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TAXATION OF FUTURES AND OPTIONS – A GUIDE

Contents

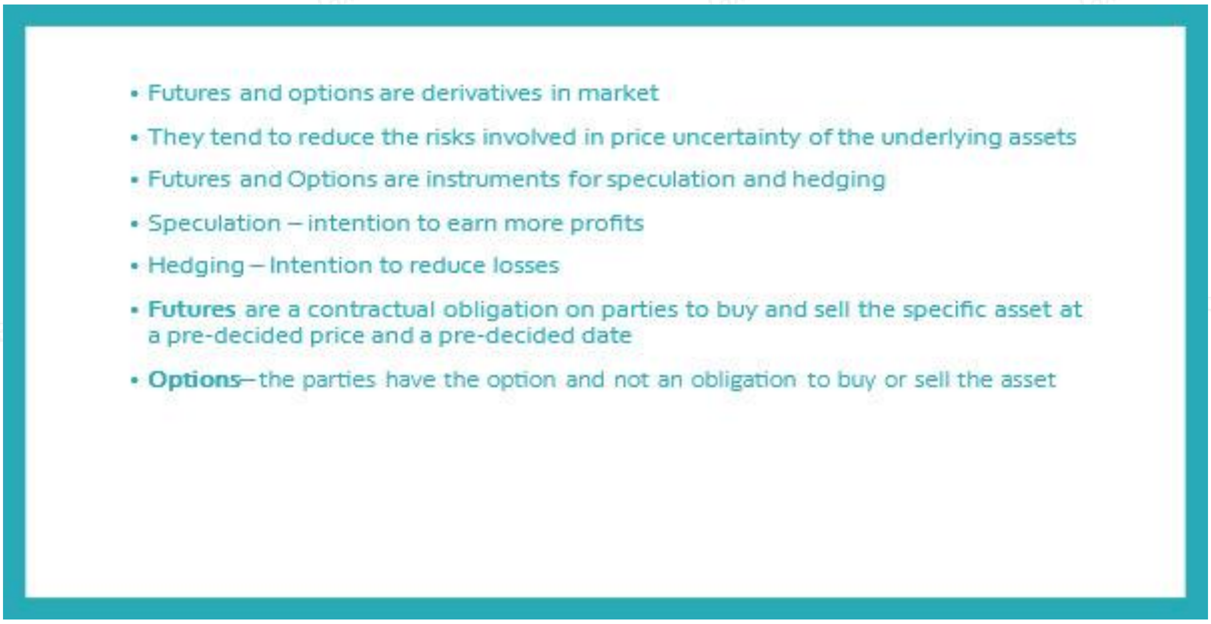
1. Introduction

Income Tax on Futures and Options

- Financial assets traded on stock markets are – shares, bonds, ETFs and all such instruments
- There are investors and traders on stock market – traders buy and sell very frequently and investors stay invested for loner periods
- Traders for bulk of the market transactions
- Futures and Options (F & O) are the most popular traded instruments

The stock market provides a platform for transactions in financial assets and instruments. Such assets are shares and securities, bonds, debentures, and Exchange Traded Funds (ETFs) etc. The people who are transacting in stock markets can be broadly categorised in two classes based on the nature of their transactions, traders, and investors. The traders are engaged in frequent buy and sell transactions and are substantially involved in market movements. On the other hand, investor transactions are typically not that frequent and are made with a long-term perspective on the investments. The traders form the bulk of the people involved in stock market platforms. Amongst the instruments traded on the stock market, futures and options (F & O) are the most popular.

2. WHAT ARE FUTURES AND OPTIONS?



The **Futures and Options** are the most popular financial contracts and derivatives. Other derivatives are 'forward contracts' and 'swaps.' They derive their existence and value from the underlying asset which may be shares, bonds, ETFs or commodities. Why are they important? The prices of shares, securities and commodities in a market are uncertain and may see huge ups and downs. In order to speculate (with an aim to earn profit) and hedge (reduce potential losses). The people who are good at predicting price movements of shares and market in general tend to be successful F & O traders.

Futures: Futures are a contract putting an obligation on contracting parties to buy and sell the shares of a specific company (from which futures are derived) at a pre-decided price and a pre-decided date. In case you sell the futures held by you before an expiry date or at an expiry date, you will either make a profit or loss. This is called as business loss.

For example: If you buy September futures of SBI at the rate of ₹ 200/share and hold them. In case, if you sell this position at the rate of ₹250/share before an expiry date, then you make a profit of ₹50/share. The total amount of profit will be based on the size of a lot. If the lot consists of 1000 shares and you bought one lot then, your profit is of ₹50,000/-.

Options: In this, the transacting parties have the option and not an obligation to buy or sell the derivatives. There is no obligation. If you are an option buyer, you need to pay a certain premium in order to book options of a particular asset (shares, index, or ETFs etc.) at a certain price. In future dates, if the price of the underlying asset goes up, you get the profit. There is no cap on such profits. For example, if you bought options of SBI at ₹200 (1000 shares lot) by paying a premium of ₹ 4,000/-. And then the price SBI shares goes up to ₹ 250/-. You can book the profit at this amount and the profit will be ₹50,000/-. However, if the prices go down to ₹150/ per share then you have a potential loss of ₹50,000/-. However, you have the option not to exercise the 'buy' contract and then you lose only the premium amount of ₹4,000/-.

The transactions entered into in F & O segment are subjected to Income tax. In this background, we will discuss the income tax implications of F & O transactions.

3. F & O AND SPECULATIVE TRANSACTIONS IN INCOME TAX

- By their nature the transactions in Futures and Options appear speculative transactions
- However, from 2006-07, Income tax Act is amended to say specifically that derivatives are not to be considered as speculative transactions.
- This is dealt with in section 43(5) of the Income tax Act
- Therefore, transaction in Futures and Options are not speculative transactions

As discussed above, the transactions in F & O happen without actual delivery of the underlying assets or commodities. Future transactions at the expiry date may need actual delivery as per new SEBI rules. Such transactions are generally treated as speculative transactions because they essentially involve speculation and hedging elements. However, since 2006, such transactions in derivatives are specifically exempted from the definition of speculative transactions by an amendment in section 43(5) of the Income Tax Act. Therefore, transactions in F & O in particular and derivatives in general are not speculative transactions and hence need to be treated as ordinary business transactions. However, this definition is relevant only for computation of business income and does not over – ride other provisions of the Income Tax Act. Therefore, the loss from F & O transactions may still be treated as '*speculative loss*'. This issue is litigated before various courts.

4. AUDIT APPLICABILITY FOR FUTURES AND OPTIONS

- In case of loss from F & O, if the turnover exceeds ₹1 crore, tax audit is necessary
- In any case, either loss or profits in F & O, if the turnover crosses ₹ 2 crores, tax audit is necessary
- In case of profits :
  - If the turnover does not cross ₹2 crores, and profits are > 8% or 6%(digital transactions), no tax audit is necessary
  - If the turnover does not cross ₹2 crores, and profits are < 8% or 6%(digital transactions), tax audit is necessary

As per the Income Tax Act, any person carrying on the business or profession needs to maintain books of account when their business turnover crosses a certain threshold. Such a threshold is ₹ 50 lakhs for professional taxpayers and ₹ 1 crore for business income. However, this threshold limit of ₹ 1 crore is enhanced to ₹ 10 crores in case NOT more than 5% of all receipts and expenses are transacted in cash. In other words, if 95% of your business transactions including receipts and payments are through digital mode, then you don't need to get your books of account audited. In other case, if your turnover is more than ₹ 1 crore but less than ₹ 2 crores and you declare profits as per presumptive tax scheme, then you don't need to get your books audited. As per this scheme, the profits need to be declared at 8% of the turnover (6% in case of digital transactions).

Since F & O transactions are considered as business transactions, this is as such applicable to these transactions. Accordingly, following situations emerge:

- If you have loss from F & O transactions, the benefit of presumptive taxation scheme will not be available and you need to get your books audited after the turnover crosses a threshold of ₹ 1 crore.
- If you have profits from F & O transactions, you can claim the benefit of presumptive taxation scheme and audit will not be needed till your turnover remains within the limits of ₹ 2 crores.
  - In case, the profits are below 8% or 6% as the case may be, you need to get the books audited

   - If you are not eligible for benefits of the presumptive tax scheme, you need to get your books audited
- In case your turnover is above ₹ 2 crores then you need to get the audit done irrespective of the percentage of profits.

5. How to compute turnover in F & O transactions?

In F & O transactions the turnover for the purposes of tax audit is computed as under:

- The aggregate of positive and negative differences in transactions should be counted as turnover.
- Premium received on sale of options is to be computed as turnover.
- In respect of any reverse trades entered, the difference thereon is counted as turnover

6. Loss from Futures and Options

- In case of loss from F & O, if the turnover exceeds ₹1 crore, tax audit is necessary
- In any case, either loss or profits in F & O, if the turnover crosses ₹ 2 crores, tax audit is necessary
- In case of profits :
   - If the turnover does not cross ₹2 crores, and profits are > 8% or 6%(digital transactions), no tax audit is necessary
   - If the turnover does not cross ₹2 crores, and profits are < 8% or 6%(digital transactions), tax audit is necessary

The treatment of loss from F & O transactions depends upon their treatment as to whether the loss is a speculative loss or not. The F & O transactions are not supposed to be speculative for the purposes of section 43 of the Income tax Act. But the definition of 'speculative transaction' in section 43(5)(d) of the same Act does not super-cede such references to speculative income or loss anywhere else. The carrying forward and set off of such a loss is dealt with as per section 73 of Income tax Act. That section has excluded certain companies which are trading in shares and securities from the scope of section 73 of the Income tax Act.

Thus, the loss from F & O transactions cannot be set off against the income under any other head. And such loss carried forward to succeeding assessment years can also not be set off against any other income. This loss needs to be set off only against the speculation income. This view has been litigated before various courts but this is the dominant legal position on this issue.

The loss from speculation business can not be carried forward for more than FOUR assessment years succeeding the year in which loss in incurred.

7. Expense claims against F & O transactions

You can claim all kinds of expenses that are claimed against normal business income. This includes telephone, internet, administrative expenses, interest etc. However, the expenses should be genuine. The depreciation on the assets used for the F & O business can also be claimed.

8. Income Tax Return Filing in F & O transactions

- If the Income Tax return is being filed under presumptive taxation scheme, then you have to file ITR in form ITR-4
- In other case, it should be filed in form ITR-3
- If the tax audit is not applicable the ITR must be filed before 31st July of assessment year (for current year this date is extended to 31st December 2021)
- If the tax audit is applicable, the ITR must be filed before 30th September (for current year this date is extended to 15th February 2022).

Since the income from these transactions is taxed as 'income under the head of business or profession'. The individuals engaged in this business can file ITRs in forms ITR – 4 if the income is offered under presumptive taxation scheme. Otherwise, ITR – 3 is applicable. If the tax audit is not applicable the ITR must be filed before 31st July of the assessment year (for current year this date is extended to 31st December, 2021). If the tax audit is applicable, the ITR must be filed before 30th September (for current year this date is extended to 15th February, 2022)