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Taxations for Speculators: Assessing Tax Consequences and Its Effect

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Taxation for Speculators: Assessing Tax Consequences and Its Effect

By: Tarun Satya and Sejal Phatak

ABSTRACT

Speculative Business is one where there is no intention of taking delivery of the contract. The intention is not to invest but to earn profits from fluctuations in prices of the stock. My research paper would be focusing on the Speculative Business from a taxation point of view. Income Tax Act,1961 has made provisions relating to different heads of income namely Income from Salary, Income from House property, Income from Capital Gains, income from Profits and Gains of Business or Profession and from other sources. Income Tax derived is subject to different computation processes under different heads of income. Thus, in order to get the computation right and to save the tax, it is required to follow the right method of calculation.

There may be confusion in determining which all transactions are Speculative and which all are not. Assessee may be slightly worried regarding the transaction which he makes would amount to Speculative or not. My research paper, having been divided into five chapters, will give a clarity to the above-stated confusion. Chapter One will be the Introduction to Speculative Business where the overview of Speculative Business will be the topic to focus. Chapter two will be focusing on Exceptions to Speculative Business. My research paper will even state the provisions for carry of losses accruing from Speculative Businesses which will be in Chapter Three. Chapter Four will be stating about the implications of tax audits for such businesses. Lastly Chapter Five would conclude my research paper and would provide recommendations to the existing tax system.

KEYWORDS:

SPECULATIVE - TRANSACTIONS - EXCEPTIONS - INCOME TAX – ASSESEE.

CHAPTERS OF PAPER

CHAPTER ONE: INTRODUCTION

Definition and Meaning

In general sense, the term speculate means "to form a theory or conjecture without firm evidence". According to Section 43(5) of Income Tax Act***, "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 scripts"[1].*** To understand the concept of speculative business, this research paper would demonstrate a hypothetical illustration. Suppose A wants to have transaction of one kilogramme of gold with B. Terms to the contract was that if there is increase in gold rate during the specified time then B would have the duty to pay A, contracted amount or vice versa, then A would be under obligation to pay B. Here there is no intention of delivery of the Gold between the parties thus amounting to Speculative transaction. Thus, Intraday equity trading would be considered as Speculative Business[2]. The shares would enter and exit on the same day in the trading account. Transactions would not be entered in DEMAT Account. There would be no intention of taking delivery of the contract. Speculative Business is taxed according to Total Income Slab at the normal rate.

CHAPTER TWO: EXCEPTIONS TO SPECULATIVE BUSINESS

Though there are few instances where certain transactions would come under the definition of Speculation yet those will not be considered as Speculative in the eyes of law.

Hedging Contracts

The word 'hedge' calls back to an older meaning for the word 'fence'. Thus, hedging means to contain a thing within a space thus controlling its outcome. Hedging Contract can be with respect to Shares or Securities and Raw Material or Merchandize. These contracts reduce or

[1] Section 43(5) of Income Tax Act,1961.

[2] https://zerodha.com/varsity/chapter/taxation-for-traders/.

eliminate certain risks that would negatively impact one's holding. Any person may enter into a hedging contract with another in order to safeguard their commodity from price fluctuations. The main aim of this contract is to minimise risk thus falls under the umbrella of exceptions to Speculative Business.

Forward Contracts

Future Contracts are the agreements between two parties to transaction an asset at specified time in future for contracted price. They are traded in Over-the-Counter. The buyer of the contracts agrees to take delivery of the asset at a future date but only at a contracted price. Same for the seller, who agrees to sell the asset at contracted price at a future date. The main aim of this contract is to hedge against any loss arising in the ordinary course of business. In Future contract, one of the parties takes a long position by agreeing to buy and another, short position who agrees to sell.

Trading Derivatives

Derivative[3] is a financial instrument which derives its value from an underlying Asset. Thus, if the price of underlying asset increases automatically the price of derivatives based on it will increase and if price of underlying asset decreases, then price of derivatives will decrease. For example, if sugarcane is the underlying asset of sugar, then when the price of sugarcane increases, the price of sugar in the market also increases and vice-versa. A transaction in respect of trading in derivatives in recognized stock exchange is an exception to Speculative Business.

CHAPTER THREE: SPECULATIVE LOSS

While every businessman aims to flourish their business with surplus profits, the possibility of losses in business cannot be eliminated. Losses are made to set off or carry forwarded to help the assessee to reduce tax during their tough phase of business. The concept of Set-off and Carry forward is based on the principle of Natural Justice.

[3] Section 2(ac) of Securities contracts(regulation) act, 1956- "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 derives its value from the prices, or index of prices, of underlying securities;

The main objective for distinction between Speculative and Non-Speculative Business is that there would be different treatment of losses between the two businesses. Rule regarding set off of speculative loss is that loss from speculative business cannot be set off against Non-Speculative Business but only against Speculative Profit. However, business loss can be set off against Speculative Income. According to Section 73 of Income Tax Act[4], if the speculative loss cannot be set off wholly, then it can carry forward the remaining loss and shall set off against the income of Speculation Business.

In the Supreme court ruling of C.I.T V Pangal Vittal Nayak and Co. Pvt Ltd[5]There arose a question whether the Commission received for such business can be treated as Deemed Speculative Income. The Supreme Court held that as commission is not speculative in nature thus cannot be considered as Speculative Profit. And thereby Speculative loss cannot be set off against such income.

The maximum period for carry forward of Speculative loss is four immediate consecutive years from the assessment year for which such loss was calculated.

In the case of C.I.T V Kurji Jinabhai[6], Supreme Court held that if the assessee has illegal Speculative Business, the benefit of Set off and carry forward in case of such business loss wouldn't be given to him.

CHAPTER FOUR: TAX AUDIT OF SPECULATIVE BUSINESS

Section 44AB of the Income Tax Act states about compulsory tax Audit. If the business turnover exceeds One Crore, then it is mandatory for the Assessee to get his Tax Audit done**.** However, Amendment to Finance Act, 2020 states that if the aggregate transactions exceed Ninety-five percent in mode other than in cash then the turnover limit is increased to Five crores.

[4] Section 73(1) of Income Act,1961- Losses in speculation business-

"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".

[5] C.I.T V Pangal Vittal Nayak and Co. Pvt Ltd (1969) 74 I.T.R 754 (S.C).

[6] C.I.T V Kurji Jinabhai (1977) 107 I.T.R 101 (S.C).

Question next arises on how the turnover of speculative business should be calculated. Intraday trading as stated earlier comes under the ambit of speculative Business. The turnover of Intraday is measured by summing up aggregate of positive and negative differences. Sum of profit and loss would lead to Absolute profit. This has been considered as Absolute turnover in the eyes of the Income Tax Department. For example, if an intraday trader makes profit of ten-thousand in the first day and loss of five-thousand in the second day, absolute profit would sum up to fifteen-thousand.

In case if assessee opted for presumptive business under Section 44AD[7], if loss or profit is below six-percent of the turnover and Income exceeds basic exemption, then tax audit is compulsory.

CHAPTER FIVE: CONCLUSION

Based on literature that has been deliberated above, it can be effectively said that Tax treatment for Speculative business is quite different from the normal business because of its speculative nature. An Assesse should clearly know under which type of Business, he is earning the Income. Is it under speculative head or under Non-speculative one.

There are many instances where Speculative Income has been misinterpreted to be a non-Speculative one. To ascertain which transactions are speculative, assessee has to be thorough with the provisions relating to Speculative business mentioned in the Income Tax Act,1961 and file their return accordingly.

This case study is for information purpose only. Nothing contained herein shall be deemed or interpreted as providing legal or investment advice.

[7] Section 44 AD of Income Tax Act,1961.