Derivatives- Income Tax Provisions

According to Securities Contract Act 1956, the derivative is a contract between two or more parties, and its price is directly related to the fluctuations of price of the underlying asset. The most common types of derivatives in India are futures and options.

Futures:

Future is a contract to buy or sale an underlying asset on a specified date at a predetermined price. On expiry of contract, futures are executed by delivering the underlying asset or through payment. In case of Futures, the buyer doesn’t have an option to cancel the contract before the pre determined date.

Options:

Option is like that Futures, here the person has an option to cancel the contract before the predetermined date, but has to pay the premium on transaction at the time of contract. When the contract gets cancelled, the premium amount was not refundable.

According to Sec 43(5) of the Income tax Act 1961, has specifically excluded the transactions in F&O market from being treated as speculative transactions. Even though these transactions are non-deliverable, these transactions would still be treated as non-speculative transactions. It would be treated as like any other business income and the expenses relating to the income will be claimed as deduction.

Section – 43 of the Income-tax Act 1961

(*5*) “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 scrip’s:

Provided that for the purposes of this clause—

(*a*) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting 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; [or]

(*e*) an eligible transaction in respect of trading in commodity derivatives carried out in a recognised association, which is chargeable to commodities transaction tax under Chapter VII of the **Finance Act, 2013** (17 of 2013),

Shall not be deemed to be a speculative transaction:

Computation of turnover and profit:

Turnover in case of F & O trading is determined as follows:

1. Total of favourable and unfavourable differences

2. Premium received on sale of options is to be included in turnover(only Options not for Futures)

Example: Mr. X bought 100 units of futures @ Rs. 3,00,000 and sold them at Rs. 3,80,000. In this case profit should be Rs.80,000

Mr. X also bought 200 units of options @ 4,50,000 and sold it @ Rs. 3,80,000. In this case loss should be Rs. 70,000

Total profit = Rs.80,000-Rs.70,000=Rs.10,000

Turnover of Mr.X = Rs.80,000+Rs.70,000=Rs.1,50,000 (In case of options premium should also be added to the turnover)

Nature of income:

If the transactions in the share market are entered into for the purpose of investment-the gains arising on such transactions would be treated as Capital gains. However if the transactions are entered in to for the purpose of business transaction then the gains arising on such transactions would be treated as Business income. It would be determined on the facts of each case whether the delivery based transactions are to be treated as capital gains or business income.

STT would not be allowed as deduction if the transaction is treated as **Capital Gains**, is only allowed as deduction when the transaction would be treated as an business income.

Normal tax rate provisions will be applicable to the business income and in case of capital gains- STCG & LTCG provisions will be applicable.

Applicability of Tax Audit Provisions:

If the turnover from the Futures and Options exceeds Rs. 1 Crore Tax Audit provisions Sec 44AB will be applicable. If the turnover is less Rs.2 Crores Presumptive Taxation provisions Sec 44AD will be applicable.

Treatment in case of losses:

Business Loss: Any loss from the Non speculative business can be set off against the incomes in the current year but not against salary income. After set off against current year income, any excess loss will be there and this loss will be carried forward to the next 8 years.

Carried of losses will be disclosed in the current year ITR while filing the income tax returns. Loss shall only be allowed for carried forward, if the return filed only within the due date. If the return is not filed within the due date then carried forward of such loss shall not be allowed.

Capital Loss: STCL or LTCL can be set off against LTCG. LTCL can be set off against LTCG only. STCL and LTCL cannot be set off any other incomes. If there is any excess loss in the current year after set off then such loss shall be carried forward to the next 8 Years.

Source courtesy: Taxguru