Opinion | Uncertainty surrounds taxation of physically settled derivatives

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There are no provisions dealing with physically settled derivatives

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Recently, physical settlement of outstanding derivatives on the settlement date has been made compulsory for certain derivatives, instead of cash settlement of such derivatives as was the norm till such change. Therefore, there is now receipt or delivery of underlying shares on the settlement of the derivatives transaction, if the transaction is not squared up by the settlement date.

Quite a few issues do arise in respect of taxation with reference to such physical settlement. Is the derivatives transaction and the subsequent physical delivery of underlying shares to be regarded as one integrated transaction of purchase or sale of shares? What is the cost or sale price of the shares—will it be the cost of the derivative plus the amount paid on physical delivery? What would be the date of acquisition or the date of sale of the shares—will it be the date that the derivatives transaction was entered into or the date of physical settlement of the derivatives transaction? Would the derivatives transaction be regarded as a business transaction?

Our tax laws provide for taxation of cash settled derivatives, but there are no provisions dealing with physically settled derivatives. A derivatives transaction on a recognised stock exchange would not be regarded as a speculative transaction. Marked to market losses and gains are not to be considered for taxation, but gains and losses on settlement are to be taken into account.

One has to, therefore, examine the manner of taxation in a vacuum. Increasingly, our tax laws are inclined to look at taxation of transactions by looking at the substance of the transactions, rather than the form of the transactions. A physically settled derivative transaction is closed out and settled by accepting or giving a physical share. The form of the transaction, therefore, is that there is a derivative transaction, which is settled by purchase or sale of a share, which is a separate transaction. If one follows taxation based on form, the profit or gain on the derivative is computed by taking the value of the share delivered on the date of physical settlement as the value of settlement of the derivative. Such value is also taken as the cost or sale price of the share.

However, the substance of the transaction is that there is purchase or sale of a share pursuant to the derivative transaction. Therefore, really, there is no gain or loss on settlement of the derivative transaction by physical delivery, as it is one integrated transaction. The gain or loss on the derivative transaction is, therefore, to be adjusted against the delivery price of the share

on the date of physical settlement, and is to be regarded as part and parcel of the cost or sale price of the share.

Let us understand through an example. Assume that you have bought a three-month call option to buy shares of company A at Rs.400 per share, for which you paid a premium of RS.30. On the settlement date on expiry of the option at the end of three months, you take delivery of the shares by paying Rs.400 even as the market rate of the share on the date of such settlement was Rs.500. In such a case, going by the substance theory, the cost of your share is Rs.430 (the premium on the option plus the amount paid for the share on exercise of the option) and not Rs.400 (the cost and Rs.30 being the loss on expiry of the option) if one were to follow the form of the transaction.

Take another case where you have sold one-month futures of company B for Rs.500, and on the date of settlement a month later, when you give the delivery of the shares, the market value of the shares is Rs.460. In such a case, going by substance, your sale price will be Rs.500. Going by form, your sale price will be Rs.460, and there will be a gain on settlement of the future of Rs.40 (the difference between Rs.500, the initial future price, and Rs.460, the future price on settlement). The substance method seems to be the more appropriate method of taxation in such cases.

What about the date of acquisition or date of sale? If one goes by the Central Board of Direct Taxes (CBDT) circular issued long back in the context of shares, it is the date of contract which has to be considered. In this case, that would mean the date on which the derivative transaction was entered into, though the physical delivery was given or received much later. This would also be the case if one goes by the substance of the transaction. If one goes by the form, it would be the date of physical delivery.

Fortunately, such transactions can definitely not be regarded as speculative transactions, whether one goes by form or by substance. Whether the derivative transactions would be regarded as business transactions depends upon the nature of the underlying share transactions. If the taxpayer is not a trader in shares or derivatives, the derivatives transactions cannot be regarded as business transactions. They would be part and parcel of the underlying investment transactions in shares.

All in all, there is too much uncertainty surrounding the taxation of such physically settled derivatives. The law needs to be amended at the earliest to remove such uncertainty, and provide clarity regarding the tax treatment. That will avoid unnecessary litigation that such uncertainty is otherwise bound to result in.

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