

A STUDY ON TAX IMPLICATIONS ON FINANCIAL DERIVATIVES IN INDIA

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ABSTRACT

Taxes are compulsory extraction of money by public authorities for public purposes, enforceable by law. It does not mean payment for services rendered. There are two types of taxes, i.e., direct taxes and indirect taxes. Taxes are levied on account of income, expenditure and capital assets. Derivatives may results into income and capital asset and hence derivatives are subject matter of taxation. Derivatives being comparatively new type of income and capital assets, taxation on derivatives are in state of dilemma. The paper is aimed at to explore history of taxation on financial derivatives and present status of taxation on derivatives. Comparison with other countries has been done to suggest on taxation on derivative instruments. A new system of taxation has been proposed and suggestions and recommendations regarding it have been incorporated in and implications have been discovered.

Keywords: Taxation, Derivatives.

I. INTRODUCTION

Derivatives are primarily risk management tools. More accurately, they are volatility management tools. The ability to assume risk is a function of capital. The basis of the efficient utilization of capital is the netting of risks against each other. Trading in derivatives has now become an integral part of the global financial market. The past three decades have seen a singular rise in the development and growth of derivatives markets the world over. Trading in futures and options has seen a big rise and time and again, new products have been introduced which are related to this concept. Futures, options and OTC derivatives markets are integral parts of almost all economies of the world which have reached an advanced stage of development. Such markets are likely to become important part of developing countries as well, helping them to move to the advanced stage with the passage of time.

The Indian government, based on the L.C. Gupta Committee recommendations, has allowed trading in derivatives to begin in India. The Derivatives Bill, passed recently, will give trading on the domestic bourses a new dimension, as index-based trading would finally be permitted, a long-standing demand in the Indian markets. The shares underlying a stock exchange index would be traded as a single unit. The passing of the Derivatives Bill also requires a change in the definition of 'securities' in the Securities Contract (Regulation) Act (SCRA), to include the words 'futures' and 'options'. The development of a derivatives market is considered as a prerequisite for the Indian capital market to be globally competitive.

'Derivative' is an instrument whose value depends on its underlying cash or physical asset. Hence it means that the value is derived from the value of the underlying assets like foreign exchange, currency, securities and commodities. It also includes market indices such as the LIBOR, BSE Sensex or benchmark interest rates. The result of a derivative transaction is a transfer or exchange of specified cash flows at defined future points in time. Derivatives include forward, future and option contracts that are of a pre-determined fixed duration, linked for the purpose of contract fulfillment, to the specified value of real or financial asset or to index of securities.

Derivatives are used to hedge against price, currency and interest rate risk. Since derivative instruments do not involve risks, they help redistribute the risk between market participants. Hence, derivatives in this sense are used for risk management. Derivatives can also be used for speculative functions.

II. REVIEW OF LITERATURE

Financial Derivatives

During the 1980s and 1990s, commercial and investment banks introduced a broad selection of new products designed to help corporate managers in handling financial risks. At the same time, the derivatives exchanges, which successfully introduced interest rate and currency derivatives in the 1970s, have become vigorous innovators, continually adding new products, refining the existing ones, and finding new ways to increase their liquidity. Since then, markets for derivative instruments such as forwards and futures, swaps and options, and innovative combinations of these basic financial instruments, have been developing and growing at a breathtaking pace (Allen and Santomero, 1998). In terms of the growth of derivatives markets, and the variety of derivatives users, the Indian market has equaled or exceeded many other regional markets (Fitch Ratings, 2004). There is no consistent method of accounting for gains and losses from derivatives trading. Thus, a proper framework to account for derivatives needs to be developed. Further, regulatory reform will help the markets grow faster. As Indian derivatives markets grow more sophisticated, greater investor awareness will become essential. In addition, institutions will need to devote more resources to develop the business processes and technology necessary for derivatives trading (Sarkar, 2006).

Makbul Rahim (2001) argued in his speech that the regulatory framework must provide the right environment for the development and the growth of the market. High standards of probity and professional conduct have to be maintained and reach world class standards. Integrity is very important as well confidence. The development of a proper free flow of information and disclosure helps investors to make informed investment decisions.

Rajeswari, T. R. and Moorthy, V. E. R. (2005) said that expectations of the investors influenced by their perception and human generally relate perception to action. The study revealed that the most preferred vehicle is bank deposit with mutual funds and equity on fourth and sixth respectively. The survey also revealed that the investment decision is made by investors on their own, and other sources influencing their selection decision are news papers, magazine, brokers, television and friends or relatives.

B. Das, Ms. S. Mohanty and N. Chandra Shil (2008) studied the behavior of the investors in the selection of investment vehicles. Retail investors face a lot of problem in the stock market. Empirically they found and concluded which are valuable for both the investors and the companies having such investment opportunities. First, different investment avenues do not provide the same level of satisfaction. And majority of investors are from younger group.

III. OBJECTIVES

The following are the objectives of study:

1. To explore present situation of taxation on derivatives.
2. To suggest changes in taxation on derivatives.

IV. RESEARCH METHODOLOGY

The present study is an exploratory and descriptive research, which is an effort to draw some conclusion on present status of taxation on derivatives in India. The study is based on secondary data such as books, journals, periodicals, magazines, websites, blogs, etc., have been referred.

V. CONCEPT OF DERIVATIVES

A derivative is a financial product which has been derived from another financial product or commodity. The derivatives do not have independent existence without underlying product and market. Derivatives are contracts which are written between two parties for easily marketable assets

A Study of Derivatives Market in India. Derivatives are also known as deferred delivery or deferred payment instruments. Since financial derivatives can be created by means of a mutual agreement, the types of derivative products are limited only by imagination and so there is no definitive list of derivative products.

A derivative is a financial product which has been derived from another financial product or commodity.

Definition of derivatives: The securities contracts (Regulation) Act 1956 defines “derivative” as under section 2 (ac). As per this “Derivative” includes

- (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 derived its value from the price, or index of prices at underlying securities.”

Participants in the derivative trading

Hedgers

Derivative products are used to hedge or reduce their exposures to market variables such as interest rates, share values, bond prices, currency exchange rates and commodity prices. This is done by corporations, investing institutions, banks and governments alike. A classic example is the farmer who sells futures contracts to lock into a price for delivering a crop on a future date. The buyer could be a food processing company, which wishes to fix a price for taking delivery of the crop in the future.

Speculators/Traders

Derivatives are well suited to trading on key market variables such as interest rates, stock market indices and currency exchange rates and on prices of commodities and financial assets. It is much less expensive to create a speculative position using derivatives than by actually trading the underlying commodity or asset. As a result, the potential returns are much greater.

A classic application is the trader who believes that increasing demand or scarce production is likely to boost the price of the commodity. He has two options with him - first option is to buy and store the physical commodity whereas other option is to go long on futures contract.

Trader chooses the second option to go long futures contract on the underlying asset. If commodity price increases, the value of the contract will also rise and he can reverse back position to book his profit.

Arbitrageurs

An arbitrage is a deal that produces risk free profits by exploiting a mispricing in the market. A simple arbitrage occurs when a trader purchases an asset cheaply in one exchange and simultaneously arranges to sell it at another exchange at a higher price. Such opportunities are unlikely to persist for very long, since arbitrageurs would rush in to buy the asset in the cheap location and simultaneously sell at the expensive location, thus reducing the price gap.

VI. Taxation of Derivatives in India

Derivative transactions are still in nascent stage in India and their tax implications are still to be tested by the Indian revenue authorities. There are no precedents directly on the subject. Margins in a swap transaction are extremely narrow. Therefore, the imposition of taxes by the country of the payer substantially alters the profitability of a swap.

General provision under the Income tax Act:

Indian residents are subject to tax on their worldwide income, non-residents on the other hand are taxed only on income received by them in India, or income that accrues or arises to them in India. Further, under

certain conditions, income can be "deemed to accrue or arise in India" and thereby be subject to tax in India. Generally, the entire tax payable by a nonresident in respect of income earned in India is liable to be withheld at source.

Taxation under the I-T Act

Section 9 of the I-T Act covers situations under which income which can be "deemed to accrue or arise in India". Under Section 9(1)(i) of the I-T Act, all income accruing or arising, through or from any business connection/property/asset or source of income in India, is deemed to accrue or arise in India. Only such part of the income as is reasonably attributable to the operations carried out in India can be deemed to accrue or arise in India.

Unlike in the United Kingdom, the Indian tax laws do not specifically distinguish between "doing business in India" and "doing business with India". The term "business connection" which is crucial to determination of taxable business income in India, is not statutorily defined. Therefore, this term is to be understood based on interpretation provided by courts. In general, it can be interpreted as a continuous relationship between a business carried on by a non-resident entity, which yields profits or gains and some activity (in India) which contributes directly or indirectly to the earning of these profits or gains.

Whether payments under derivative transactions would constitute "Income deemed to accrue or arise in India" is a question which can be dealt with only qua facts of a specific transaction. The I-T Act does not specifically deal with the tax incidence of income flows arising out of a derivative transaction. Indian courts have also not analyzed the taxation of such income. Though there are no direct cases on the point, courts have opined on the taxability of profits/losses arising to an assessee merely due to the appreciation or depreciation in the value of foreign currency held by it. The position adopted by courts has been that such profits/losses would ordinarily be trading profit/losses if the foreign currency is held by the assessee in revenue account or as a trading asset or as part of circulating capital. If, on the other hand, the foreign currency is held by the assessee as a capital asset or as fixed capital, such profit or loss would be of capital nature. (*Sutlej Cotten Mills V. CIT*, (1979) 116 ITR 1, *State Bank of Travancore v. CIT*, (1986) 158 ITR 102).

Section 10(15)(iv) of the I-T Act exempts certain types interest payments from taxation in India. The Finance Act, 1999 has enlarged the scope of the word 'interest'. Now, interest includes hedging transaction charges on account of currency fluctuation. This would mean that any payment made for hedging against foreign currency rate fluctuations in respect of foreign currency debt obligation may be exempt from taxation in India.

Tax Treaty Provisions:

India has tax treaties with a number of countries. Indian tax law is unique as it statutorily offers a tax payer choice between the provisions of the treaty and the domestic tax law under Section 90 (2) of the I-T Act. The effect of this section is that, a tax payer may opt for the treaty or I-T Act, whichever is more beneficial.

Most comprehensive treaties give the country of source the right to tax business income only if the recipient has a Permanent Establishment (PE) in the country of source. PE is a much narrower concept than "business connection". Therefore, many foreign parties, which may have a "business connection" in India by virtue of having the counter party in India and source of income in India, may not have a PE in India. This distinction is so crucial that the entire income, which could be taxable under the first concept, could be tax exempt under the other one. In the absence of a permanent establishment in India, the business income arising out of the derivative transactions made by the Indian payer, will not be subject to tax in India.

Even if a PE is found to exist, only such part of the business income, which is attributable to the permanent establishment, can be taxable in India. Such income is taxable on 'net' basis after deduction of certain expenses. While foreign companies are taxed at the rate of 48 %, domestic companies are taxed at the rate of 35% on such business profits. The Nondiscrimination Article in some of the tax treaties may help reduce the tax incidence from 48% to 35%.

For giving effect to the treaty provisions, reliance will have to be placed by the Indian counterparty on the payee representations. The payee may have to provide evidence that it qualifies for the relevant exemption from withholding taxes. The Indian counterparty can withhold the tax at the rates in force.

Non-residents are eligible for applying for an advance ruling which is available on an existing or a proposed transaction, on questions of law or facts. These rulings are binding upon the applicant and the tax authorities, in respect of that applicant. Such a ruling may help the foreign counter party to determine the relevant tax implications in India.

Withholding Tax:

In a cross-border DFI transaction, withholding tax is a crucial question as the traders want their cash flows free of taxes. In general, withholding tax is levied on interest, dividend or royalty payments. Most countries have regarded payments under derivative contracts as falling outside 'interest' and 'dividend' articles as they do not reflect the true return on capital. The same principle should apply to payments of differences on futures contracts, swap fees and premiums on options. Most of these payments fall within 'business profits' or 'other income' articles and therefore, are remitted gross, free of withholding taxes. The taxation is determined in the country of residence.

In India, the position is slightly different. Section 195(1) of the I-T Act entrusts the payer with the liability to withhold tax on certain payments being made to a foreign recipient. An issue arises with respect to withholdings under section 195 that whether the payer has to deduct tax on the gross amount of payments due to the non-resident, or on the income or profit element received by the non-resident. The Supreme Court has authoritatively settled this issue in the case of Transmission Corporation of AP Ltd. V. CIT. The Apex court has held that the scheme under section 195 of the ITA applies not only to the amounts that bear an element of income or profit, but also to gross sums, the whole of which may not be income or profit of the recipient.

In order to obtain an exemption from withholding any tax, or for withholding tax at a lower rate, the payer/payee will have to file an application with the Assessing Officer to determine the appropriate portion of the sum that should be chargeable to tax. However, it should be noted that a certificate granted in this regard is only provisional. Final tax liability is ascertained upon regular assessment after a tax return is filed (if necessary).

It is pertinent to note that in case of a banking company, exemption from withholding taxes is available only if the payments (not classified as interest on securities or dividend) are received by the branch operating in India, on its own account and are not received on behalf of the head office or any other branch situated outside India.

Thus, the Indian payer making payments to overseas parties under a derivative transaction is generally liable to withhold tax at source. The procedure for obtaining this lower tax withholding certificate has been recently simplified. Now, based on a Chartered Accountant's certificate, the Indian payer can remit the payment after withholding tax at the lower rate applicable under the treaty or without withholding any tax, as the case may be. However, it has to submit an undertaking that it shall undertake to pay the shortfall in tax, interest or penalty, which are payable in accordance with the provisions of I-T Act.

Gross-up of Tax:

Under the terms of the ISDA Master Agreement, the payer has to bear the burden of withholding taxes, where the tax is payable because of a connection with its chosen tax jurisdiction (i.e.: India). The burden to bear the taxes falls upon the payee only in limited circumstances where the payee has made a representation which is not true at the time it is made or which becomes untrue as a result of subsequent events or where the payee fails to conform to a provision in the ISDA Master Agreement requiring performance of a tax related obligation.

In India, however the payer will have to comply with the provisions of section 195A of the I-T Act read together with circular number 370 issued by the Central Board of Direct Taxes. These require that when the payer bears the income tax liability, the calculation of tax to be withheld at source should be made not with reference to the 'net-of-tax' amount payable to the non-resident payee, but should be made with

reference to the gross amount. This provision may further affect the profitability of a derivative transaction in India.

Tax Implications on Swaps:

Taxation of swap payments is fairly complicated. The issue involved is one of characterization of the settlement amount. The characterization of the amount could be either business income or interest income. There is a strong case for the swap payment to constitute business income in the hands of the non-resident recipient as against interest income or other income.

Under the I-T Act, the term "interest" is defined under section 2(28A) to mean interest payable in any manner in respect of moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized.

In a swap transaction, there is no money borrowed or debt incurred. The principal of a swap deal is the notional amount and the adjustment takes place between the bank and the counterparty in respect of the amounts payable by them. Only the net amount changes hands. Therefore, such amounts should qualify as trading income. However, in a synthetic transaction, where the deal is structured in a manner where there is a debt incurred and the payment is made in respect of debt incurred, such payment could be regarded as 'interest'. In the Indian context, such a situation may be the practical reality faced by the Indian corporate who are forced to enter into synthetic transactions. The consequences may be different in a cross-border transaction, especially where the non-resident counterparty is from a treaty jurisdiction.

Article 11(3) of the OECD Model Convention defines interest as: "The term interest as used in this Article means income from debt-claim of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds and debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this article."

Thus, even the definition of OECD Model Convention (OECD MC) lays emphasis on the debt-claim. The commentary to OECD MC also supports the above argument.

Thus it can be concluded that, as long as the underlying 'debt-claim' remains purely hypothetical, the equalization payment is not interest. The fact that the swap was created to secure the payments on a loan does not change the payment into interest. However, if one party pays a lumpsum amount to the other and the same is repaid over the course of the swap (an off-market swap), the return and equalization payments could be seen to contain a loan element.

If these amounts were to be treated as interest, they may attract a withholding tax in India at the rate of 20% on the gross amount. This rate could be reduced further depending upon the tax treaty provisions. If a foreign company earns any business income that is deemed to accrue or arise in India, it would be liable to be taxed at the current applicable rate of 48% on its net business income.

VII. CONCLUSION

In many countries, a definite position on the taxation of financial derivatives has not been reached as yet. There is also an ongoing discussion on which distributive rules of the current OECD Model Convention will apply to the income resulting from financial derivatives. The differences in national tax systems further complicate the difficulties already present in the double taxation treaties. Further clarity is required to be provided in the commentaries to model treaties to affirm the tax treatment of new instruments like financial derivatives.

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