Bombay High Court The Commissioner Of Income-Tax vs Shri Bharat R. Ruia (Huf on 18 April, 2011 Bench: J.P. Devadhar, R. S. Dalvi 1 itxa1539-10

IN THE HIGH COURT OF JUDICATURE AT BOMBAY

ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX APPEAL NO.1539 OF 2010

The Commissioner of Income-tax, Central-IV]
R. No.663, Aayakar Bhavan, M.K. Road,]
Mumbai - 400 020.] ..Appellant.

V/s.

Shri Bharat R. Ruia (HUF)]
Phoenix Mills Premises,]
462 Senapati Bapat Marg,]

Lower Parel, Mumbai - 400 013.] ..Respondent.

Mr. Vimal Gupta Mrs. Padma Divakar, Advocates for the appellant.

Mr. J.D.Mistri, senior Advocate with A.K.Jasani for the respondent.

Dr. K. Shivram. Advocate for the intervenor.

CORAM : J.P. DEVADHAR AND MRS. R.S, DALVI, JJ.

JUDGMENT RESERVED ON : 21ST MARCH, 2011

JUDGMENT PRONOUNCED ON : 18TH APRIL, 2011

JUDGMENT (PER J.P. DEVEDHAR, J.)

1) This appeal was admitted on 21/12/2010 on one question of law, which at the hearing of the appeal, by consent, is reframed into two questions, as follows :-

a) Whether the transactions in exchange traded financial derivatives are "speculative transactions" as defined in Section 43(5) of the Income Tax Act,1961 ?
b) If so whether clause (d) inserted to the proviso to Section 43(5) of the Act w.e.f. 1-4-2006 would apply to such transactions undertaken in the assessment year 2003-04 ?

2) The respondent-assessee is an HUF engaged in the business of trading in shares and securities, etc.

3) In the assessment year 2003-04, the assessee had entered into certain transactions in exchange traded derivatives ('derivative transactions' for short) which resulted in loss amounting to Rs. 28,37,707/-. The assessee claimed the above loss as business loss. In the assessment order passed under Section 143(3) of the Income Tax Act, 1961 ('IT Act' for short) the assessing

officer rejected the contention of the assessee and held that the loss incurred was speculation loss covered under Section 43(5) of the Act. The appeal filed by the assessee against the order of the assessing officer was dismissed by C.I.T. (A). 3 itxa1539-10

4) On further appeal filed by the assessee, the ITAT following

the Coordinate Bench decision of the Tribunal in the case of Grishma Securities Pvt. Ltd. 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. Challenging the aforesaid order, the revenue has filed the present appeal. 5) Mr. Gupta, learned counsel for the revenue submitted that a 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. Referring to Section 2(ac) and Section 2(h) of the Securities Contracts (Regulation) Act, 1956 ('1956 Act' for short) which define the expression 'derivative' and 'securities' respectively, Mr. Gupta submitted that 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. 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 4 itxa1539-10 Section 43(5) of the IT Act. Loss incurred in such transactions could be set off only against income from speculative business. 6) Mr. Gupta further submitted that clause (d) inserted to the proviso to Section 43(5) by Finance Act, 2005 specifically provides that with effect from 1/4/2006 exchange permitted derivative transaction shall not be deemed to be a speculative transaction. Clause (d) being prospective in nature would not apply to the loss incurred in AY 2003-04. Therefore, the decision of the Tribunal being contrary to law, appeal filed by the revenue must be allowed. 7) Mr. Mistri, learned senior Advocate appearing on behalf of the assessee on the other hand submitted that the transactions in futures carried on by the assessee 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 at all. 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. 8) Mr. Mistri submitted that derivatives are Stock Exchange

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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. 9) Relying on a decision of the Apex Court in the case of Davenport & Co. P. Ltd. V/s. CIT reported in 100 ITR 715 (S.C.), Mr. Mistri submitted that a transaction can be said to be a speculative transaction only if the transaction falls within the definition under Section 43(5) of the Act. To fall within the purview of Section 43(5) of the Act, the transaction must involve purchase or sale of any commodity including stocks and shares. The contracts entered into by the assessee are not contracts for the purchase or sale of any commodity and hence the transactions cannot fall within the ambit of Section 43(5) of the Act. 10) Mr.Mistri submitted that the expression 'commodity' as per Black's Dictionary means tangible goods which are article of trade or commerce such as raw materials, etc. Calcutta High Court in the case of CIT V/s. Nirmal Trading Co. reported in 82 ITR 782 has held that letters of renunciation conferring on the renouncee the right to apply for shares of the company would neither constitute 'shares' nor commodities and such transactions would not be speculative transactions. Similarly, the 6 itxa1539-10 transactions in futures does not involve purchase or sale of any commodity and, therefore, fall outside the scope of Section 43(5) of the Act. Therefore, purchase / sale of financial instruments for transfer of risks such as derivatives cannot be treated as speculative. 11) Mr. Mistri further submitted that the 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. 12) Relying on the decision of the Apex Court in the case of Bharat Co-operative Bank Ltd. V/s. Co-op. Bank Employees Union reported in (2007) 4 SCC 685, Mr. Mistri submitted that in a definition Section if the phrase 'means' is used, then what follows is intended to be exhaustive and no meaning other than that put in the definition can be assigned. Therefore, 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. 7 itxa1539-10

13) Mr. Mistri submitted that 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. In support of the above proposition, reliance is placed on the decision of the ITAT in the case of DCIT V/s. SSKI Investors Services P. Ltd. reported in 113 TTJ 511 (Bom) and RKB Securities P. Ltd. V/s. RTO reported in 118 TTJ 465 (Bom). 14) Mr. Mistri further submitted that a derivative contract is merely a contract to transfer or manage risk and is akin to a contract of insurance. It is, therefore, not a contract for the purchase or sale of anything which is a requirement to fall within the ambit of Section 43(5) of the Act. Further in order to fall within Section 43(5) of the Act, the contract in question must be of a type that can be settled by actual delivery or transfer of the commodity or scrip. In the present case, it is impossible to settle the contract by actual delivery (or in any manner 8 itxa1539-10 otherwise than by payment of money) and, therefore, it is clear that the contract in question is not intended to fall within the scope of Section 43(5) of the Act. In support of the above contention, reliance is placed on the decision of the Apex Court in the case of CIT V/s. B.C. Srinivasa Setty reported in 128 ITR 294 (SC), PNB Finance Ltd. V/s. CIT reported in 307 ITR 75 (SC) and CIT V/s. Official Liquidator, Palai Central Bank Ltd. reported in 130 ITR 539 (SC). 15) Mr. Mistri submitted that clause (d) to the proviso to Section 43(5) of the Act inserted by the Finance Act, 2005 with effect from 1/4/2006 also supports the contention of the assessee. In the memorandum explaining the provisions of the Finance Bill, 2005, it is stated that there has been sufficient transparency to prevent generation of fictitious losses due to screen based computerised trading and, therefore, clause (d) has been inserted. Screen based trading was introduced on the Bombay Stock Exchange in the year 1995 and in the National Stock Exchange since its inception prior to 2005 amendment. Derivative trading from inception in the year, 2000 has been screen based only. Therefore, the insertion of clause (d) is clarificatory and curative in nature since the purpose of amendment as set out in the memorandum explaining the provision of the Finance Bill, 2005 were in existence at the time of introduction of derivative trading in India. Accordingly, Mr.Mistri submits that the only reasonable way to construe 9 itxa1539-10 the insertion of clause (d) to the proviso to Section 43(5) is to hold that the said insertion is clarificatory and curative and applicable for all the assessment years prior to 2006-07. He submits that the insertion of clause (d) is intended to remedy a clearly unintended consequence and an amendment brought about to remedy the possible unintended consequence has to be treated as retrospective. In support of the above proposition, reliance is placed on the decision of this Court in the case of Godrej & Boyce Mfg. Co. Ltd. V/s. DCIT reported in 328 ITR 81 (Bom), decisions of the Apex Court in the case of Allied Motors Pvt. Ltd. V/s. CIT reported in 224 ITR 677 (SC), CIT V/s. Poddar Cement P. Ltd. reported in 226 ITR 625 (SC), CIT V/s. Alom Extrusions Ltd. reported in 319 ITR 306 (SC) and CIT V/s. Gold Coin Health Food P. Ltd. reported in 304 ITR 308 (SC). 16) Mr. K. Shivram, learned counsel appearing on behalf of the intervenor, while adopting the arguments of Mr. Mistri, submitted that 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. 17) We have carefully considered the rival submissions. 10 itxa1539-10

18) Before dealing with the question as to whether derivative

transactions are speculative transactions under Section 43(5) of the Act, it would be appropriate to consider the nature of derivative transactions. 19) The nature of the derivative transaction has been lucidly brought out by the learned Judge of the Madras High Court in the case of Rajshree Sugars & Chemicals Ltd. rep. by its Directors and Chief Operating Officer Mr. R. Varadaraj. Coimbatore V/s. Axis bank Ltd. reported in (2008) 8 MLJ 261 in the following terms:- " 5. What are these derivatives which have gained such a great deal of notoriety ? In simple terms, derivatives are financial instruments whose values depend on the value of other underlying financial instruments. The International Accounting Standard (IAS) 39, defines "derivatives" as follows: " A derivative is a financial instrument (a) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the 'underlying'); (b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and 11 itxa1539-10 (c) that is settled at a future date. " Actually, derivatives are assets, whose values are derived from values of underlying assets. These underlying assets can be commodities, metals, energy resources, and financial assets such as shares, bonds and foreign currencies. 6. Derivatives can be used as insurance cover against certain types of business risks such as fluctuations in the rate of foreign exchange, fluctuations in the rate of interest on borrowings, fluctuations in the value of specified assets etc. To take an example, it is common knowledge that the price of gold keeps fluctuating. If a manufacturer of gold jewellery anticipates that he would require a particular quantity of gold at a specified distance of time, he may enter into a contract with the seller of gold bars for the supply of the same at a future date, at the rate specified in the contract. This contract reduces the risk for the buyer, against a possible steep rise in the price of gold. It equally reduces the risk of the seller against a steep fall in the price. Thus the contract acts as an insurance cover. When the transaction goes through without any dispute, the contract is fulfilled. But when the transaction fails and the motive behind the transaction is not necessarily the sale and supply of gold, but the receipt or payment of the difference in the price (difference between the prevailing price and the price fixed in the contract), many eyebrows are raised and many questions are asked. This is the point where the transaction takes a detour from a simple contract of insurance. 7. There are atleast 4 categories of derivatives, commonly in use. Some of them are traded through exchanges and they are known as Exchange-Traded-Derivatives (ETD). Others are traded 12 itxa1539-10 directly between the parties and they are known as Over-The-Counter (OTC) derivatives. The 4 categories of derivatives are as follows:- (1)

Forwards: A contract between two parties. One party agrees to buy a commodity or financial asset on a date in the future at a fixed price, while the other agrees to deliver that commodity or asset at the predetermined price. These are not traded on exchanges because they are negotiated directly between two parties. (2) Futures: igA contract essentially the same as a forward contract, except that the deal is struck via an organized and regulated exchange. There are three key differences between forwards and futures (i) Futures contract is guaranteed against default (ii) They are standarized and (iii) They are settled on a daily basis. (3) Swaps: A swap is an agreement made between two parties to exchange payments on regular future dates. Swaps are OTC (Over the counter) products. Swaps are used to manage or hedge risk associated with volatile interest rates, currency exchange rates, commodity prices and share prices. Swaps can be considered as series of forward contracts. (4) Options: An option gives the holder right to buy or sell an underlying asset at a future date at a predetermined price. A call option is the right to buy. The buyer of a "call option" has the right, but not the obligation to buy an agreed quantity of a particular commodity or financial instrument 13 itxa1539-10 (underlying instrument), from the seller (or writer) at a certain time (the expiration date) for a certain price (strike price). The buyer pays a premium for this right. In contrast, a put option is the right to sell. The buyer of a "put option" has the right, but not the obligation to sell an agreed quantity of a particular commodity or financial instrument (underlying instrument), to the seller (or writer) at a certain time (the expiration date) for a certain price (strike price). We have a variety of options such as American and European options, depending upon the time of exercise of the right. Both call option and put option can be combined to achieve "zero cost option." 8. Trading in these markets are regulated internationally by Commodity Futures Trading Commission (CFTC) and International Swaps and Derivatives Association (ISDA) and the National Futures Association (NFA). Experts in the field of economic, finance and investment feel that derivatives are valuable because they provide efficient ways to manage and transfer risk. A business owner who is exposed to changes in market prices can enter into an a,ppropriate derivatives contract and the risk can be assumed by a trader or speculator who is prepared to live with uncertainty in return for the prospect of achieving an attractive return. A large financial institution can withstand more risk than a small corporate and thus may choose to engage in derivatives products for a reasonable compensation. Nobel Laureate Kenneth Arrow predicted that this would increase economic prosperity since people would be more prepared to engage in risk-taking activities. It could also serve to improve the quality of prediction of future events in the world of finance and investments. Derivatives provide a global network for intelligent assessment, 14 itxa1539-10 management, and distribution of risk on a large scale. " 20) The 1956 Act was enacted with a view to regulate the business of dealing in securities. The expression 'securities' under the 1956 Act included shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate. By Act 31 of 1999 the definition of the expression 'securities' was extended to include derivatives with effect from 22/2/2000 and the expression ‘derivative’ was defined by inserting clause (ac) to Section 2 of the 1956 Act as follows:- ‘Section 2(ac) ’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. Thus, the transactions in derivatives could be legally traded under the 1956 Act with effect from 22/2/2000. Section 18A inserted in the 1956 Act with effect from 22/2/2000 provides that the contracts in derivative shall be legal and valid if such contracts are traded on a recognized stock exchange and settled on the clearing house of the recognized stock exchange in accordance with the rules and bye laws of 15 itxa1539-10 such stock exchange. Thus, the transactions in derivatives is legal and valid only if they are traded on a recognized stock exchange and cleared on the clearing house of recognized stock exchange. 21) The question in the present case is, whether the loss incurred from the derivative transactions carried on, on a recognized stock exchange during the year 2003-04 would constitute loss from speculative transaction as contemplated under Section 43(5) of the IT Act. Section 43(5) as enacted at the commencement of the Act reads thus:- " Definitions of certain terms relevant to income from profits and gains of business or profession. 43. In sections 28 to 41 and in this section, unless the context otherwise requires - (1) to (4) ——- (5) “speculative transaction” means a transaction in which a contract for the purpose 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; Provided that for the purposes of this clause - (a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for actual 16 itxa1539-10 delivery of goods manufactured by him or merchandise sold by him; or (b) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or (c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; shall not be deemed to be a speculative transaction; " 22) Section 43(5) has been amended by Finance Act, 2005 with effect from 1/4/2006 by inserting clause (d) and Explanation as follows:- " Definitions of certain terms relevant to income from profits and gains of business or profession. 43. In sections 28 to 41 and in this section, unless the context otherwise requires - (1) to (4) —— (5) “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 scrips; 17 itxa1539-10 Provided that for the purposes of this clause- (a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him; or (b) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or (c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; [or] (d) an eligible transaction in respect of trading in derivatives referred to in clause (ac) of section 2 of the Securities Contracts (Regulations) Act, 1956 (42 of 1956) carried out in a recognised stock exchange; shall not be deemed to be a speculative transaction; Explanation - For the purposes of this clause, the expressions- (i) "eligible transaction" means any transaction.– (A) carried out electronically on screen-based systems through a stock broker or sub-broker or such other 18 itxa1539-10 intermediary registered under section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) or the Securities and Exchange Board of India Act, 1992 (15 of 1992) or the Depositories Act, 1996 (22 of 1996) and the rules, regulations or bye-laws made or directions issued under those Acts or by banks or mutual funds on a recognised stock exchange; and (B) which is supported by a time stamped contract note issued by such stock broker or sub-broker or such other intermediary to every client indicating in the contract note the unique client identity number allotted under any Act referred to in sub-clause (A) and permanent account number allotted under this Act; (ii) "recognized stock exchange" means a recognised stock exchange as referred to in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) and which fulfills such conditions as may be prescribed and notified by the Central Government for this purpose; " 23) Plain reading of clause (d) to Section 43(5) makes it clear that with effect from 1/4/2006, 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 19 itxa1539-10 speculative transaction. It is only because, the transactions in derivatives referred to under Section 2(ac) of the Act carried out in a recognized stock exchange were covered under Section 43(5) of the Act, the legislature could exclude those transactions from the purview of Section 43(5) with effect from 1/4/2006. In other words, unless the transactions referred in clause (d) were covered under Section 43(5), there would be no question of excluding those transactions from the purview of Section 43(5). 24) It is however contended on behalf of the assessee that the derivative transactions carried out at the stock exchanges were not at all covered under Section 43(5) of the Act and that clause (d) has been inserted to the proviso to section 43(5) as and by way of clarification and hence it would apply retrospectively so as to make it clear that the exchange traded derivative transactions carried out in a recognized stock exchange were always outside the scope of Section 43(5). The question, therefore to be considered is, whether the derivative transactions fell outside the scope of main Section 43(5) of the IT Act. 25) Chapter IV of the Act contains provisions relating to the computation of profits and gains of business or profession. Section 28 in Chapter IV of the Act inter alia provides that the profits and gains of any business or profession which are carried on by the assessee at any time 20 itxa1539-10 during the previous year shall be chargeable to income tax under the head 'profits & gains of business or profession'. 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 72 of the Act provides for set off of the carried forward business losses not being a loss sustained in a speculation business. Section 73 provides that the carried forward losses in speculation business shall not be set off except against profits and gains, in any other speculation business. The assessee claims that the losses incurred in derivative transactions are business losses which could be set off against profits and gains of any other business / any other heads of income, whereas the revenue contends that the losses incurred by the assessee in derivative transactions are speculative transactions covered under Section 43(5) of the Act which could be set off only against profits of speculation business. 26) 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. 21 itxa1539-10

`27)          The question, therefore to be considered is, whether the`

transactions in futures contracts carried on by the assessee through a broker of the recognized stock exchange which is ultimately settled otherwise by actual delivery, constitutes transactions or contracts for the purchase and sale of any commodity under Section 43(5) of the Act ? 28) 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. As per Black's Dictionary (Eight Edition) the expression 'commodity' means an article of trade or commerce which are tangible in nature. As per "THE MAJOR LAW LEXICON' by Pramantha Aiyer (4th Edition) the expression 'commodity' has two meanings (one) in economics, it is any tangible goods that is traded and (two) it is raw materials and goods, especially such goods as cocoa, cofee, jute, potatoes, tea, etc. which may also be traded. Thus, in common parlance, the expression commodity means an article of trade or commerce which are tangible in nature. 29) 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. 22 itxa1539-10

`30)          As per the 'Hand Book on Derivatives Trading' published by`

the National Stock Exchange of India Limited ("NSE' for short), a futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. There are various types of futures available for trading at the NSE. An investor can trade the 'entire stock market' by buying index futures instead of buying individual securities with the efficiency of a mutual fund. The advantages of trading in index futures as per the Hand Book on Derivatives Trading published by the NSE are :-" The contracts are highly liquid Index Futures provide higher leverage than any other stocks It requires low initial capital requirement It has lower risk than buying and holding stocks It is just as easy to trade the short side as the long side Only have to study one index instead of 100's of stocks Settled in cash and therefore all problems related to bad delivery, forged, fake certificates, etc. can be avoided. " 31) Futures contracts in both index as well as stocks can be bought and sold through the trading members of recognized stock exchange. Futures contracts expire on the last Thursday of the expiry month. All futures contracts are settled in cash either on a daily basis or at the expiry of the respective contracts as the case may be. Clients / Trading members are not required to hold any stock of the underlying for 23 itxa1539-10 dealing in the Futures Market. There are presently 53 stocks which can be traded under the Futures / Options Contracts. 32) To illustrate, suppose the share value of a company 'X' in the Stock Exchange on 1st January is Rs.100/- per share. If an investor considers that the shares of Company 'X' are likely to shoot up in the next three months, then he may, if he has funds, purchase 100 shares of company 'X' on 1st January itself by paying Rs.10,000/ @ Rs.100/- per share. In the alternative, he may enter into a futures contract on 1st January itself to purchase 100 shares of company 'X' on 29th March at Rs.12,000/- inclusive of brokerage charges, etc. In such a case, the assessee is not required to make payment on 1st January. If on 29th march the value of 100 shares of company 'X' on the Stock Exchange are Rs.13,000/- then the assessee would be making profit of Rs.1,000/- by setting the futures contract at Rs.12,000/-. If the value of 100 shares of company 'X' on 29th March on the stock exchange are Rs.11,000/- then by paying Rs.12,000/- under the futures contract, the assessee would incur loss of Rs.1,000/-. 33) Thus, 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 24 itxa1539-10 transaction in a commodity relates to purchase / sale of an asset which is tangible and which is capable of being delivered. However, Section 18A of the 1956 Act inserted with effect from 22/2/2000 provides that notwithstanding anything contained in any other law for the time being in force, contracts in derivative (like futures contracts) shall be legal and valid if such contracts are traded on a recognized stock exchange and settled on the clearing house of a recognized stock exchange in accordance with the rules and bye-laws of such stock exchange. Thus, by operation of law, the transactions in futures are made legal and valid even if the underlying securities permitted to be purchased / sold under the futures contracts are not tangible and incapable of actual delivery, provided such transactions are traded on a recognized stock exchange and settled on the clearing house of a recognized stock exchange. Moreover, Section 43(5) of the Act provides that a transaction for purchase / sale of any commodity would be a speculative transaction if it is settled otherwise than by actual delivery. 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. 34) It is contended that the expression ‘commodity’ does not

include ‘stocks & shares’, however, for the purposes of Section 43(5), the expression ‘commodity’ has been expanded to include ‘stocks & shares’ and since transactions in derivatives are not specifically included in Section 43(5), the same would fall outside the purview of Section 43(5). We see no merit in the above contentions. 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. 35) The argument that Section 43(5) refers to contracts which are capable of settlement by actual delivery whereas the transactions in futures are incapable of settlement and therefore, transactions in futures would fall outside the scope of Section 43(5) is also without any merit, because, the very object of Section 43(5) is to treat transactions which 26 itxa1539-10 are settled otherwise than by actual delivery as speculative transactions. As noted earlier, Section 43(5) refers to contracts for purchase / sale of any commodity and it is not restricted to contracts which are capable of performance by actual delivery. Therefore, 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. 36) 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 1/4/2006. Therefore, the transactions covered under clause (d) would not be treated as speculative transactions only with effect from 1/4/2006. 37) The argument advanced on behalf of the assessee that clause (d) inserted to the proviso to Section 43(5) by Finance Act, 1995 with effect from

1/4/2006 is clarificatory and hence retrospective in nature, cannot be accepted, because, firstly, the legislature by Finance 27 itxa1539-10 Act, 1995 has specifically provided that clause (d) to the proviso to Section 43(5) shall come into operation prospectively with effect from 1/4/2006. 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 these circumstances, the argument that clause (d) inserted to the proviso to Section 43(5) has retrospective effect cannot be accepted. 38) We do not consider it necessary to deal with various decisions relied upon by the Counsel for the assessee, as in our opinion, all those decisions are distinguishable on facts. However, we may note that the decision of the Calcutta High Court in the case of Nirmal Trading Co. (supra) wherein it is held that the 'letters of renunciation' are neither transactions in commodity nor transactions in shares, has no relevance to the facts of the present case, because, firstly, the letters of renunciation cannot be treated on par with futures contracts and secondly letters of renunciation are not articles of trade, whereas futures contracts are articles traded on the stock exchange. Various decisions 28 itxa1539-10 of the ITAT wherein it is held that the derivative transactions are not speculative transactions, in our opinion, do not correctly interpret Section 43(5) of the IT Act. Similarly, various decisions of the Apex Court relied upon by the counsel for the assessee in support of the contention that insertion of clause (d) to the proviso to Section 43(5) of the IT Act is retrospective in nature are also distinguishable on facts as the ratio laid down therein have no relevance in interpreting the provision of Section 43 (5) of the IT Act. The futures contracts cannot be equated with insurance contract, because, unlike futures contract, the insurance contract is not an article of trade which can be traded. Thus, the futures contract being an article of trade created by an authority under the 1956 Act, the transactions in futures contracts would constitute transaction in commodity under Section 43(5) of the IT Act. 39) In the result, we hold that 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. We further hold that clause (d) inserted to the proviso to Section 43(5) with effect from 1/4/2006 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. 29 itxa1539-10

40) For all the aforesaid reasons, we allow the appeal filed by the

Commissioner of Income Tax by answering the questions raised in the appeal in the above terms with no order as to costs. (MRS. R.S. DALVI, J.) (J.P. DEVADHAR, J.)