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EY Tax Alert

Mumbai Tribunal holds no depreciation allowable on BSE membership card post corporatization of BSE



Executive summary

This Tax Alert summarizes a recent ruling of the Mumbai Income Tax Appellate Tribunal (Tribunal) in the case of Sino Securities Pvt. Ltd. (Taxpayer) v. ITO [ITA No. 6264/Mum/2009] which has held that post demutualization and corporatization (collectively 'corporatization') of Bombay Stock Exchange (BSE) in the tax year 2005-06, no depreciation is allowable on the BSE membership card held by the Taxpayer prior to the corporatization. It further held that the ratio of Supreme Court's ruling in the case of Techno Shares & Stocks Ltd. v. CIT [327 ITR 323] (Techno Shares ruling) allowing depreciation on the BSE membership card is valid only for the period prior to the corporatization of BSE.

Background

- ▶ BSE is a recognized stock exchange in India. Prior to tax year 2005-06, it functioned as an Association of Persons comprising of its members which held membership cards. The membership card conferred rights to its members to participate in the assets of BSE (ownership right) as also right to trade on the stock exchange (trading right)..
- ▶ The Techno Shares ruling confirmed that the BSE membership card is an 'intangible asset' falling within the scope of its definition provided in the Income Tax Act (ITA), being in the nature of business and commercial rights, and, hence, qualifies for depreciation.

- ▶ In the tax year 2005-06, pursuant to a scheme of corporatization approved by securities trading regulator, BSE was succeeded by a company viz., Bombay Stock Exchange Ltd. (BSEL) formed under the Indian Company Law. One of the objects of the corporatization scheme was to segregate the ownership and trading rights held by the members. In terms of the scheme, the members of BSE were given, *in lieu* of membership cards held by them, (a) shares in the new company, BSEL and (b) trading rights.
- ▶ The shares conferred ownership rights in BSEL and were freely transferable. The trading rights conferred right to trade on the stock exchange. It was not necessary for a shareholder to hold trading rights. Similarly, it was not necessary for trading right holder to hold shares in BSEL.
- ▶ A new person interested in acquiring trading rights in BSEL was required to pay a refundable security deposit. The trading rights could be surrendered back to BSEL in return of the deposit. However, the members which held membership cards prior to the corporatization and which were given shares and trading rights were not required to pay such security deposit. As part of the corporatization scheme, an amount equivalent to the security deposit was credited in their favor, which they could claim on surrender of the trading rights.
- ▶ The Finance Acts of 2001 and 2003 inserted specific set of provisions in the ITA to ensure that the process of the corporatization was exempted from capital gains tax and also to provide for the cost of various assets which were part of the

corporatization scheme. By virtue of such provisions, the cost of shares in BSEL is deemed to be the cost of acquisition of original membership whereas the cost of trading rights in BSEL is deemed to be nil. Furthermore, the holding period of the BSE membership card is included in the holding period of both shares and trading rights.

Facts

- ▶ The Taxpayer acquired the BSE membership card in tax year 2000-01 for a cost of INR25m. It claimed depreciation on the card from that year.
- ▶ Though the allowability of depreciation on the card was disputed by the Tax Authority, by virtue of the Techno Shares ruling, the dispute got resolved in favor of the Taxpayer.
- ▶ In the tax year 2005-06, the year in which BSE was corporatized, the Tax Authority denied the depreciation, *inter alia*, on the ground that post corporatization and after segregation of ownership and trading rights, the BSE membership card stood extinguished and, hence, no depreciation can be allowed.
- ▶ The First Appellate Authority confirmed the disallowance of depreciation. Being aggrieved, the Taxpayer appealed further to the Tribunal.

Taxpayer's contentions

- ▶ By virtue of the Techno Shares ruling, it is clear that the BSE membership card is eligible for depreciation. Once depreciation is allowed in earlier years, the same needs to be continued till the written down value of the asset becomes nil.
- ▶ The specific provisions in the ITA providing for cost of shares and trading rights, as also holding period inclusion, are relevant only for the purpose of computation of capital gains on transfer of shares or trading rights. They do not affect allowability of depreciation for computation of business income.
- ▶ The language of the depreciation-related provisions, being clear and unambiguous, must be interpreted in the light of the Techno Shares ruling. In any case, where there are two possible views of the matter, it is trite law that the view favoring the taxpayer should be adopted.

Tax Authority's contentions

- ▶ Pursuant to the corporatization, the rights in the BSE membership card were segregated into shares and trading rights. The BSE membership card, therefore, got extinguished in the process.
- ▶ Due to the specific provision in the ITA, the cost of the membership card is attributed to the shares

and the cost of trading rights is deemed to be nil. Since shares do not confer any trading rights, no depreciation can be allowed thereon. Furthermore, no depreciation can be allowed even on trading rights since its cost is deemed to be nil.

Tribunal's ruling

The Tribunal ruled in favor of the Tax Authority and held that no depreciation was allowable on the BSE membership card post corporatization, for the following reasons:

- ▶ Pursuant to the corporatization, the rights held by the Taxpayer in the BSE membership card were segregated into two distinct rights viz., (a) Shares in BSEL which conferred ownership rights. (b) Trading rights on stock exchange.
- ▶ The SC had clarified in the Techno Shares ruling that its judgment was confined to the rights in the BSE membership card for the tax years with which it was concerned i.e., 1998-99 to 2001-02. Hence, the ratio of this ruling cannot be extended to tax year 2005-06, where the rights have undergone a change as a consequence of the corporatization and are not held in the same form.
- ▶ The report of the group constituted by the securities regulator, explaining the process of the corporatization, and the notification approving the scheme of corporatization support that the erstwhile rights of the Taxpayer as a BSE membership cardholder got extinguished and, *in lieu* thereof, it acquired shares and trading rights

in BSEL. Such extinguishment was not liable to capital gains tax by virtue of the specific provisions in the ITA. The card system for trading rights was replaced by the deposit system and the quantum of deposit is equivalent to the commercial value of trading rights. The trading rights holder has to retain the deposit to continue its trading rights. It can demand refund of its deposit by surrendering the trading rights.

- ▶ The shares in BSEL do not confer any trading rights and do not qualify for depreciation.
- ▶ The trading rights could have qualified for depreciation, being in the nature of business and commercial rights, necessary to qualify as 'intangible asset' under the ITA. However, since its value is equivalent to the quantum of deposit which the Taxpayer is entitled to refund on surrender of trading rights, its value cannot depreciate. As a result, there is no independent commercial value to the trading rights and, hence, no depreciation can be granted on the trading rights.
- ▶ On the limited point that the specific provisions in the ITA providing for cost of shares and trading rights, as also holding period inclusion, are relevant only for the purpose of computation of capital gains on transfer of shares or trading rights and do not affect the allowability of depreciation, the Taxpayer is right and its contention needs to be accepted but depreciation is not allowable for other reasons discussed above.

Comments

This Tribunal ruling deals with the tax impact of the corporatization of BSE on its members. It recognizes that the process of corporatization has no capital gains tax implications for the BSE membership cardholders. It confirms that even if depreciation has been claimed on the BSE membership card prior to the corporatization, the cost of acquisition of original membership substitutes the cost of shares in BSEL by virtue of the specific provisions in the ITA. As a consequence, the cost of trading rights is deemed to be nil. The ratio of this ruling would be useful while evaluating the capital gains tax implications on subsequent sale of shares of BSEL by erstwhile BSE membership cardholders.

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