

Tax Impact on Bonus shares, Right shares and Stock splits

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Introduction:

For an investor, news about Bonus, Right shares or Stock Splits is normally a matter of rejoice as he receives additional shares in the Company on the strength of his existing holding in the Company. It also increases the liquidity of such shares in the stock market. In the case of Bonus issue, one receives additional shares free of cost from the company whereas in the case of Rights offer, he gets the option to buy additional shares in the Company at a fixed price (generally lower than the ruling market price). In the case of Stock split, one gets more shares of smaller denomination in exchange of the existing holding of larger denomination. For example, in exchange of one share of face value of Rs. 10/-, one may get five shares of face value of Rs. 2/- each.

Though no tax is payable at the time of receiving such shares, the sale of these shares does attract "Capital Gains" under the Income Tax Law. If the shares are sold after holding them for one year, the resultant gains are treated as "Long Term Capital Gains" otherwise "Short Term Capital Gains". Whereas Long term Capital gains on Sale of listed Shares are exempt from tax, the Short term Capital Gains are liable to tax @ 10% plus surcharge and education cess.

In this article, for the sake of simplicity, all the examples and workings have been based on the assumption of Short term Capital Gains. The Capital Gains on sale of shares can be calculated as under:

| Particulars | Amount (Rs.) |
|---|---------------------|
| Sale Consideration for 100 Shares @ 10/- per share | 1,000 |
| Less: Cost of Purchase of 100 Shares @ 5 per share | 500 |
| Less: Expenses in connection with the Sale (e.g. Brokerage, D.P. Charges, etc on Sale) | 50 |
| Capital Gains (Balance) | 450 |
| Tax on the Capital Gains @ 10% (excluding surcharge and education cess) | 45 |

- **Taxation of Bonus Shares**

As the Bonus shares are received free of cost, the Cost of such shares is taken as NIL. As mentioned earlier, there is no taxation of notional gain (Market value minus cost which is NIL) at the time of allotment of Bonus Shares. However the Sale of such shares attracts Capital Gains and the same is chargeable to tax. The taxation of Bonus shares can be explained with the help of following example.

Example:- Mr. Patel was holding 1000 Equity Shares in X Ltd. At the cost of Rs. 10/- per share as on 1st April 2005. On 30th September 2005, he was allotted 500 Bonus Shares (market value on the date of allotment Rs. 15/- per share). Due to further appreciation he decided to sell 1,400 Equity Shares (1,000 original shares plus 400 Bonus shares) @ Rs. 20/- per share on 1st March 2006. His Capital Gains will be as under:

| Particulars | Original 1,000 shares | 400 Bonus Shares |
|--|------------------------------|-------------------------|
| Sale Consideration @ Rs. 20/- per share | 20,000 | 8,000 |
| Less:- Cost of Purchase @ Rs. 10/- Share | 10,000 | N I L |
| Capital Gains | 10,000 | 8,000 |
| Tax on above @ 10% | 1,000 | 800 |

Thus it can be seen from the above example that in case of Sale of Bonus shares, entire sale consideration is treated as Capital Gains as cost of Bonus Shares is NIL. The cost of remaining 100 shares in the hands of Mr. Patel would be NIL.

The notional gain of Rs. 7,500/- (500 shares @ Rs. 15/- per share) at the time of allotment of Bonus shares is not taxable.

- **Taxation of Right Shares**

Unlike Bonus shares, one has to pay for acquiring the Rights shares. The cost of such shares would be the price paid for acquiring such shares. Again there is no taxation of notional gain (Market value minus cost which of purchase) at the time of allotment of Rights Shares. Nonetheless the Sale of such shares triggers the Capital, which is explained below.

Example:- Mr. Patel was holding 1000 Equity Shares in X Ltd. at the cost of Rs. 10/- per share as on 1st April 2005. On 31st August 2005, the Company

announced the option of Right shares to the shareholders @ Rs. 15/- per share. Mr. X exercised his option to buy the right shares and was allotted 500 Right Shares on 30th September 2005 (market value as on 30th September 2005 Rs. 30/- per share). Out of 1,500 Shares, he decided to sell 1,400 Equity Shares (1,000 Original and 400 Rights shares) @ Rs. 40/- per share on 1st March 2006. His Capital Gains would be as under:

| Particulars | Original 1,000 shares | 400 Right Shares |
|--|------------------------------|-------------------------|
| Sale Consideration @ Rs. 40/- per share | 40,000 | 16,000 |
| Less:- Cost of Purchase @ Rs. 10/- Share for Original shares and Rs. 15/- for Right Shares | 10,000 | 6,000 |
| Capital Gains | 30,000 | 12,000 |
| Tax on above @ 10% | 3,000 | 1,200 |

Thus it can be seen from the above example that in case of Sale of Right shares, actual cost of purchase of Right shares would be deducted from the sale consideration and the balance is treated as Capital Gains and there is no taxation of notional gains at the time of allotment of Rights shares. Remaining 100 Rights shares will continue to be held by Mr. Patel at the cost of Rs. 1,500 (100 shares @ Rs. 15/- per share).

- **Taxation of Stock Splits**

There is no taxation at the time of split of shares into smaller denominations. However one needs to pay the tax on capital gains at the time of sale of such shares. The same has been explained in the following example:

Example:- Mr. Patel was holding 1000 Equity Shares in X Ltd. at the cost of Rs. 10/- per share as on 1st April 2005. On 30th September 2005, the Company announced the Stock Split whereby he was allotted Five Shares of face value of Rs. 2/- each in exchange of one share of face value of Rs. 10/-. The same resulted in his getting 5,000 new shares in exchange of 1,000 old shares. Out of the total 5,000 shares, he decided to sell the 4,000 Equity Shares @ Rs. 20/- per share on 1st March 2006. His Capital Gains would be as under:

| Particulars | 4,000 New Shares |
|---|-------------------------|
| Sale Consideration @ Rs. 20/- per share | 80,000 |
| Less:- Cost of Purchase 4,000 @ Rs. 2/- per Share | 8,000 |
| Capital Gains | 72,000 |
| Tax on above @ 10% | 7,200 |

Thus it can be seen that while calculating cost of shares in case of stock split, cost of purchase of original holding is spread over the new shares. However the total cost of the holding remains the same. In the above example, remaining 1,000 shares will continue to be held by Mr. Patel at the cost of Rs. 2,000 (1000 shares @ Rs. 2/- per share).

Conclusion:

The tax on gains of sale of bonus, rights and stock splits is payable only on the actual sale of the shares so held / allotted. Till such sale, the event of allotment of such shares does not attract any tax. The investor would be advised to try and hold on to the shares for over 12 months, when the holding becomes long term, and consequently even on sale no tax is payable. Happy investing!!!