Research Paper
Refereed Monthly Journal

AIJRRR
ISSN :2456-205X

TAXATION ON FINANCIAL DERIVATIVES

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Introduction

The term tax is defined as compulsory extraction of money by government authorities for public purposes enforceable by law and does not mean payment for services rendered. Taxes are compulsory contributions imposed by the government on its citizens to meet its general expenses incurred for the common good, without any corresponding benefits to the tax payer (Mehrotra and Agarwal, 2007). Derivatives are the instrument, which derive their value from the underlying assets. The underlying assets can be currency, stock, stock index, commodity, etc. (Sharma, 2007). Derivatives are not inherently bad or good. They are a bit like electricity, dangerous if mishandled, but bearing the potential to do tremendous good (Dubey, 2010).

Although derivatives can be traced back to Aristotle (Cecchetti 2006), a precise definition remains elusive in practice and theory. From an economic perspective, any security deriving its value from one or more primitive securities could be referred to as a derivative. This definition, however, requires identifying the set of primitive securities in question because the derivatives could, in fact, be the primitive securities (Ryan 2007). A more common approach is to define a derivative as a financial contract or security deriving its value based on its relationship to something else, typically referred to as the underlying (e.g., Stulz 2004). The underlying is often another financial instrument (i.e., primitive security) or economic good (i.e., commodity), but can be almost anything. For example, derivatives exist where the value is based on the S&P 500 index, the price of oil and fertilizer, the amount of frost in Florida, and even other derivative instruments.

Review of Literature

Financial Derivatives

During the 1980s and 1990s, commercial and investment banks introduced a broad selection of new products designed to help corporate managers in handling financial risks. At the same time, the derivatives exchanges, which successfully introduced interest rate and currency derivatives in the 1970s, have become vigorous innovators, continually adding new products, refining the existing ones, and finding new ways to increase their liquidity. Since then, markets for derivative instruments such as forwards and futures, swaps and options, and innovative combinations of these basic financial instruments, have been developing and growing at a breathtaking pace (Allen and Santomero, 1998). In terms of the growth of derivatives markets, and the variety of derivatives users, the Indian market has equaled or exceeded many other regional markets (Fitch Ratings, 2004). There is no consistent method of accounting for gains and losses from derivatives trading. Thus, a proper framework to account for derivatives needs to be developed. Further, regulatory reform will help the markets grow faster. As Indian derivatives markets grow more sophisticated, greater investor awareness will become essential. In addition, institutions will need to devote more resources to develop the business processes and technology necessary for derivatives trading (Sarkar, 2006).

Objectives

The following are the objectives of study:

1. To explore present situation of taxation on derivatives.
2. To suggest changes in taxation on derivatives.

Research Methodology

The present study is an exploratory and descriptive research, which is an effort to draw some conclusion on present status of taxation on derivatives in India. The study is based on secondary data such as books, journals, periodicals, magazines, websites, blogs, etc., have been referred.

Discussion

History of Taxation on Derivatives in India

Prior to Financial Year 2005–06, no special provisions were there for trading of derivatives, in Income Tax Act, 1961. Although derivatives contract have been traded on Indian stock exchanges since 2000, but were considered as speculative transactions for the purpose of determination of tax liability under the Income-tax Act. The Finance Act, 2005 has amended the provision to section 43(5), with effect from assessment year 2006-07, to provide that derivatives trading transactions would not be regarded as speculative transactions, subject to the fulfillment of certain conditions (NSE's Certification in Financial Markets, 2011).

Current Scenario of Taxation on Derivatives

Taxation of Profit/Loss on Futures and Options

Prior to Financial Year 2005–06, transactions in Futures and Options were considered as speculative transaction for the purpose of determination of tax liability under the Income-tax Act. This is in view of section 43(5) of the Income-tax Act which defined speculative transaction as a "transaction in which a contract for 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 scripts. However, such transactions entered into by hedgers and stock exchange members in course of jobbing or arbitrage activity were specifically excluded from the purview of definition of

speculative transaction. In view of the above provisions, most of the transactions entered into in Futures and Options by investors and speculators were considered as speculative transactions. The tax provisions provided for differential treatment with respect to set off and carry forward of loss on such transactions. Loss on Futures and Options transactions could be set off only against other speculative income and the same could not be set off against any other income. This resulted in payment of higher taxes by assesses. The Finance Act, 2005 has amended section 43(5) so as to exclude transactions in derivatives carried out in a "recognized stock exchange" for this purpose. This implies that income or loss on derivative transactions that are carried out in a "recognized stock exchange" is not taxed as speculative income or loss. Thus, loss on derivative transactions can be set off against any other income during the year except Income from Salary. In case the same cannot be set off, it can be carried forward to subsequent assessment year and set off against any income under the head "Income from Business or Profession" of the subsequent year. Such losses can be carried forward for a period of 8 assessment years. Firstly, it is to be set off from the business income and if the business income is not sufficient then it can be set off against the income of any other heads except the head salaries (Singhania and Singhania, 2013; Saklecha and Saklesha, 2013). It may also be noted that Securities Transaction Tax and proposed Commodity Transaction Tax paid on such transactions is eligible as deduction under Income-tax Act, 1961.

Security Transaction Tax

As per Chapter VII of the Finance (No. 2) Act, 2004, Securities Transaction Tax (STT) is levied on all transactions of sale and/or purchase of equity shares and units of equity oriented fund and sale of derivatives entered into in a recognized stock exchange. As per Finance Act, 2008, the following STT rates are applicable with effect from 1st June, 2008 in relation to sale of a derivative, where the transaction of such sale is entered into in a recognized stock exchange:

S. No	Taxable Securities Transaction	Rate	Payable By
1	Sale of An Option in Securities	0.017%	Seller
2	Sale of an Option in Securities, where Option is Exercised	0.125%	Purchaser
3	Sale of a Futures in Securities	0.017%	Seller

Proposed Commodity Transaction Tax

In the union budget 2008-09, the government has proposed to impose a commodity transaction tax (CTT) of 0.017% of the contract value of Commodity Futures Contracts, but it is not yet imposed. The stated rationale for imposing higher taxes is to contain price rise and volatility, to generate revenue, and to increase transparency.

Taxation on Forwards and Swaps

The forward contract which results in delivery does not comes under the definition of speculative transaction under Income Tax Act so it will be considered as non speculative income. Those forward contracts which do not settled by actual delivery will come under the definition of speculative transaction defined under section 43(5) of Income Tax Act, 1961, and taxed accordingly.

Taxation of swap payments is very much complicated. The issue involved is one of characterization of the amount of settlement. The amount could be considered as either business income or interest income. In a swap transaction, there is no money borrowed or debt incurred. The principal of a swap deal is the notional amount and only the adjustment takes place between the bank and the counter party in respect of the amounts payable by them. Only the net amount changes the hands. Such amounts should qualify as trading income. In a synthetic transaction, where the deal is fully structured in a manner where there is a debt incurred and the payment is made in respect of debt incurred, such payment could be regarded as 'interest'.

Proposed Taxation System for Derivatives

The taxation structure for derivatives needs to be refined and there should be clear structured, as derivative instruments are available in varieties. Taxation of financial derivatives is equally complex as is the transaction of financial derivatives. Thus, there should be separate chapter in the Income Tax Act, 1961 which must be exclusively for derivatives trading. The proposed system should contain no taxation if futures and option are used for hedging, mentioning clear definition of hedging and speculation separately. Arbitrage opportunities availed under derivatives and speculations should be taxed and by higher separate flat rate. There should not be any STT and CTT on the transactions of derivatives. There should have tax treaty with other countries regarding taxation on derivatives and especially in case of swap transactions between the parties of two or more countries.

Suggestions, Recommendations and conclusion

There should be proper sections in the law to explain taxation on derivatives clearly. To promote hedging and demote speculation & arbitraging there should be differential tax rates for these. For this hedging, capacity needs to be defined. There should be proper guidelines in law to differentiate hedging and speculation. To promote hedging there should be no taxes on hedging contract and more taxes on speculative contract of derivative. The existing rules should be changed at some places. There should be clear demarcation on which income should be considered as business income and which should be considered as capital gains and in that too which should be considered long term gain and which to be considered as short term gain and which income to be considered as non speculative income and which to be considered speculative income. The definition given by US Tax law should be adopted by India, which seems to be more realistic and of practical use. There should be proper clarification that whether offsetting of positions in futures and options should use FIFO of FILO system to measure the duration for which contract hold. A person or party should also get the option of actual delivery of the

underlying assets, which in fact right now is not being provided in India except for commodity futures. There should be tax treaty with other countries regarding taxation on derivatives and especially in case of swap transaction between two or countries. The government should call for discussion of experts and all stakeholders in this matter, to introduce more clear-cut definition and taxation thereof, taking care of international scenario.

Implications

Financial derivative market is increasing at a rapid growth. Different countries perceive different derivative products differently. Derivatives products are also taxed upon. There is no agreement regarding commonness in taxation of derivatives among different countries. Taxation on derivatives is also being developed according to the development of derivative products. There is a change in the taxation of derivative products on the basis of type of assessee and depending upon the capacity in which he/it is working. Continuity and frequency of the transactions also makes the difference.

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