

**CBDT's Circular No.4/2007 -  
Does not serve the intended purpose.**

[Published in 210 CTR (Art.) p. 155 (Part-V)]

**By S.K.Tyagi**

The Central Board of Direct Taxes (CBDT) has recently issued a Circular No.4/2007, dated 15.6.2007, which has sought to lay down certain tests in order to distinguish between shares held as stock-in-trade and shares held as investment. The need to issue the aforesaid Circular has arisen because there are a number of tax-payers who are trading in shares but at the same time they are also earmarking a part of their investment in shares as investment yielding income by way of dividends. In other words, a number of tax-payers are claiming a part of their shares as investment, whereas the other part as stock-in-trade. It may be understood here that any profit and gain on sale of shares held as stock-in-trade will partake the nature of business income, whereas any gain on the sale of shares held as investment will partake the nature of capital gain. Such capital gains will be long-term or short-term capital gains on the basis of the period of holding of such shares by the tax-payer.

As pointed out earlier, normally any profit and gain on the sale of shares held as a stock-in-trade is treated as business income, which is liable to tax at the rate of 30%. On the other hand, any gain made on the sale of shares held as investment is normally liable to tax at the rate of 10%. Thus, there is a big difference between the rate of taxation of income earned on sale of shares held as stock-in-trade and those held as investment. Therefore, every tax-payer tries to claim that the shares in question were held by him as investment and not as a stock-in-trade.

In order to understand the implications of the aforesaid Circular in the correct perspective, it would be necessary to understand the meaning of certain terms as provided under section 2 of the Income-Tax Act, 1961 (the Act). The same are discussed as follows :-

- (i) **Capital asset – Section 2(14)**

Section 2(14) of the Act defines the term “*capital asset*”. As per section 2(14), “*capital asset*” means property of any kind held by an assessee, whether or not connected with his business or profession, but it does not include –

- (a) Any stock-in-trade, etc, and
- (b) Personal effects

In this context it must be understood that the word “*property*” is a term of the widest import and subject to any limitations which the context may require, it signifies every possible interest which a person can clearly hold and enjoy. The expression “*property of any kind*” is of such wide amplitude so as to take in tangible and intangible assets of any kind other than those comprised in the exceptions carved out in the definition itself.

(ii) **Long term capital asset – Section 2(29A)**

As per section 2(29A), “*long term capital asset*” means a capital asset which is not a short term capital asset. Thus, the definition of the term “*long term capital asset*” is based on the definition of the term “*short term capital asset*”, as provided under section 2(42A) of the Act.

(iii) **Long term capital gain – Section 2(29B)**

As per section 2(29B), “*long term capital gain*” means capital gain arising from the transfer of a long term capital asset.

The definition of “*long term capital gain*” is also not complete in itself, because this clause is to be read alongwith clauses (42A) and (42B) of section 2 of the Act.

(iv) **Short term capital asset –Section 2(42A)**

As per section 2(42A), “*short term capital asset*” means a capital asset held by an assessee for not more than 36 months, immediately preceding the date of its transfer.

For the sake of ready reference, section 2(42A) is reproduced as follows :-

-----  
 2. *In this Act, unless the context otherwise requires, -*

(42A) “*short term capital asset*” means a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of its transfer :

*Provided that in the case of a share held in a company or any other security listed in a recognized stock exchange in India or a unit of the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963) or a unit of a Mutual Fund specified under clause (23D) of section 10 or a zero coupon bond, the provisions of this clause shall have effect as if for the words “thirty-six months”, the words “twelve months” had been substituted.*

*Explanation I – (i) In determining the period for which any capital asset is held by the assessee-*

- (a) *in the case of a share held in a company in liquidation, there shall be excluded the period subsequent to the date on which the company goes into liquidation;*
- (b) *in the case of a capital asset which becomes the property of the assessee in the circumstances mentioned in sub-section (1) of section 49, there shall be included the period for which the asset was held by the previous owner referred to in the said section;*
- (c) *in the case of a capital asset being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a transfer referred to in clause (vii) of section 47, there shall be included the period for which the share or shares in the amalgamating company were held by the assessee;*
- (d) *in the case of a capital asset; being a share or any other security (hereafter in this clause referred to as the financial asset) subscribed to by the*

*assessee on the basis of his right to subscribe to such financial asset or subscribed to by the person in whose favour the assessee has renounced his right to subscribe to such financial asset, the period shall be reckoned from the date of allotment of such financial asset;*

- (e) in the case of a capital asset, being the right to subscribe to any financial asset, which is renounced in favour of any other person, the period shall be reckoned from the date of the offer of such right by the company or institution, as the case may be, making such offer;*
- (f) in the case of a capital asset, being a financial asset, allotted without any payment and on the bases of holding of any other financial asset, the period shall be reckoned from the date of the allotment of such financial asset;*
- (g) in the case of a capital asset, being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a demerger, there shall be included the period for which the share or shares held in the demerged company were held by the assessee;*
- (h) in the case of a capital asset, being trading or clearing rights of a recognized stock exchange in India acquired by a person pursuant to demutualisation or corporatisation of the recognized stock exchange in India as referred to in clause (xiii) of section 47, there shall be included the period for which the person was a member of the recognized stock exchange in India immediately prior to such demutualization or corporatisation;*
- (ha) in the case of a capital asset, being equity share or shares in a company allotted pursuant to demutualization or corporatisation of a recognized stock exchange in India as referred to in clause (xiii) of section 47, there shall be included the period for which the person was a member of the recognized stock exchange in India immediately prior to such demutualization or corporatisation;*

***The following sub-clause (hb) shall be inserted after sub-clause (ha) of clause (i) of Explanation 1 to clause (42A) of section 2 by the Finance Act, 2007, w.e.f. 1-4-2008:***

*(hb) in the case of a capital asset, being any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost or at concessional rate to his employees (including former employee or employees), the period shall be reckoned from the date of allotment or transfer of such specified security or sweat equity shares;*

*(ii) In respect of capital assets other than those mentioned in clause (i), the period for which any capital asset is held by the assessee shall be determined subject to any rules which the Board may make in this behalf.*

*Explanation 2 – For the purposes of this clause, the expression “security” shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);*

***The following Explanation 3 shall be inserted after Explanation 2 to clause (42A) of section 2 by the Finance Act, 2007, w.e.f. 1-4-2008 :***

*Explanation 3 – For the purposes of this clause, the expressions “specified security” and “sweat equity shares” shall have the meanings respectively assigned to them in the Explanation to clause (d) of sub-section (1) of section 115WB;*

-----

From the aforesaid provisions of section 2(42A), it may be seen that capital asset is divided as short-term or long-term with reference to the period of holding of the asset by the assessee or by the previous owner and the assessee under certain circumstances. The period of holding of the asset is computed from the date of acquisition to the date immediately preceding its transfer.

An asset, being shares in a Company or any other security listed in a recognized stock exchange in India or a unit of UTI or a mutual fund, etc, shall be treated as short-term capital asset, if held for not more than 12 months and as long-term capital asset, if held for more than 12 months.

On the other hand, an asset other than the aforesaid asset, is treated as short-term capital asset, if held for not more than 36 months and long-term capital asset, if held for more than 36 months.

(v) **Short term capital gain – Section 2(42B)**

As per section 2(42B), “*short term capital gain*” means capital gain arising from the transfer of a short-term capital asset.

(vi) **Transfer – Section 2(47)**

“*Transfer*”, in relation to a capital asset, includes the sale, exchange or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law or in a case where the asset is converted by the owner thereof into, or as treated by him as, a stock-in-trade to a business carried on by him, such conversion or treatment or the maturity or redemption of a zero coupon bond.

Transfer includes –

- (a) Possession of immovable property given without registration of conveyance deed; and
- (b) Transactions in agreement to buy or sell any immovable property or any rights therein.

Transfer of immovable property is complete when delivery of possession is complete. Transfer of immovable property, normally, is complete only when the conveyance deed is registered. However, for the purposes of capital gains, the transfer is treated as complete when delivery of possession and when agreement to sell/buy immovable property is entered into or when such agreement is itself a subject matter of transaction.

(vii) **Tax on short term capital gains in certain cases –Section 111A**

As per section 111A, short term capital gains arising out of transfer of an equity share in a company, or unit of an equity oriented fund where such transaction is chargeable to Securities Transaction Tax; shall be charged at the rate of 10%.

As a result of introduction of Securities Transaction Tax, it was decided to spare liability on long term capital gains under section 10(38) of the Act, while stipulating a concessional rate of 10% tax on short term capital gains under section 111A.

**It is, however, to be borne in mind that neither section 10(38), nor section 111A will be applicable, if the shares or units of equity oriented funds are held as stock-in-trade, because in such a case the surplus will be assessable as income from business, which is liable to tax at the rate of 30%. Concessional treatment is available only in respect of capital gains.**

(viii) **Tax on long term capital gains – Section 112**

Section 112 was inserted in the Income Tax Act by the Finance Act 1992, with effect from 1.4.1993. It provides that where the total income of an assessee includes any income, arising from the transfer of a long term capital asset, which is chargeable under the head “capital gains”, the tax payable by the assessee on the total income shall be aggregate of –

- (a) The amount of income tax payable on the total income as reduced by the amount of such long-term capital gains; and
- (b) The amount of income-tax calculated on such long term capital gains at the rate of 20%.

However, as per the proviso to section 112(1), in case of all categories of assessee, where income-tax on long term capital gains on listed securities or units or from the assessment year 2006-07 onwards zero coupon bond, computed in the normal manner as applicable to gains on other long term capital assets, exceeds 10% of capital gains on the said securities, etc, computed without the benefit of indexation of cost of acquisition, then such excess shall

be ignored. In other words, the rate of income tax on long term capital gains arising from the transfer of listed securities, etc, will be 10% of the gains computed without indexation of cost of acquisition.

The aforesaid Circular is to be understood in the light of the aforesaid provisions of the Income-Tax Act. The salient features of the aforesaid Circular may be summarized as follows :-

1. In order to determine whether the surplus on the sale of shares, etc, will be business income or capital gain, the Assessing Officer will be guided by the following three criteria :
  - (i) Whether the shares purchased were held and valued as stock-in-trade.
  - (ii) Whether there were substantial transactions. In this context, the magnitude of the transactions, ratio between purchases and sales, entries in the books of account; will be relevant.
  - (iii) Whether the object of investment in shares was to derive income by way of dividends or realizing profits by the purchase and sale thereof.
2. The CBDT advises that a tax payer may have to maintain two portfolios viz.
  - (i) The investment portfolio comprising securities which are to be treated as capital assets; and
  - (ii) Trading portfolios comprising stock-in-trade which are to be treated as trading assets.

Where the assessee has both the aforesaid portfolios, he may have income under both heads i.e, capital gains as well as business income.

The investor, therefore, will have to classify his portfolio into two categories – one where the intention is to keep the shares for long term and two, where the intention is to trade in such shares.

3. Right now, no books are maintained by most of the ordinary investors. But if a big portion of his income comes from the stock market, some basic books of account will have to be maintained and a consistent classification method will have to be followed to distinguish between investment and stock-in-trade.

It may however be pointed out that a Circular of the CBDT is not binding on the assesses/tax-payers.

In this context, we would have to examine the provisions of Section 119(2) of the Act. The CBDT has been empowered under Section 119(1) of the Act, to issue such orders, instructions and directions to other I.T. authorities as it may deem fit for the proper administration of this Act and such authorities and all other persons employed in the execution of this Act, are required to observe and follow such orders, instructions and directions of the CBDT. Under Section 119(2), however, it has been laid down that the Board may issue directions or instructions for the purpose of proper and efficient management of work of assessment and collection of revenue, **provided such directions or instructions are not prejudicial to the assesses.**

Therefore, any direction or instruction to be issued by the Board should not adversely affect the interests of the assesses or the tax-payers. If such directions are issued, then they have to be held *ultra vires* the scope of Section 119(2) of the Act. This proposition is supported by the judgement of Madras High Court in the case of *Madura Coats Vs. Dy.CIT [2005] 195 CTR 138 (Mad)*.

In view of the aforesaid reasons, the contents of the aforesaid Circular of the CBDT are not, at all, binding on the assesses / tax-payers.

In the light of the aforesaid reasons, a tax-payer will be free to produce other independent pieces of evidence in order to prove that the shares held by him were by way of investment and not as a stock-

in-trade and accordingly, the surplus realized on the sale thereof, should be treated as capital gain and not as business income.

In the final analysis of the aforesaid Circular, it may be stated that irrespective of the aforesaid criteria laid down in the Circular, the assessment of an assessee is likely to be subjective, as no clear-cut objective parameters have been laid down to determine the nature of income and its tax-treatment.

In view of the aforesaid reasons, the tax-payers who earn income by investment in shares, either as stock-in-trade or as investment, are advised to maintain separate portfolio in respect of shares purchased for the purpose of long-term investment and those for the purpose of trading. Besides such tax-payers should start maintaining some basic books of account, wherein the transactions in respect of the purchase and sale of shares are entered. Such books of accounts must be so maintained as to provide a clear-cut division between the shares held as investment and the shares held as stock-in-trade.

---

<b>S.K.TYAGI</b>	☎ Office	: (020) 26133012	Flat No.2, (First floor)
M.Sc.,L.L.B., <b>Advocate</b>	Fax	: (020) 41006161	Gurudatta Avenue
Ex-Indian Revenue Service	Residence	: (020) 40044332	Popular Heights Road
<b>Income-Tax Advisor</b>	Email	: sktyagidt@sify.com	Koregaon Park
			PUNE 411 001

---