ACCOUNTING & TAXATION OF SECURITIES TRANSACTIONS wrt FUTURES & OPTIONS

A. ACCOUNTING ASPECTS :

1. Accounting treatment of Futures and Options transaction is of a peculiar nature and based on regulations of exchange and typical trading mechanism of Derivative contracts. The Institute of Chartered Accountants of India has issued guidance note on Accounting for "Equity Index and Equity Stock Futures and option". Prior to that there were many issues relating to accrual of Income, booking of losses, calculation of profit, disclosures etc. However, all such major issues have been dealt with in guidance note issued by the Institute.

2. Equity Derivative Instruments are a type of financial instruments, which are bought or sold with specific motives, e.g., speculation, hedging and arbitrage. The accounting treatment recommended in the Guidance Note is applicable to all contracts entered into for Equity Derivative Instruments irrespective of the motive. Typical accounting entries for Futures and Options are enumerated in the following paragraphs.

3. **Accounting treatment for Future Contracts**

   Accounting for future contracts can be broadly divided into following categories

- Accounting at the inception of contract
- Accounting during continuation of the contract
- Accounting at the time of final settlement of or squaring up contract
- Accounting for Open Interest as on Balance Sheet date

4. **Example**

Mr. X purchased the following future contracts on 25th March 2005.

400 units of BSXMAY'05 at Rs.6000/-. The initial margin is 10%.

Daily Settlement price of this unit were as under

Date	Situation I	Situation II
	Daily Settlement Price	Daily Settlement Price
25/03/2005	6040	5975
28/03/2005	6040	5975
29/03/2005	6040	5975
30/03/2005	6020	5950
31/03/2005	6060	5990
01/04/2005	6070	5970
04/04/2005	6050	6010

The amount of MTM margin receivable or payable on daily basis is as under

Situation I

Date	MTM Margin Receivable	MTM Margin Payable	Cumulative Gain/(Loss)
25/03/2005	16000	-	16000
28/03/2005	-	-	16000
29/03/2005	-	-	16000
30/03/2005	-	8000	8000
31/03/2005	16000	-	24000
01/04/2005	4000	-	28000
04/04/2005	-	8000	20000

Situation II

Date	MTM Margin Receivable	MTM Margin Payable	Cumulative Gain/(Loss)
25/03/2005	-	10000	(10000)
28/03/2005	-	-	(10000)
29/03/2005	-	-	(10000)
30/03/2005	-	10000	(20000)
31/03/2005	16000	-	(4000)
01/04/2005	-	8000	(12000)
04/04/2005	16000	-	4000

Now, let us consider the accounting treatment in the following paragraphs.

5. Accounting at the inception of contract

When the futures contract is entered into for purchase or sale of equity index or equity stock no payment is required to be made except for the initial margin. Clearing Corporation/Clearing House determines this margin from time to time and it serves as security deposit for the exchange. This margin can be paid either in cash or in form of collaterals like Bank Guarantees, Securities, and Fixed Deposits etc.

Initial margin paid in cash shall be debited to "Initial Margin Index/Stock Futures Account" and additional margin paid if any shall be accounted in the same manner. Here in both the situation Rs.2, 40,000/- shall be debited to "Initial Margin – BSXMAY05" Account.

As at the Balance Sheet date the balance in initial margin account shall be shown separately in respect of each series under the head "Current Assets".

The receipt of the initial margin in the form of collaterals shall be recorded in memorandum records, and no entry is required to be made in the financial books. If any collateral is returned back the memorandum records shall be updated accordingly.

6. Accounting during continuation of Contract

All future contracts are marked to Market (MTM) on daily basis on account of Daily Settlement. The MTM margin shall be collected in cash, unlike initial margin where collaterals are also been accepted.

Such payments made or received on account of MTM are routed through MTM Margin account separately. While making payment of MTM margin, "MTM Margin Stock/Index account" will be debited and on receipt of the same this account will be credited. In situation I, the accounting treatment for initial three days shall be as under

25/3/2005	Bank A/c Dr.	16000	
	To MTM-BSXMAY05	16000	
30/3/2005	MTM-BSXMAY05 A/c Dr.	8000	
	To Bank A/c		8000
31/3/2005	Bank A/c Dr.	16000	
	To MTM-BSXMAY05	16000	

In situation II accounting treatment for initial three days shall be as under

25/3/2005	MTM-BSXMAY05 A/c Dr.		10000
	To Bank A/c		10000
30/3/2005	MTM-BSXMAY05 A/c Dr.	10000	
	To Bank A/c		10000
31/3/2005	Bank A/c Dr.	16000	

To MTM-BSXMAY05 16000

Any balance in "MTM Margin Stock/Index Futures" account at the year-end shall appear under the head "Current Assets" or "Current Liabilities" as the case may be.

7. Accounting at the time of final settlement or squaring up of the contract

At the expiry of the contract or on squaring up the contract, the profit or loss is computed and recognized in the Profit and Loss account. The profit or loss in such cases is the difference between final settlement price and contract price. The entries relating to profit and loss shall be passed by corresponding debit or credit to the MTM margin account. Balance in MTM account for a particular series of contract thus will be recognized as income or expense on final settlement. However, where a balance exists in the provision account (which may have been created at the year end for anticipated loss,) any loss arising on such settlement shall be first charged to such provision account and the balance if any should be charged to profit and loss account.

In situation I, assuming that the contract is squared up on 04/04/2005 Credit Balance in MTM-BSXMAY05 A/c amounting to Rs.20000/- shall be booked as profit.

8. Accounting for Open Interest as on Balance Sheet date

Open interest refers to total number of future contracts that have neither been offset and closed by opposite future account for anticipated loss equivalent to the debit balance in the "MTM Margin Account". Credit balance in this account represents the anticipated profit in open position, the same shall be ignored and no credit shall be taken in profit and loss account. The provision so created at the end of the year shall be shown as deduction from the "MTM Index/Stock Future Account" appearing under the head "Current Assets".

In situation I, no provision is required because as on 31st of March the "MTM Margin Account" shows a credit balance of Rs. 24,000/- whereas in situation II the provision is required to be made to the tune of Rs. 4,000/-.

9. Accounting Treatment of Option Contracts

The accounting treatment in case of option contracts can be broadly classified into following categories:

- Accounting at the inception of the contract
- Accounting during continuation of the contract
- Accounting at the time of final settlement of or squaring up of the contract
- Accounting for the Open Interest as on Balance Sheet date

Let us consider the example and its accounting treatment in following paragraphs.

10. Example

Mr. A (buyer) buys the following option contract from Mr. B (Seller) and following further information is available

Date of Transaction	25/03/2005
Contract Specification	SNPCNXNIFTY MAY05
Strike Price	Rs. 1,900/-
No. of Units	200
Initial Margin	10%
Premium on 25/03/2005	Rs. 20/- per unit
Price as on last day of settlement	Rs. 2,000/-
Premium as on 31/03/2005	Rs. 23/- per unit
Price as on 31/03/2005	Rs. 1,950/-

11. Accounting at the inception of contract

a) In the books of Buyer

The buyer or the holder of option contract has to pay the premium on the inception of the contract. The buyer of the contract is not required to pay initial margin as the risk in case of buyer is limited and the loss cannot exceed the amount of premium. On payment of the premium "Equity Index/Stock Option

Premium" account shall be debited. This account will appear on asset side under the head "Current Asset".

In the above example Rs.4000/- shall be debited to premium account.

b) In the books of Seller

The seller of the option contract receives the premium and at the same time he is also required to pay initial margin. The accounting treatment for the payment of initial margin is similar to that applicable for future contracts. "Equity/Stock Option Initial Margin Account" shall be debited, which will appear under the head "Current Assets" in the books of seller. Premium received shall be credited to "Equity Index/Stock Option Premium Account" which will appear on liabilities side under the head "Current Liabilities".

In above example following two entries shall be passed in the books of the seller.

a) Index Option Initial Margin A/c Dr 38000
To Bank A/c
38000

b) Bank A/c Dr 4000
To Index Option Premium A/c 4000

12. Accounting during continuation of contract

A. In the books of Holder/Buyer

No entries are passed in the books of buyer because he is not subject to any additional margin or any MTM Margin during continuation of contract.

B. In the books of seller

In addition to initial margin the seller is subject to MTM margin on daily basis since his liability is unlimited being seller of option. Payment made or received by the seller shall be routed through "Option MTM Margin Account". The payment made on account of margin shall be debited to "Equity Index /Stock option MTM Margin Account". In case if the excess margin is refunded then this account shall be credited. This account will appear on asset side under the head "Current Assets" when there is a debit balance. At times, exchange collects "Variation Margin" instead of MTM Margin on daily basis, under such circumstances entries are entered through variation margin account instead of MTM Margin Account.

13. Accounting at the time of final settlement or squaring up of the contract

a) In the books of buyer

On exercising the option the buyer of the contract receives a favorable difference when the underlying is Equity Index. At the time of settlement the buyer will recognize the premium as an expense by debiting the profit and loss account and crediting the option premium account. In case of index contract the favorable difference will also be credited to profit and loss account as an income. In the above example Rs.20000/- i.e. 200(2000-1900) shall be credited to profit and loss account and premium paid Rs.4000/- shall be recognized as expense in the books of buyer.

In case of stock call option if it is exercised relevant underlying scrip shall be debited by crediting bank account. For put option buyer will be required to give the delivery of the stock by receiving the payment and the relevant stock account shall be credited. However, currently the difference is settled through cash and not by exchange of deliveries.

b) In the books of seller

On settlement of option, the premium received by the seller shall be recognized as income by debiting "Equity Index/Stock Option Premium Account". In case of index option contracts if it is exercised the seller is required to pay the adverse difference to the buyer, which will be recognized as a loss in the profit and loss account.

In above example Rs.20, 000/- shall be debited by the seller as a loss and at the same time premium of Rs.4, 000/- shall be recognized as a income.

On the settlement or squaring up of the contract the Initial margin paid will be released by the exchange.

On exercising the call option on stock the seller is required to deliver the underlying scrip. In such cases relevant stock account shall be credited by debiting bank on receipt of money. In case of put option relating to stock if it is exercised the underlying stock account shall be debited by crediting bank account. However, at present the difference is settled through cash and not by exchange of deliveries.

14. Accounting for Open Interest as on Balance Sheet date

a) In the books of buyer

The equity index/stock option premium account shall appear under the head "Current Assets". A provision shall be made for the amount by which the premium paid for the option exceeds the premium prevailing in the market as on the balance sheet date for the same series of contract. In case the premium prevailing in the market is higher than what is being paid by the holder, the excess shall not be treated as income considering the "Principle of Prudence". The provision so created shall be shown as a deduction from "Equity Index/Stock Option Premium Account" appearing under the head "Current Assets".

Here as the premium prevailing in the market is Rs.23/- per unit which is higher than Rs.20/- paid by Mr. A, and hence no provision is required to be made in his books of accounts.

b) In the books of Seller

The premium received by the seller shall be shown under the head "Current Liabilities" as on the balance sheet date. A provision shall be created for the amount by which the premium prevailing in the market as on balance sheet date exceeds the premium received by the seller for the same series of contracts. The excess of premium received over the premium prevailing in market shall not be recognized as income considering the "Principle of Prudence". The provision so created shall be shown as provision under the head "Current Liabilities" in the books of seller.

The provision of Rs.600/- i.e. 200(23-20) shall be made by the seller in above example.

B. TAXATION ASPECTS OF FUTURES AND OPTIONS

1.1 The question as to whether the transaction has been entered into as a trader or investor is first required to be answered before one, analyses the tax provisions relating to dealing in derivatives. Profit on dealing in contracts held as "Stock in trade" is taxed as a "Business Income" and dealing in such contract which are held as an Investment would be taxable as a "Capital Gain". The frequent & regular activities & also the motive of entering into a transaction can determine whether the activities relating to purchase or sale is a "Business activity" or an "Investment activity".

1.2 Some indicative parameters are given hereunder, which however requires to be examined on case-to-case basis.

a. Motive/intention while purchase
b. Frequency of transaction
c. Regularity /continuity of transactions
d. Volume of transactions
e. Period of holding
f. Source of acquisition
g. Existence of other business
h. Object clause in Memorandum of Association
i. Percentage of volume between delivery based/non delivery based transactions.
j. Status/ nature of activities in previous years

1.3 Keeping in mind the demarcation of "Investment Activity" and "Business Activity", let us examine the taxation aspects relating to Derivatives for both:

i. Investors
ii. Traders

2. Derivative Transactions for a Investor

2.1 Index Futures for Investor

If an investor enters into transactions of purchase and sell of Index , whether, the amount of profit or loss is taxable under the head "Capital Gain" or Otherwise?
Let us examine the question:

Any transaction on Capital Gain is primarily required to be examined with reference to the following factors.

i. Whether the transaction relates to a "Capital Asset"?
ii. If it relates to a Capital Asset, whether such asset is transferred or not?

In the given case one has to examine the transaction on the basis of following conditions:

i. Whether Index Future can be regarded as "Capital Asset"?
ii. Whether settlement of Index Futures transactions involves "Transfer"?

Let us further examine both the conditions.

i) Condition regarding Capital Asset

Sec. 2(14) of Income Tax Act defines the Capital Asset as, *"Capital Asset means property of any kind held by an assessee, whether or not connected with his business or profession………".*

Index Futures are regarded as "security" under the Securities Contract (Regulation) Act, 1956. Index Futures contracts are contracts carrying rights that can be enforced in the market and they can be considered as a property carrying value. Under this premise Index Futures can be considered as a "Capital Asset".

2.2 Condition regarding transfer

Sec. 2(47) of the Income Tax Act, defines Transfers in relation to Capital Assets

To include "the sale, exchange, or relinquishment of the asset, or extinguishments of any rights therein or……….".

In case of Index Futures, settlement through deliveries are not possible and the difference is settled in cash. At the time of settlement or maturity, right under the contract expires. In practice, the situation is that the Investor buys the index at strike price and sells the same at prevailing market price on the settlement day. When the rights in the contract are worked out, it can be regarded as extinguishments or relinquishment of right. Here on settlement of the contract the relevant contract ceases to exist and under the circumstances it is arguable that the settlement of Index Futures contract involves "Transfers".

As both the prime conditions are satisfied the gain or loss can qualify under the head "Capital Gains". Computations aspects as prescribed under Section 48 of the Act may not pose any peculiar problem "as cost of purchase" and "sales consideration" are available for computation, in spite of the contract getting settled through difference.

2.3 Poser

Can it be argued that Index future whether entered into for hedging or otherwise will always be in nature of business and hence the profit/loss is taxed under "Business Income"?

3. Stock Futures for Investors

3.1 As stated earlier, currently 'Stock Futures' contracts are also cash settled and its trading and settlement mechanism is similar to that of Index Futures. The discussion made in above paragraphs regarding conditions of "Capital Assets" and "Transfers" shall also apply to the contracts relating to stock futures.

As both the conditions satisfies the difference of cash settled stock futures contracts qualifies to be taxed under the head "Capital Gains".

3.2 However, if the Stock Futures are "Delivery Settled" then the complications deepens For example, A person buys a stock futures contracts and allows it to be converted into delivery by paying a contracted price at the time of settlement (Refer example in Para). At what point of time the Gain arises, at the time of "Settlement of future contract" or at the time of actually selling of underlying stock in future.

3.3 This issue can be examined by determining whether Derivative contract in Stock futures are independently existing or they are part and parcel of the same contract through which one purchases an underlying stock? Whether "Stock futures" contract merges with the underlying stock? or the stock futures contracts expires (settles) and the underlying stock is purchased thereafter?

Trading Mechanism and various patterns and parameters of Derivatives Trading Market supports the arguments of "Derivative contracts having separate and independent existence". It can further be perceived by some of the following points.

I. Derivative segment and Cash Market segment on the Stock Exchange are separately and independently existing.

II. Derivatives are defined as separate "security" under Section 2(h) of Securities Contract (Regulation) Act, 1956.

III. The contract of Stock future expires on settlement day when delivery is actually being taken. At no point of time "stock future contract" and its underlying stock exist parallel. The delivery of an underlying stock comes into being only on expiry of stock futures contract.

On the basis of above arguments, If Stock Future Contracts (Delivery Settled) can be held as separate and independent contract. However, once it is held to a separate and independent contract issue which pertains to "Year of Chargeability" arises.

4. Example

4.1 Mr. A purchases a stock future contract of a particular stock at Rs. 600/- per unit. On the date of settlement Market price is Rs. 800/- per unit and Mr. A decides to take delivery by making payment of Rs. 600/-(contracted price)

If derivative is held as an independent asset the gain of Rs. 200(Rs. 800-Rs.600) can be taxed as short term capital gain out of Derivative contract.

But what about the cost of stock, is it Rs. 600/- (contracted price)? or Rs. 800/- (settlement price) ?. Here it is logical to consider the cost in such cases to be at Rs. 800/- per unit.

4.2 However, the chargeability of tax should be deferred in a year in which such stock is actually been transferred as no tax can be paid on notional gain. As far as period of holding is concerned the same shall be reckoned from the date of settlement.

5. Options Contracts for Investors

5.1 Two Basic questions which arise here are,

(i) If the option is exercised, whether premium paid shall be added to the cost of the shares or allowed to be deducted from sales consideration?

(ii) If the options is not exercised what will be treatment of premium paid?

The term 'cost' is not defined in the Act. The "cost of acquisition" referred to in section 48 of the Income Tax Act does not only contemplate the purchase cost but also all the incidental expenses necessary to bring in the asset into a state which enables the owner to put the asset in "Ready" or "Deliverable" stage. Expenses like brokerage, stamp duty, Dmat charges etc. certainly forms part of cost of acquisition.

On the same premise it can be argued that the premium forms part of cost of acquisition and can be added to the cost vice-versa can be reduced from sales consideration.

If derivatives are considered as a separate and independent contract, as discussed in detail in previous (paragraphs) the treatment of tax will be different and the premium may not be allowed to be adjusted either with cost or sales consideration as the case may be.

5.2 The second issue is about the treatment of premium paid by the investor, when option is not exercised. In above case, whether loss can be considered as a "Capital Loss" or it is a loss of Capital, which is not deductible under Income Tax Act.

5.3 As discussed earlier, two prime conditions for chargeability of income under the head "Capital Gains" are:

a. There has to be capital asset
b. There has to be transfer

Options contracts are recognized as "Securities" under the Securities Contract (Regulation) Act, 1956 and they carry rights, which can be enforced in the market by the holder of the contract. As the option contracts are property-carrying value it will certainly qualify as a "Capital Asset" as defined under Sec. 2(14) of the Income Tax Act.

When the options contracts are not exercised; i.e., if they are allowed to be lapsed there are extinguishments of right attached therein. The definition of "Transfer" u/s. 2(47) of the Income Tax includes "extinguishments" of rights and hence the second condition is also satisfied.

Therefore, amount of Premium paid can be claimed as a "Capital Loss".

5.4 **Poser**

Can it be said that options contracts are the tools made only for traders and not for Investors and transactions entered into Option contracts are always in capacity as a "Traders".

6. TRADERS–TAXABILITY OF FUTURES & OPTION CONTRACT

6.1 Finance Act 2005 has brought in an important amendment in Section 43(5), clarifying the tax treatment of Derivative transaction under Income Tax Act.

6.2 Section 43(5) as amended has been reproduced as below which has come into effect from 1.4.2005

6.3 Speculative transaction" means a transaction in which a contract for the 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 scrips:

Provided that for the purposes of this clause—

(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

(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***]**

(d) *an eligible transaction in respect of trading in derivatives referred to in clause* (aa) *of section 2 of the Securities Contracts (Regu-lation) Act, 1956 (42 of 1956) carried out in a recognised stock exchange;*

shall not be deemed to be a speculative transaction;

Explanation.—*For the purposes of this clause, the expressions—*

(i) *"eligible transaction" means any transaction,—*

(*A*) carried out electronically on screen-based systems through a stock broker or sub-broker or such other intermediary registered under section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) or the Securities and Exchange Board of India 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 recognised stock exchange; and

(*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;

*(*ii*) "recognised stock exchange" means a recognised 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;*

Poser

6.4 What happens to Arbitrage business between Capital Market and Derivative Market for corporate traders with reference to Explanation to Section 73.

6.5 Whether the amendment is clarificatory in nature (or) it applies only from A.Y.2006-07 ?

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