Time for commodities transaction tax?

A differential tax structure for derivatives is not fair but CTT will act as a dampener for investors and cut commodity trade volumes

Madhoo Pavaskar
Commodity economist

"If CTT is applied, then the commodity derivatives trade will move to much more liberal offshore exchanges or to illegal, unregulated dabba shops"

Stock exchanges want commodities, currency and fixed income derivatives to be taxed in the same way as securities. The stock markets and other markets serve different economic utility functions: one is for investments and the second is for price discovery and risk management. Hence, they cannot be treated the same way.

Stock derivatives attract the Securities Transaction Tax (STT) but, when the stock exchanges talk of a level-playing field, they are fully aware that they enjoy a special tax treatment under Section 43 (5) of the Income Tax (I-T) Act. Under this section, profits or losses from stock market transactions are treated as "business" incomes and losses, and are allowed to be offset against losses or profits from other economic activities — whether it is real estate, treasury, cement, chemicals and so on. The same tax treatment applies to currency and fixed income derivatives (where there is no STT). The sole stepchild of the special tax treatment is the commodity derivative segment. Income from commodity derivative transactions is considered "speculative" income or loss under Section 73 (A) of the I-T Act and is taxed up to 33 per cent.

The cash segment of the stock markets also enjoys favourable tax treatment in that short-term capital gains are taxed at 15 per cent, while long-term capital gains are tax-free. That is not the case with the spot markets in commodities, currency and fixed income bonds.

If the turnover at the exchanges and revenue maximisation were to be the criteria for levying a Commodities Transaction Tax (CTT), then currency derivatives stand first in the queue. That is because volumes in currency derivative trading are $57 billion a day compared to $12 billion a day for commodities and $3 billion a day for fixed income.

If, hypothetically, policy makers want to levy a derivative transaction tax, they should not discriminate among different derivatives — commodities, currencies and interest rates. Even among commodities, it is unfair to discriminate between markets in farm and non-farm commodities only because non-farm commodities have higher volumes. This is like saying STT should be levied on Infosys, and not on Suzlon, because the former has a higher turnover. It will not be fair and equitable to tax only one segment of any market. That will defeat the "horizontal equity" principle in the canons of taxation, and will be construed as the highest level of discrimination.

CTT will reduce liquidity in the market, and widen the bid-ask price spread. The commodity derivative market in India provides for the lowest impact cost (bid-ask spread) in the world, despite the fact that transaction costs are among the highest. Estimates of the sensitivity of commodity trade volumes to the prevailing transaction charges levied by exchanges reveal that a one per cent rise in transaction costs can lead to a 7.8 per cent decline in volume. The spot-to-futures multiple in India is just 5, 10, 15 compared to global ratios of 20, 30, 50 in agricultural commodities, energy and metals, which disqualifies the argument of excessive speculation.

As it is, CTT is not levied anywhere in the world, except Taiwan where volumes have dwindled and moved to Singapore. Unlike the perception propagated, every commodity trade requires a unique client code and the permanent account number, and attracts service tax and stamp duty. In addition, all trades are reported to the Forward Markets Commission and the I-T department. So, they are 100 per cent in the tax net anyway.

CTT was proposed in Union Budget 2008 and finally, based on the recommendation of the Prime Minister's Economic Advisory Council, it was abolished in the Budget of July 2009. In practice, the tax was never notified and applied. Since the context and logic have not changed since then, it beats the merit of even a discussion.

Despite this recent history, if the corporate competitive agenda prevails in policy-making, then the commodity derivatives trade, which has created 1.5 million jobs in the country in the last decade, will move to much more liberal offshore exchanges or to illegal, unregulated *dabba* (bucket) shops. That eventuality will only ensure the corporate competitive agenda of destroying the commodity derivatives market in the guise of creating a level-playing field.

Sandeep Dandapat
Head - Business Development, BSE

"To provide a level-playing field, transaction taxes should be levied on all derivatives instruments, in order to ensure that there is no tax arbitrage"

Stock exchanges are instrumental in building capital, and they have been doing so for over 100 years. The capital raised with the help of the stock exchanges not only enables and empowers institutions to add to production and, hence, the country's gross domestic product, but also leads to job creation. Other organised markets trading derivatives that do not have transaction taxes have encouraged trading and investment in non-productive assets, practically reducing the amount of capital available for investment in productive asset classes like equity.

The fact remains that more retail investor funds are moving to the commodities markets, instead of finding their way to the equity markets. The presence of the Securities Transaction Tax (STT) for equity trades is acting as a dampener for retail investors to put their money in the equity markets. This is clear from the turnover data of the stock and the commodity exchanges reported in *Business Standard.* The average daily securities turnover on the stock exchanges has seen a reduction from Rs 59,615 crore in the financial year 2007-08 to Rs 43,118 crore in 2011-12, a decline of 27.67 per cent in four years. In contrast, the average daily turnover in non-agricultural commodities futures

has jumped from Rs 10,277 crore to Rs 50,147 crore in the same period, a growth of 387.95 per cent!

That explains the increasingly vocal demand from banks, the stock exchanges and market professionals for a level-playing field between all organised markets if STT cannot be removed. To provide a level-playing field across all financial derivatives, a transaction tax should be levied on all kinds of derivatives instruments, based out of equities, currency, interest rate, commodities and electricity, to ensure that there is no tax arbitrage that would encourage traders to move from one asset class to another. Further, the rate of transaction tax should be uniform to enable fair and just treatment from a tax standpoint for derivative instruments that could be used for both hedging, portfolio balancing, trading and speculative purposes.

It is a well-known fact that derivatives on financial instruments, such as equity or bonds, are similar in nature to derivatives in commodities. Therefore, in academic literature, all derivatives are treated as financial instruments, irrespective of the underlying asset on which they are constructed. In other words, in concept or in practice, there is no difference between derivatives in commodities, currencies, interest rates or equities. They are all financial instruments that are used primarily for speculation or hedging, so there is no reason for a differential taxation structure.

STT on equities, which is basically an instrument for investment, needs to be brought down and made the lowest. The transaction tax on futures should be higher. Options should be even higher. In essence, a new transaction tax structure needs to be put in place to ensure there is no tax arbitrage across asset classes.

Volumes on the equity markets and the tax collected by the government have progressively gone down year after year since the imposition of STT, while the tax-free volumes on other organised markets, which have become a haven for speculators, have been mushrooming. If a similar transaction tax is not imposed on other organised derivatives markets and STT remains – i.e. if any disparity remains in taxation of other asset classes vis-à-vis securities – past trends suggest that stock market volumes will go down further and collections will come down to less than Rs 1,000 crore in the next two years compared to the more than Rs 10,000 crore that can be collected.

People have already started walking away from highly-taxed instruments like securities, and this process will accelerate. Not imposing transaction taxes on other organised markets derivatives transactions will ensure that there is a loss of STT revenue and the transaction tax revenues the government could have collected, and the collections may have worked out to be more than Rs 10,000 crore in a year when the government is battling a rising fiscal deficit. By not creating a new transaction tax structure, the government would have successfully stunted the stock market, propped up speculative trading in other markets and would not have helped the cause of tax collection either.

(Business Standard)