Should Share Losses of Companies due to Valuation of Stock be treated as 'Speculative'?

Explanation to section 73 of the Income Tax Act, 1961 brings all the profits and losses pertaining to share transactions of trading and manufacturing companies under the ambit of 'Speculation' i.e. such profits and losses are treated as speculative profits or losses as the case may be. Speculative losses can be set off against speculative profits of the current year or that of the subsequent four years. In this connection a question arises whether a loss incurred in connection with share business of trading and manufacturing companies (not because of sale and purchase of shares but because of valuation of stock-in-trade) be treated as speculative loss. A loss which arises on account of valuation of shares is neither in the hands of the company nor does it pertain to sale and purchase of shares, and moreover, cannot be said to have incurred with a motive to manipulate and reduce taxable income of companies, and therefore, must be treated as ordinary loss or profit as the case may be.

Meaning of Speculative

Speculative loss or profit arises from a speculative transaction. 'Speculative Transaction' has been defined under subsection (5) of section 43 of I.T. Act, 1961, which reads as under:

"Speculative Transaction means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips:

(a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchandising business to guard against loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him; or

(b) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or

(c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; [or]

(d) an eligible transaction in respect of trading in derivatives referred to in clause [(ac)] of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) carried out in a recognised stock exchange;

shall not be deemed to be a speculative transaction"

As per the definition mentioned above, it is clear that when a transaction in which a contract for purchase or sale of any commodity including shares and stocks is settled otherwise than by the actual delivery or transfer of the commodity or scrips, it is treated as a speculative transaction. The above definition is subject to certain exceptions as stated in the proviso, which are not of much importance in connection with the subject matter under discussion.

Share Transactions considered as Speculative even on Actual Delivery

So far as shares are concerned, a transaction of sale and purchase of shares, even if settled on actual delivery, can still be treated as a speculative transaction in some cases. This is due to the operation of the Explanation to section 73 of the I.T. Act, 1961. Section 73 of the Act states that any loss from a speculative business carried on by the assessee can be set off with another speculative

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business only and not against profits and gains of normal business. The following Explanation to the aforesaid section states that:

"Where any part of the business of a company [(other than a company whose gross total income consists mainly of income which is chargeable under the heads 'Interest on Securities', 'Income from house property', 'capital gains' and 'Income from other sources') or a company the principal business of which is the business of banking or the granting of loans and advances] consists of the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares."

The effect of the insertion of above explanation is that the income of all companies, which are either trading or manufacturing and deriving income from sale and purchase of shares, is treated as speculative income (profit) notwithstanding the fact that sale and purchase took place on actual delivery basis. The only exception to the above Explanation are such companies whose main income falls under the heads interest on securities, income from house property, capital gains or income from other sources. Exception also includes companies whose principal business is that of banking or the granting of loans and advances. Such companies are known as Investment Companies.

Background of Insertion of Explanation to Section 73

It seems that the Exchequer believed that many trading and manufacturing companies used to enter into share transactions and derive deliberate losses to set off against their profits from usual trading and manufacturing business and thus were able to avoid the taxes payable by them. Such share transactions used to take place on actual delivery basis so that the same may not fall under the definition of speculative transaction.

Hence, in order to curb such practices and based on the recommendation of the Wanchoo Committee, an Explanation to section 73 was inserted by the Taxation Laws (Amendment) Act, 1975, w.e.f.1.4.1977, whereby all trading transactions in shares entered by the trading and manufacturing companies are considered on speculative transaction notwithstanding the fact that these were effected through actual delivery of scrips.

As stated earlier, the following companies have been excluded from the operation of the aforesaid provisions:

1. A company whose gross total income consists mainly of income, which is chargeable under the following heads:
   (a) Interest on securities.
   (b) Income from house property
   (c) Capital gains
   (d) Income from other sources.
2. A company the principal business of which is banking or the granting of loans and advances.

So far as losses incurred by trading and manufacturing companies on sale and purchase of shares are concerned, the same are treated as speculative loss due to insertion of aforesaid Explanation since there is a possibility that such companies may enter into sham share transactions and thereby derive losses which may be adjusted against their profits to avoid the legitimate tax which was otherwise payable by the companies, and the aforesaid explanation was inserted keeping this aspect in mind.

Valuation of Stock-in-Trade

However, in this connection a point arises in a case wherein a company does not enter into any transaction of sale and purchase during the year and still suffers loss in share trading account due to valuing the closing stock of shares at cost or market value of shares, whichever is lower, as per the practice regularly followed by the company in the past.

Accounting Standard-2 (AS-2) issued by ICAI deals with valuation of stocks, which states that 'inventories should be valued at a lower cost and net realisable value'. This standard does not apply to inventories consisting of shares, debentures and other financial instruments held as stock-in-trade.

Accounting Standard–13 (AS-13) deals with Accounting for investments, which is applicable

for investments only. Therefore, there is no mandatory Accounting Standard for valuation of shares held as stock-in-trade. But in the absence thereof, the trading or manufacturing companies generally follow the practice of valuing Closing Stock (Trading Stock) of shares (other than shares held as an investment) on the basis of AS-2 that is lower of cost or net realisable value.

In case shares are held by Trading and Manufacturing Companies as investments, the same are to be valued in accordance with Accounting Standard-13 (AS-13) which states that current investments should be valued at cost or fair market value, whichever is lower. Long-term investments are generally valued at cost.

NBFC companies are required to value their investment in shares in accordance with NBFC Prudential Norms (Reserve Bank) Directions, 1998 issued by Reserve Bank of India.

Section 145 of the Income Tax Act, 1961 states that method of accounting should be either cash or mercantile system of accounting regularly employed by the assessee. However, so far as companies are concerned they are bound to follow the mercantile (accrual) system of accounting as per the provision of section 209(3)(b) which requires that books of account should be kept on accrual basis and according to the double entry system of accounting.

Section 145A of the I.T. Act, 1961 requires that method of valuation of stocks should be in accordance with the method of accounting regularly employed by the assessee.

From the above, we can conclude that companies are under mandatory obligation to value their stock-in-trade in accordance with the method of valuation regularly employed by them and are not allowed to deviate from the same as required by section 145A of the I.T. Act, 1961.

No Option With the Company

In view of valuing the stock-in-trade as per the system regularly followed, a company has no option to deviate from the system and has to value the stock-in-trade as per the system of valuation regularly followed by it in the past, which is generally cost or net realisable value, whichever is lower.

By following the aforesaid system, a company suffers loss in shares due to valuation of shares at cost or net realisable value, whichever is lower. Net realisable value depends on the market and in case of heavy fall in Sensex of shares a company is bound to value its stock-in-trade of shares at a lower value and thereby suffer losses.

The issue is whether the aforesaid loss is to be termed as 'Speculative' over which the company does not have any control. No company can deliberately incur loss in the shares, which occurs due to valuation and to adjust the same against profits of the company from the other business. Then, there appears to be no valid reason to treat such loss as speculative. However, in many cases whenever Department came

across any loss from shares by a company, it held the same as 'speculative' without going into the cause of loss by applying the Explanation to section 73 of the I.T. Act, 1961.

Loss Occurred Due to Valuation to be treated as Ordinary Loss

It is submitted that from the plain language, the Explanation to section 73 clearly states that any loss that arises on account of sale and purchase of shares be treated as speculative. In other words where loss did not arise because of sale and purchase but because of valuation only, the same should not be considered as speculative. For example, in case a company neither purchases nor effects sale of any share during the year, but suffers a loss of Rs. 10 lacs in shares due to valuing its stock-in-trade of share as per the practice regularly followed by it in the past; then the company is under mandatory obligation to follow the same. How can this loss be treated as of speculative nature when it was not at all incurred on account of sale or purchase of shares?

Case Laws on the Subject

The aforesaid view was accepted by the Honorable Income Tax Appellate Tribunal, Delhi Bench in the case of *Marathon Money Market Ltd. vs. I.T.O.* (ITA No. 4553/Del/02).

Moreover, as per the Karnataka High Court decision in *Mysore Rolling Mills (P) Ltd. vs. CIT* [1992] 192 ITR 404, unless it is conclusively established that the assessee had entered into a transaction clearly as a speculative venture, the courts cannot infer the transaction to be a speculative venture only because the assessee had subsequently derived the benefit of tax reduction. As held by this High Court the facts of each case will have to be examined to arrive at the conclusion whether the transaction in question is a speculative venture or business transaction. The nature of the assessee's business in general, the purpose behind the particular transaction, the effect of the transaction etc. are all to be considered.

In *Apollo Tyres Ltd. vs. CIT* (2002) 255 ITR 273, it was held that buying and selling of units by the assessee company could not be treated as a speculative business because in the absence of any specific deeming provision in regard to the units as shares it would be erroneous to hold the unit as a share.

The object of introduction of the Explanation to Section 73 was to curb the device sometimes resorted to by the business houses controlling group of companies to manipulate and reduce the taxable income of companies under their control, which was reflecting from the departmental Circular No. 204 dated 24.7.1976. In the light of the aforesaid circular Kolkata Bench of the Tribunal in *Paharpur Pooling Towers Ltd. vs. Deputy CIT* (2003) 85 ITD 745 has held that in the aforesaid case as there is nothing on record to suggest that there was any effort to manipulate or reduce the taxable income, the application of Explanation to Section 73 will be contrary to legislative interest behind introducing the provision.

In another case, it was held that unless the loss was resorted to in terms of Para 19.2 of Circular No. 204 to manipulate and reduce the taxable income, authorities were not justified in treating the loss as a speculative loss by invoking the Explanation to section 73 [*Aman Portfolio (P) Ltd. vs. DCIT* (2005) 92 TTJ (Del) 351].

Conclusion

The Explanation to Section 73 was introduced to curb the device sometimes resorted to by business houses controlling group of companies to manipulate and reduce the taxable income of companies under their control. The losses otherwise incurred by trading and manufacturing companies in their share transactions should not be treated as that of speculative nature. In view of the above as well as the plain language of the explanation, where the loss is incurred due to valuation over which a company has no control and also does not pertain to sale and purchase of shares, and as such, it cannot be said that the loss so arrived was with a view to manipulate and reduce the other taxable income. And therefore, losses suffered on account of valuation do not fall at all under the ambit of speculation. ❐