

Detailed analysis on Issuing Bonus Debentures

A new realm of reality

By Shreya Jain
(shreyajain@sjaykishan.com)

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Introduction

Issue of Bonus Debentures, though not a recent phenomenon yet a unique concept does seem to see its glory days ahead. This method is seldomly used by companies, only a handful of companies have has dealt with the idea of issuance of bonus debentures to the equity shareholders was coined by Hindustan Unilever Limited back in 2001.

The company instead of issuing bonus shares to its members, offers debentures, therefore, retaining the characteristics of debentures in its core. While the CA, 2013 covers bonus issue of **shares** in its ambit (Section 63), issuance of bonus debentures has not been exclusively dealt with in the CA, 2013.

Therefore, to issue such bonus debentures, a company shall have to approach the tribunals/high court with a scheme of arrangement under section 230-232 (391) of the CA, 2013 (1956) for the approval of such issue.

A Brief analysis of this concept is covered under this write up as below -

Background

As per Section 2(30) of the Companies Act, 2013 ("CA 2013") the term debenture encompasses –

“(30) “debenture” includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not;

Provided that—

- a. the instruments referred to in Chapter III-D of the Reserve Bank of India Act, 1934; and*
- b. such other instrument, as may be prescribed by the Central Government in consultation with the Reserve Bank of India, issued by a company, shall not be treated as debenture;”*

The process of issuing such debentures is covered under Section 71 of CA 2013 and in case of listed companies, such issuance shall also be regulated under SEBI (Issue and Listing of Debt Securities) Regulations, 2008 (“ILDS Regulations”) which have been dealt with in this write up.

Modes of issue of debentures

Regulation 2(e) of SEBI ILDS Regulations defines debt securities as **non-convertible debt securities** which create or acknowledge indebtedness and includes debentures, bonds and such other securities of a body corporate or a Trust registered with the Board as a Real Estate Investment Trust or an Infrastructure Investment Trust, or any statutory body constituted by virtue of a legislation, whether constituting a charge on the assets of the body corporate or not, but excludes bonds issued by Government or such other bodies as may be specified by the Board, security receipts and securitized debt instruments

Non-convertible debentures (“NCDs”) are financial instruments that are used to raise long term capital of a company. NCDs as the name suggests, cannot be converted into equity at any point in time. NCDs are further classified into two types of securities, i.e., secured and unsecured. Notably, a company cannot issue unsecured NCDs unless the same are listed on any stock exchange platform as per Rule 2(1)(c)(ixa) Companies (Acceptance of Deposits) Rules, 2014.

Factors that induce a company to issue such debentures

- Issuance of bonus debentures leads to gradual conversion of accumulated reserves of the company into its debt, which further leads to an increment in the debt quotient. The contrary holds to be true in case of issuance of bonus shares since it does not alter the net worth of company.
- Payment of interest on the debentures to be issued can be seen as replacement for the dividend that the company would have given
- A material difference in the above is that the dividend is paid out of the tax paid profits while it’s the contrary in case of payment of interest on debentures which are tax deductible.
- The company can further claim the interest paid on the debentures as an expense for tax purposes, which in turn shall reduce the tax incidence of the company.
- While dividends are paid out of the profits of a company, interest on money lent (i.e., debentures) must be paid even when the company does not make any profit from the money borrowed. *A.H. Wadia v. Commissioner of Income-Tax*¹.
- Issuing of bonus debentures drastically alters the debt-equity ratio, which enhances due to issuance of debentures, resulting in an increase in the leverage ratio of the company (debt-equity ratio). While in case of issuance of equity shares, the opposite is held to be true, i.e., the equity of the company increases thereby reducing the leverage ratio of the company.

¹ <https://indiankanoon.org/doc/768449/>

Procedure for issuing of Debentures

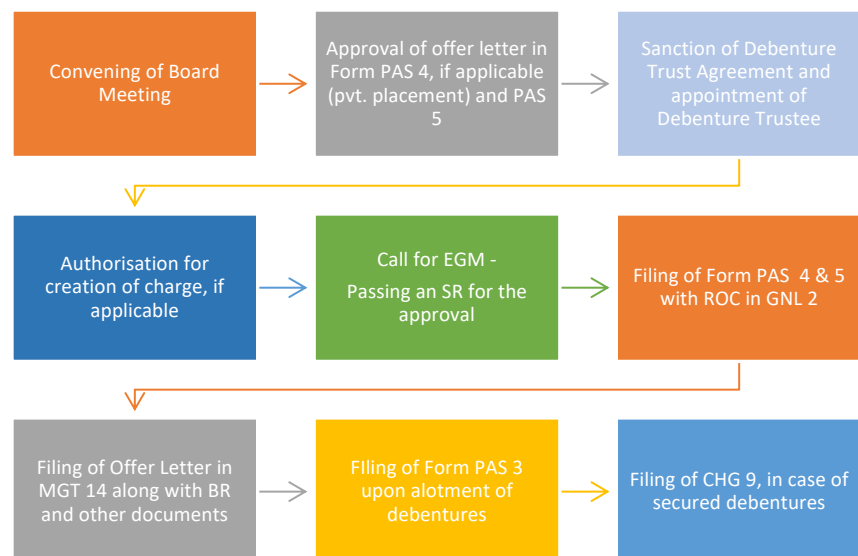
For issuing debentures, a company shall have to comply with multifarious rules and regulations laid across several platforms. The key provisions have been detailed in the forthcoming.

Before delving into Section specific applicability, the company on a preliminary basis shall have to ensure the following –

- a. The company shall not issue any debentures carrying any voting rights.
- b. The company shall further have to create a debenture redemption reserve account out of its profits which are otherwise available for distribution as dividends and that such amount credited to the reserve shall be solely used for the purpose of redemption of debentures.
- c. The company shall under no circumstances issue the prospectus of such debentures to members exceeding five hundred, unless a debenture trustee has been appointed to this accord.

The general procedure of issuing debentures under the Companies Act, 2013 comprises the following:

The mentioned procedure is applicable only in case where the company is issuing such debentures on a private placement basis, which implies that Section 42 along with Section 71 of the CA, 2013 shall be applicable in such situations. However, when the company is already listed on a stock



exchange or that such company is proposing to issue the debentures to public at large, a different set of provisions shall also be applicable to such company in addition to that of the CA, 2013. In furtherance, when such company proposes to issue the said set of debentures inter-alia foreign investors as well, the company shall further have to comply with the guidelines of RBI in this regard. Therefore, the company in such cases shall have to comply with the following –

1. Companies Act, 2013.
2. SEBI ILDS, LODR Regulations.
3. Guidelines for issuance of Non-Convertible Debentures (NCDs) by the RBI.

Applicable provisions for issuance of bonus NCDs to its shareholders

Companies Act, 2013

Section 39 and Companies (Prospectus & Allotment of Securities) Rule, 2014

Whenever a company having a share capital makes any allotment of **securities**, it shall file with the Registrar a return of allotment in such manner as may be prescribed.

Rule 12: (1) Whenever a company having a share capital makes any allotment of its securities, the company shall, within thirty days thereafter, file with the Registrar a return of allotment in Form PAS-3, along with the fee as specified in the Companies (**Registration Offices and Fees**) Rules, 2014

Form PAS 3: The company upon completion of allotment of the debenture shall have to file Form PAS 3 within 30 days of allotment of the said securities.

Applicability of Section 71 and Companies (Share Capital and Debentures) Rules, 2014:

The tenet of Section 71 of CA 2013 essentially involves issuance of **secured debentures**, hence, there are several provisions which shall remain inapplicable to the company as regards to issuance of **unsecured non-convertible debentures**.

For the sake of brevity, Sections which are applicable in such case has been pointed out (reason for non-applicability of sections wherever necessary has been covered).

As per Section 71(4) of CA, 2013 read along with Rule 18(7) of SHA Rules, the company shall have to create a debenture redemption reserve account out of profits of the company which is otherwise available for distribution of dividend. The company shall further have to ensure that such reserve created shall only be utilised for the purpose of redemption of debentures.

Further, as per Section 71(5) and Rule 18(2) of the CA 2013 and SHA Rules respectively, the company shall further have to ensure that the appointment of Debenture Trustee is in place in case such allotment of debentures to the members exceeds five hundred in number.

Section 71(13) of CA 2013 read along with 18(5) of the SHA Rules further demands the company to duly file the Debenture Trust Deed as may be executed in in Form SH-12.

Creation of a debenture redemption reserve as laid down in the foregoing paragraphs.

Provisions not applicable

Provisions of below-mentioned Sections shall not apply in case of issuance of bonus unsecured non-convertible debentures-

Applicability of Section 42, Section 62 and Section 63 of CA, 2013:

Section 42 of the Act deals with **private placement** of securities.

In the instant case, Section 42 of CA 2013 shall remain inapplicable because the said securities are allotted to the members of the company and not to a specific set of people.

In addition to the above, Section 62 and Section 63 specifically deals in issuance of shares of a company, therefore, when it comes to issuance of debentures, these provisions shall also remain inapplicable.

Section 73 of CA, 2013

The concept of issuing bonus debentures or securities is to distribute the accumulated profits of the company. The company in return is not receiving any consideration in this regard. Hence, the applicability of deposits shall not arise.

Further, as per 2(1)(c)(ixa) Companies (Acceptance of Deposits) Rules, 2014 – **Deposit excludes any amount raised by issue of non-convertible debenture not constituting a charge on the assets of the company and listed on a recognized stock exchange.**

Provisions of SEBI

SEBI (Issue and Listing of Debt Securities) Regulations, 2008

As per Regulation 3 the provisions of the Regulations are applicable to the following –

- a. Public issue of debt securities and
- b. listing of debt securities issued through public issue or on private placement basis on a recognized stock exchange.

Given that bonus issue of non-convertible debentures has not been dealt with in the Regulations, a company should therefore, rationally apply the applicability of these Regulations.

The first and foremost action that a company should take in order to list its securities is to duly file an application before the recognized stock exchange and obtain an in-principal approval from the said stock-exchange (Regulation 4 and 19).

The company shall further have to comply with the provisions of the CA 2013 and simultaneously ensure that a proper credit rating for the issuance of the said debentures are in order and that the same has been disclosed wherever necessary.

Regulation 5-14 shall not be applicable to a company which is issuing bonus non-convertible debentures since the same deals with issuances of prospectus and the likes of it which is inapplicable in case of bonus issue of debentures.

NCDs are a special kind of issuance under Section 230-232 of the CA 2013, wherein the issue is proposed by a way of scheme of arrangement duly approved by the Adjudicating Authority, therefore, the company need not issue any prospectus and its ancillary activities in this regard.

Regulation 16 encompasses the creation of debenture redemption reserve which is in lines with the provisions of CA 2013 and the company shall have to comply with the same.

Regulation 17 entails creation of a security which is inapplicable in case of an unsecured debenture.

SEBI (Listing Obligations and Disclosures Requirements) Regulations, 2008

Chapter V of the above-mentioned Regulations shall be applicable to a company in case of issuance of non-convertible debentures.

As per Regulation 50(2) The listed entity shall intimate the stock exchange(s), **its intention to raise funds through new non-convertible debt securities** or non-convertible redeemable preference shares it proposes to list either through a public issue or on private placement basis, prior to issuance of such securities:

Provided that the above intimation may be given prior to the meeting of board of directors wherein the proposal to raise funds through new non-convertible debt securities shall be considered.

As per Regulation 50(3), the entity should intimate the stock exchange about the meeting of Board of Directors at least two working days in advance.

A tabulated list of applicable Regulations has been referred below:

Regulation	Relevant Provisions
Regulation 50(2)	Intimation to stock exchange regarding intention of raising funds through NCDS
Regulation 50(3)	Intimation to stock exchange about the meeting of Board of Directors at least two working days in advance
Regulation 51	Disclosure of information having bearing on performance/operation of listed entity and/or price sensitive information
Regulation 52(3)	Submission of annual audit report and "Statement on Impact of Audit Qualifications (applicable only for audit report with modified opinion)"
Regulation 52(4)	Disclosure of line items along with financial results
Regulation 52(5)	Submission of certificate signed by debenture trustee that it has taken note of the contents
Regulation 52(6)	Financial Results-additional disclosure as a notes to financials
Regulation 53	Annual Report
Regulation 55	Credit rating
Regulation 56	Documents and Intimation to Debenture Trustees
Regulation 57	Other submissions to stock exchange
Regulation 58	Documents and information to holders of NCDS
Regulation 59	Structure of NCDs
Regulation 60	Record Date
Regulation 61	Terms of non-convertible debt securities

Provisions FEMA

FEM (Debt Instruments) Regulations, 2019

As per Regulations 6 of the above-mentioned Regulations,

Merger or demerger or amalgamation of Indian companies

*Where a Scheme of Arrangement for an Indian company has been approved by National Company Law Tribunal (NCLT)/ Competent Authority, the Indian company may issue non-convertible redeemable preference shares or **nonconvertible redeemable debentures out of its general reserves by way of distribution as bonus to the shareholders resident outside India**, subject to the following conditions, namely:*

- a. the original investment made in the Indian company by a person resident outside India is in accordance with these Regulations and the conditions specified in the relevant Schedule;*
- b. the said issue is in accordance with the provisions of the Companies Act, 2013 and the terms and conditions, if any, stipulated in the scheme approved by National Company Law Tribunal (NCLT)/ Competent Authority have been complied with;*
- c. the Indian company shall not engage in any activity/ sector in which investment by a person resident outside India is prohibited.*

Further, Schedule I of the said Regulation also allows the Non-resident Indians or Overseas Citizens of India to purchase listed non-convertible debentures issued in terms of Regulation 6 on a repatriation or non-repatriation basis².

Therefore, complying with the abovementioned provisions is simpler, the company shall have to ensure that the compliances with respect to the applicable provisions are in place and that the Adjudicating Authority has given its stamp of approval to the said scheme so proposed by the company.

Taxation at the time of Issue of NCDs

Given that the allotment of debentures is done from the additional balances in the reserves and surplus of the company, one may draw reference to section 2 (22) (b) of the Income Tax Act, 1961 ("ITA"), per which such distribution of debentures by a company, to its shareholders, whether with or without interest, out of its accumulated profits, **are deemed dividends** and therefore shall be taxed accordingly.

Until Assessment Year 2020-21, companies were required to pay a dividend distribution tax under Section 115-O of the ITA. However, w.e.f. Assessment Year 2021-22, domestic companies are no longer required to pay dividend distribution tax on any amount declared, distributed or paid by such company by way of dividend. Such dividend received from the company shall be taxable in the hands of the shareholder. Section 10(34) which provides for exemption in respect of dividend received by shareholder has been amended to provide that no exemption shall be available in respect of dividend received on or after April 1, 2020.

In case of issue of such debentures to the non-residents - Under Section 195 of the ITA, any person paying a sum to a non-resident that is chargeable to tax under the ITA (read with the applicable DTAA)

² <https://egazette.nic.in/WriteReadData/2019/213316.pdf>

would be required to withhold taxes on such sum at the appropriate rate. **Such withholding is required to be made either at the time of payment or at the time of credit of income to the account of the non-resident, whichever is earlier.** As provided, distribution of such NCDs shall be deemed as dividend, therefore, applicable withholding tax shall be applicable to such non-residents. While the regular rate of tax is 20% for non-resident shareholders, lower rate may be applicable based on the applicable DTAA.

Taxation at the time of Redemption of NCDs

Redemption of debentures may be done by an actual repayment to the debenture-holders, or by conversion of debentures into shares. In the latter option, only available in case of convertible debentures, the issuing company simply issues its shares of equivalent amount to the debenture-holders in exchange for the debentures.

In subsequent years, from the tax point-of-view when the debentures are either sold or redeemed, the sale price or the redemption amount received by the debenture holder will not be taxable to the extent of the capital value of the debentures already taxed as dividend in the year of the issue of the bonus debentures. Only the additional appreciation will be taxed as capital gains.

Taxation w.r.t. interest on NCDs

In case of payment of interest, the amount received by the members of the Company shall be included in its regular income itself and shall be taxed under the head "Income from other Sources" and is taxed at the slab rates (if, individual shareholders) or as per tax rates of the company (if, shareholder is a domestic Company). The interest income can be offered for tax either on receipt basis or on accrual basis.

For the issuer company, such payment of interest shall qualify for deduction under Section 37 of the ITA.

In case of non-residents

Section 194LC was introduced in the Finance Act, 2012³. Initially, the scope of the section was to provide for a lower rate of withholding tax on interest in case of amounts borrowed in foreign currency from a source outside India in the form of loan or long term infrastructure bonds.

Subsequently, the Finance Act, 2013⁴ brought in two significant changes with respect to withholding taxes on interest on investments made by non-residents:-

- (a) *First*, the inclusion of investments made by non-residents in rupee-denominated long term infrastructure bonds within the scope of section 194LC; and
- (b) Insertion of section 194LD- Section 194LD extended the lower withholding taxes on interest paid on investments in rupee denominated bonds issued by Indian companies and government securities.

³ http://egazette.nic.in/WriteReadData/2012/E_25_2012_152.pdf

⁴ http://egazette.nic.in/WriteReadData/2013/E_21_2013_216.pdf

Subsequently, on 29th October, 2015, the Central Board of Direct Taxes [‘CBDT’] issued a Press Release⁵, by which relaxation with respect to the rate of withholding taxes was extended to amounts borrowed in the form of rupee denominated bonds. The said Press Release was issued with an objective to align the Income Tax Provisions with the RBI’s guidelines⁶ on issue of rupee denominated bonds outside India dated 29th September, 2015.

Finally, the section was amended vide the Finance Act, 2017⁷, whereby interest paid on amount borrowed from a source outside India in the form of rupee denominated bonds was inserted. The amendments were made effective retrospectively with effect from 1st April, 2016, hence, covering FY 2015- 16 as well. The Objects and Reasons⁸ of this amendment stated

“Further, consequent upon demand from various stakeholders for granting benefit of lower rate of TDS to rupee denominated bonds, a Press Release dated 29th October, 2015 was issued clarifying that TDS at the rate of 5 per cent would be applicable to these bonds in the same way as it is applicable for off-shore dollar denominated bonds. In order to give effect to the above, it is further proposed to extend the benefit of section 194LC to rupee denominated bond issued outside India before the 1st July, 2020.”

Section 194LD of the Income Tax Act, 1961, provides that *“Any person who is responsible for paying to a person being a Foreign Institutional Investor or a Qualified Foreign Investor, any income by way of interest referred to in sub-section (2), shall, at the time of credit of such income to the account of the payee or at the time of payment of such income in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rate of five per cent.”*

Section 194LD was introduced with effect from 1st June, 2013, in such cases wherein the deductee is a foreign institution investor or a qualified foreign investor⁹. While the rate of TDS is fixed at 5%, if the recipient does not have PAN, tax is deductible at the rate of 20%, and shall be paid at the time of payment, or giving credit to the recipient, whichever is earlier.

Thus, section 194LC referred to rupee denominated bonds issued outside India, and section 194LD refers to rupee denominated bonds, presumably issued in India, but held by specified classes of investors, viz., Foreign Institutional Investors and Qualified Foreign Investors as an investment, whether pursuant to primary market or secondary market acquisition.

Nature of expense incurred while issuance of debentures

Capital Expenditure or Revenue Expenditure

For Income Tax purposes, expenses incurred by an assessee may be categorised as Capital Expenditure or Revenue Expenditure. While the ITA does not define the two terms exclusively, in common

⁵ <https://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/404/Press-Release-Off-shore-Rupee-Denominated-Bonds-29-10-2015.pdf>

⁶ <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10049&Mode=0>

⁷ <http://egazette.nic.in/WriteReadData/2017/175141.pdf>

⁸ <https://www.indiabudget.gov.in/budget2017-2018/ub2017-18/memo/memo.pdf>

⁹ “Qualified Foreign Investor” shall the meaning assigned to it in Circular No. Cir/ IMD/ DF/ 14/ 2011 dated 9th August, 2011, as amended from time to time, issued by SEBI

parlance, capital expenditure refers to deployment of funds towards enhancing the revenue generating capacity of an entity, for instance- acquiring and/ or upgrading assets; whereas, Revenue Expenditure are expenses which are incurred on a regular basis, to actually generate income.

The distinction between the two is crucial from a taxation point of view because capital expenditure, even if incurred for the purpose of earning income, is **not** deductible unless expressly provided for. In fact, as may be seen above, section 37 (1) explicitly disallows capital expenditure while computing income. On the contrary, Revenue Expenditure is deductible while computing taxable income, unless expressly disallowed. As such, to determine whether the issue related expenses would be admissible, the first step would be to check whether it is a capital expenditure or revenue expenditure.

As opposed to the cost incurred for issuance of equity capital, the expense incurred on the issuance of debentures is a revenue expense¹⁰, and hence an admissible deduction¹¹ under section 37 (1). Now, in absence of any straight-jacket definition of “revenue expenditure”, the rationale for categorising debenture-issue related expenses as such can be drawn from the order of the Hon’ble Supreme Court of India in the matter of *India Cements Ltd. v. CIT*¹², wherein it was held that expenditure incurred on raising a loan after setting up a business is a revenue expenditure. In determining the nature of expenditure (revenue or capital) incurred in obtaining a loan, it is irrelevant to consider the purpose of the loan.

Hence, relying on the above principle and given that debentures, by their very nature, are nothing but a specie of “loan”, expenses incurred in its issue shall therefore be classified as revenue expenses, and hence be admissible. Furthermore, the said expenses shall be entirely availed by the issuer company in the year of issue¹³; and as such, debentures may also be considered as a tool for reducing the overall tax incidence of the issuing company.

Further, as per Section 37 of the ITA provides that any expenditure (not being capital or personal in nature), incurred wholly and exclusively for the purposes of the business, would qualify as an allowable expenditure to be considered while computing taxable business or professional income therefore reducing the tax incidence of the company. The Hon’ble Supreme Court in *Eastern Investments Ltd. v. CIT [1951] 20 ITR 1 (SC)*¹⁴ held that interest paid on the purchase of debentures will be allowed under Section 37(1) and not under Section 36(1)(iii) of the Income Tax Act.

Thus, from a broader perspective, it may be said that the expense incurred for issuance of debentures is an allowable expense under section 37 (1) of the ITA.

Applicability of TDS

TDS received from listed NCDs shall not be subject to TDS as per Section 193(ix) of the ITA.

¹⁰ *Asst. CIT v. VXL India Limited [2015] 54 103/ 229 Taxman 199 (Guj.)*, ITA No. 531/Bang/2017 *Shanders Properties Pvt. Ltd. Vs The Income Tax Officer (ITAT Bangalore)*

¹¹ *Premier Automobiles Ltd. v. CIT [1971] 80 ITR 415 (Bom)*;

¹² [1996] 60 ITR 52 (SC)

¹³ Held by Hon’ble ITAT, Ahmedabad in *Gruh Finance Ltd. vs. JCIT, Range-4* in No.2903/Ahd/2015

¹⁴ <https://indiankanoon.org/doc/1627616/>

Glossary

CA 2013	<i>Companies Act, 2013</i>
FEMA	<i>Foreign Exchange Management Act</i>
ILDS	<i>Issue and Listing of Debt Securities</i>
ITA	<i>Income Tax Act, 1961</i>
LODR	<i>Listing Obligations and Disclosure Requirements</i>
NCD	<i>Non-convertible debenture</i>
SEBI	<i>Securities and Exchange Board of India</i>
SHA Rules	<i>Share and Debentures Rule</i>