

Overview of Accounting, Reporting and
Taxation of
Futures, Options and other
Derivatives

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Accounting aspects

Accounting Aspects

Issues - AO can not disregard accounting standards of ICAI

- Accounts regularly maintained in the course of business are to be taken as correct unless there are strong and sufficient reasons to indicate that they are unreliable.
- AO cannot disregard the method of accounting followed by the assessee where the method of accounting is based on a standard or guideline commended for adoption by a professional body such as the ICAI.
- **Woodward Governor India (P.) Ltd. vs CIT [2009] 179 TAXMAN 326 (SC)**
- **CIT vs Virtual Soft Systems Ltd. [2012] 18 taxmann.com 119 (Delhi)**
- **Jt CIT vs K. Raheja (P.) Ltd. [2006] 102 ITD 414 (Mum.- Trib.)**

Notified Accounting Standards by central government (Till date) under section 145 of income tax act, 1961

- A. Accounting Standard I - relating to disclosure of accounting policies.

- B. Accounting Standard II - relating to disclosure of prior period and extraordinary items and changes in accounting policies

Draft Tax Accounting Standards

- Drafts of the Tax Accounting Standards on the following issues based on the corresponding Accounting Standard issued by the ICAI after harmonising the same with the provisions of the Act

S. No.	TAS	Corresponding AS
1.	Disclosure of Accounting Policies	AS-1
2.	Valuation of Inventories	AS-2
3.	Events Occurring After the Previous Year	AS-4
4.	Prior Period Expense	AS-5
5.	Construction Contracts	AS-7
6.	Revenue Recognition	AS-9
7.	Accounting for Tangible Fixed Assets	AS-10

Draft Tax Accounting Standards

S. No.	TAS	Corresponding AS
8.	The Effects of Changes in Foreign Exchange Rates	AS-11
10.	Securities	AS-13
11.	Borrowing Costs	AS-16
12.	Leases	AS-19
13.	Intangible Assets	AS-26
14.	Provisions, Contingent Liabilities and Contingent Assets	AS-29

Accounting standards V. Tax Accounting Standards - In respect of Derivatives

Accounting standards by ICAI

- The mark-to-market gain/ loss or an expected gain/ loss should be recognized in the statement of Profit and Loss as per AS- 30, para 99(a) (Derivative Hedging instrument at fair value).

TAS - 1

As per TAS on Accounting Policies

- The mark-to-market loss or an expected loss (except those covered by other TAS) shall not be recognized.

Accounting Standards issued by ICAI -In respect of Financial Instruments including derivatives

AS-30

AS-31

AS-32

AS - 30

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graph TD; A[AS - 30] --- B[Recognition and non recognition of Financial Instruments]; A --- C[Measurement of Financial Instruments]; A --- D[Derivatives and Hedge accounting];
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Recognition and
non recognition
of Financial
Instruments

Measurement
of Financial
Instruments

Derivatives and
Hedge
accounting

AS-30 issued by ICAI

- The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.
- Requirements for presenting information about financial instruments are in Accounting Standard (AS) 31, Financial Instruments: Presentation.
- Requirements for disclosing information about financial instruments are in Accounting Standard (AS) 32

Contd....

AS - 31

Presentation of
Financial
instruments

AS - 32

Disclosure of
Financial
instruments

AS – 31- Presentation of financial instruments

Objective:

To establish principles for presenting financial instruments as Liabilities or Equity, and for off-setting financial assets and financial liabilities.

Scope:

1. Classification of Financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments.
2. Classification of related interest, dividends, losses and gains.
3. Circumstances in which financial assets and financial liabilities should be offset.

AS – 32- Disclosure of financial instruments

- The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.



Reporting aspects

Determination of turnover in non- delivery based transactions

- The ICAI has issued guidance notes for accounting treatment with a view to *determine the turnover for the purpose of sec 44AB.*
- The total of positive and negative, or favorable and unfavorable differences shall be taken as turnover.

Guidance on accounting treatment

- Premium received on sale of options is to be included in turnover.
- In respect of any reverse trades entered, the difference thereon shall also form part of the turnover.

Tax Audit

- In case a lot of transactions are executed in routine, then it can be held as an adventure in the nature of trade and profit or loss from such a business will be covered under the head PGBP.
- In case of derivatives of securities the profit/loss is not treated as speculative. Moreover, it is said to be non- speculative.

Tax Audit

- However, in case of commodity transactions, it shall be considered as speculative, if the same is not for the purpose of hedging (upto AY 2013- 14).
- As per sec clause (e) of 43(5) of the Income Tax Act, 1961, commodity transactions shall be considered as non-speculative, *from AY 2014- 15 as per the amended Finance Bill 2013 (Passed by Lok Sabha).*

Computation of turnover

Eg. a) Mr. X offered to purchase 5000 shares at a cost of Rs. 1000 each and also offered to sell 5000 shares at a price of Rs. 1100 each of Reliance Ltd.

(b) He also offered to purchase 1000 shares at a cost of Rs. 3000 each and also offered to sell 1000 shares at a price of Rs. 2800 each of L&T.

Thus, the *turnover* of Mr. X will be *calculated as under*:

(i) Turnover in (a) above, Rs. 55 Lacs - 50 Lacs = Rs. 5 Lacs

(ii) Turnover in (b) above, Rs. 28 Lacs - 30 Lacs = Rs. (2 Lacs)

Thus, the *net turnover* of Mr X. would be (i) + (ii) = Rs. 7 Lacs.

Taxation aspects

MAJOR ISSUES.....

- **Whether the derivative transaction is a speculative transaction?**
- **Taxability- whether as business income or capital gains?**
- **Whether set off of losses from derivative transactions is possible?**

Taxation aspects

Key Points

- No specific provision under the Act regarding taxability of derivatives.
- Provisions having an indirect bearing on derivative transactions are Section 28, sec. 73(1) and sec.43(5).
- The presentation and disclosure of derivatives in financial statements is required by 'AS-31 and 32' respectively issued by ICAI.

Speculation transaction as per Sec 43(5) of IT Act

- *Speculative transaction* means a transaction in which a contract for the purchase or sale
- of any commodity including stock and shares,
- is periodically or ultimately settled
- otherwise than by actual delivery or transfer of commodity or scrips.

Provisions to Sec 43(5)

Transactions not to be deemed as speculative :

- (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

Provisions to Sec 43(5)

- (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

Provisions to Sec 43(5)

- (d) an eligible transaction in respect of trading in derivatives referred to in clause (ac) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) carried out in a recognized stock exchange.

Eligible transactions on BSE and NSE w.e.f. 25th Feb 2006 shall not be considered as speculative *vide Notification No. 2/2006, dated 25-1-2006 of Income Tax Act, 1961.*

Derivatives

- As per clause (ac), of sec 2 of **Securities Contract (Regulations) Act, 1956**, Derivatives include :-

(a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security.

(b) a contract which derives its value from the prices, or index of prices, of underlying securities.

- The definition of derivatives earlier rederred to in clause (aa) was re-lettered as clause (ac), of sec 2 of Securities Contracts (Regulations) Act, 1956 *vide Circular no. 14/2006, Dated 28-12-2006 of the Income Tax Act, 1961.*
- Accordingly, the amendment has been done in clause (5) of section 43 of the Income Tax Act, 1961.

Explanation - Eligible transaction

A) carried out *electronically* on screen-based systems *through a stock broker* or sub-broker or such other intermediary registered *u/s 12* of the SEBI Act, 1992 (15 of 1992) in accordance with the provisions of the SC(R)A, 1956 (42 of 1956) or the SEBI 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 recognized stock exchange; and

Explanation - Eligible transaction

(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;

Explanation- Recognized Stock Exchange

- A *recognized 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.
- BSE and NSE as recognized stock exchanges.

Amendments as in Finance Bill, 2013

As passed by Lok Sabha-

- Insertion of clause (5) in the proviso, *w.e.f. 1st day of April 2014.*
- Clause(e)- “An *eligible transaction* in respect of trading in *commodity derivatives* carried out in a *recognized association*”

Amendments as in Finance Bill, 2013

- Explanation shall be renumbered as “Explanation 1” thereof and in the Explanation 1 as so renumbered, for the words “this clause” the word, brackets and letter “clause (d)” shall be substituted.

Amendments as in Finance Bill, 2013

- Explanation 2 for the purposes of clause (e), the expressions –
- Commodity derivatives: shall have the meaning as assigned to it in Chapter VII, of the Finance Act, 2013 (i.e. Commodities Transaction Tax).

Amendments as in Finance Bill, 2013

Explanation 2

- “*Eligible transaction*”: Means any transaction-
- (A) carried out electronically on screen-based systems through member or an intermediary, registered under the bye-laws, rules and regulations of the recognized association for trading in commodity derivatives in accordance with the provisions of the Forward Contracts (Regulation) Act, 1952 and the rules, regulations or bye-laws made or directions issued under that Act on a recognized association; and

Amendments as in Finance Bill, 2013

Explanation 2

(B) which is supported by a time stamped contract notes issued by such member of intermediary to every client indicating in the contract note, the unique client identity number allotted under the Act, rules, regulations or bye-laws referred to in sub-clause (A), unique trade number and permanent account number allotted under this Act;

Amendments as in Finance Bill, 2013

Explanation 2

- “***Recognized association***” means a recognized association as referred to in clause (j) of section 2 of the Forward Contracts (Regulation) Act, 1952 and which fulfils such conditions as may be prescribed and is notified by the Central Government for this purpose.’

Capital Gain vs. Business income

- As per section 2(14) of the Act, 'capital asset' means property of any kind held by an assessee, whether or not connected with his business or profession.
- Derivatives are security defined under SC(R) Act or the contracts carrying right, thus they can be considered as a property carrying value.

Tax treatment in brief

Non-corporate assessee

Investor-taxability under capital gains

Businessman-

i) *if actual delivery, under PGBP*

ii) *if no actual deliver, speculation (sec. 43)*

Corporate assessee

Investor- taxability under capital gains

Businessman-

i) *If actual delivery:*

* *If banking co. regarding shares- NormalPGBP (expl. To sec. 73)*

* *Any co. regarding any other commodity-NormalPGBP*

Other Co. regarding shares- Speculation (expl.sec. 73)

ii) *If no actual delivery- speculation (sec. 43)*

Set off of speculation losses-Sec 73 of IT Act, 1961

- 1) Any loss, computed in respect of a speculation business carried on by the assessee, shall not be set off except against profits and gains, if any, of another speculation business.
- 2) Where for any assessment year any loss computed in respect of a speculation business has not been wholly set off under sub-section (1), so much of the loss as is not so set off or the whole loss where the assessee had no income from any other speculation business, shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

Set off of speculation losses-Sec 73 of IT Act, 1961

(i) it shall be set off against the profits and gains, if any, of any speculation business carried on by him assessable for that assessment year; and

(ii) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on.

Set off of speculation losses-Sec 73 of IT Act, 1961

- (3) In respect of allowance on account of depreciation or capital expenditure on scientific research, the provisions of sub-section (2) of section 72 shall apply in relation to speculation business as they apply in relation to any other business.
- (4) No loss shall be carried forward under this section for more than four assessment years immediately succeeding the assessment year for which the loss was first computed (*vide Circular no. 3/2006 dated 27.02.2006 w.e.f. AY 2006-07*).

Set off of speculation losses-Sec 73 of IT Act, 1961

- *Explanation.*—Where any part of the business of a company [other than a company whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources"], or a company the principal business of which is the business of banking or the granting of loans and advances) consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares.

Clarification for carry forward of speculative losses

- The loss in respect of speculation business shall be allowed to be carried forward for four years in place of eight years *vide Circular no. 3/2006, dated 27.02.2006*.
- Finance Act, 2005 has amended the said sub-section (4) so as to reduce the period of loss to be carried forward from eight assessment years to four assessment years.
- Applicability: From A.Y. 2006-07 onwards.

Issues.....

Whether transaction in an exchange before the release of notification would amount to speculation?

No, the notification is only clarificatory in nature, therefore, the transaction would not be considered as speculative.

ACIT, Vs. Arnav Akshay Mehta [2012] 25 taxmann.com 252 (ITAT - Mum.)

ACIT, Vs. Vimal Vadilal Shah [2012] 27 taxmann.com 197 (ITAT - Ahm.)

Issues.....

- Whether mere violation w.r.t. to fulfillment of conditions of invoice and contract would amount to speculation?
- Mere intention of law was that the transactions to be carried out through recognized stock exchange and hence, *not to be considered as speculative.*
- Vibha Goel Vs. JCIT, [2012] 25 taxmann.com 142 (ITAT - Chandigarh)

Issues

- If actual delivery of share scrips does not take place both for purchases as well as sales – Sec 43(5) – delivery recalled by brothers – No actual delivery.
- Speculative transaction – Loss cannot be set off against business income.
- **ACIT Vs. Claytone Commercial Co. Ltd. (ITAT, Delhi) 67 ITD 118**
- **Ram Lal & Sons Vs. ITO (ITAT, Asr) 71 ITD 256**

Other Issues.....

- Whether derivatives transactions not settled through delivery of the asset would be considered as speculative?
- Derivatives transactions (not a commodity derivative) through a recognized stock exchanged shall not be speculative.
- **[Dy. CIT v. Paterson Securities (P.) Ltd. [2010] 127 ITD 386 (Chennai)]**

Speculative business income

Explanation 2 of Sec 28 of Income Tax Act, 1961-

- Where *speculative transactions* carried on by an assessee are of such a nature as to *constitute a business*, the business (hereinafter referred to as "*speculation business*") shall be *deemed to be distinct and separate from any other business*.

Tax treatment for derivative transactions

Business- If actual delivery-

- If Banking Company – Tax under PGBP [Expl. to 73]
- If Co. regarding any other commodity- PGBP.

Other Company regarding shares- Speculation as per Expl. To Sec 73.

- If not actual delivery-
 - Speculation business, tax at normal rates.



Recapitulation

Speculative transactions.....

- Intra-day trading shall be considered as speculation business transactions and the income there from would be either speculation gains or losses.
- However, if based the on facts and circumstances of your case, you can prove that *though* delivery was not actually taken it was within your normal business transaction, it could be treated as non-speculation business income.

Taxability of speculative transactions

- Income from speculation gains is taxed at the normal rates.
- Speculation losses can be set off only against speculation gains as per sec 73.
- Trading in derivatives (futures and options) is treated as non-speculation business even though delivery is not effected in such transactions.

Taxability of speculative transactions

- Speculation losses can be carried forward for a maximum of four years immediately succeeding the relevant assessment year vide Circular no. 3/2006, dated 27.02.2006 of Income Tax Act, 1961.
- Considering the fact, the physical existence of money, currency can be considered as a commodity.

Taxability of speculative transactions

- Therefore, currency derivatives transactions shall be covered by main part of the speculative transactions definition.
- However, there have been different decisions of various Tribunals of considering currency derivatives transactions as commodity and non-commodity transactions.

Taxability of speculative transactions

- Also, currency derivatives are transacted at stock exchanges and not on commodity exchanges.
- Therefore, should not be considered as speculative transactions, if they qualify as derivatives under SCRA, 1956.

Taxability of speculative transactions

- Currency transactions on stock exchanges, indicates them to be a type of securities.
- Therefore, qualify for treatment as security derivatives (non-speculative).

Speculative transactions

- Since, the income from speculative transactions is considered as business income,
- Audit would be required if the turnover exceeds 60 Lacs (*1 Cr w.e.f. FY 12-13*).
- Sale value of the transaction shall be considered for the purpose of calculation of turnover.

Provisions of Sec 44AD to have impact

- In respect of loss from non-delivery of transactions such as F&O and derivatives.
- It mandates disclosure of at least 8% of net profit on gross turnover and if not, books of accounts are required to be maintained.
- There is no clear cut guidelines, as to whether assessee w.r.t. to derivatives transaction, can use the provision of this section or not.

THANK YOU !!!!!

For any queries, feel free to contact:

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