



Taxation of Securities – Issues and analysis

Regional Training Institute of Income Tax
Department

10th August 2011

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Characterization

✦ Head of Income

- Business Income
- Capital Gains
- Other Sources

✦ Issues

- Speculation/deemed speculation
- Capital Gains or Business Income/ Adventure in nature of trade

August 10, 2011 Business Income or Other Sources by Katherine Paria

Controlling authorities.

- Members of stock exchanges..

- Stock Exchange.
- SEBI

- Non Banking Financial Companies (NBFC)

- Reserve Bank of India

- Unregistered NBFC

- ????

- Investors/traders in securities

- SEBI (if abnormal movements, insider trading..)

A Broker's – P/L (31.03.2009)

Income

| | |
|------------------|------------|
| – Brokerage | 100 |
| – F&O | 40 |
| – Trading | (-)40 |
| – Speculative | (-)15 |
| – Interest on fd | 5 |
| – Dividend | 20 |
| – LTCG | 40 |
| – STCG(15%) | 60 |
| – Total | 210 |

August 10, 2011

Expenses

| | |
|----------------|-----------|
| – STT | 15 |
| – Expenses | 40 |
| – Depreciation | 15 |
| – Interest | 10 |
| – Total | 80 |

 **Taxable Income** **70**

 **Tax paid** **12**

by kkchhaparia

Speculation business

✦ Section 73(1)

- Set off of loss from speculation business

✦ Explanation 2 below Section 28

- Defines speculation business

✦ Section 43(5)

- Defines speculative transactions
 - Transaction of commodity/shares settled otherwise than by actual delivery
 - Proviso provides four exceptions

✦ Explanation to section 73

- Deemed speculation loss

Exceptions – speculative transactions

Proviso to Section 43(5)

- (a) contract in respect of *raw materials or merchandise* in *course of business* to *guard against loss* against *future price fluctuation*
- (b) Contract in respect of *stocks and shares* by *dealer or investor* to *guard against loss* against *future price fluctuation*
- (c) Contract entered into by *a member of stock exchange* in nature of
 - Jobbing
 - Arbitrage
 - Guard against loss which may arise in ordinary course of business as such member
- (d) Eligible transactions in *derivatives*

Exceptions – speculative transactions

43(5)(a) and (b)

– *Departmental circular dt 12.09.1960*

- *Pt.1 : Hedging transactions genuine to the extent stock of raw materials or merchandise in hand*
- *Pt 2:Hedging transactions may not identically in same commodity*
- *Pt 3: Transactions in scripts outside holding – not a hedging*

Exception 43(5)(c)

Jobbing..

- Normally, it means a broker who gives two way quotes in a stock
- SEBI Defines otherwise
 - ‘Regulation 10 of SEBI (Stock Brokers and Sub-brokers) Regulations, 1992 - Registration Fees to be paid by every stock broker and sub-broker
 - Where the annual turnover does not exceed Rs. 1 crore in a FY – Rs. 5000/- pa
 - Where the annual turnover > Rs. 1 crore in a FY – 1/100th of 1% pa
 - Notwithstanding anything above, ...it is clarified that the fee shall be computed as under
 - *in respect of Jobbing transactions that is to say all transactions which are squared off during the same day which have not been undertaken by the broker on behalf of clients, the fees shall be computed at 1/200th of 1% pa*

Exception 43(5)(c)

Arbitrage

- ✦ Arbitrage consists of purchasing a commodity or security in one market for immediate sale in another market
- ✦ Eg. NSE Vs. BSE, CM Vs. F&O, Option Vs. Future etc...
- ✦ Arbitrage Income include Cost of financing plus entrepreneur's profit

Exception 43(5)(d)

Derivative transactions

43(5)(d) – Derivative transactions

– Eligible transactions

- Carried out electronically through a recognized broker on a recognized stock exchange

– Trading in derivatives

- S.2(ac) of Securities Contract Act

– Recognized stock exchange

- NSE and BSE notified on 25.01.2006
- MCX(Currency) notified on 22.05.2009



Derivatives – a discussion...

- Derivatives are **financial instruments** that derive their value from an underlying asset. The underlying assets can be **equity, currency or a commodity**.
- Securities were introduced in India in June 2000.
- Commodity futures allowed from 2003
- Currency futures in 2008

Derivatives – a discussion...

✦ The advantage of derivative trading can be summarised as follows :

- (1) Advantage of Leverage
- (2) Advantage of Hedging
- (3) Advantage of Arbitrage
- (4) Power to earn Fixed Income

Trading in derivatives and options

Options

- **Put option** – right to sell at a specified price on a particular future date
- **Call option** – right to buy at a specified price on a particular future date

Futures

- Contract between two counter parties to deliver or to accept delivery of a financial instrument on a specified date
 - Stock futures
 - Index futures



Derivative - some terms...

- Option – Put and call
- Future – Script and Index
- October Series, November Series etc..
- Initial Margin vs. M2M Margin
- Option premium received/given
- Difference received or given
- F&O loss or profit
- Provision for unexpired contracts

Derivatives – Accounting treatment

☛ Three **Guidance Notes**

- Accounting for Equity Index Futures issued in Dec, 2000
- Accounting for Equity Index Options – June, 2002
- Accounting for Equity Stock Options – June, 2002

☛ **Substituted by**

- Accounting for Equity Index/Stock Futures –Options issued in September, 2003

☛ **Turnover as per Para 5.11 of Guidance Note on tax audit by ICAI**

- Total of favorable and unfavorable differences

Proprietary / Clients' Open Position

- Share Broker entering orders on the trading system
 - to identify them as **proprietary** (if they are own trades) or **client** (if entered on behalf of clients) through '**Pro / Client**' indicator provided in the order entry screen.
 - The proprietary positions are calculated on net basis (buy - sell)
 - Client positions are calculated on gross of net positions of each client i.e., a buy trade is off-set by a sell trade and a sell trade is off-set by a buy trade.

Derivatives issues...

- ✱ Mark to Mark loss

- ✱ Buying of losses

- By brokers

- By others – finance companies etc..

- ✱ Buying of profits

- Commodity exchange



Speculative Business – Summing up

- ✘ Set off not allowed
- ✘ Settled without delivery
 - Exceptions
 - Derivative transactions
 - Hedging, Arbitrage or jobbing
- ✘ Deemed speculation loss