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BUDGET: HOW TAX HIKE ON F&O COULD IMPACT TRADERS?

The finance ministry plans to impose higher taxes on futures and options (F&O) transactions in the upcoming Union Budget, as per reports. Proposed changes include reclassifying these transactions as 'speculative income' from 'non-speculative business income' and introducing TDS on them. This news has unsettled the trader community. Let us understand why.

Derivatives are financial contracts that derive value from underlying assets. These trades are executed within a day without physical delivery. Even if income is derived from the sale of securities, due to the unique nature of these trades, there exist specific provisions for its classification and taxability. One, unlike the sale of shares that are classified as income from capital gains, transactions of futures and options are income from business profits. This key distinction sets it apart from other securities, making profits taxable at the slab rate of an individual, irrespective of the holding period.

Further, unlike capital gains, in which only expenses wholly and exclusively incurred related with the transfer are allowed as a deduction, all expenses attributable to the business of trading are allowed as a deduction under business income. So, traders enjoy a lower tax rate and higher expense deductions, which makes F&O trading more attractive than retail investment. Any losses from these instruments can be used to set off against other business income of the assessment year, or carried forward, and set off against business income for the subsequent eight years. This provided a cushion for traders against the volatile nature of the market. F&O traders rely on trend analysis and probability computation requiring years of experience and knowledge about markets and trends. The ministry's proposal stems from its concern for retail investors, whose participation in the derivatives market has seen a significant increase.

Introduction of TDS on F&O transactions adds another layer of complexity

The strategy being to take the appeal of lower tax rates and higher deductions away from the instruments and raise the applicable taxes.

What the Budget may propose: The ministry is reportedly considering the following: (i) Applying a higher tax rate of 30% to such profits, replacing the current slab rate applicability; (ii)

Introducing a nominal TDS to better track these transactions; and (iii) The proposed reclassification of F&O income as speculative income will significantly impact traders.

First, the ability to offset losses from F&O transactions against other business income would be curtailed. This change would result in higher tax liabilities for traders, particularly those who use losses in one segment to offset gains in another, balancing their overall tax obligations. With the new classification, only profits and losses within the speculative category can be offset against each other, which can lead to higher taxable income and, consequently, higher taxes.

Second, the imposition of a flat 30% tax on F&O profits would eliminate the benefit of slab rates, which provides a lower tax burden for individuals in lower-income brackets. This change would impact small and retail traders who may not have substantial profits but will face a significantly higher tax rate on their gains.

The introduction of TDS on F&O transactions adds another layer of complexity. While the primary objective is to track transactions more effectively and ensure tax compliance, it will also increase the immediate tax burden on traders. TDS will require traders to have more liquidity in hand to meet tax obligations upfront, reducing the capital available for trading.

The overall market could face stress due to these changes. Higher taxation and stricter loss set-off rules might discourage retail participation in the F&O segment, leading to reduced liquidity and higher volatility. Institutional investors may also reassess their strategies, potentially withdrawing from the market or seeking alternative instruments with more favorable tax treatments. In conclusion, while the finance ministry's proposal aims to protect retail investors and increase tax collections, it may have unintended consequences for traders and broader market.

The reclassification of F&O income as speculative, the imposition of a higher tax rate, and the introduction of TDS could create a more challenging environment for traders. Policymakers must carefully consider these impacts to strike a balance between safeguarding investors and maintaining market stability.

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