Sale of a capital asset converted into stock-in-trade : Tax-treatment

[Published in 377 ITR (Journ.) p.17 (Part-4)]

In business there are occasions when a capital asset is converted into stock-in-trade and stock-in-trade is converted into capital asset. There may also be occasions when an asset ceases to be a stock-in-trade. In this context, section 45(2) of the Income-Tax Act, 1961 (the Act) is relevant. For the sake of ready reference, section 45(2) is reproduced as follows :

"*Capital gains.*

45. *(2) Notwithstanding anything contained in sub-section (1), the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its treatment by him as stock-in-trade of a business carried on by him shall be chargeable to income-tax as his income of the previous year in which such stock-in-trade is sold or otherwise transferred by him and, for the purposes of section 48, the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset."*

From the aforesaid provisions of section 45(2), it may be seen that the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its treatment by him as stock-in-trade of a business carried on by him, is to be charged to tax under the heading "*Capital gains"* in the previous year in which such stock-in-trade is sold or otherwise transferred by him. It has been further provided that, for the purposes of computing the capital gains in such case, the fair market value of the capital asset on the date on which it was converted or traded as stock-in-trade, is to be deemed to be the full value of consideration received or accruing as a result of the transfer of the capital asset.

In the present context, it will be appropriate to deal with the following aspects :

(i) Relevance of legal precedents laid down by the Supreme Court before the insertion of section 45(2) of the Act.

(ii) Detailed discussion about the provisions of section 45(2) of the Act.

(iii) The relevant legal precedents.

(iv) Conclusion

The same are discussed as follows :

I. Relevance of legal precedents laid down by the Supreme Court before the insertion of section 45(2) of the Act.

In this regard, it may be appropriate to consider the relevant legal development before the insertion of the present sub-section (2) in section 45 of the Act, vide the Taxation Laws (Amendment) Act, 1984, with effect from 1.4.1985. In this context there are two landmark judgements delivered by the Apex Court. One in the case of *Sir Kikabhai Premchand* and the other in the case of *Bai Shirinbai K.Kooka.* Both the aforesaid judgements of the Supreme Court are discussed as follows :

1. *CIT Vs Sir Kikabhai Premchand [1953] 24 ITR 506 (SC).*

In this case, the assessee was a dealer in silver and shares and he was the sole owner of the business. The assessee maintained his accounts according to the mercantile system and valued his stock at cost price both at the beginning and at the end of the year. During the relevant year of account, the assessee withdrew some silver bars and shares from the business and settled them on certain trusts in which he was the managing trustee. In his books, the assessee credited the business with the cost price of the bars and shares so withdrawn. The Income-tax authorities held that the assessee derived income from the stock-in-trade, thus, transferred and assessed him on a certain sum being the difference between the cost price of the silver bars and shares and their market value on the date of their withdrawal from the business. The appellate Tribunal and the High Court upheld the action of the IT authorities.

On appeal to the Supreme Court, it was held that the assessee might have stored up a future advantage for himself, but as the transactions were not business transactions and as he derived no immediate pecuniary gain, the State could not tax them, for under the Income-Tax Act, the State has no power to tax a potential future advantage. It was further held that in revenue cases, regard must be held to the substance of the transaction rather than to its mere form.

2. *CIT Vs Bai Shirinbai K.Kooka [1962] 46 ITR 86 (SC).*

Thereafter, the Supreme Court delivered another landmark judgement on the issue, in the case of *CIT Vs Bai Shirinbai K.Kooka [1962] 46 ITR 86 (SC).* In this case, the assessee who held by way of investment several shares in companies, commenced a business in shares, converting the shares into stock-in-trade of the business and subsequently, sold these shares at a profit. In this case, a Bench of seven judges decided by six to one, held that the assessee was entitled to record the market price as cost of his investment in his business books. In this case, where the assessee brought his shares held as investments into stock-in-trade, the earlier decision of the

Supreme Court in *Sir Kikabhai Premchand's* case was sought to be relied upon by the Revenue, which required cost to be adopted consistent with the principle decided in that case. The Supreme Court, however, distinguished *Sir Kikabhai Premchand's* case on the following ground. The important observations of the Hon. Supreme Court, on page 92 of the Report are as follows :

"*From what has been stated above it would at once appear that Kikabhai's case was the converse of the present case. In Kikabhai's case a part of the stock-in- trade was withdrawn from business; there was no sale nor any actual profit. The ratio of the decision was simply this. Under the Income-Tax Act the State has no power to tax a potential future advantage and all it can tax is income, profits and gains made in the relevant accounting year. In the case under our consideration the admitted position is that there has been a sale of the shares in pursuance of a trading or business activity and actual profits have resulted from the sale. The question in the present case is not whether the State has a power to tax potential future advantage, but the question is how should actual profits be computed when admittedly there has been a sale in the business sense and actual profits have resulted therefrom. We agree with the High Court that in this respect there is a vital difference between the problem presented by Kikabhai's case and the problem in the present case. We further agree with the view expressed by the High Court that the ratio in Kikabhai's case need not necessarily be extended to the very different problem presented in the present case, not only because the facts are different, but because there is an appreciable difference in principle. The difference lies in this : in one case there is no question of any business sale or actual profits and in the other admittedly there are profits liable to tax, but the question is how the profits should be computed. We must, therefore, overrule the first two arguments of the learned Additional Solicitor General that the distinction drawn by the High Court between Kikabhai's case and the present case is not warranted on principle and that the ratio of the decision in Kikabhai's case must necessarily apply to the present case also.*"

It was, thus, held that the assessee's assessable profits on the sale of the shares was the difference between the sale price of the shares and the market price of the shares prevailing on the date when the shares were converted into stock-in-trade of the business in shares and not the difference between the sale price and the price at which the shares were originally purchased by the assessee. The principle in *Kikabhai's* case is not applicable to a case like this, as there was no sale in *Kikabhai's* case and the ratio of the decision was that under the Income-Tax Act, the State had no power to tax a mere potential advantage.

Thus, while holding that the market value should be adopted when investment is converted into stock-in-trade, it also held that there was no inconsistency when cost is adopted on conversion to stock-in-trade to investment.

II. Discussion about the provisions of section 45(2) of the Act.

On the basis of the discussion in the preceding paragraph (I), it may be seen that section 45(2) of the Act, does not make a departure from the principle laid down by the Supreme Court. Since market value is adopted on conversion of investment into stock-in-trade, it is considered only fair that after introduction of tax on capital gains on sale of investment, the assessee should pay tax on such capital gains, with reference to the market value adopted for computing the business income arising to the assessee from investments or personal assets converted to stocks. **The provision is also fair in that the tax on such capital gains will be payable only on realization of such converted stock in the year of sale thereof, though the capital gain is determined on the date of conversion.**

It is, thus, quite clear that on conversion of a capital asset into stock-in-trade, and thereafter, sale of the stock-in-trade, the tax-treatment in respect thereof, will be as follows :

(i) There will be capital gains liability in respect of the conversion of capital asset into stock-in-trade, at market value thereof. Thus, the capital gains will be computed as a difference between the cost of capital asset to the assessee and the market value of such capital asset on the date of its conversion into stock-in-trade.

However, the capital gains tax will be required to be paid only at the time of sale of the stock-in-trade.

(ii) As regards the sale of the stock-in-trade, the profit realized will be liable to tax as business income and such profit would accrue at the time of sale of the stock-in-trade.

The business income will be computed as a difference between the sale price of the stock-in-trade and market value of the capital asset on the date of its conversion into stock-in-trade.

In the present context, it must be appreciated that while framing the provisions of section 45(2), a practical view has been adopted in respect thereof, in as much as even capital gains liability would arise not on the date of conversion of the capital asset into stock-in-trade, but on the date of sale of such stock-in-trade.

In this regard, it will be appropriate to refer to Circular No.791, dt.2.6.2000, issued by the CBDT. This Circular relates to the issue whether the date of transfer, as referred to in section 54E of the Act, is the date of conversion of the capital asset into stock-in-trade or the date on which the stock-in-trade is sold or otherwise transferred by the assessee. In this regard, paragraph (4) of the aforesaid Circular is relevant, which is reproduced as follows :

"***4.*** *Sections 54EA, 54EB and 54EC also provide deduction from long-term capital gain if the sale proceeds/long-term capital gain is invested in specified assets within a period of 6 months from the date of transfer. It is not possible for an assessee to make the required investment under the aforesaid sections at the point of conversion of capital asset into stock-in-trade because the right to collect sales consideration in such cases arises only at the point of sale or transfer otherwise of stock-in-trade. The board has considered the matter afresh in consultation with the Ministry of Law and has decided that the period of 6 months for making investments in specified assets for the purpose of sections 54EA, 54EB and 54EC should be taken from the date such stock-in-trade is sold or otherwise transferred, in terms of section 45(2) of the Act."*

It is, thus, clear that for investment of long-term capital gains, it is not possible for an assessee to make the required investment under the provisions of sections 54EA, 54EB and 54EC, at the point of conversion of capital asset into stock-in-trade, because the right to collect the sale consideration in such cases arises only at the point of sale or transfer of stock-in-trade. Therefore, the period of six months for making investments in specified assets for the purpose of sections 54EA, 54EB and 54EC, is to be reckoned from the date such stock-in-trade is sold or otherwise transferred, in terms of section 45(2).

III. The relevant legal precedents :

In the present context, it will also be necessary to deal with some of the relevant legal precedents in relation to the correct understanding of the provisions of section 45(2) of the Act. These legal precedents are discussed as follows :

1. *CIT Vs Saffire Hotels P.Ltd [2015] 116 DTR 385 (Bom)*

   In this case, the assessee was engaged in the business of developing property and declared income of Rs.35.59 lakhs for the AY 2003-04. The Respondent assessee claimed to be following project completion method and no premises had been sold during the relevant AY. During the assessment proceedings, the contention of the assessee that no premises had been sold was found to be incorrect. Thus, by an order, dt.23.1.2006, the AO enhanced the income to Rs.2.61 crores, being the undisclosed income.

In appeal before the CIT(A), the assessee took up an alternative stand, viz. that even if the AO is correct in determining that the property had been sold during the year, yet a portion of the undisclosed income is assessable as capital gains, in as much as the land originally was a capital asset of the assessee company, which had been formed to run a hotel. Therefore, the provisions of section 45(2) of the Act, were attracted when the land (capital asset) was converted into stock-in-trade. It is at that time that the same is brought to tax, although payable when stock-in-trade was sold . The CIT(A) did not accept the aforesaid submission of the assessee and upheld the order of the AO.

On further appeal, the Tribunal on the basis of facts found that during the course of assessment proceedings before the lower authorities, evidence was brought on record which indicated that the assessee was incorporated in 1970. Its main object was to carry on its business of running a hotel and for which purpose the land, in question, was acquired as a capital asset. It was only later that the land, in question, was utilized as part of its stock-in-trade for the purpose of carrying on its business of construction. The aforesaid conclusion was reached by placing reliance on the permission of the Government of India, Tourism Department, dt.21.8.1971, evidencing approval for the proposed construction of a hotel building. Further evidence was laid before the Tribunal in the form of commencement certificate issued in 1972 by the Pune Municipal Corporation for undertaking the basic initial construction work for the hotel project. Thus, the Tribunal held that the provisions of section 45(2) of the Act, would be applicable in the present case.

Further, on the issue as to the date on which capital asset was converted into stock-in-trade, the assessee contended that 1993 be treated as the year, while Revenue contended that 1989 be treated as the year of conversion into stock-in-trade. The impugned order of the Tribunal restored the issue of date of conversion into stock-in-trade to the AO to decide, on the basis of evidence produced before it.

On appeal by the Revenue before the High Court, it was held that on the basis of evidence before the lower authorities, even if ignoring the fresh evidence which was in the form of commencement certificate, dt.15.6.1972, issued by the Pune Municipal Corporation during the course of hearing before the Tribunal, it is clear that the land was originally a capital asset, which was later on converted into stock-in-trade. Therefore, section 45(2) is applicable. Accordingly, the Tribunal was correct in setting aside the case to the file of the AO to decide the year of conversion or treatment of land into stock-in-trade, since tax is payable only in the year in which the assessee ultimately sells such stock-in-trade.

2. *CIT Vs Najoo Dara Deboo [2013] 218 Taxman 473 (All)*

In this case, the assessee, owner of a premises, entered into an agreement in 1994 with the builder for construction of a multi-storeyed building. The builder, accordingly, developed the land and constructed a complex thereon. As per the agreement, the builder was to give 35 per cent of the built-up area to the assessee and was to get 65 per cent of built-up area along with undivided 65 per cent interest in the land. The AO held that since the assessee had handed over possession of the plot to the builder in pursuance of an agreement for transfer and thus, transfer took place during the relevant previous year, in view of the provision of section 2(47) of the Act. The AO, therefore, made addition on account of long-term capital gains. On appeal, the CIT(A) and the Tribunal deleted the addition.

On further appeal by the Department, it was held by the High Court that the assessee paid capital gains tax in the assessment years 1998-99 to 2000-01, when flats / built-up areas were sold and sale consideration was reeceived. Therefore, no capital gains tax would be charged in the assessment year, in question, when the agreement was signed. In the present context, paragraph 9 of the order of the High Court, on page 477 of the Report is relevant, which is reproduced as follows :

"9. It may be mentioned that the capital gain can be charged only on receipt of the sale consideration and not otherwise. How can a person pay the capital gain if he has not received any amount. In the instant case, the assessee has honestly disclosed the capital gain for the assessment years 1998-99 to 2000-01, when the flats/areas were sold and consideration was received. During the year under consideration, only an agreement was signed. No money was received. So, there is no question to pay the capital gain. When it is so, then we find no reason to interfere with impugned orders passed by the Tribunal. The same are hereby sustained along with reasons mentioned therein."

3. *CIT Vs Rajesh Bahadur and Others (AOP) [2007] 294 ITR 297 (Del)*

In this case, the assessee was an association of persons (AOP) which by an agreement, dt.1.6.1981, joined together with the common object of re-developing certain property and to build flats on the plot. A return of income was filed by the AOP for the AY 1982-83, showing Nil income. In respect of the year ending 31.3.1988, the assessee submitted a return of income showing a loss of Rs.16,49,310, in which interest payment of Rs.15,86,219, for the period from 30.6.1980 to 31.3.1988, on amounts given to the AOP by its members, was claimed as deduction. One of the issues in this case was with regard to the deletion of addition of Rs.30

lakhs made by the AO on account of value of land adopted by the assessee in the Profit and Loss Account at market value instead of cost price. The assessee had claimed deduction in respect of this amount being the market value of property which was converted into stock-in-trade in June, 1988. The AO had taken the view that the assessee should have taken only the cost price as the value of the opening stock, since the closing stock had been valued at cost and there was no provision in the Act for valuing the stock at market price and as such, he rejected the claim of the assessee.

It was held by the High Court that it is sell-settled that when the capital assets are converted into stock-in-trade, the assessee is entitled to adopt the market value of the asset as on the date of conversion and this principle has been approved by the Apex Court, in the case of *CIT Vs Bai Shirinbai K.Kooka [1962] 46 ITR 86 (SC).* In view of the decision of the Apex Court, the High Court agreed that the reasoning given by the Tribunal that there was no question of valuing the closing stock as on 31.3.1988, because there was no closing stock left on that date and thus, the claim of the assessee was fully justified and allowable.

4. *CIT Vs Subodhchandra S.Patel [2004] 265 ITR 445 (Guj) : 138 Taxman 185 (Guj)*

In this case, the assessee was holding certain shares as capital assets in its books of account. The said shares were converted into stock-in-trade and contributed by the assessee to a partnership firm as its capital. The AO held that the conversion of capital assets into stock-in-trade was not genuine and only capital assets were transferred to the partnership and not stock-in-trade, as claimed by the assessee. Accordingly, the AO taxed the difference in cost of shares and market value of the shares as capital gains in the hands of the assessee. The order of the AO was also confirmed by the CIT(A). On further appeal, the Tribunal, upholding the order of the CIT(A), held that the transaction would amount to transfer, within the meaning of section 2(47), in the light of the decision of the Apex Court, in the case of *Sunil Siddharthbhai Vs CIT [1985] 156 ITR 509 (SC).* Thereafter, the assessee filed a Miscellaneous Application contending that the Tribunal failed to apply second proposition of the said decision of the Supreme Court. The Miscellaneous Application was allowed by the Tribunal.

On a reference, it was held by the High Court that the Revenue admitted in no uncertain terms that the capital assets were transferred within the meaning of section 2(47) from the assessee to the partnership firm, by way of capital contribution and once that was so, it was not possible for the Revenue to contend that the firm was not genuine. The moment the Revenue took that stand, there could be no transfer of the assets and there could be no movement of assets from the assessee to the other entity, which would result in a transfer amenable to capital gains tax.

In the circumstances, once it was held that there was a transfer of the assets from the assessee to the partnership firm, it was clear that the same was without consideration and in such circumstances, no tax on capital gains could be levied, as the computation machinery failed.

In other words, it was held by the High Court that the Tribunal having failed to record a finding in relation to the second proposition of law enunciated by the Supreme Court, in the case of *Sunil Siddharthbhai Vs CIT [1985] 156 ITR 509 (SC)* that a transfer of capital asset by a partner to a firm falls outside the scope of capital gains tax.

5. *Ramesh Abaji Walavalkar Vs Addl.CIT [2012] 80 DTR (Trib) 319 (Mum)*

It was held in this case that on the facts of the case, there was a conversion of land by the assessee into stock-in-trade on 15.5.2002, within the meaning of section 45(2) and therefore, the profits or gains arising from the transfer by way of such conversion were chargeable to tax as the income of the assessee under the heading "*Capital gains*" in the AY 2005-06, in which the stock-in-trade was sold by the assessee.

It was further held that in case of land allotted to the assessee in lieu of acquisition of agricultural land, which was, later on, converted into stock-in-trade and sold by the assessee, the cost of acquisition of the land for the purpose of computing capital gain shall be the market value of the said land on the date of allotment.

IV. Conclusion

In the light of the discussion in the preceding paragraphs, it may be seen that if a person desires to develop or exploit in any other manner, a capital asset held by him, he may take full advantage of the provisions of section 45(2) of the Act. Such a person or the assessee may convert the capital asset into stock-in-trade and thereafter, he may either develop it or exploit it in any other manner.

Such a course of action will be very useful in the case of a person who desires to develop a plot of land, which he is holding as a capital asset. He may convert such a plot of land into stock-in-trade and thereafter, by way of development of the plot of land, he may construct residential or commercial building units on the same. Such a course of action will provide an advantage to such a person, because he will not be required to pay capital gains tax immediately on the date of conversion of the capital asset into stock-in-trade. He may, in view of the provisions of section 45(2) make payment of the capital gains tax at the time of sale of such capital asset, after its conversion into stock-in-trade.

Besides, such an assessee will have another advantage by way of reduction of his tax liability in respect of the gains realized by him, by way of difference between the market value of the capital asset on the date of its conversion into stock-in-trade and the cost of such capital asset.

In other words, he will be required to pay capital gains tax in respect of such gains in place of normal tax, which is definitely higher than the capital gains tax.

Thus, the tax liability of the assessee in such a case will be two-fold, as follows :

1. He will be required to pay capital gains tax on the amount of difference between the market of the capital asset on the date of its conversion into stock-in-trade and cost of such capital asset.

   He will have an additional advantage as such capital gains tax will be required to be paid only at the time of sale of such stock-in-trade.
2. The assessee will be required to pay tax on the business income by way of profit realized by him, as a difference between the sale price of the stock-in-trade and market value of the capital asset on the date of its conversion into stock-in-trade.

The concerned tax-payers may derive lot of tax benefit by following the aforesaid guidelines, in view of the provisions of section 45(2) of the Act.

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