**CONVERSION OF STOCK INTO CAPITAL ASSET- SECTION 28(via)**

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1. **Introduction-**

Finance Act 2018 inserted Clause (via) to Section 28 whereby fair market value of stock in trade on conversion into capital assets is chargeable as profits and gains of business or profession. Section 2(24) also is amended to insert clause (xiia) treating the fair market value of inventory as referred in Section 28(via), as income. The amendment distinctly sounded as a sequel to the amendment in Section 45(2) in the context of Capital Gains, though brought about much belatedly. The echo of this amendment was heard in Memorandum explaining the amendment that –“ Section 45 of the Act, inter alia, provides that capital gains arising from a conversion of capital asset into stock-in-trade shall be chargeable to tax. However, in cases where the stock in trade is converted into, or treated as, capital asset, the existing law does not provide for its taxability. In order to provide symmetrical treatment and discourage the practice of deferring the tax payment by converting the inventory into capital asset, the amendment proposed….”

The reason or objective as echoed, behind such amendment seemed obvious or even logical in view of the prevailing provision like Section 45(2) in case of conversion of capital asset into stock. By way of insertion of Section 45(2) wef 1985, sale of capital asset which is converted into stock was made chargeable as capital gains up to the date of conversion and subsequent gain up to sale as business income. The reverse situation of conversion of stock into capital asset remained without similar chargeability in the Act. The fine reading of the amendment by Finance Act 2018 inserting Section 28(via), however, creates a jolt in travelling beyond the stated objective and seeking to tax the event of conversion of stock into capital asset as income simpliciter rather than providing a mechanism of chargeability of gain. Ostensibly, the amendment seems clear, unambiguous and express but the thorough study of the legal history and the conceptual scrutiny in the context would impel one to draw more than one meaning.

The amended provision on plain interpretation seemingly pre-pones the taxable event even before income is conceived and creates a charge on “Potential Future advantage or notional income”. “Notional income” is presumption while “Potential future advantage” is stage before conception. The amendment appears revolutionary in that sense entailing re-look at the ‘concept of income’ as also the scheme of the Act. The amendment eventually becomes a subject of research and critical study for purportedly piercing the income veil under the Income Tax Act.

The amendment inserting Section 28(via) has deep rooted history where the principles in this context have been enunciated in the classic decisions of the Apex Court. The chronological study and critical analysis is necessary to highlight the controversy and importance of the subject. It is intended to have *all-inclusive* discussion in this study for a coherent conclusion.

1. **Memorandum Explaining Provisions of relating to conversion of stock into capital asset-**

The Memorandum explaining the Amendment objective behind insertion of Section 28(via), further explains the proposed amendment as -

(i) Section 28 so as to provide that any profit or gains arising from conversion of inventory into capital asset or its treatment as capital asset shall be charged to tax as business income. It is also proposed to provide that the ‘fair market value’ of the inventory on the date of conversion or treatment determined in the prescribed manner, ***shall be deemed to be the full value of the consideration received or accruing as a result of such conversion or treatment;***

(ii) clause (24) of section 2 so as to include ‘such fair market value’ in the definition of income;

(iii) section 49 so as to provide that for the purposes of computation of capital gains arising on transfer of such capital assets, the fair market value on the date of conversion shall be the cost of acquisition;

(iv) clause (42A) of section 2 so as to provide that the period of holding of such capital asset shall be reckoned from the date of conversion or treatment.

1. **Provisions as Enacted –**

**Section 28(via) –**“The fair market value of inventory as on the date on which it is converted into, or treated as, a capital asset determined in the prescribed manner.”

**Section 49(9) –**“Where the capital gain arises from the transfer of a capital asset referred to in clause (via) of section 28, the cost of acquisition of such asset shall be deemed to be the fair market value which has been taken into account for the purposes of the said clause.”

**Explanation 1 to Section 2(42A)(ba) –**In the case of a capital asset referred to in clause (via) of section 28, the period shall be reckoned from the date of its conversion or treatment;

**Further Section 43(1) defining Actual Cost is amended to include Explanation 1A as-** Where a capital asset referred to in clause (via) of section 28 is used for the purposes of business or profession, the actual cost of such assets to the assessee shall be the fair market value which has been taken into account for the purposes of the said clause.

1. **History and the Judicial Precedents-**

It would be momentous to first refer to the legal position prevailing before the Amendment with reference to the judicial decisions to grasp the background of the amendment.

**4.1 Does income spring from withdrawal of stock ?**

The footprints of the recent amendment of Section 28(via) can be traced in the judgment of Supreme Court of 1953 in case of Sir Kikabhai Premchand V CIT reported in 24 ITR 506. The provision of Section 28(via) can be laidback to this decision that dealt with question of taxability on withdrawal of stock from business. Undoubtedly a situation of conversion of stock into capital asset! The assesse in that case dealing in silver and shares followed mercantile system of accounting and employed the cost price method for valuation of stock. In the course of the year the appellant withdrew some stock, (bars and shares) from the business. According to the appellant, the act of withdrawal resulted in neither income nor profit nor gain either to himself or to his business, nor was it a business transaction, accordingly it was not taxable.

The withdrawal of stock from business was sought to be taxed by the Revenue on two grounds- Firstly, that as the bars and shares were brought into the business, any withdrawal of them from the business must be dealt with along ordinary and well-known business lines, namely, that if a person withdraws an asset from a business he must account for it to the business at the market rate prevailing at the date of the withdrawal. Secondly, if the act of withdrawal is at a time when the market price is higher than the cost price, then the State is deprived of a potential profit.

Interestingly the judgment was delivered by five judges Bench after granting Special Leave of Appeal by the Supreme Court. The judgment was delivered with one dissenting view comprehending a view that when the asset is withdrawn from the stock-in-trade of the business so far as the business is concerned the asset would go out and cease to be a part of its stock-in-trade and this again would be the measure of the profit or loss as the case may be of the business qua that particular asset. It makes not the slightest difference whether an asset is realised in the course of the business or is withdrawn from the stock-in-trade of the business.

The view of the Revenue and the Dissenting judge seems to wobble between ordinary commercial practice-accounting principle and taxing provision. In commercial practice, one is not able to earn profit on mere change of the intention of user of trading stock to investment. The Accounting principle of Conservatism states that anticipated profits are not recognized but losses are to be provided for. The view thus does not get support from commercial practice and accounting principle. The tax principle was expressed in the majority view of the said judgement.

The question was settled with majority view deciding whether any income would spring at all from withdrawal of stock. While deciding in so many words, the majority view spelt out the fundamental concept of income under the Income Tax Act. Defying the spirit of being frugal with space, I dare to opt for the extravagance of the discussion, in reproducing the extract of the judgement, for one to grasp this fundamental principle so immaculately crafted.

**Majority View**

**First Question-**

For income-tax purposes, each year is a self-contained accounting period and one can only take into consideration income, profits and gains made in that year and not potential profits which may be made in another year. The appellant was right in entering the cost value of the silver and shares at the date of the withdrawal, because it was not a business transaction and by that act the business made no profit or gain, nor did it sustain a loss, and the appellant derived no income from it. He may have stored up a future advantage for himself but as the transactions were not business ones and as he derived no immediate pecuniary gain the State cannot tax them, for under the IT Act the State has no power to tax a potential future advantage. This principle was followed in subsequent decision of Delhi High Court in CIT v. Dhanuka & Sons [1980] 124 ITR 24 (Cal).

**Second Question-**

It is wholly unreal and artificial to separate the business from its owner and treat them as if they were separate entities trading with each other and then by means of a fictional sale introduce a fictional profit which in truth and in fact is non-existent. Cut away the fictions and you reach the position that the man is supposed to be selling to himself and thereby making a profit out of himself which on the face of it is not only absurd but against all canons of mercantile and IT law.

***Remark:***

***4.2 The above dictum clinches the question holding that no income can be said to be earned on mere conversion of stock into capital asset as one cannot make profit with himself so as to tax fictional profit. It unequivocally pronounces the absolute limitation of legislature to plunge such synthetic charge in the waters of income. The limitation is expressed in terms of Power of the State to tax such Potential Future advantage. Quoting this prescription, if Section 28(via) seeks to tax Potential future advantage, one could rather rest his case in defense. This prompts the discussion for testifying the validity of provision, the scope of charge brought in and the workability of the provision.***

**4.3 Conversion of Capital Asset into Stock in Trade-**

The above decision was referred and discussed in subsequent decision of a Apex Court (seven members bench) in case of CIT V Bai Shirinbai K Kooka (1962) reported in 46 ITR 86 SC that dealt with conversion of capital asset into stock in trade (exactly reverse situation) and its ultimate sale. Reference to this decision would further bring clarity to the discussion relating to *insertion* of provision like provided in Section 45(2). With the added emphasis, the question involved was of taxability of gain when there is actual sale /actual income earned in a situation of conversion of conversion of capital asset into stock.

In that case, the assessee held shares as investment which were converted into stock-in-trade and subsequently sold. Issue arose in the said case as to whether the assessee's assessable profit on the sale of shares is the difference between the sale price and the cost price, or the difference between the sale price and the market price prevailing on difference on date of conversion?

Income from sale of shares was computed by the assesse on the basis of the difference between the ruling market price at the beginning of the account year and the sale proceeds. While contending that notionally market value cannot be adopted, Department relied upon Kikabhai’s case. High Court distinguished Kikabhai’s case ; firstly, on the ground that the question before the High Court was the content of taxable profits in a commercial sense out of the amount actually received by the assessee by a sale of her shares, whereas the problem in Kikabhai's case was of a different nature, namely, whether it was open to the Department to tax an assessee on a fictional sale or potential profits; and, secondly, on the ground that the principle laid down in Kikabhai's case had no application to a case where real or actual profits, as distinguished from fictional profits, have to be allocated or attributed to the trading activity. After distinguishing Kikabhai’s case, the High Court accepted the claim of the assesse while computing the business profits from sale of converted stock. The claim regarding cost of stock was accepted at market value on conversion rather than actual cost of the asset so converted. On appeal to Supreme Court, the Supreme Court accepted the distinction made by High Court in Kikabhai’s case and made the legal principle absolute.

**The important observations of Supreme Court are-**

“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. “

***Remark:***

***4.4 The distinction of Kikabhai’s case by the Supreme Court in Shirinbhai Kooka seals the principle of tax on Potential Future Advantage, absolutely. At the same time, the Supreme Court in Shirinbhai Kooka, lays down the law in the context of cost of stock so converted from capital asset to be computed with reference to market value on conversion. The principle was later applied by the Supreme Court in CIT v. Groz-Beckert Saboo Ltd. [1979] 116 ITR 125. In view of this law, the taxable business profits are to be determined by adopting the market value on conversion as cost of stock while the difference between cost price of asset and the market value on conversion escaped from taxation. Precisely for the reason, the introduction of Section 45(2) was thought of by legislature to overcome the judgment of the Supreme Court in what is known as CIT v. Bai Shirinbai K. Kooka [1962] 46 ITR 86. It is thus clear that provision in Section 45(2) was brought to apprehend the escape from taxation; the income attributable to the difference in cost price and market value when the asset is sold.***

1. **Explanatory Memorandum to Taxation Laws (Amendment) Act 1984-II for Introduction of Section 45(2)-**

The intention of the legislature while introducing Section 45(2) gets clear referring to the memorandum explaining Taxation Laws (Amendment) Act 1984-II as -

“Transfer” to include conversion into or treatment as a trading asset - Section 2(47)

2.1 Under section 2(47) of the Income-tax Act, 1961 (hereinafter referred to as “the Act”) the term “transfer” in relation to a capital asset, has been defined to include the sale, exchange or relinquishment of the asset ; or the extinguishment of any rights therein ; or the compulsory acquisition of the asset under any law.

2.2 ***Under the existing provisions, an assessee who converts a capital asset owned by him into a trading asset of his business and then sells the converted asset is able to avoid payment of tax on the capital gains represented by the appreciation in the value of the asset up to the date of its conversion. This is because the assessee can claim that the mere conversion of a capital asset into a trading asset does not amount to a transfer. The assessee can also claim that for the purposes of determining his business profits from the sale of the converted asset, the cost of such asset should be taken as its market value on the date of its conversion into a trading asset and not its actual cost of acquisition to him. Hence, when the converted capital asset is sold by him as stock-in-trade, only the difference between sale price and market value of the stock-in-trade on the date of the conversion of the capital asset can be regarded as profit accruing to the assessee from the transaction.***

2.3 With a view to preventing the avoidance of tax on such capital gains through the device of converting a capital asset into a trading asset, the Amending Act has substituted the definition of “transfer” in section 2(47) of the Act by a new definition to provide that, in a case where a capital asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment shall also be regarded as a transfer of the asset.”

***Remark:***

***5***.***1 It is interesting to note that having amended Section 2(47) defining transfer to include conversion of Capital Asset into Stock, Section 45(2) specifically provided for chargeability therefrom, in the year of sale of stock. Fairly, provision under Section 45(2) honors the fundamental principle as to the power of the state to tax “Future Potential Profits” by not providing chargeability in the year of conversion. The amendment guards the difference in Market Value of Asset on conversion and its actual cost to tax.***

**6.0 Instances of conversion of stock in trade into capital asset-**

The reverse situation of conversion of trading asset into capital asset was not addressed under the Act. In absence of specific provisions to deal with such reverse situation of conversion, taxpayers considered cost of stock as the cost of acquisition of capital asset and holding period reckoned from the date of acquisition of stock upto the date of sale. However, drawing analogy from the provisions as specified under section 45(2) applicable for conversion of capital asset in to trading asset, the tax authorities upon sale of capital asset converted out of trading asset, sought to tax gains till to the date of conversion of trading asset in to capital asset as business income, and only the residual, if any, as capital gains. The discussion highlighting such controversies follows hereinafter-

**6.1 Issues and divergent judicial precedents -**

In absence of specific provisions in reverse situation, i.e., conversion of trading asset in to capital asset, several controversies arose regarding i) the value to be adopted for determining business income, ii) holding period and iii) cost of acquisition of capital asset, etc.

**One view-** Holding period of capital asset to be reckoned from date of conversion when trading asset is converted to capital asset - Where trading asset is converted in to capital asset, the holding period for the purpose of classifying it as long-term or short-term capital asset shall be reckoned by excluding the period for the period it is held as held as trading asset. In other words, holding period of capital asset converted from trading asset to be reckoned from date of such conversion. This view is supported by the following case laws:

(i) CIT v. Abhinandan Investment Ltd. [2015] 63 taxmann.com 263 (Delhi)

(ii) Deensons Trading Co. (P.) Ltd. v. ITO [2017] 81 taxmann.com 71 (Chennai - Trib.)

(iii) Splendor Constructions (P.) Ltd. v. ITO [2009] 27 SOT 39 (Delhi - Trib.)

**Second view -** On sale of capital asset which is converted from trading asset gains arising on transfer shall be treated as capital gain in the year when capital asset is transferred, no business income .This view is supported by the following case laws:

(i) Deeplok Financial Services Ltd. v. CIT [2017] 80 taxmann.com 51/247 Taxman 139 (Cal.)

(ii) Asstt. CIT v. Bright Star Investments (P.) Ltd. [2008] 24 SOT 288 (Mum. - Trib.). The Hon’ble ITAT held as under :

(i) While incorporating sub-section (2) to section 45, the Legislature has not visualised the situation in other way round, where the stock-in-trade is to be converted into the investment and later on the investment is sold on profit. In the absence of a specific provision to deal with this type of situation, a rational formula should be worked out to determine the profits and gains on transfer of the asset.

(ii) The formula which was adopted by the assessees i.e., the difference between the sale price of the shares and the cost of acquisition of share, which is the book value on the date of conversion with indexation from the date of conversion, should be computed as a capital gain was to be accepted.

It is to be noted that no appeal against the above decision was filed by the Department. However the Income Tax Department filed an appeal before the Bombay High Court in the case of Synchem Chemicals (I) Ltd. reported in 384 ITR 498 (Bom.)(HC) wherein the ITAT had followed the decision of ACIT v. Bright Star Investment (P.) Ltd. (supra). The Department appeal was dismissed by the High Court.

**6.2 Cost of acquisition and Indexation-**

In the case of Kalyani Exports & Investment (P.) Ltd./Jannhavi Investment (P.) Ltd./Rajgad Trading (P.) Ltd. v. Dy. CIT [2001] 78 ITD 95 (Pune) (TM) assessee acquired certain shares in the year 1977. On the original holding they received bonus shares in the financial year 1981-82 and additional bonus shares in the financial year 1989-90. All the shares were held as stock-in-trade till 6-11-1987. On the sale of the shares, while working out capital gain, assessee computed fair market price as on 1-4-1981. Indexation was also claimed by taking base year as AY 1981-82. The Assessing Officer held that since the assessee was holding the shares as stock-in-trade up to 2-11-1987 and as the said shares were not capital assets as on 1-4-1981, the option adopted as fair market price as on 1-4-1981 was not available to the assessee and indexation should be allowed from the year of conversion. The Tribunal held as under:

(i) There can be only one acquisition of an asset and that when the assessee acquires it for the first time, irrespective of its character at that point of time. It was therefore, held that what is relevant for the purpose of capital gains is the cost of acquisition and not the date at which the asset became a capital asset. Thus, FMV as on 1-4-1981 was to be taken as cost as acquisition and (ii) Indexation has to be taken from the Base Year 1981-82.

The Department raised a contention in case before Bombay High Court in CIT v. Jannhavi Investment Pvt. Ltd. [2008] 304 ITR 276that by Finance Act, 1992, w.e.f. 1993, the mode of computation of income chargeable under head "Capital gain" had changed and the concept of "indexed cost of acquisition" had been introduced and defined under Expln. III to the 5th proviso of s. 48. According to him the concept "indexed cost of acquisition" was calculable on the basis of the cost of acquisition for the first year in which the asset was held or on the first day of April, 1981, whichever was later. Section 55(2)(b) which related to calculation of the cost of "any other capital asset" was referred. The High Court held that-

The amendment of 1993 referred to hereinabove does not in any way nullify or dilute the ratio as laid down in the case of Keshavji Karsondas v. CIT reported in [1994] 207 ITR 737 (Bom.) The cost of acquisition can only be the cost on the date of the actual acquisition. There was no acquisition of the shares when the same were converted from stock-in-trade to a capital asset.

***Remark:***

***The Amendment inserting Section 28(via) could have been intended to counter the issues in the context of capital gains relating to the cost of acquisition and the indexation benefits with reference to holding period reflected in the past actions and the controversies arose in the context. It indeed would be rhythmic with the scheme under section 45(2). The scheme of amendment brought about by way of Section 28(via) needs to be relooked from this background.***

**7.0 Comparative analysis of Section 45(2) and Section 28(via)-**

The comparative study of mechanism of chargeability with reference to Section 45(2) vis-a vis 28(via) may bring clarity and understanding of the provision.

1. **Concept**-45(2)-When Capital Asset is converted into stock in trade, the said stock is intended to be readily sold at the earliest occasion and profit would arise from such sale. The profit is conceived though would germinate only on sale.

28(via)-In case of conversion of Stock into Capital Asset, the subsequent course would diverge in each case. e.g. For earning income by exploiting the asset from its use like rent/lease or for personal use or for the purpose of business as fixed asset. The act of change of intention of its holding as stock or conversion of stock in trade into asset per se is a stage of changing the gear for different stream of income. The conversion itself does not create any specific source or title for earning income but the subsequent actions or decisions in respect of the asset would create the way for springing the income. The conception of income at this stage is obscure.

1. **Objective**-45(2)-The object as stated in amendment to Section 45(2) as in case of conversion a capital asset into a trading asset of his business, was to prevent avoidance of tax on the capital gains represented by the appreciation in the value of the asset up to the date of its conversion escaped taxation.

28(via) -In reverse case of conversion of stock into capital asset, there is no such escapement of tax and the entire gain is taxed as capital gains in absence of mechanism to bifurcate business income upto the date of conversion. There is no tax avoidance though there may be tax benefit in terms of concessional tax rate applicable for Capital Gains.

1. **Chargeability and Computation-**Section 45(2) provides that the profits and gains arising from the transfer by way of conversion of a capital asset into stock in trade shall be chargeable to income tax as-

Income of the previous year in which such stock in trade is sold or otherwise transferred.

For the purpose of Section 48, the fair market value of the asset on the date of conversion shall be deemed to be the full value of consideration received or accruing as a result of transfer of the capital asset.

The mechanism clearly spells out the consideration being fair market value and the chargeability in the year of sale of stock or otherwise transfer. The mechanism achieves to bifurcate the profit on sale of asset so converted into capital gains and business income to be taxed in the year of actual sale or transfer.

28(via) -The perceptive look at the wordings of Section 28(via), on the other hand, shows that it creates a charge upon the fair market value of the inventory on the date of conversion or treatment stock into capital asset as a business income. The Section does not provide for the year of the chargeability.

Section spills the computation over Rule 11UAB that specifies differential methods to determine fair market value as consideration for different types of assets. Clause (i) of Rule 11UAB provides that in case of Land or Building or both, the Value assessed or assessable by the State Government for stamp duty purposes on the date of conversion. In other words the valuation for stamp duty purposes is prescribed as Fair Market Value. It makes a wide departure from the one provided in Section 45(2) in inserting this Stamp Value basis.

Fair Market Value being placed synonymous to State Govt’s Stamp duty itself is a contradiction in view of the settled legal principles. The valuation made by the Stamp Authorities may not represent the fair market value. Refer decision of Madras High Court in the case of Thulasimani Ammal V CIT 158 CTR 5. In the decision of Madras High Court in the case of Ponnusamy & others V Collector of land 1999, the High Court held that the guideline value is not the conclusive evidence of the market value of land. Supreme Court in the case of Ramesh Chand Bansal Vs District Collector (11/5/1999) has held that the circle rate is not final but it is prima facie determination of rate in the concerned area to give guidance to the registering authority to test prima facie whether the instrument has properly described the value. The Supreme Court held that the circle rate has limited application and it does not take away any right of any person to show that the land was correctly valued in case of undervaluation. Ref ACIT V Mrs N Meenakshi reported in 125 TTJ 856 Chennai Bench and Neville De Noranhe V ACIT reported in 115 TTJ 390 Kol.

The basis of Stamp Duty Value is also found in provisions like Section 50C and Section 56. These provisions provide an inbuilt mechanism to verify the Stamp Value with the fair market value if disputed by the Assessee. The assesse has been provided right to challenge the Stamp Duty value if it does not represent the fair market value. The Assessing Officer is bound to make reference to the Valuation Officer to determine the fair market value. No such mechanism is provided in Rule 11UAB.

The delegation to subordinate legislation of a friendly and fortified computation mechanism as prevailing in Section 45(2) makes it impertinent. The still gap left in such computation about the year of chargeability is probing rather galloped as unintended omission.

1. **Fiction-**45(2)-In the context of Section 45(2), the legislature unhesitatingly enacted it as a fiction by deeming it as transfer and deeming the fair market value as consideration.

28(via) -The candid expression in Section 28(via) coupled with other related amendments is a manifestation of the conceptual overconfidence that it is by its very nature an income. The inconsistency in expressions between the two provisions hovers un-reconciled.

1. **Accrual-**The provision 45(2) makes a departure from the charge under Section 45(1) with reference to year of transfer and the Capital Gains is made chargeable to income tax as income of the previous year in which such stock in trade is sold or otherwise transferred.

28(via) -The charge under Section 28 of the Act provides that the income from business would arise and accrue when the right to receive income arises as per Section 4. Section 28(via) treats conversion of stock into capital asset as profit or gains from business. Having created a dent in the fundamental principle of accrual of profit when there is no actual right to receive income, an enabling provision for accrual of income ought to have been spelt out and specifically provided. Corresponding amendment in Section either Section 4 or 9 could have been comprehended. Absence of the vital in Section 28(via) is blatant.

1. **Ancillary Amendments-**Section 45(2) created a charge by amending transfer u/s 2(47) to include conversion of capital asset into stock in trade and providing the chargeability with computation mechanism in Section 45(2).

Section 28(via) fore mostly stroked definition of income under section 2(24). Section 28(via) dragged amendments in Sections 49(cost of acquisition), 2(42A) Period of Holding, 43(1) actual cost. The consequential amendments synchronize with the subsequent workability of capital gains under the Act. Of these consequential amendments, one provided in Section 43(1) is perplexing for providing depreciation on the value adopted in Section 28(via). A disguised super imposition of the charge under section 28(via).!

**8.0 Literal Interpretation Vs Purposive Interpretation-**

The moot question to be resolved is as to whether the provision is clear and unambiguous or open for more than one interpretation. The chronology of the amendments with the legal history makes the construction of the provision critical.

The words if considered plain and unambiguous would make the conversion an income simplicitor. The same needs to be tested on the dictum in the context of “Potential Future Advantage” as also fictional sale on impossibility of making profit out of himself.

The amendment clearly strikes the fundamental principle laid down in Kikabhai’s case. Firstly it treats the conversion as business whereas Supreme Court said it was not a business transaction. So is the principle that there is no pecuniary gain. Such interpretation creates a charge on inchoate income.

**9.0 “Potential Future Advantage” on Conversion of Stock into Capital Asset:**

At this juncture, it is pertinent to understand the concept of conversion of Stock into Capital Asset. Stock in Trade presupposes that an asset is held in the business for the purpose of earning profit by sale or turnover. The conversion of stock into capital asset itself does not create a source for earning income but the subsequent actions or decisions in respect of the asset would create the way for springing the income. As discussed earlier, in case of conversion of Stock into Capital Asset, the subsequent course would diverge in each case. e.g. For earning income by exploiting the asset from its use like rent/lease or for personal use or for the purpose of business as fixed asset. In the event, stock is converted to earn income from its use, act of conversion is just a mental state to be followed by the actual action for generation of income. So is the case for situation when conversion of stock is made to use the asset for business as fixed asset. The income that would arise is profit from such business which cannot be attributed purely to the event of conversion. The linking of business profits with the conversion of asset is farfetched, as profits is the result of so many factors rather than just conversion of one asset. In situation when stock is converted for personal use, the asset goes out of income earning apparatus in every situation. So act of conversion do not lead to any potential income. The source of resultant income will have various Heads of income which enjoy different set of rules for actual income/profits computation.

In all these eventualities, there are variant subjective factors that would independently operate and make the income susceptible. E.g if asset is to be used for earning rental income but no such income could be earned for varied reasons like no buyer could be found for rental or the rent was not received out of default.

Conversion does not have any tangible existence and is mere a mental (theoretical) state. It cannot be called even a transaction. A transaction would take place between minimum two persons. (P.K.Subramania Iyer Vs CGT(1968) 67 ITR 612(Mad-HC). To treat the conversion of stock into capital asset as business would involve impossibility of one trading with himself.

Even though a literal interpretation is to be applied, the Act is silent on the year of accrual which in absence of specific provision is to be the year in which right to receive arises. This lacuna itself makes the provision vulnerable to more than one interpretation.

***Remark:***

***The literal interpretation would make provision preposterous. The purpose behind the Amendment as stated in the Memorandum accords such conclusion. An even handed reference to the object and purpose stated in the Memorandum would show that such construction was not thought of even by the legislature.***

**10.0 Object behind the Amendment-**

As per Memorandum, the object as stated is “In order to provide symmetrical treatment and discourage the practice of deferring the tax payment by converting the inventory into capital asset”.

If the intention is to give symmetrical treatment, the amendment makes a wide departure and seeks to travel much ahead of providing for symmetrical tax treatment.

The second object as stated is to discourage the practice of deferring the tax payment by converting the inventory into capital asset. The mere conversion of Stock into capital asset does not give any taxable event and therefore in a genuine case of conversion, the action of deferment of tax would not arise. However, some practices of conversion involving tax deferment as indicated in the Memorandum suggests some artificial or dubious methods to obtain unfair tax advantage. The stated object is capturing such illegal practices.

One has to fall on aid to interpretation when literal interpretation is unworkable. The words or text understood to be ambiguous or open for more than one interpretation, purposive interpretation can be fallen upon. In case of doubt or difficulties encountered in ascribing proper meaning to a provision or word in a provision the Statement of Object and Reasons or the Explanatory Notes on Clause relating to the amendment or the report of the Joint Parliamentary Committee which preceded the legislation concerned will be useful to ascertain the intention of the legislature in enacting a particular provision [M Rangaswamy v. CWT. (1996) 221 ITR 39, 45 (Mad)].

In determining the legislative intent the three factors are required to be considered viz the context and the object of the statute, the nature and precise scope of the relevant provision and the damage suffered not of the kind to be guarded against.

**11.0 Mischief Rule-**

The mischief rule of statutory interpretation could be applied while there is ambiguity in the statute. Under the mischief rule the court’s role is to suppress the mischief the Act is aimed at and advance the remedy. Under the Rule, four things are to be considered -

1) What was the law before the passing of the Act?

2) What was the mischief and defect for which the law did not provide?

3) What remedy the Parliament has resolved and appointed to cure the Mischief.

4) The true reasons for the remedy.

And then the Court is always to make such construction as shall suppress the mischief and advance the remedy.

Mischief is part of the context and that other sections of the statute, the preamble, the existing state of the law and other statutes in pari materia may be used to throw light on that mischief.

***Remark:***

***The Mischief Rule would fall on the objective behind the amendments and would operate to construe the provision so as to provide symmetrical treatment in case of conversion of stock into capital asset, like one provided in Section 45(2) and not beyond. The intendment of the amendment to the provisions u/s.28 of the Act is pari materia with section 45(2).***

**12.0 Constitutional Validity-**

Though the question of Constitutional validity becomes a broad spectrum of challenges, the specific areas challenges can be highlighted-

**12.1 Definition of Income-**

Article 246 of the Indian Constitution, distributes legislative powers including taxation, between the Parliament of India and the State Legislature. Schedule VII enumerates these subject matters with the use of three lists: Union List, State List & Concurrence List. Sl No. 82 of the Union list mandates – Income Tax – Taxes on income other than agricultural income.

The term “Sale” falls into definition of income. However, in the given situation, it is really the potential future advantage that needs to be tested. As held by Supreme Court in case of Kikbhai’s case that in such transaction, no income is earned and at the most it may have stored up Potential future advantage. The state has no power to tax such income. This may become a ground of challenge the constitutional validity with reference to the specific entry no 82 relating to Income. Income in the said entry of the Union List, would not include potential future advantage. The scope of income within the meaning of Entry 82 needs to be tested on these lines. This challenge would be testing the legislative competence.

Supreme Court in K P Varghese V ITO reported in 131 ITR 597 held that -It is a well settled rule of interpretation that the Court should as far as possible avoid that construction which attributes irrationality to the Legislature. Besides, Art. 246, under entry 82 in List I of the Seventh Schedule to the Constitution, which deals with "Taxes on income other than agricultural income" and under which the IT Act has been enacted, Parliament cannot choose to tax as income an item which in no rational sense can be regarded as a citizen’s income or even receipt. It is now a well-settled rule of construction that where the plain literal interpretation of a statutory provision produces a manifestly absurd and unjust result which could never have been intended by the Legislature, the Court may modify the language used by the Legislature or even "do some violence" to it, so as to achieve the obvious intention of the Legislature and produce a rational construction vide Luke vs. IRC (1963) AC 557. The Court may also in such a case read into the statutory provision a condition which, though note expressed, is implicit as constituting the basis assumption underlying the statutory provision.

**12.2 Violation of Constitutional Provision-** **Discrimination between two classes of taxpayers and violating Article 14 of the Constitution**

i. The purpose is to introduce symmetrical provisions for taxing conversion of trading asset into capital asset vis-à-vis the already existing provisions under section 45(2) for conversion of capital asset in to a trading asset. However, the year of taxability of business income in the proposed amendment in the case of conversion of trading asset into capital asset is not aligned with the existing provision on conversion of capital asset into trading asset and, accordingly, proposed amendment creates a discrimination among two class of assessees which is against the provisions of Article 14 of the Constitution.

ii. The mechanism in Section 45(2) clearly spells out the consideration being fair market value.

Clause (i) of Rule 11UAB provides that in case of Land or Building or both, the Value assessed or assessable by the State Government for stamp duty purposes on the date of conversion. It creates discrimination among two class of assessees which is against the provisions of Article 14 of the Constitution.

iii. Within Rule 11UAB, the valuation for different categories of assets creates discrimination among the different classes of assets without any rationale. Under clause (iii) being residual clause for other assets the Rule prescribes the value that would be ordinarily fetched if sold in the open market as fair market value as against Stamp Duty Value for Land and Building.

iv. An inbuilt mechanism to verify the Stamp Value with the fair market value if disputed by the Assessee in provisions like Section 50C and Section 56. No such mechanism is provided in Rule 11UAB.

v. The object behind the amendment being to curb the practices of deferring the taxes, the amendment is made uniformly applicable to genuine transactions done in normal course. This violates Article 14 of the Constitution and makes the provision vulnerable to challenge on the ground of being unreasonable, arbitrary and causing hardship.

**13.0 Doctrine of Reading down-**

In view of the questions as to legislative Competence or Violation of Constitutional Provision, the Doctrine of Reading Down may be relevant.

The rule of reading down statutory provision means that a statutory provision is generally read down in order to save such provisions from being declared illegal or unconstitutional. The rule of reading down is in itself a rule of harmonious construction in a different name and generally used to straighten crudities or ironing out creases to make a statute workable. This rule should be used for limited purpose to bring it in harmony the provisions of the statute.

The second situation which summons its aid is where the provisions of the statute are vague and ambiguous and it is possible to gather the intention of the legislature from the object of the statute, the context in which the provision occurs and the purpose for which it is made.

**14.0 Concluding Remarks-**

The whole discussion is intended to high light the excessiveness in the literal interpretation of the provision contained in Section 28(via). The actions in compliance of the provision may not be decided without giving deep thought and study of the subject. The professional acumen ought to take appropriate efforts to test the provision at its optimum.