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Foreign exchange gain on redemption of shares at par is not taxable as capital gain

The Delhi Bench of the Income-tax Appellate Tribunal (ITAT) rendered its decision that foreign exchange gain arising due to repatriation of foreign currency (on redemption of shares at par in relevant foreign currency) is not subject to capital gains tax.

Background:

- The taxpayer[1] is engaged in the business of manufacturing of switchgears, energy meters, cables & wires, electrical fans, compact fluorescent lamp and related components and trading luminaries, lighting fixtures and exhaust fans.
- During the Financial Year (FY) 2007-08, corresponding to Assessment Year (AY) 2008-09, the taxpayer (amongst others) had invested in the shares of one its overseas subsidiary company. Some of the shares were redeemed at par in the same year i.e. FY 2007-08 (corresponding to AY 2008-09).

  The taxpayer had realised foreign exchange gain on redemption of shares in the said foreign subsidiary. Since the gain was not on account of increase in value of the shares, as shares were redeemed at par value, but merely on account of repatriation of proceeds received on exchange fluctuation, the taxpayer treated the gain as capital receipt, not eligible to tax in the income-tax return for the relevant AY 2008-09.
- During audit proceedings, the Assessing Officer (AO) amongst others, held that since the gain arose on sale or redemption of shares, the same was taxable as capital gains in terms of section 45 of the Income-tax Act, 1961 (ITA).
- In appeal proceedings, the matter reached the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Decision of the ITAT:

- The ITAT observed the following:
  - It was an undisputed fact that investment made by the taxpayer in shares of its overseas subsidiary was made in Euro and redemption of such shares were also made in Euro. Thus, actual profit or loss on sale / redemption of such shares were to be computed in Euro only and thereafter, converted to INR for the purposes of Section 45 of the ITA.

[1] Havells India Ltd. V. ACIT ITA No.4695/DEL/2012 (DELHI)

In other words, the cost of acquisition of shares and consideration received thereon was to be considered in Euro and the resultant gain / loss thereon was thereafter to be converted into INR at the prevailing market rate.

- In the present case, the net gain / loss on redemption of shares was Nil, since the shares were redeemed at par value and thereby there was no capital gains taxable under section 45 of the ITA.
- As per section 45 of the ITA, for taxation of any profits or gains arising from the transfer of a capital asset, only gains accruing as a result of transfer of the asset could be taxed. In the present case, there was no 'gain' on transfer / redemption of the shares in so far as the shares were redeemed at par value.
- The said contention was supported by Rule 115 of the Income Tax Rules, 1962 , as per which capital gain in rupee was determined as being equal to capital gain in foreign currency (which in the present case was Nil) x applicable rate of exchange = Nil. In the present case, since capital gains in Euro was Nil, the resultant gain in Indian Rupees was Nil.
- The exchange gain was only a consequence of repatriation of the consideration received in Euro to INR and could not be construed to be part of consideration received on redemption of shares.

In view of the above, the ITAT held that section 45 of the ITA did not apply in the current case.

Comment:

This ruling lays down the principle that foreign exchange gain arising on redemption of shares at par in relevant foreign currency is not taxable as capital gains under section 45 of the ITA. Taxpayers with similar facts, may want to evaluate the potential impact of this ruling.