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# EY Tax Alert

Mumbai ITAT rules that bonus shares allotted on original shares constituting foreign exchange asset are also foreign exchange asset



## Executive summary

This Tax Alert summarizes a recent decision of the Mumbai Income Tax Appellate Tribunal (ITAT) [ITA No. 2989/Mum/2008] in the case of Sanjay Gala (Taxpayer) on the issue of whether bonus shares, allotted on the basis of original shares which are acquired, purchased or subscribed to in foreign exchange (foreign exchange asset), can also be regarded as foreign exchange asset. The issue has relevance for exemption under special provisions of the Indian Tax Laws (ITL) for non-resident Indians (NRIs) wherein long-term capital gains (LTCG) is earned by NRIs on transfer of foreign exchange asset if the sale consideration from such asset is reinvested in other specified assets (like shares, debentures or deposits of Indian companies, Central Government securities, etc.). The ITAT held that bonus shares on eligible asset can also be regarded as foreign exchange asset since its cost is embedded in the cost of the original shares which constituted foreign exchange asset and, hence, the Taxpayer is eligible for exemption in the same manner in which exemption can be claimed on sale of the original shares.

## Background and facts

- ▶ The ITL provides that the capital gains in case of a non-resident taxpayer who has purchased shares or debentures of an Indian company in foreign currency will be computed by converting the sale consideration, cost of acquisition and cost of improvement into the same foreign currency as was originally utilized for purchase of the shares

or debentures. This protects the non-resident taxpayer from the adverse movement of exchange rates.

- ▶ In case of a taxpayer being an NRI i.e., an individual being a citizen of India or a person of Indian origin<sup>[1]</sup> who is also a non-resident for Indian tax purposes, the ITL contains special provisions for taxation of income derived from foreign exchange assets of specified nature (like shares, debentures or deposits of Indian companies, Central Government securities, etc.). Under the special provisions, the investment income (i.e., interest or dividends) is charged at the concessional rate of 20% (plus applicable cess)<sup>[2]</sup> and the LTCG are charged at the concessional rate of 10% (plus applicable cess)<sup>[3]</sup>. Furthermore, the LTCG are fully exempted if the sale consideration is reinvested in another specified asset within a period of six months from the date of transfer.
- ▶ Furthermore, by virtue of an amendment made by the Finance Act, 1995, effective from 1 April 1996, the ITL provides that the cost of acquisition of bonus shares is 'nil'. Thus, the capital gains are computed with reference to the sale consideration of the bonus shares, without any cost deduction.

<sup>[1]</sup> A person is deemed to be of Indian origin if he or either of his parents or any of his grandparents was born in undivided India.

<sup>[2]</sup> As against the normal maximum marginal rate of 30% (plus applicable cess)

<sup>[3]</sup> As against the normal rate of 20% (plus applicable cess)

- ▶ The Taxpayer, an NRI, held certain shares which constituted foreign exchange asset, on which bonus shares were allotted.
- ▶ The Taxpayer sold the bonus shares and reinvested the sale consideration in another specified asset and claimed exemption under the special provisions.
- ▶ The Tax Authority denied the exemption on the ground that the bonus shares cannot be regarded as foreign exchange asset since they are not acquired, purchased or subscribed to in foreign currency. The first appellate authority upheld the action of the Tax Authority.
- ▶ Aggrieved by the order of the first appellate authority, the Taxpayer preferred an appeal before the ITAT.

## Taxpayer's contentions

- ▶ The bonus shares were allotted on the basis of the original shares which constituted foreign exchange asset.
- ▶ The cost of the bonus shares is, therefore, embedded in the cost of the original shares though it is fictionally considered as 'nil' for the purposes of the ITL.

- ▶ Reliance was placed on the decisions of the Supreme Court<sup>[4]</sup> and the High Courts<sup>[5]</sup> (rendered prior to the amendment in the ITL providing for 'nil' cost for bonus shares) which held that the cost of bonus shares needs to be determined by spreading the cost of the original shares. Support was also drawn from the Explanatory Memorandum explaining the amendments by Finance Bill, 1995, which stated that the provision for 'nil' cost of bonus shares is for the sake of simplicity.

## Tax Authority's contentions

- ▶ The definition of 'foreign exchange asset' in the ITL makes it clear that it is an asset which is 'acquired or purchased with, or subscribed to in' foreign exchange. Bonus shares are merely allotted on the basis of holding of the original shares. Hence, they cannot be regarded as foreign exchange asset since they are not acquired, purchased or subscribed to in foreign exchange.
- ▶ The exemption under the special provisions of the ITL is available only for LTCG arising on transfer of foreign exchange asset. It cannot be extended to LTCG arising on bonus shares allotted on the basis of holding of foreign exchange asset.

[4] CIT v Dalmia Investment Co. [52 ITR 567]

[5] D.M. Dahanukar v CIT [88 ITR 454(Bom)] and Escorts Farms (Ramgarh) Ltd. v CIT [143 ITR 749(Del)]

## ITAT's ruling

Upholding the contentions of the Taxpayer, the ITAT held that the bonus shares were eligible for exemption under the special provisions on account of the following reasons:

- ▶ There is no dispute on the aspect that the original shares, on the basis of which bonus shares were allotted, constituted foreign exchange asset, since the Taxpayer subscribed to the original shares in foreign exchange.
- ▶ Prior to the specific amendment providing for 'nil' cost of bonus shares, it was well settled that the cost of bonus shares needs to be determined by spreading out the cost of the original shares over the original and bonus shares. This was on the principle that the value of the original shares gets diminished on the issuance of bonus shares and the value of the original shares is split between the two. Bonus shares have a close linkage with the original shares. The cost is also required to be spread over the original shares and bonus shares.
- ▶ Since the bonus shares were allotted on the basis of holding of the original shares, it cannot be said that they were acquired in isolation.

## Comments

This ruling provides useful guidance that, where the original shares constitute foreign exchange asset by virtue of being acquired, purchased or subscribed to in foreign exchange, bonus shares which are allotted on

the basis of such original shares also meet the test and, hence, constitute foreign exchange asset. Consequently, the LTCG arising on such bonus shares are eligible for exemption under the special provisions of the ITL.

The ITL provides for general exemption of LTCG arising on transfer of listed equity shares where the sale is entered into through recognized stock exchanges and is subjected to Securities Transaction Tax. This ruling would be helpful to NRIs who can explore availing exemption under the special provisions if they are not eligible for exemption on the LTCG under the general provisions. Also, one may need to evaluate the impact that this decision can have on interpretation of capital gains computation under provisions which requires capital gains to be computed by adoption of parameters of sales etc., into foreign currency.

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