Taxability of Income arising from Derivative Contracts

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With a view to provide advanced risk management tools and to strengthen and deepen securities market, the Securities Contracts (Regulation) Act 1956 was amended by the Securities Laws (Amendment) Act, 1999 to expand the definition of securities to include derivatives within its ambit so that trading in derivatives may be possible within the framework of that Act. The bill proposing the above amendment was examined by the Parliamentary Standing Committee on Finance which held the opinion that the introduction of derivatives, if implemented with proper safeguards and risk containment measures would certainly give fillip to the sagging market, result in enhanced investment activity and instill greater confidence among the investors and participants.

Trading of derivatives commenced with index futures on two exchanges (National Stock Exchange (NSE) and The Stock Exchange, Mumbai (BSE)) in June 2000. It is generally observed that the volumes in the derivatives market are roughly five times the volumes in the cash market. However, the trading volumes have been modest in the last six months since introduction of derivatives trading. One of the major reasons cited for the low trading volumes is lack of clarity on taxability of income arising from trading in derivatives.

Three broad categories of participants - hedgers, speculators, and arbitrageurs - trade in the derivatives market. While it is theoretically possible to talk of these three categories as distinct, in practice there is a rather thin line that separates them. Hedgers and speculators are actually two sides of the same coin. Hedging is not possible if there are no speculators. The derivatives market's capacity to absorb buying/selling by hedgers is directly dependent on the availability of speculators to act as counter-parties to hedgers. The derivatives market can be expected to take off and be liquid only if it has speculative appeal. This is why decisions about many aspects of derivatives trading, e.g., contract design, taxation, accounting etc. has to strike a balance between the needs of the hedgers and the necessity to attract an adequate number of well capitalised speculators who are prepared to take upon themselves the price risk which hedgers want to give up.

The Income-tax Act does not have any specific provision regarding taxability of income from derivatives. Only provisions which have an indirect bearing on derivative transactions are sections 73 (1) and 43 (5). Section 73 (1) provides that any loss, computed in respect of a speculative business carried on by the assessee, shall not be set off except against profits and gains, if any, of any speculative business. Section 43(5) of the Act defines a 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 actual delivery or transfer of the commodity or scrips. It excludes the following types of transactions from the ambit of speculative transactions:

i. A contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holding of stocks and shares through price fluctuations;

ii. 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 ordinary course of business as such member.

From the above, it appears that a transaction is speculative, if it is settled otherwise than by actual delivery. The hedging and arbitrage transactions, even though not settled by actual delivery, are considered non-speculative. A transaction to be speculative therefore requires that (i) the transaction is in commodities, shares, stock or scrips, (ii) the transaction is settled otherwise than by actual delivery (iii) the participant has no underlying position, and (iv) the transaction is not for jobbing/arbitrage.

In the absence of a specific provision, it is apprehended that the derivatives contracts, particularly the index futures which are essentially cash-settled, may be construed as speculative transactions and therefore the losses, if any, will not be eligible for set off against other incomes of the assssee and will be carried forward and set off against speculative income only up to a maximum of eight years. The fact, however, is that derivative contracts are not for purchase/sale of any commodity, stock, share or scrip. Derivatives are a special class of securities under the Securities Contracts (Regulation) Act, 1956 and do not any way resemble any other type of securities like shares, stocks or scrips. Derivative contracts, particularly index futures are cash-settled, as these can not be settled otherwise. As explained earlier, derivative contracts are entered into by the hedgers, speculators and arbitrageurs. A derivative contract has any of these two parties and hence some of the derivative contracts, not

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all, have an element of speculation. At least one of the parties to a derivative contract is a hedger or an arbitrageur. It would, therefore, be unfair to treat derivative transactions as speculative. Otherwise it would be a penalty on hedging which the Securities Laws (Amendment) Act, 1999 seeks to promote. In view of these difficulties in applying the existing provisions, it is desirable to clarify or make special provision for derivatives of securities.

Section 43 is relevant in case of contracts where actual delivery is possible, but these are settled otherwise than by actual delivery. This provision can not be applied to the derivatives, particularly with index futures, which can be settled only by cash. There can not be actual delivery. Hence the condition of actual delivery for a contract to be non-speculative can not be applied to derivative contracts.

Every derivative contract has two parties, generally a hedger and a speculator. This means, the speculators have to be treated equitably, that is at least at par with hedgers, if not better. All types of participants need to be provided level playing field so that the market is competitive and efficient. As regards taxability, the law should not treat income of the hedgers, speculators and arbitrageurs differently. Income of all the participants from derivatives need to be treated uniformly.

This is all the more necessary as it is well neigh impossible to ascertain if a participant is trading for speculation, hedging or arbitrage. Such attempts to differentiate hedges in commodity, shares and stocks have led in the past to a flood of litigation at the time of assessment. This is why regulation is brought in only if there is a specified set of criteria or procedures for deciding what fits within the scope of the enunciated policy, and also an administrative apparatus for implementing the policy. In the absence of a specified objective criterion, it is possible that a hedging transaction is misconstrued as speculative one. It is better to give benefit of doubt to exempt all speculative transactions than to misconstrue a hedging transaction. It is like acquitting hundreds of culprits rather than convicting a single innocent person.

Further, a transaction is considered speculative, if a participant enters into a hedging transactions in scrips outside his holdings. It is possible that an investor does not have all the 30 or 50 stocks represented by the index. As a result an investor's losses or profits out of derivatives transactions, even though they are of hedging nature in real sense, it is apprehended, may be treated as speculative. This is contrary to capital asset pricing model which states that portfolios in any economy move in sympathy with the index although the portfolios do not necessarily contain any security in the index. The index futures are, therefore, used even for hedging the portfolio risk of non-index stocks. An investor who does not have the index stocks can also use the index futures to hedge against the market risk as all the portfolios have a correlation with the overall movement of the market (i.e. index).

In view of (i) practical difficulties in administration of tax for different purposes of the same transaction, (ii) inherent nature of a derivative contract requiring its settlement otherwise than by actual delivery, (iii) need to provide level playing field to all the parties to derivatives contracts, and (iv) need to promote derivatives markets, it is suggested that the exchange-traded derivatives contracts are exempted from the purview of speculative transactions. These must, however, be taxed as normal business income.

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