

Taxation of Derivatives

Since, there is no transfer or delivery of the underlying asset in case of futures, the income or loss from it cannot be taxed under the head “capital gains. Therefore, depending upon the fact whether the assessee is a trader or an investor, the head of income — that is, income from business and profession or income from other sources (IFOS) — will be determined, but in either case the income will be taxed on net basis at the rates of tax applicable to the assessee.

The option premium is an income for the writer of the option and a tax-deductible expense in the hands of the buyer of the option. In case of a trader, the taxability of the gains on exercise of the option is akin to that in the case of futures trading.

However, in case of an investor, since there is an extinguishment of a right, “the gain therefrom will be treated as a capital gain, rather than an IFOS, and the premium will be allowed as the cost of acquisition.

Open interest refers to a situation, wherein on the date of the financial year end, there are outstanding derivatives contracts in the hands of the market participants. Since, under the prudent accounting principles, derivatives contracts are marked-to-market (MTM), there can be unrealised MTM gains or losses prevailing as on March 31. Whether the assessee will be liable to tax on the gains or take the benefit of the losses in such a case.

Only real income/loss attracts tax provisions and not the notional gains/losses. However, in certain judicial decisions notional losses have also been allowed as a deductible expense. Nevertheless, this is one area which can attract litigative exercise.

With the insertion of Section 43(5)(d), eligible transactions on notified stock exchanges have been rendered non-speculative in nature. So far only BSE, NSE and MCX-SX have been notified for this purpose. Therefore, trading in commodity and equity derivatives traded on stock exchanges other than those mentioned above, is still treated as speculative, the loss wherefrom cannot be adjusted against any other sources of income.

Losses from derivatives are eligible to be carried forward for a period of four years.

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