reward of being a shareholder is singular: share in profits of the company. A few widely known forms of corporate rewards include cash dividends, bonus shares, preference shares, bonds, debentures, warrants and options , of which cash dividends and bonus shares are most popular.

Just on the lines of bonus shares is another innovative instrument called as **bonus debentures**.

This write up is an attempt to understand the concept, rationale , features, benefits and implications of issue of bonus debenture.

Economic rationale

Bonus debentures are issued out of distributable profits and reserves to the shareholders for free. Like any other debenture, bonus debentures also carry a face value, an interest and a maturity period. In essence, this instrument has some features similar to bonus shares, some resembling debentures and some distinct ones of its own. But before delving into the nitty–gritties of this instrument, it would be appropriate to reflect upon the rationale behind issuing such intruments.

A company usually employs two methods to share its divsible profits with its investors: cash dividends and bonus shares. While cash dividends involve immediate payment of cash by the company, bonus shares involve issuance of additional shares to the equity investor. Cash dividends involve huge outflows from the company immediately, which could have been retained by the company for business purposes for a little more longer.

Bonus shares being the other alternative, do work well but then it leads to dilution in equity- as there is an expansion in the equity base of the company that eventually reduces the earnings per share as well as dividend payout.

Bonus debenture in this regard is thus unique in its kind as it perfectly subsumes within itself the benefits of cash distribution and capitalisation of profits (erstwhile bonus shares) thereby limiting outgo of huge cash from the company and making it a staggering outflow (atleast until redemption). This ensures availability of funds to meet business and opertaional needs of the company.

How is the issue done?

A Company may declare bonus debentures out of its free reserves i.e profits available for distribution to shareholders. Instead of paying dividends in cash, shareholders receive debentures equivalent to the amount of dividend. In layman terms, the company issues a paper acknowledging the dividend, having a face value , coupon rate and a redemption period .

For example, a shareholder owns 100 shares in company. The company declares a dividend of Rs. 5 per share. Total dividend share of the shareholder is Rs. 500. Company issues 100 bonus debentures with face value of Rs. 5 each carrying a coupon rate of 10%, redeemable at the end of 3 years.

Such bonus debentures may be secured or unsecured. Secured bonus debentures shall be secured in manner provided in rule 18 of the Companies (Shares and Debentures) Rules, 2014. Further, secured bonus debentues may be listed with stock exchanges to provide better liquidity to the shareholders.

Benefits of Bonus Debentures

This instrument caters to the needs of the investor as well as the company. From a company's perspective the instrument helps the company improve its return on equity as there is an increase in the debt capital of the company, which in turn brings the advantages of leverage. These instruments are issued from the accumulated profits and thus do not impact reported profits of a company. There is no immediate cash outflow and the company is able to utilize its excess cash over a period of time, atleast until maturity of the instruments. Further, it is one of the most efficient ways of offering "bonus" without expanding the equity capital base and without diluting the earnings per share. Bonus debentures do not dilute the share value unlike bonus shares. Further, the interest payments made to investors are tax deductible. Hence, the company can save on the tax outgo to the extent of interest payment made in a given period.

From a shareholder's perspective, bonus debentures are additional rewards that shareholders receive from company. Issue of bonus debentures entitle them to yearly interest until such debentures mature or are redeemed. In addition, it is a tax-free receipt of redemption amount. The amount of bonus debentures is not taxable in the hands of debenture holders as the dividend distribution tax is paid by the company. Listed bonus debentures further provide a shareholder with better liquidity options, as shareholders can easily sell them in the secondary market if they desire.

Provisions of law

Bonus debentures are not expressly covered under provisions of Companies Act, 1956 or Companies Act, 2013. Further, section 123 (5) of the Companies Act, 2013 provides that a dividend shall be paid to shareholders in cash or shall be utilized to issue fully paid up bonus shares or shall be used for payments of such amounts that are unpaid on the shares held by the members. Except for these, any other form of dividend paid to the shareholder is not explicitly allowed by the Act. Further, provisions relating to bonus shares under section 63 of Companies Act, 2013 are not attracted as they specifically deal with the issue of shares only.

In absence of any explicit provision of law governing issue of bonus shares, it is obvious that one would wonder as to what would be the procedure of issuing such instruments. Bonus debentures are issued pursuant to a scheme of arrangement under sections 391-394 of Companies Act, 1956, that involves approval of shareholders and the High Court and Reserve Bank of India (in case issued to non resident shareholders). It is pertinent to note here that since a scheme is prepared and approved by the members, the requirement for an express provision in the articles of association of the company is also not required.

Further, a company may additionally choose to list its bonus debentures to provide better liquidity to its shareholders. In such a scenario, compliance with provisions of debt listing agreement, 100% asset cover for the listed bonus debentures- in line with rule of 18 of Companies (Share Capital and Debentures) Rules, 2014 and provisions of debt listing agreement, appointment of debenture trustees and creation of debenture redemption reserve in line with 71(4) of Companies Act, 2013, rule 18(7)(c) of Companies (Share Capital and Debentures) Rules, 2014 and rule 7 of Companies (Share Capital and Debentures) Rules, 2014 would be required. Further, provisions of private placement under section 42 of the Companies Act, 2013 will *mutatis mutandis* apply to bonus debentures.

Scheme of arrangement:

Bonus debentures are issued as a scheme of arrangement under sections 391-394 of Companies Act, 1956, as express provisions on such instruments are absent. Any scheme under section 391-394 is essentially an arrangement either between the company and its shareholders or the company and its creditors, as the case may be. Further, a scheme of arrangement between the company and its members may be for any arrangement that the company and its memebrs amy enter into, not necessarily pertaining to reconstruction only. In this case, the scheme is drawn for distribution of dividends other than cash. The scheme would thus have to be in full compliance with provisions of sections 391-394 of the Companies Act, 1956 as corresponding provisions under Companies Act, 2013 are yet not enforced.

The provisions as they stand today require the scheme to be approved by the High Court and by majority of shareholders of the company. In case of bonus debentures, it is worthy to note here that a separate meeting of creditors may not be required at all unlike a scheme of reconstruction or merger/demerger. In a scheme of reconstruction or merger approval of creditors is required as the interests of creditors are likely to get affected by such a scheme. A scheme purely between the company and its members for distribution of dividend in no way affects the interests of the creditors as the creditors anyways have no right/share in the divisible profits of the company.

Further, Reserve Bank of India vide *Notification No.FEMA.291/2013-RB dated October 4, 2013*[1] has amended its guidelines so as to grant a general permission to Indian companies to issue debentures to non-resident shareholders, including the depositories that act as trustees for the ADR/GDR holders, by way of distribution as bonus from its general reserves under a scheme of arrangement approved by a court in India and subject to no-objection from the Income Tax authorities.

Taxation of Bonus Debentures

Section 2(22) (b) of the Income Tax Act, 1961 provides that dividend includes a distribution by a company to its shareholders of debentures by way of bonus to the extent of accumulated profits of the company. Thus it is evidently clear that the allotment of bonus debentures is treated as dividend and company shall pay dividend distribution tax

[1]*http://www.updateindia.in/full1.php?M=278*

(DDT) on the amount of bonus debentures issued. Since such dividend is exempt in the hands of the shareholder, there would be no tax payable by the shareholder. In subsequent years, when the debentures are either sold or redeemed, only the difference between the sale price or redemption amount would be subjected to capital gains tax.

Further, the yearly interests paid by the company to its shareholders until redemption qualify as admissible deduction under the provisions of Income Tax Act, 1961.

Precedents in India:

The concept of bonus debentures is still nascent and is yet to gain grounds among Indian companies. In India, the bonus debentures were first issued by Hindustan Unilever Ltd in 2001. Post that Britannia Industries Limited came with its issue of bonus debentures in 2009, followed by Dr. Reddy's Laboratories Ltd in 2010. Coromandel International Ltd. made its first attempt of bonus debentures in the year of its golden jubliee in 2011. In recent times, Blue Dart Express Ltd and National Thermal Power corporation (NTPC) have rewarded their shareholders with fully paid up bonus debentures.

Even though bonus debentures may seem to be truly rewarding for both the shareholders as well as the company, the presence of the instruments in market is less. This may primarily be due to the fact that legal procedures involved for approval of the scheme from various authorities is lengthy and time consuming. A little simplification of the lengthy procedures may provide the necessary impetus to companies to come out with bonus debentures, as successful implemenation of the scehme has been very positive for the companies opting for it.