Derivative transactions in shares whether covered by the definition of speculative transaction – A Case Study

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The Bombay High Court in its recent ruling namely *Commissioner of Income Tax vs. Bharat R. Ruia* (*HUF*) (*MANU/MH/0535/2011*) decided on 18.4.2011 dealt with the issue as to whether the transactions in exchange traded financial derivatives are "speculative transactions" as defined in Section 43(5) of the Income Tax Act, 1961 and if so whether clause (*d*) inserted to the proviso to Section 43(5) of the Act w.e.f. 1st April, 2006 would apply to such transactions undertaken in the assessment year 2003-04 relating to speculation transaction.

Factual background

Assessee, an HUF, engaged in the business of trading in shares and securities, etc, in the assessment year 2003-04, had entered into certain transactions in exchange traded derivatives ("derivative transactions"), which resulted in loss amounting to Rs. 28,37,707/-. The Assessee claimed the above loss as business loss.

The contentions of the Assessee was rejected by the assessing officer on the ground that the loss incurred was speculation loss covered under Section 43(5) of the Act. CIT (*A*) also affirmed findings of the AO. ITAT while disposing appeal filed against the same, followed the Coordinate Bench decision of the Tribunal in the case of *Grishma Securities Pvt. Ltd.* and held that clause (*d*) to the proviso to Section 43(5) of the Act being retrospective in nature, the losses incurred from the derivative transactions could not be treated as speculation losses incurred by the assessee in AY 2003-04. The Revenue against the impugned finding of ITAT has filed the present appeal.

Issues for adjudication

The issues that arose for consideration before the Court were:

(*i*) Whether the transactions in exchange traded financial derivatives are "speculative transactions" as defined in Section 43(5) of the Income Tax Act, 1961?

(*ii*) If so whether clause (*d*) inserted to the proviso to Section 43(5) of the Act w.e.f. 1st April, 2006 would apply to such transactions undertaken in the assessment year 2003-04?

Contentions

Contentions raised by Revenue:

- Derivative transaction is in essence a contract for purchase or sale of underlying security which is ultimately settled otherwise than by actual delivery.
- Such a transaction which is settled otherwise than by delivery would be speculative transaction under Section 43(5) of the IT Act.
- By entering into a derivative contract, one has purchased or sold the underlying security and any difference in the price of the underlying security would have to be borne by the said purchaser or seller.

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- Therefore, the transaction to purchase the underlying securities namely shares through the medium of derivative transactions, which is settled, otherwise than by delivery would be speculative transaction under Section 43(5) of the IT Act.
- Loss incurred in such transactions could be set off only against income from speculative business.

Contentions raised by Assessee:

- Transactions in futures carried on through the Stock Exchange were to be settled only in terms of money, by payment/receipt of price differences.
- Under these exchange permitted transactions delivery of shares is not contemplated.
- These transactions in derivatives can never result in the purchase or sale of the "underlying security". The underlying security only gives a market driven price (so that it cannot be manipulated), which would determine the quantum of profit or loss on the contract.
- Derivatives are Stock Exchange approved standard instruments whose purpose is to transfer/manage risk. The person entering into derivative contracts only makes a profit/loss in terms of money and there is no possibility of obtaining the underlying security which in very many cases is impossible to obtain delivery of the underlying security.
- Words "including stocks & shares" in Section 43(5) of the Act supports the contention of the assessee that stocks and shares are not as such commodities but artificially included within the meaning of commodity for the purposes of Section 43(5).
- However, in the present case, the transactions carried on by the assessee are not in law capable of purchasing or selling stocks and shares and, therefore, the transactions would not fall within the scope of Section 43(5) of the Act.
- In Section 43(5), the definition takes within its ambit only a commodity and stocks and shares. Since permitted derivatives do not fall within the scope of any of the said words, the loss incurred by the Assessee cannot be said to be speculative loss.
- A contract for purchase/sale of a permitted exchange traded derivative is not a contract for the purchase of shares even when the particular underlying is a share for the simple reason that the number of such derivatives are not limited by the number of shares. Since it is permissible to have a larger number of derivatives with a particular share as the underlying than there are shares of the underlying in existence, it is evident that the transactions in exchange traded derivatives are not intended for purchase/sale of shares and, therefore, outside the purview of Section 43(5) of the Act.

Contentions raised by intervenor:

- A contract which derives its value from the prices or index of price of underlying securities cannot be said to be speculative contract. As the derivatives form a category different from the category of shares and stocks, they are not covered under Section 43 (5) of the Act.

Conclusion

- Plain reading of clause (*d*) to Section 43(5) makes it clear that with effect from 1^{st} April, 2006, only those eligible transaction in derivatives referred to under

Section 2(ac) of 1956 Act which are carried out in a recognized stock exchange shall not be deemed to be a speculative transaction.

- Unless the transactions referred in clause (*d*) covered under Section 43(5), there would be no question of excluding those transactions from the purview of Section 43(5).
- Explanation 2 to Section 28 provides that where speculative transactions carried on by an assessee are of such a nature as to constitute a business, then such speculation business shall be deemed to be distinct and separate from any other business.
- Section 43(5) of the Act defines the expression "speculative transaction" to mean 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.
- The expression "commodity" is not defined under the Act. Therefore, the expression "commodity" in Section 43(5) has to be given meaning as understood in common parlance, under which it means an article of trade or commerce, which are tangible in nature.
- In the present case, the assessee had entered into futures contracts for purchase of shares of certain companies at a specified future date and at a specified price, which were to be settled in cash without actual delivery of the shares. Such a contract, whether constitutes a contract for purchase of a commodity is the question.
- The futures contracts being articles of trade and commerce, which are legally permitted to be traded on the stock exchange, the transactions in futures would be transactions in a commodity as contemplated under Section 43(5) of the Act.
- Ordinarily a transaction in a commodity relates to purchase/sale of an asset which is tangible and which is capable of being delivered. For the purposes of Section 43(5), it is not necessary that the commodity agreed to be purchased or sold must be capable of actual delivery. Therefore, future contracts for purchase / sale of an underlying security permitted to be traded on the stock exchange and settled otherwise than by actual delivery would be speculative transactions under Section 43(5) of the Act.
- The expression "commodity" would cover all articles of trade including stocks & shares. Even under Section 43(5), the expression "commodity" is not expanded to include "stocks & shares". In fact, use of "comma" in between the word "commodity" and the words "including stocks & shares" in Section 43(5) make it clear that transactions for purchase of any commodity would include transaction for purchase or sale of stocks & shares. In other words, Section 43(5) does not seek to expand the scope of expression "commodity" but merely emphasizes that the transaction in commodity includes transactions in stocks & shares. Therefore, transactions in futures contracts like transactions in stocks & shares when settled otherwise than by actual delivery would be speculative transactions under Section 43(5) of the Act.
- The very object of Section 43(5) is to treat transactions which are settled otherwise than by actual delivery as speculative transactions. The fact that the futures contracts are settled otherwise than actual delivery cannot be a ground to hold that the futures contracts are not speculative transactions under Section 43(5) of the Act.

- The exceptions enumerated in the proviso to Section 43(5) clearly provide that where speculative transactions are carried out with a view to guard against loss in respect of contracts for actual delivery in cases referred to in clause (*a*), (*b*) & (*c*) of the proviso, then, such speculative transactions shall not be deemed to be speculative transactions. So far as the transactions covered under clause (*d*) are concerned, they are deemed not to be speculative transactions only with effect from 1st April, 2006. Therefore, the transactions covered under clause (*d*) would not be treated as speculative transactions only with effect from 1st April, 2006.
- The legislature by Finance Act, 1995 has specifically provided that clause (*d*) to the proviso to Section 43(5) shall come into operation prospectively with effect from 1st April, 2006. Secondly, insertion of clause (*d*) was not necessitated on account of the fact that the provisions of Section 43(5) were unworkable or interpretation of Section 43(5) resulted in unintended consequences. Thirdly, even after insertion of clause (*d*), all transactions in derivatives are not taken outside the purview of Section 43(5).
- It is only those derivative transactions which are covered under clause (*d*) are taken outside the purview of Section 43(5) and the rest of the transactions in derivatives would continue to be covered under Section 43(5) of the IT Act.
- In the instant matter, the exchange traded derivative transactions carried on by the assessee during AY 2003-04 are speculative transactions covered under Section 43(5) of the Act and the loss incurred in those transactions are liable to be treated as speculative loss and not business loss. Clause (*d*) inserted to the proviso to Section 43(5) with effect from 1st April, 2006 is prospective in nature and the ITAT was in error in holding that clause (*d*) to the proviso to Section 43(5) applied retrospectively so as to apply to the transactions carried on by the assessee during AY 2003-04. Appeal by the Commissioner of Income Tax accordingly allowed.