TAXATION OF ZERO COUPON BONDS

Finance Act 2005 had introduced provisions relating to income-tax treatment of Zero Coupon Bonds. These provisions are effective from assessment year 2006-07.

Definition of Zero Coupon Bond [Section 2 (48)]

According to Section 2 (48), ***"Zero coupon bond"*** means a bond :

(a) issued by any ***"Infrastructure Capital Company"*** or ***"Infrastructure Capital Fund"*** or ***"Public Sector Company"*** or ***"Scheduled Bank"*** on or after the 1st day of June, 2005;

(b) in respect of which no payment and benefit is received or receivable before maturity or redemption from infrastructure capital company or infrastructure capital fund or public sector company; and

(c) which the Central Government may, by notification in the Official Gazette, specify in this behalf.

Meaning of ***"Infrastructure Capital Company"*** :

"Infrastructure Capital Company" means such company as has made investments by way of acquiring shares or providing long term finance to an enterprise wholly engaged in the business referred to in sub-section (4) of section 80-IA or sub-section (3) of section 80-IAB or a housing project referred to in sub-section (10) of section 80-IB or a hotel project or a hospital project and which has been approved by the Central Government on an application made by it in accordance with the rules made in this behalf and which satisfies the prescribed conditions [Clause (a) of Explanation 1 to Clause (23G) of Section 10].

Meaning of ***"Infrastructure Capital Fund"*** :

"Infrastructure Capital Fund" means such fund operating under a trust deed registered under the provisions of the Registration Act, 1908 (16 of 1908) established to raise monies by the trustees for investment by way of acquiring shares or providing long-term finance to an enterprise wholly engaged in the business referred to in sub-section (4) of section 80-IA or sub-section (3) of section 80-IAB or a housing project referred to in sub-section (10) of section 80-IB or a hotel project or a hospital project and which has been approved by the Central Government on an application made by it in accordance with the rules made in this behalf and which satisfies the prescribed conditions [Clause (b) of Explanation 1 to Clause (23G) of Section 10].

Meaning of ***"Public Sector Company"*** :

"Public Sector Company" means any corporation established by or under any Central, State or Provincial Act or a Government company as defined in Section 617 of the Companies Act, 1956 [Section 2 (36A)].

Zero coupon bonds are notified by the Central Government subject to the following guidelines [Rule 8B] :

- Application should be made in Form No. 5B.
- The application should be made at least 3 months before the date of issue of Zero coupon bonds.
- The application should be accompanied by a copy of certificate of incorporation or a copy of registered trust deed or a copy of relevant Act under which the applicant has been incorporated.
- The life of bonds should not be less than 10 years and more than 20 years.

- The applicant should have an investment grade rating from at least 2 registered credit rating agencies.
- The applicant should have made necessary arrangements for listing the zero coupon bonds.
- An undertaking should be furnished by the applicant to invest the money realized on issue of zero coupon bonds in the following manner :

If the applicant is an infrastructure capital company or an infrastructure capital fund	If the applicant is a public sector company
25% or more of the money realized shall be invested before the end of the next financial year (i.e., the financial year immediately following the financial year in which the bonds are issued).	15% or more of the money realized should be invested before the end of the next financial year (i.e., the financial year immediately following the financial year in which the bonds are issued)
The balance should be utilized within a period of 4 financial years immediately following the financial year in which the bonds are issued.	The balance should be utilized within a period of 6 financial years immediately following the financial year in which bonds are issued.

- A certificate from a Chartered Accountant shall be submitted within 2 months from the end of each financial year specifying the amount invested in each financial year.

Tax treatment in the hands of company issuing such bonds [Section 36 (1) (iiia)]

While computing the income under the head "Profits and gains of business or profession" of the company issuing such bonds, a deduction of *pro-rata* amount of ***"Discount"*** on Zero Coupon Bonds having regard to the ***"Period of Life"*** of such bonds is allowed as deduction under Section 36 (1) (iiia).

Meaning of ***"Discount"*** :

"Discount" means the difference between the amount received (or receivable) by the company issuing such bonds and the amount payable by such company on maturity (or redemption) of such bonds. In other words :

Discount on Zero Coupon Bonds = Maturity Value (or Redemption Price) – Issue Price

Meaning of ***"Period of Life"*** :

"Period of Life" of the bond means the period commencing from the date of issue of the bond and ending on the date of maturity (or redemption) of such bonds. In other words :

Period of Life = Date of Maturity – Date of Issue

Note :

No tax will be deducted at source under Section 194A by the issuing company in respect of income payable to the investors of Zero Coupon Bonds. Therefore maturity value (or redemption price) reaches to the investors without any tax deduction at source.

Illustration :

ABC Limited, an infrastructure capital company, issued 4,800 Zero Coupon Bonds specified by the Central Government by notification in the official gazette. All Zero Coupon Bonds were fully subscribed by the public. From the following additional information provided by the ABC Limited you are required to calculate deduction available to the company under Section 36 (1) (iiia) for the different previous years falling during the period of life of bonds :

Date of issue	1st August, 2010
Issue price per bond	Rs. 500/-
Date of redemption	31st July, 2020
Redemption price per bond	Rs. 1,000/-

Solution :

Discount per bond = Maturity Value (or Redemption Price) – Issue Price
= Rs. (1,000 – 500) = Rs. 500/-

Total discount = Discount per bond x Total no. of bonds issued
= Rs. 500 x 4,800
= Rs. 24,00,000/-

Period of life = Date of Maturity – Date of Issue
= 31st July, 2020 – 1st August, 2010
= 10 Years (i.e. 120 Months)

$$\text{Total discount for 1 month} = \frac{\text{Total discount}}{\text{Period of life in no. of months}}$$

$$= \frac{\text{Rs. } 24{,}00{,}000}{120} = \text{Rs. } 20{,}000/-$$

Therefore, deduction available under Section 36 (1) (iiia) to ABC Limited on *pro-rata* basis for the different previous years falling during the period of life of bonds will be as follows :

Previous year 2010-11 :

= Rs. 20,000 x 8 months (i.e. from 1st August, 2010 to 31st March, 2011) = Rs. 1,60,000/-

Previous year 2011-12 (and next 8 previous years) :

= Rs. 20,000 x 12 = Rs. 2,40,000/-

Previous year 2020-21 :

= Rs. 20,000 x 4 months (i.e. from 1st April, 2020 to 31st July, 2020) = Rs. 80,000/-

Tax treatment in the hands of investor

1. Profit arising to the investor on maturity (or redemption) of Zero Coupon Bonds is chargeable under the head "Capital gains" because redemption or maturity of these bonds is regarded as transfer as per Section 2 (47).

2. Zero Coupon Bond becomes long-term capital asset if period of holding exceeds 12 months. In other words, if period of holding is upto 12 months, these bonds are treated as short-term capital asset [Section 2 (42A)]

3. Short-term capital gain on transfer of Zero Coupon Bonds is subject to normal tax rate.

4. Long-term capital gain on transfer of Zero Coupon Bonds is chargeable to tax subject to the lower of the following :

   (a) 20% of long-term capital gain after indexation of cost of such bonds.

   (b) 10% of long-term capital gain before indexation of cost of such bonds.