AN EXPLORATION OF FINANCIAL DERIVATIVES OF THE TAX IMPLICATIONS IN INDIA.

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Abstract- **Taxes are legally-mandated, forced financial gains made by public authority for public uses. It does not imply payment for labor done. There exist two distinct categories of taxes: direct taxes and indirect taxes. Taxes are imposed based on capital assets, income, and expenses. Because derivatives have the potential to produce income and capital assets, they are taxable. Given that derivatives are a relatively new class of capital and income assets, taxes on them are now problematic. The purpose of the article is to examine the taxation of financial derivatives historically and currently. To provide recommendations about the taxation of derivative instruments, comparisons with other nations have been made. There has been a proposal for a new tax system, and its ramifications have been identified and included along with comments and recommendations.**

Keywords**: Tax, Finance, Derivatives.**

I. INTRODUCTION

The main purpose of derivatives is to manage risk. They should be called volatility management tools. Capacity to take on risk is a product of capital. The netting of risks against one another forms the basis of capital usage that is efficient. Derivatives trading is now a crucial component of the world financial market. Global derivatives markets have developed and grown at an unprecedented rate during the last three decades. There has been a significant increase in the trading of futures and options, and related products have been developed on a regular basis. The markets for futures, options, and over-the-counter derivatives are essential components of nearly any economy in the world that has grown to a high level of development. With time, these markets are probably going to demarcate a magnificent role in developing nations as well, assisting them in transitioning to a more developed state.

As per recommendations of the L.C. Gupta Committee, the Indian government has approved to start trading of derivatives in Bharat. The recently passed Derivatives Bill will bring a new dimension to trade within the ambit of domestic bourses by allowing index-based trading, which have been long-standing demand in the Indian markets. The index of stock-exchange constituent shares would be traded as a single item. The Securities Contract (Regulation) Act (SCRA) must amend its definition of "securities" to include the terms "futures" and "options" in light of the passing of the Financial-Derivatives Bills. To be globally competitive, the Indian capital market is thought to need to develop a derivatives market.

A "derivative" is an instrument whose value is determined by the cash or tangible asset that underlies it. This implies that the value is determined by taking into the account valuable consideration of underlying assets, which include commodities, securities, foreign exchange, and currency. It also comprises benchmark interest rates and market indices like the BSE Sensex, LIBOR, and others. A transfer or exchange of specific cash flows at pre-determined future points is state of time, and is outcome of a derivative transaction. Derivatives are contracts for forward, future, and options with predetermined fixed durations that are tied with Securities Index or to the specified real value or financial assets that is being made for contract fulfillment.

Interest rate, currency, and price risk can be managed with derivatives. Derivative instruments aid in risk redistribution among market entrants because they don't carry any risks. Derivatives are therefore used to mitigate risk in this sense. Speculative functions would be handled with derivatives.

II. REVIEW OFLITERATURE

FINANCIALDERIVATIVES

Commercial and investment banks launched a wide range of new products in the decades of 1980 and 1990s to assist corporate managers in managing financial risks. Simultaneously, since they were successful in introducing interest rate and derivatives of currency in the 1970s, the derivatives exchanges have developed into active innovators, constantly introducing new products, improving the ones that already exist, and coming up with new strategies to boost their liquidity. Since then, there have been an incredible surge in the development and expansion of derivatives markets, encompassing forwards and futures, swaps and options, of creative amalgamations of these fundamental financial instruments (Allen and Santomero, 1998). The Indian market has surpassed or equaled many other regional markets with respect to growth of derivatives markets and the derivatives diversity users (Fitch Ratings, 2004). Gains and losses from trading in derivatives are not consistently accounted for. Therefore, it is necessary to develop an appropriate framework to account for derivatives. Moreover, regulatory reform will facilitate faster market growth. Increased investor awareness will be crucial as the Indian derivatives markets become more complex. Institutions will also need to invest more money in developing the technology and business procedures required for trading derivatives (Sarkar, 2006).

In his speech, Makbul Rahim (2001) mentioned that the regulatory framework needs to envisage the ideal conditions for the market's expansion and development. Maintaining and raising the bar for professional conduct and probity must be done at a global level. Integrity and confidence are both crucial. Establishing an appropriate and unrestricted exchange of information and transparency facilitates investors in making well-informed investment choices.

According to Rajeswari, T. R., and Moorthy, V. E. R. (2005), investors' expectations are shaped by their perceptions, and people typically equate perception with action. As per the survey, bank deposits are commonly used type of investment, with mutual funds and equity coming in fourth and sixth, respectively. The survey also showed that while investors make their own investment decisions, news articles, magazines, brokers, television, and friends and family can also have an impact.

In 2008, B. Das, Ms. S. Mohanty, and N. Chandra Shil conducted a study on investor behavior when choosing investment vehicles. There are numerous challenges for individual stock market investors. They arrived at conclusions based on empirical evidence that are

beneficial to companies offering investment opportunities as well as investors. First off, not all investment opportunities offer the same degree of satisfaction. Additionally, the bulk of investors are younger.

III. OBJECTIVES

The objectives of the research are as follows:

1. To investigate the current state of derivatives taxation.
2. To propose modifications to derivatives taxation.

IV. RESEARCH METHODOLOGY

The goal of this exploratory and descriptive study is to make some conclusions about how derivatives are currently taxed in India. The study's foundation is secondary data from sources that have been cited, including books, journals, periodicals, magazines, websites, and blogs.

V. CONCEPT OF DERIVATIVES

Any financial product that has been developed from any other financial productsand/or commoditiesare known as a derivative. Derivatives cannot exist on their own without the underlying product and market. Contracts for the most attractive and easily available marketable assets that are written between two parties are known as derivatives.

An analysis of the Indian derivatives market. Another name for derivatives is deferred payment or deferred delivery instruments. There is no definitive list of derivative products because they can be created through mutual agreement, which means that the types of derivative products are only limited by the imagination.

A financial product that has been derived from another financial product or commodity is known as a derivative.

Definition of derivatives: The "derivatives" is mentioned in securities contracts (Regulation) Act, 1956 under section 2 (ac). As per the Act, "Derivative" includes -

i. *"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."*

ii. *"A contract which derived its value from the price, or index of prices at underlying securities."*

Participants of Derivatives Trading

Hedgers

They can hedge or lessen their exposure to market factors by using derivative products. Companies, financial institutions, governments, and banks all carry out this activity. Any farmers who manage tosale any future contracts to lock their expected future price for delivering their crop at a later stage is considered to be Derivative Trading. A food processing business that wants to set their charges for receiving any crop in future could be the buyer.

Speculators/Traders

Trading on important market variables like interest-rate, stock market indices, currency exchange rates, and the quotation of financial assets and existing commodities is a good fit for derivatives. Using derivatives to establish a

speculative position is far less expensive than trading the underlying commodity or asset. The potential rewards are therefore significantly higher.
The most prominent example is a trader who thinks that a commodity's price will rise due to rising demand or limited supply. He has two choices available to him: purchasing and storing the actual good, or taking a valuable position in future contract.
To purchase a lengthy future contracts of the underlying assets, the trader selects 2nd options. The contract's value will rise in tandem with an increase in the price of the commodity, allowing him to reverse back into a profit-making position.
Arbitragers
The transaction that takes advantage of any market mispricing to generate profits without taking any risks. Arbitrage can classified into various segments; the simple arbitrage is said to be when any traders buy an asset at certain discount on one exchange and plans to sell it at a higher price on another exchange at the same time. These kinds of available opportunities may not likely to last very long because arbitrageurs would likely rush to purchase that assets at the lower price, and simultaneously, they will able to sell it at the higher price, dealing with larger price gaps.

VI. Bharat's Taxation of Derivatives

The Indian revenue authorities are currently assessing the tax implications of derivative transactions, which are still in their early stages in Bharat. There aren't any direct precedents for the topic. In any swap transactions, margins are very small. As such, the profitability of any swaps are significantly impacted by taxes imposed by the payer's nation.
General provision of the Income Tax Act:
Indian residents are required to pay taxes on their worldwide income, whereas non-residents are only taxed on income earned or derived within India. Additionally, under certain conditions, income may be "deemed to accrue or arise in India" and be subject to Indian taxation. In general, the full amount of a nonresident's tax obligation on income received in India may be withheld at the source.
Taxation under the ITA:
The ITA's Section 9 lists the situations in which income is "deemed to accrue or arise in India." Section 9(1)(i) of the ITA states that all income arising or accruing through or from any business connection, property, asset, or source of income in India is deemed to arise or accrue in India. If the income can be reasonably connected to the operations carried out in India, it can only be concluded that a portion of it originated or accumulated there.
The tax laws in India do not demarcate a distinction between "doing business in India" and "doing business with India," unlike those in the UK. Statutorily defined, the term "business connection" is essential for determining taxable income in India. As a result, the meaning of this term must be understood in light of the legal interpretation. In general, it can be interpreted as a continuous collaboration between a non-resident company engaged in profitable business and an activity (in India) that helps the earning of said gains or profits, either directly or indirectly.
The question of whether payments made under derivative transactions would be considered "Income deemed to accrue or arise in India" can only be answered in terms of the particular facts of each transaction. The tax incidence of income flows from derivative transactions is not expressly covered by the Income Tax Act. Additionally, Indian courts have not examined how such income is taxed. Courts have expressed opinions regarding the taxability of gains or losses incurred by an assessee solely as a result of an increase or decrease in the value of foreign currency that it holds, even in the absence of direct cases on the subject.
The stance taken by the courts has been that if the assessee holds the foreign currency in a revenue account, as a trading asset, or as part of circulating capital, then such profits or losses would typically be considered trading profits or losses. However, such a profit or loss would be considered capital if the assessee held the foreign currency as fixed capital or as a capital asset. (State Bank of Travancore v. CIT, (1986) 158 ITR 102, and Sutlej Cotten Mills V. CIT, (1979) 116 ITR 1).
Section 10(15)(iv) of the Income Tax Act exempts some interest payments from Indian taxation. The definition of "interest" was expanded by the Finance Act of 1999. Interest now covers transaction costs for hedging against currency fluctuations. This would imply that any money paid to hedge against changes in foreign exchange rates related to a foreign currency debt obligation might not be subject to Indian taxation.
General Provisions of Tax Treaty:
India and several other nations have tax treaties. Section 90 (2) of the ITA gives taxpayers in India the option to choose between the treaty's provisions and domestic tax law, making Indian taxation law distinct. This section means that a taxpayer may choose to use the ITA or the treaty, depending in which is more advantageous.
Most comprehensive treaties permit business income to be taxed by the source country only if the recipient has a Permanent Establishment (PE) in that nation. Compared to PE, "business connection" is a far more expansive term. Because they have an Indian counterparty and income source, many foreign parties may have a "business connection" but not a PE in India. The entire income that would have been taxable under the first concept may instead have been tax

exempt under the second due to the significance of this distinction. If there is no permanent establishment in India, the business income arising from the derivative transactions made by the Indian payer will not be taxable.

Few of the portion of the business source of income that may be attributable to the permanent establishment as per taxation laws of India, even in that event that PE is determined to exist. Once certain expenses have been deducted, this said category of income will always be subject of "net" taxation. Domestic companies pay taxes @ of 35% on business profits, while foreign companies pay taxes @ of 48%. A few tax treaties have a non discrimination article that could aid in bringing the tax incidence down from 48% to 35%.

The Indian counterparty will have to rely on the payee representations with respect to give effect to the treaty provisions. It might be necessary for the payee to present proof with respect to eligible for the applicable withholding tax exemption. The tax may be withheld by the Indian counterparty at the current rates.

Applications for an advance ruling on a proposed or current transaction, on legal or factual issues, would be accepted from non-residents. Regarding that applicant, both the authorities & the applicant are bound by these decisions. A decision of this kind might assist the foreign counterparty in ascertaining the pertinent tax ramifications in Bharat.

Withholding Tax:

In a cross-border DFI transaction, withholding tax is crucial to take into account because the traders want their cash flows to be tax-free. Generally, royalties, dividends, and interest payments are subject to withholding tax. Most countries have considered payments made under derivative contracts to be outside the scope of "interest" and "dividend" articles because they do not fairly represent the return on capital. The same principle should apply to futures contract differences, swap fees, and premium payments on options. Since most of these payments are categorized as "business profits" or "other income" articles, they are made gross, meaning that withholding taxes are not deducted. Taxation is determined by the country in which a person resides.

In India, things are a little different. Under Section 195(1) of the I-T Act, the payer is liable for withholding tax on certain payments made to a foreign recipient. Regarding withholdings under section 195, the issue arises as to whether the payer must deduct tax from the gross amount of payments owed to the non-resident or from the income or profit element that the non-resident receives. In the Transmission Corporation of AP Ltd. V. CIT case, the Supreme Court has provided a conclusive answer to this query. The program under section 195 of the ITA is applicable to gross sums, amounts that contain a component of income or profit but may not be the recipient's total income or profit.

To be eligible for a reduction in withholding tax or an exemption from withholding altogether, the payer/payee must submit an application to the Assessing Officer identifying the specific amount that should be subject to tax. It's critical to keep in mind that the certificate granted in this instance is only transient. The final tax liability is ascertained by periodic assessment (if required) after a tax return has been filed.

The key thing to keep in mind is that a banking company can only receive an exemption from withholding taxes if its Indian branch receives payments (which aren't dividends or interest on securities) for its own account and not on behalf of the head office or any other branch that is located outside of India.

Gross-up of Tax:

In situations where taxes are owed because of a connection to the payer's designated tax jurisdiction (such as India), the payer is liable for withholding taxes in accordance with the terms of the ISDA Master Agreement. The payee only becomes responsible for paying taxes under specific circumstances, such as when the payee makes a representation that is subsequently shown to be untrue or untrue at the time it is made, or when the payee violates an ISDA Master Agreement provision requiring the fulfillment of a tax-related obligation.

In India, however, the payer is required to follow Central Board of Direct Taxes Circular Number 370 and section 195A of the Income Tax Act. These require that, in cases where the payer is liable for income taxes, the tax withheld at source be computed using the gross amount rather than the "net-of-tax" amount that has to be given to the non-resident payee. This clause may further affect the profitability of a derivative transaction in India.

Implications of Taxes on Swaps:

The process of taxing swap payments is not very simple. The issue at hand is the characterization of the settlement amount. The sum may be categorized as either business or interest income. There is a strong case to be made for the swap payment to be regarded by the non-resident recipient as business income in contrast to interest income or other types of income.

"Interest" is defined as any interest that is payable in connection with money borrowed or debt incurred (which may include a deposit, claim, or any similar right or obligation) under section 2(28A) of the I-T Act. It also includes any service charge or other expense associated with money borrowed, debt incurred, or an unused credit facility.

There is never any debt or money borrowed in a swap transaction. The principal of the swap deal is the notional amount, and the amounts that each party must pay the other are negotiated between the counterparty and the bank. Only the ownership has changed net. These amounts should therefore be regarded as trading income. However, if the terms of a synthetic transaction are such that a debt is created and a payment is made in respect of that debt, then that payment might be regarded as "interest." In the Indian context, it is possible for Indian corporations to find themselves in a situation where they are forced to participate in artificial transactions. In a trans-border transaction, the outcomes might differ, particularly if any NRI counterpart is governing through the treaty jurisdiction.

As per Article 11(3) of the OECD Model Convention, interest is defined as follows: "In this context, interest is defined as income from debt-claim of any kind, including income from government securities, income from bonds and debentures, including premiums and prizes attached to such securities, bonds, or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. For the purposes of this article, penalties for late payments will not be considered interest."Therefore, the debt-claim is emphasized even in the OECD Model definition. The said argumentsare also supported by the OECD MC commentary.

Therefore, the applicable interest is not applied to the equalization payment as long as the underlying "debt-claim" is purely hypothetical. Still, the payment is made in interest, even though the swaps were established to guarantee loan payments. However, the abovesaid equalization payments and their return might be viewed as having a loan component, if any party makes a one-time payment to another & repays it over the course of the swaps.

These amounts may lead to withholding of taxes in Bharat on the total amount if they were considered interest. This rate may be further lowered based on the period of tax treaty. A foreign business will be charge subject to taxation at applicable rate of 48 Percent on its net accrued business income, if it generates any business income in Bharat.

VII. CONCLUSION

There is currently no consensus in many nations regarding the taxation of financial derivatives which distributive rules of the OECD Model would be applicable to the income resulting from the said derivatives i.e. another topic of ongoing discussion. The challenges posed by double taxation treaties are further exacerbated by the variations in national tax systems. It is also prime responsibility to upgrade the tax structure of novel instruments such as financial derivatives, more clarification is needed in the model treaty commentaries.

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