Bonus Shares

**Definition**

Bonus shares are additional shares given to the current shareholders without any additional cost, based upon the number of shares that a shareholder owns. These are company's accumulated earnings which are not given out in the form of dividends, but are converted into free shares.

**Record Date**

Bonus shares are usually announced by the company with a record date, the date which is considered for the bonus shares. All the investors holding the shares on the record date are eligible for bonus shares. After the announcement of the bonus but before the record date, the shares are referred to as cum-bonus. After the record date, when the bonus has been given effect, the shares become ex-bonus.

**Example of issue of bonus shares**

When a company offers 1:5 bonus shares, it means a shareholder will get 1 free share for 5 shares. So if an investor holds 100 shares at the time of bonus then they will become 120 shares.

**Why do companies declare bonus?**

Companies issue bonus shares to encourage retail participation and increase their equity base. When price per share of a company is high, it becomes difficult for new investors to buy shares of that particular company. Increase in the number of shares reduces the price per share. But the overall capital remains the same even if bonus shares are declared. Company usually gives bonus shares as a substitute of dividend payouts.

**What are the effects of a bonus issue?**

Bonus shares do not directly affect a company's performance. Bonus issue has following major effects:

- Share capital gets increased according to the bonus issue ratio.
- Liquidity in the stock increases.
- Effective Earnings per share, Book Value and other per share values stand reduced.
- Markets take the action usually as a favorable act.
- Accumulated profits get reduced.
- A bonus issue is taken as a sign of the good health of the company.
**Will the share price change after bonus issue?**

A bonus issue adds to the total number of shares in the market leading to dilution in equity. The earnings of the company will have to be divided by that many more shares. \(\text{Earnings Per Share} = \frac{\text{Net Profit}}{\text{Number of Shares}}\) Since the profits remain the same but the number of shares has increased, the EPS will decline. Theoretically, when EPS declines, the stock price should also decrease proportionately. But, in reality, it may not happen due to the following reasons:

- The stock is now more liquid. Now that there are so many more shares, it is easier to buy and sell.
- A bonus issue is a signal that the company is in a position to service its larger equity. What it means is that the management would not have given these shares if it was not confident of being able to increase its profits and distribute dividends on all these shares in the future.

**What is Bonus Stripping in Shares?**

Bonus stripping in shares is an option where an investor buys shares of a company which announced bonus shares and sells them off after bonus date and book notional loss. The notional loss can be legally adjusted against any other capital gains for the year thereby resulting in a tax saving for the investor.

**Advantages of bonus stripping in shares:**

- Notional loss can be adjusted against the short term capital gain or long term capital gain from stocks, equity funds, debt funds, fixed deposit interest income, gold and property
- Unadjusted loss can be carried forward to 8 financial years.
- Good strategy for high tax bracket investors.

**Limitations of bonus stripping in shares:**

- Bonus shares have to be held for at least 1 year to avoid tax impact since acquisition price of bonus shares is zero. If sold within 1 year then short term capital gain tax would apply.
- Strategy does not apply if original shares bought ex-bonus are held for more than 1 year.
- Strategy is not ideal during bear markets or when markets are expected to see correction.

**Example of bonus stripping scenario:**

Say Infosys share is trading at 4,000 and investor has bought 100 shares. Bonus is announced in (1:1) ratio and price has fallen to 2,000 on bonus date.
Investor sells original shares within 1 year @ 2,100 and bonus shares sold after 1 year from date of bonus issue.

Short term capital loss arising on sale of original shares: \((2,100-4,000) \times 100 = 1,90,000\)

Profit on Bonus shares sold after 1 year: \((2,100-0) \times 100 =1,90,000\). There is no capital gain tax liability as shares are sold after one year. Short term capital loss of 1, 90,000 can be carried forward to next 8 years or adjust against gains.

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