TAXATION ASPECTS OF FUTURES & OPTIONS

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Derivatives are powerful "Risk Management Tools". The markets of derivatives have popularly grown and it has assumed a very significant place in the capital market of our country. The Turnover of Derivative segment has outnumbered the turnover of Cash Market segments on two leading Stock Exchanges of our country. Currently, Futures and Options are very popular contracts of a financial derivative market and are regularly traded on both these exchanges.

The word "Derivative" originates from the mathematics and refers to a variable, which has been derived from another variable. The term derivative indicates that it has no independent value and its value is entirely derived from the value of the underlying asset. The contracts on Derivatives are specialised contracts entered in cash or spot markets the settlement of which is deferred on some future date. The value of contract depends on time factor and also on price of underlying asset, which is essential ingredient of derivative contract.

Futures Contracts

Futures contract is an agreement to buy or sell an underlying asset at specified future date at specified future price. They are standardised contracts traded on the exchange. They are standardised in terms of size, expiration date, settlement terms, etc. The price at which the contract will be settled in future is agreed upon at the time of entering into the contract and it casts an obligation on both the parties to fulfill the terms as specified in the contract.

Commodity futures contracts have the underlying assets as agricultural commodities, precious metals, etc., whereas financial futures contracts have financial assets like currency, bonds, shares, index equity stock etc.

When an investor buys a futures contract from an exchange he is assuming a right and obligation to take the delivery as per terms of a contract on agreed future date and the vice-a-versa when he sells it. Futures contract, the underlying of which is a specific stock, is known as "Stock Futures" and in case the underlying is the stock index, it is known as "Index Futures". As on date Stock Exchanges permit trading in 3 months futures contracts, i.e. in the month of October 2005, the Futures, which can be traded, are October 2005, November 2005 and December 2005.

Options Contracts

Options are type of derivative contracts where a person gets a "right" but not an "obligation" to buy or sell an underlying asset at an agreed price on or before the specified future date. Under an options contract, the right (option) is purchased from the seller. This option may be the right relating to purchases (call option) or the right relating to sales (put option). The person who buys such right is called 'Buyer' or 'Holder' of the contract and the person who sells this right is known as 'Seller' or 'Writer' of the contract. The buyer of the contract has a right but not an obligation to perform as per the terms of the contract and for acquiring this right, buyer has to pay 'Premium' to the seller. This premium amount is one time cost and not adjustable against final consideration. On the other hand, the seller has an obligation to buy or sell the specified underlying asset at an agreed price, if the buyer chooses to exercise the option, whether call or put.

There are two types of options, i.e. American Options and European Options. An American Options is an options contract that can be exercised at any time between the date of purchase and the date of expiry, whereas European Options is an options contract that can only be exercised on the expiration date. A person can buy either a call option or a put option.

The rights and obligations of the parties involved in an options contract can be summarised in a tabular form, as under:

The price at which the buyer has a right to buy or sell an underlying asset is known

as 'Strike Price' or 'Exercise Price', which is agreed at the time of entering into a contract by both the parties.

As on date Stock Exchanges have 3-month options contract with an underlying asset of either a Stock Index or a particular Stock. The index options contract is named such as to state the month expiry, call or put option, European or American Options and Strike price.

Taxation Aspects of Futures and Options

The question as to whether the transaction has been entered into, as a "Trader" or "Investor" is first required to be answered, before one analyses the tax provisions relating to dealing in derivatives. Profit on dealing in contracts held as "Stock in trade" is taxed, as a "Business Income" and dealing in such contracts, which are held as an Investment, would be taxable as a "Capital Gain". The frequent & regular activities & also the motive of entering into a transaction can determine whether the activities relating to purchase or sale is a "Business activity" or an "Investment activity".

Some indicative parameters are given hereunder, which however, requires to be examined on case-to-case basis.

(a.) Motive/intention while purchase.
(b.) Frequency of transaction.
(c.) Regularity/continuity of transactions.
(d.) Volume of transactions.
(e.) Period of holding.
(f.) Source of acquisition.
(g.) Existence of other business.
(h.) Object clause in Memorandum of Association.
(i.) Percentage of volume between delivery based/non delivery based transactions.
(j.) Status/nature of activities in previous years.

Keeping in mind the demarcation of "Investment Activity" and "Business Activity", let us examine the taxation aspects relating to Derivatives for both:

(i.) Investors
(ii.) Traders

Option	Buyer or Holder	Seller or Writer
Call	Right but not an obligation to buy the underlying asset	Obligation but no right to sell the underlying asset.
Put	Right but not an obligation to sell the underlying asset	Obligation but no right to buy the underlying asset

Derivative Transaction for an Investor

Index Futures for an Investor

If an investor enters into transactions relating to purchase and sale of an "Index", the amount of profit or loss is taxable under the head "Capital Gain" or Otherwise?

Any transaction on Capital Gain is primarily required to be examined with reference to the following factors:

i. Whether the transaction relates to a "Capital Asset"?
ii. If it relates to a Capital Asset, whether such asset is transferred or not?

In the given case one has to examine the transaction on the basis of following conditions:

i. Whether Index Futures can be regarded as "Capital Asset"?
ii. Whether settlement of Index Futures transactions involves "Transfer"?

Let us further examine both the conditions.

(i) Condition regarding Capital Asset:

Section 2(14) of Income Tax Act defines the Capital Asset as, *"Capital Asset means property of any kind held by an assessee, whether or not connected with his business or profession……".*

Derivatives transactions (in Index Futures) are regarded as "Securities" under the Securities Contracts (Regulation) Act, 1956. Index Futures contracts are contracts carrying rights that can be enforced in the market and they can be considered as a property carrying value. Under this premise Index Futures can be considered as a "Capital Asset".

(ii) Condition regarding transfer

Section 2(47) of the Income Tax Act, defines "Transfer" in relation to Capital Assets,

To include "the sale, exchange, or relinquishment of the asset, or extinguishments of any rights therein or……..".

In case of Index Futures, settlement through deliveries do not take place and the differences are settled in cash. The rights under the contract expires, at the time of settlement or maturity. In practice, the situation is that the Investor buys the index at strike price and sells the same at prevailing market price on the settlement day. When the rights in the contract are worked out, it can be regarded as extinguishments or relinquishment of right. Here on settlement of the contract the relevant contract ceases to

exist and under the circumstances it is arguable that the settlement of Index Futures contract falls within the definition of "Transfer".

CIT Vs. Mrs. Grace Collis (2001) 248 ITR 323 (SC):

Extinguishments of rights are independent and otherwise than on account of transfer.

Anarkali Sarabhai Vs. CIT 224 ITR 422 (SC):

Redemption of Preference Shares are also held as a "transfer" under clause (i) of Section 2(47) of The Act.

As both the prime conditions are satisfied, the gain or loss can qualify under the head "Capital Gains". Computation aspects as prescribed under Section 48 of the Act may not pose any peculiar problem as "cost of purchase" and "sales consideration" are available for computing capital gain, even though the contracts are getting settled through differences.

The extreme view can be, the transactions in Index futures whether entered into for hedging or otherwise will always be in nature of business and hence the profit/loss is taxed under "Business Income". However, one needs to examine whether there is any trade or adventure in the nature of trade. In the case of *Morgan Stanley & Co. International Ltd. (AAR) 142 Taxman 630*, Authority for Advance Ruling, one can find the argument on both the side as to whether derivatives considered as "Capital Asset" or "Stock in Trade".

Stock Futures for an Investor

Currently "Stock Futures" contracts are also cash settled and its trading and settlement mechanisms are similar to those of Index Futures. The discussion made in above paragraphs with respect to conditions of "Capital Asset" and "Transfer" shall also apply to the contracts relating to "Stock Futures".

As both the conditions are satisfied, the difference arising out of cash settled stock futures contracts also qualifies to be taxed under the head "Capital Gains".

However, if the Stock Futures contracts become "Delivery Settled" then the complications deepens.

For example, if a person buys a Stock Futures contracts and allows it to be converted into delivery by paying a contracted price at the time of settlement, at what point of time the Gain arises?

(a) at the time of "Settlement of futures contract" or

(b) at the time of actually selling the underlying stock in future.

This issue can be examined by determining whether Derivative contract in Stock futures are independently existing or they are part and parcel of the same contract through which one purchases an underlying stock? Whether "Stock futures" contract merges with the underlying stock? (or) The stock futures contracts expires (settles) and the underlying stock is purchased thereafter?

Trading mechanisms and various parameters set for Derivatives trading supports the arguments of "Derivatives contracts having separate and independent existence". The view can be further strengthened by the following points:

I. Derivative segment and Cash Market segment on both the stock Exchanges have their independent existence.

II. Derivatives are separately defined as "Securities" under Section 2(h) of Securities Contracts (Regulation) Act, 1956.

III. The contract of Stock futures expires on settlement day when delivery is actually taken. At no point of time "stock futures contract" and its "underlying stock" exist in parallel. The delivery of an underlying stock comes into being only on expiry of stock futures contract.

On the basis of above arguments, Stock Futures Contracts (Delivery Settled) can be considered as a separate and independent contract. However, once it is held to a separate and independent contract, issue pertaining to "Year of Chargeability" arises.

Example: Mr. A purchases a stock futures contract of a particular scrip at Rs. 600/- per unit. On the date of settlement Market price is Rs. 800/- per unit and Mr. A decides to take delivery by making payment of Rs. 600/- (contracted price)

If derivative is held as an independent asset, the gain of Rs.200 (Rs.800-Rs.600) can be taxed as short-term capital gain out of Derivative contract. However, question may arise whether capital gain tax is payable on notional gain.

The other argument can be, that the delivery of stock shall always be given at Rs.600/- i.e. at contracted price and mark to market margin of Rs.200/- is to be adjusted at the time of settlement, as if it was never been received. Under this situation, in the absence of any income the question of taxability does

not arise. However, one will have to wait till the futures market of derivatives becomes delivery based in our Country.

Options Contracts for Investors

Two Basic questions, which arise here, are,

(i) If the option is exercised, whether premium paid shall be added to the cost of the shares or allowed to be reduced from sales consideration?

(ii) If the option is not exercised what will be the treatment of premium paid?

Let us examine these issues:

The term 'cost' is not defined in the Income Tax Act, 1961 The "cost of acquisition" referred to in section 48 of the Income Tax Act not only contemplate the purchase cost but also all the incidental expenses necessary to bring in the asset into a state which enables the owner to put the asset in "Ready" or "Deliverable" stage. Expenses like brokerage, stamp duty, D'mat charges, etc. certainly forms part of cost of acquisition. **On the same premise, the premium can also form part of cost of acquisition and can be added to the cost (vice-versa can be reduced from sales consideration).**

If contract of derivatives are considered as a separate and independent contract, (as discussed in detail in previous paragraphs), the treatment of tax will be different and the premium may not be allowed to be added to the cost or reduced from the sales consideration, as the case may be. Under this situation options will be held as independent capital asset and the difference of either premium or the contracted price and the prevailing market price may be brought under the tax net. However, proper examination can be done only on implementation of delivery-based options in the capital market of our country.

The second issue is about the treatment of premium paid by the investor, when options are not exercised. In this case, whether loss can be considered as a "Capital Loss" or it is a loss of Capital, which is not deductible under Income Tax Act.

As discussed in previous paragraphs, two prime conditions for chargeability of income under the head "Capital Gains" are:

(a.) There has to be capital asset, and

(b.) There has to be transfer

Options contracts of derivatives are recognised as "Securities" under the Securities Contracts (Regulation) Act, 1956. They carry rights, which are enforceable in the market by the holder of the contract. As the options contracts are property-carrying value it will certainly qualify as a "Capital Asset" as defined under Section 2(14) of the Income Tax Act.

When the options contracts are not exercised; i.e., if they are lapsed then there are extinguishments of right attached therein. The definition of "Transfer" under section 2(47) of the Income Tax includes "extinguishments" of rights and hence the second condition is also satisfied.

Observations made in *Vania Silk Ltd. Vs. CIT 191 ITR 647*, has no bearings on this issues as the same has been overruled by other pronouncements such as *CIT Vs. TISCO 206 ITR 196, Kartikeya sarabhai Vs. CIT (1997) 228 ITR 163.*

Therefore, amount of Premium paid can be claimed as a "Capital Loss".

The other view can be that Options contracts are the tools made only for traders and not for Investors and transactions entered into Options contracts are always in capacity as a "Traders". However, for determining the same one has to keep in mind the various parameters and also the arguments given in the case of *Morgan Stanley & Co. International Ltd.(AAR) 142 Taxman 630.*

Traders – Taxability of Futures & Options Contract

Finance Act, 2005, has brought in an important insertion in Section 43(5), clarifying the tax treatment of Derivative transaction under Income Tax Act.

Section 43(5) as amended has been reproduced as below which has come into effect from 1.4.2005

"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:

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 (aa) 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;

Explanation—For the purposes of this clause, the expressions—

(i) "eligible transaction" means any transaction,—

(A) carried out electronically on screen-based systems through a stock broker or sub-broker or such other intermediary registered under section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) or the Securities and Exchange Board of India Act, 1992 (15 of 1992) or the Depositories Act, 1996 (22 of 1996) and the rules, regulations or bye-laws made or directions issued under those Acts or by banks or mutual funds on a recognised stock exchange; and

(B) which is supported by a time stamped contract note issued by such stock broker or sub-broker or such other intermediary to every client indicating in the contract note the unique client identity number allotted under any Act referred to in sub-clause (A) and permanent account number allotted under this Act;

(ii) "recognised stock exchange" means a recognised stock exchange as referred to in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and which fulfils such conditions as may be prescribed and notified by the Central Government for this purpose;

Whether the insertion is clarificatory in nature (or) it applies only from A.Y.2006-07?

The insertion seems to be clarificatory in nature as there are no new conditions prescribed for excluding derivative transactions from the clutches of Section 43(5) of the Act. The transactions entered into prior to 1.4.2005 were similar in nature and also fulfilling the conditions given in the definition of "eligible transaction". There cannot be different set of treatment for the transactions of a similar nature. One can also possibly argue that even in the pre amendment scenario, Derivatives, not being a commodity (including Stock and Shares) could always have been excluded from the definition of "Speculative transaction" given in Section 43(5).

Conclusion

The turnover of Derivative market in our country is showing an increasing trend and the volume is scalping new heights day by day. The Capital market is on a global radar and one can expect many new innovative products to be launched in near future. As this being an emerging market, it will obviously take some time to settle on to the taxation aspects relating to "Derivative transactions".

While the Government has attempted to exclude "Derivatives" out of speculative transactions there is a high time that the Explanation to Section 73 of the Act requires to be revisited. When legal machineries are examining the taxation issues on derivatives under different scenario, one will have to wait till the outcome of the same. ❐