ZERODHA

Markets and Taxation

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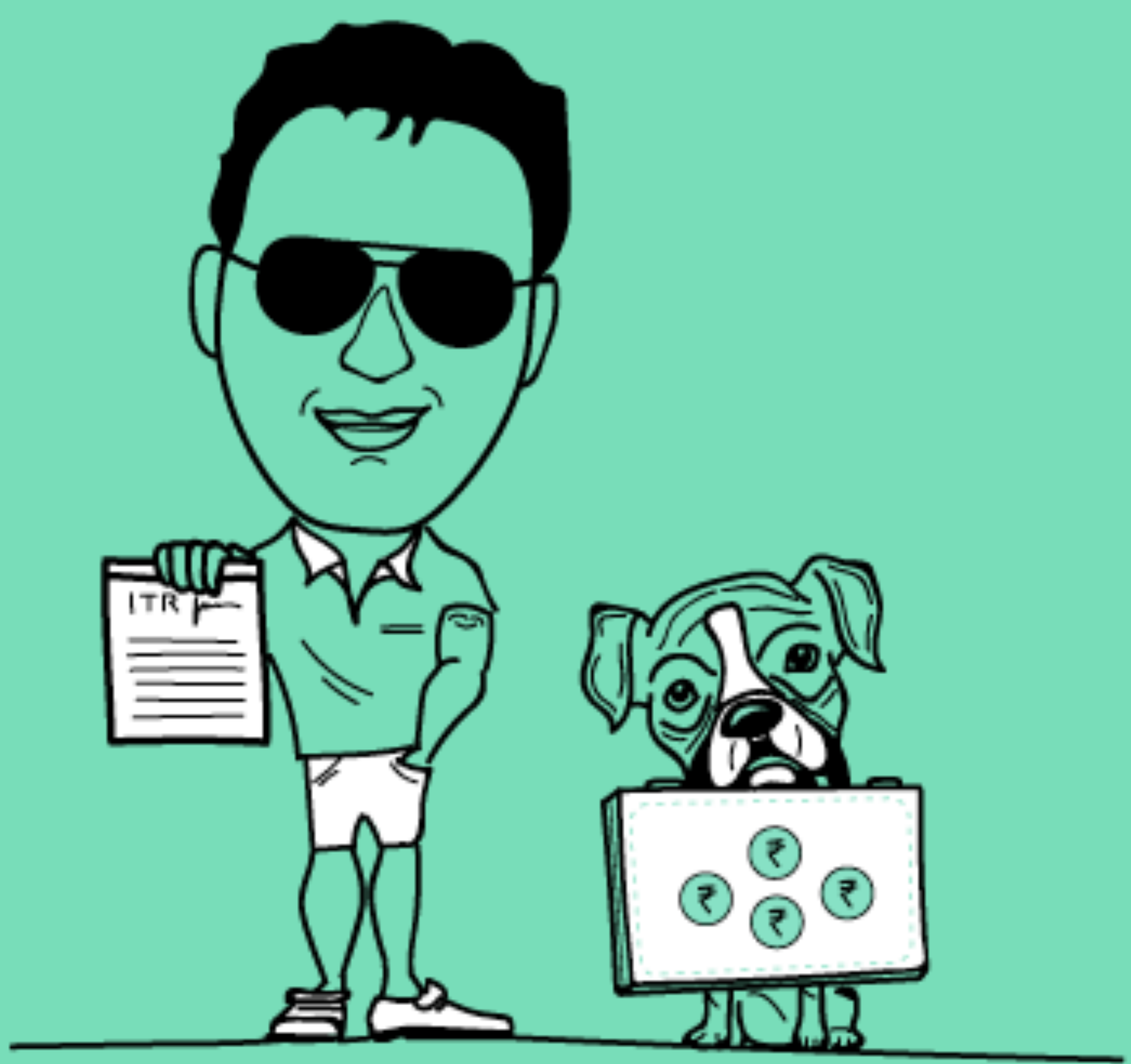

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CHAPTER 1

Introduction(Setting the Context)

I remember a time (maybe about 6 years ago) I had the opportunity to meet one of those hard to find Charted Accountants who knew both taxation and markets quite well. It was at a friend's party that I got introduced to him. He asked me what I do for a living, to which I promptly replied that I trade for a living. We immediately struck a chord and had a great conversation going. Somewhere during that engaging conversation he asked me a few questions –

- ➡ How would I declare my Profits and/or Losses from my market activity?
- ➡ Do I bifurcate between speculative business income and non-speculative business income?
- ➡ Also, he asked me about the books of accounts that I'm supposed to maintain.

Thanks to my ignorance I had no answers to give him.

I was an eager learner, as I spent all my time learning about the markets and trading strategies but spent very little time learning about taxation and its relevance to market participants.

Probably the reason why I consciously ignored learning about taxation was because I always feared the heavy usage of jargon, random references to sections, subsections, circulars, and whatnot. To my defense – I once did honestly try to learn about taxation. I paid a visit to my broker's office and met my dealer and questioned him on taxation. This is what he had to say – "Arre, why are you so worried? Long-term capital tax is 0% and short-term capital gains tax is 10%, that's it, it is a simple matter."

I for sure knew it was not just that, I insisted to meet someone more knowledgeable to understand the topic in greater detail. To my luck I got to meet the Regional Head of the stock broking company, enthusiastically I picked his brains about taxation for market participants; unfortunately even he reiterated the same thing that my dealer had told me. It seemed even worse as the regional manager had a sense of pride while he gave me that sloppy answer.

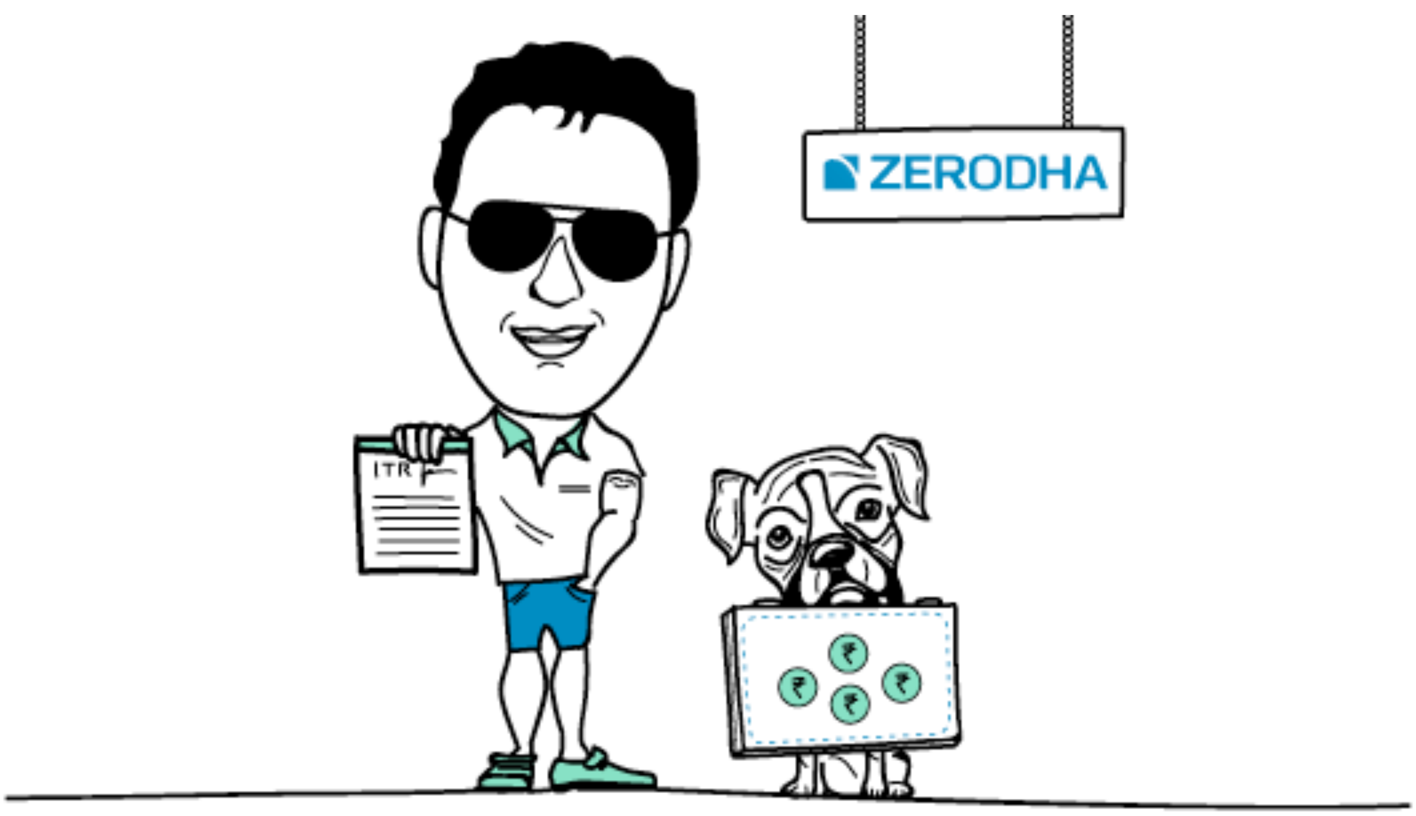
Frustrated, I visited a CA and he essentially said the same thing that my dealer said, but he used fancy jargon and complicated the whole matter to no end. At that point in time nobody had blogged about it online, no good articles were written on the topic and thus my quest to learn taxation related to markets got squashed like a bug.

In retrospect, had I known more about this topic, had I got more information – I would have clearly benefited in multiple ways.

I'm certain there are many traders and investors in a similar situation as I was few years ago. In fact this is true considering that our blog on taxation (which was put up a few years ago) has received over 2000 questions! This number is besides the numerous emails received and queries asked on Trading Q&A.

Keeping this in perspective, we are happy to introduce our new module on Zerodha Varsity aptly titled "Markets & Taxation". The module deals with literally everything that you need to know about taxation related to markets – be it short term capital gains, or treating your intraday trades as speculative business income, or about Section 44AD – we have it all on Zerodha Varsity – in one place, concise, and simplified.

Now here is the best part – the whole module is authored by Nithin himself, which means that we get to learn about taxation from a trader/investor's perspective and not really from the CA's perspective. This makes a huge difference in terms of topic narrative. With a seasoned trader discussing taxation, we get to learn about the essential topics without digressing into the taxation wilderness.



Lastly, if I look back in time, I could not imagine brokers giving out such valuable information to clients. In fact, stock brokers were always known to hoard information and pass it only to select clients. I'm sure you would agree with me on this, especially if you have been trading the Indian markets for a while now. Stock Brokers in India have always been snobby, expensive, and full of unwanted attitude.

However the stock broking industry is slowly waking up to the fact that the customer, irrespective of his size deserves the best. This change in attitude is leading to a revolution of sorts in the industry – and I do believe Zerodha is the epicenter of this revolution – changing the way the Indian broking industry functions. Be it providing you high quality tools to trade, better trader education, or ready to use tax friendly reports – Zerodha has it all for you.

So please do go ahead and explore this unique module on Markets & Taxation. I can assure you that the content presented here will make you more confident about matters related to taxation, and with that new-found confidence you will never have to fear the taxman!

Stay connected, stay profitable.

– Karthik Rangappa

Basics

2.1 – Overview

India needs help from all of us countrymen in developing a tax culture. The fear about income tax department can be removed only by gaining knowledge on all the basic rules and regulations. Income tax rates in India have drastically reduced from over 90% in the early seventies to now (2015) where no tax has to be paid on annual income upto Rs 2.5lks. But the apathy of taxpayers towards filing income tax returns and paying taxes continues till today.

With the systems used by the IT department becoming sophisticated every year, the chances of repercussions in terms of notices and penalties due to non-filing, mis-filing, and hiding information while filing your income tax returns (ITR) is going up significantly. Similar to how Income tax (IT) department has access to all your bank account details, they can also check upon all your capital market activity easily through the exchanges as they are all mapped to your PAN (Permanent account number).

Even if the intent is there to be compliant, most people including many Chartered Accountants (CAs) don't understand the subject of taxation when investing & trading very well. We had put up blog post, "Taxation Simplified" on Z-Connect a few years back simplifying key aspects of taxation for market participants. Over the last 2 years we have received a few thousand queries on the post. Answering all of them it was obvious that we had to do a lot more to simplify all aspects around taxation while trading or investing in the markets, hence this module.

If you only invest into stocks or mutual funds filing returns is quite simple, but can get tricky if trading intraday stocks or financial derivatives (futures and options).

We will in this module break all the concepts down into small easy to understand chapters without any of those jargons typically used by CA's or tax consultant's. Here is a sneak peak into what you can expect going forward in this module –

1. Introduction (Setting the Context)
2. Basics
3. Classify your Market Activity
4. Taxation for Investors

5. Taxation for Traders
6. Turnover, Balance Sheet, and P&L
7. ITR Forms (The Finale)

2.2 – What is income tax?

It is a tax levied by the Government of India on the income of every person. The provisions governing the Income-tax Law are given in the Income-tax Act, 1961. In simpler words, Income Tax is a portion of money that you earn paid to the government of India.

Why should I pay tax?

Yes India does not offer social security and free medical facilities as being provided in some developed countries, but the government needs funds collected as taxes to discharge number of responsibilities like Government hospitals, Education, National defense, Infrastructure development just to name a few.

Who is supposed to pay income tax?

Income-tax is to be paid by every person who earns more than the minimum income slab set by the government. The term 'person' as defined under the Income-tax Act covers in its ambit natural as well as artificial persons (including corporate).

Only 2.9 percent of over 121 crore population are taxpayers in India compared to over 45% in a developed economy like U.S.A. Part of the reason for such an abysmally low number is also because many Indians don't earn enough to qualify to pay income tax, but the larger factor has got to do with lack of tax culture.

Taxes have to be paid based on how much income you earn every financial year. Financial year in India starts from April 1st and ends on 31st March. Do note that year can be specified either as financial year (FY) or assessment Year (AY).

FY is used to denote the actual year the income was earned for which you are filing taxes. So FY 2014/15 is the financial year starting April 1st 2014 and ending 31st March 2015.

AY is used to denote the year in which you are supposed to file your taxes. So AY 2015/16 is the year when you file the returns for income earned in FY 2014/15. So AY 2015/16 and FY 2014/15 are one and the same. So you will use ITR with AY 2015/16 on it to file your taxes for the income earned in financial year starting April 1st 2014 and ending 31st March 2015.

2.3 – Income tax slabs in India for financial year 2014/15

All Indians have to pay taxes on the total income earned every year as per the below tax slabs they belong to. If you are salaried, your employer would already be paying taxes on your behalf to the government and issuing you a 'Form 16' as an acknowledgement for having paid the taxes. Your employer will not have access to all your sources of income, like bank interest, capital gains, rental income, and others. You are supposed to use the form 16, add all your other income, calculate and pay any additional tax, and file your income tax returns before due date every year. The tax slab for individuals (FY 14/15) is as below –

Individual (age upto 60 years)

Income slabs	Tax Rates
0 – Rs 2.5 lks	NIL
Rs 2.5lks – Rs 5lks	10% of amount by which income exceeds Rs 2.5lks.
Rs 5lks – Rs 10lks	Rs. 25,000 + 20% of the amount by which income exceeds Rs 5lks
10lks and above	Rs. 125,000 + 30% of the amount by which income exceeds Rs 10lks

Senior citizen (age 60 to 80 years)

Income slabs	Tax Rates
0 – Rs 3 lks	NIL
Rs 3lks – Rs 5lks	10% of amount by which income exceeds Rs 3lks.
Rs 5lks – Rs 10lks	Rs. 20,000 + 20% of the amount by which income exceeds Rs 5lks
10lks and above	Rs. 120,000 + 30% of the amount by which income exceeds Rs 10lks

Super senior citizen (age 80 years and above)

Income slabs	Tax Rates
0 – Rs 5 lks	NIL
Rs 5lks – Rs 10lks	20% of the amount by which income exceeds Rs 5lks
10lks and above	Rs. 100,000 + 30% of the amount by which income exceeds Rs 10lks

From the next chapter we will start focusing in detail on all aspects of taxation when trading and investing in the markets.

Key takeaways from this chapter

1. Filing correct Income tax returns is the duty of every Indian resident
2. The Income tax department has access to your market activity
3. Only 2.9 % of Indians are tax payers
4. Financial year (FY) is the year income was earned, Assessment year (AY) is the year you file your taxes on the income earned
5. Financial year is between 1st of April of the current year and 31st March of the following year
6. The income tax applicable to you depends on the income tax slab you belong to
7. The income tax slabs vary based on your age group

Disclaimer – Do consult a chartered accountant (CA) before filing your returns. The content above is for your general knowledge only. Content meant for Individual retail investors/traders in India.

CHAPTER 3

Classifying Your Market Activity

3.1 – Are you a trader or investor or both?

Identifying yourself as a trader or an investor is the first step to file your income tax returns. This may seem like an easy task, but here is what this circular from CBDT (Central board of direct taxes) says:

"If you buy shares with the intent of earning income through dividends you are an investor, and if you buy and sell shares with the intent to profit, you are a trader":) .

Yes, that is how vague it is, and this is a circular dated 2007, released after 18 years of the original circular. Numerous judicial pronouncements and government was still unable to clear this highly debatable issue. Thanks to the vagueness of this circular, it has given too much power in the hands of the assessing Income tax officer (AO) especially considering the fact that most of the stock purchases are done intending to profit from the price appreciation.

So before filing income tax returns, you will have to first classify yourself as an investor, trader, or both. We will in this chapter help you figure this out in line with what most AO's would be expecting. By income I mean **both** profits and losses.

When trading or investing you need to classify your income under one of these heads, broadly speaking they are –

1. Long term capital gain (LTCG)
2. Short term capital gain (STCG)
3. Speculative business income
4. Non-speculative business income

Let us understand what each of these mean.

Long term capital (LTCG)

Assume you buy stocks or Mutual Funds today for Rs.50,000/- and sell the same after 365 days at Rs.55,000/-, then the profit or gain of Rs.5,000/- is considered as Long term capital gain. Generally speaking, gain or profit earned by investing into stocks or equity mutual funds, and selling after 1 year from date of purchase can be categorized under LTCG. Currently in India any gains realized and categorized as LTCG (equity & equity MF) is completely exempt from taxes. In other words, tax on LTCG is at 0%. Do note – the purchase and sale of shares has to be conducted via a recognized exchange.

Just to reemphasize – if you had bought Infosys shares worth Rs.1,00,000/- 10 years ago, and sold the same today for Rs 1 crore, you don't have to pay any taxes on your gain or profit of Rs 99,00,000.

So, taxes on long term capital gain of Rs 99,00,000 = 0 (Zero) or exempt

If the investment and the consequent sale were done via an off-market transaction,

- ➡ Non listed stocks – Tax on LTCG is 20% (for example purchase and sale of shares belonging to startup companies by Venture Capitalists)
- ➡ Listed stocks – Tax on LTCG 10%

Short term gain (STCG)

Assume you buy stocks or Mutual Funds today for Rs.50,000/- and sell the same within the completion of 365 days, say at Rs.55,000/-, then the profit or gain of Rs.5,000/- is considered as a Short term capital gain(STCG) .

Generally speaking, gain or profit earned by investing into stocks or equity mutual funds holding for more than 1 day (also called delivery based) and selling them within 1 year from date of purchase can be categorized under STCG.

Currently tax on STCG in India is flat 15% on the gain or profit.

Therefore, if you buy Infosys shares worth Rs 100,000/- today and sell the same 10 days later for Rs.120,000/-, then you are liable to pay 15% on Rs 20,000 (STCG) or Rs 3000/- as taxes.

So, tax on short term capital gain = flat 15% of the gain/profit.

Speculative Business income

As per section 43(5) of the Income Tax Act, 1961, profits earned by trading equity or stocks for intraday or non-delivery is categorized under speculative **business income.**

There is no fixed rate like capital gains tax rate when you have a business income. If you have a business income, it has to be added to the rest of your other income and tax has to be paid as per the tax slab you fall in.

For example, assume for the financial year my profit from trading intraday stocks was Rs. 100,000/-, and my salary for the year was Rs.400,000/-. So my total income for the year is Rs 5,00,000, and I have to pay taxes on this as per my tax slab, Rs 25000 in this case as shown below.

SL No.	Slab	Taxable Amount	Tax Rate	Tax Amount
1	0 to Rs.250,000	2,50,000	0%	Nil
2	250,000 to 5,00,000	2,50,000	10%	25000
Total Tax applicable				**Rs. 25,00o**

So the point here is that, one needs to club the speculative business income with other income source and identify the taxable amount. Once this is done, tax has to be paid based on the tax slab one belongs to.

Non – speculative Business income

Income from trading futures & options on recognized exchanges (equity, commodity, & currency) is categorized under non-speculative business income as per section 43(5) of the Income Tax Act, 1961.

Like discussed earlier, business income has no fixed tax rate, you are required to add the non-speculative business income to all your other income, and pay taxes according to the slab applicable to you.

For example, assume a trader cum hotelier earns Rs, 500,000 by trading F&O. Besides this assume he also earns Rs.20,00,000/- from his hotel business. Therefore his total income for the year is Rs 25,00,000/- (Rs.500,000 + Rs.20,00,000) and therefore his tax obligation is as follows

SL No.	Slab	Taxable Amount	Tax Rate	Tax Amount
1	0 to Rs.250,000	2,50,000	0%	Nil
2	250,000 to 5,00,000	2,50,000	10%	25000
3	500,000 to 1,000,000	5,00,000	20%	1,00,000
4	10,00,000 to 25,00,000	15,00,000	30%	4,50,000
Total Tax applicable				**Rs.575,000**

Effectively the business man here is paying 30% of his F&O profits as taxes.

You would be wondering why trading equity intraday is considered 'speculative' but trading F&O is considered 'non speculative'?

When trading intraday there is no intention of taking delivery, and hence it is considered speculative business. F&O is defined as non-speculative by the government, maybe as they can be used for hedging and also for taking/giving delivery of the underlying contract (even though currently equity and currency derivatives in India are all cash settled, but by definition they give rise to giving/taking delivery. Certain commodity F&O contracts like gold have delivery option to it).

3.2 – Pros and cons of declaring trading as a business income

Let us look at the bright side first; here is a list of advantages of declaring trading as a business income

1. **Low tax** – If the total income (trading + any other) is less than Rs.250,000/-, then there is no tax implication and if less than Rs.500,000/- effectively one has to pay less than 10% of income as tax.
2. **Claim expense** – One can claim benefit of all expenses incurred for the business of trading (while for capital gains only charges on your contract note other than STT can be claimed). For example, brokerage charges, STT, other statutory taxes while trading, internet, phone, newspapers, depreciation of computers and electronics, research reports, books, advisory, etc.
3. **Offset the loss with gains** – If one incurs any non-speculative F&O trading loss, this can be set-off against any income other than salary. For example, if I incur Rs 5,00,000 loss in trading F&O and my other income (like rent & interest, excluding salary) is Rs 10,00,000 , I will have to now pay tax only on Rs 5,00,000.

4. **Carry forward the F&O loss** – If there is net loss any year (non-speculative F&O + any income other than salary), and if income tax returns are filed before due date, loss can be carried forward for the next 8 years. During the next 8 years, this loss can be set-off against any other business gain (non-speculative business income).For example, if you had net loss of Rs 5,00,000 this year trading F&O which was declared on time, you can carry forward this loss next year and assuming you made a profit of Rs 20,00,000 next year, you can set-off the previous year's Rs 5,00,000 loss and pay taxes only on Rs 15,00,000.

5. **Carry forward your intraday equity loss** – Any speculative or intraday equity trading loss can be set-off only against any other speculative gain (note: you cannot set-off intraday equity trading loss which is considered speculative with F&O trading which is considered non-speculative). Speculative losses can be carried forward for 4 years if the returns are filed on time.So assume an equity intraday trader makes a loss of Rs.100,000/- this year, he cannot off set this against any other business income. However, he can carry it forward to the next year (upto 4 years). Assume the next year he makes a profit of Rs.50,000/- by trading equity intraday, then in that case he can use the previous year's Rs.100,000/- loss to offset the complete gains of this year (Rs.50,000). The balance loss of Rs.50,000/- can still be carried forward to the next 3 years. So do note, partial offset of losses is possible.

The following table summarizes the above points –

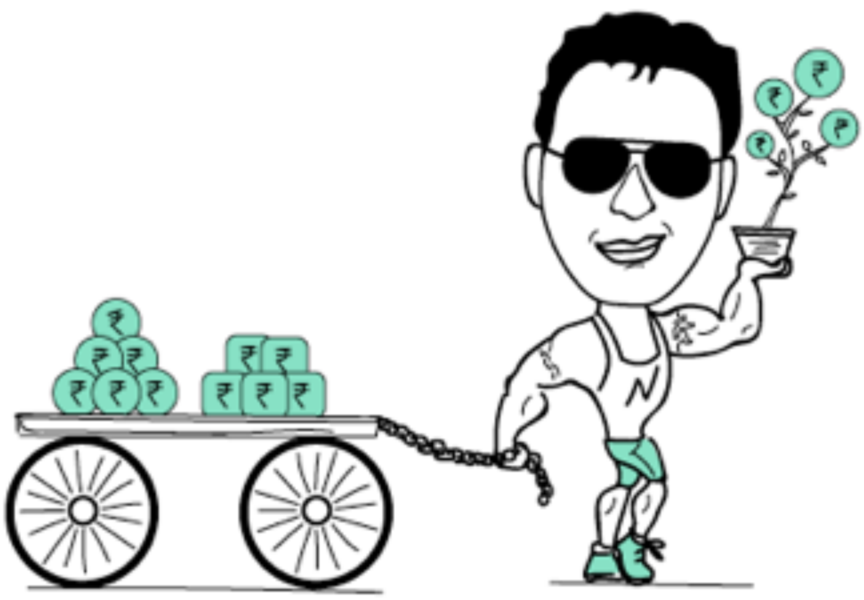
Head of income under which Loss is incurred	Whether loss can be set- off within the same year		Whether Losses can be carried forward and set-off in subsequent years		Time limit for carry forward and set-off of losses
	Under the same head	Under any other Head	Under the same head	Under any other Head	
Losses of F&O as a Trader	Yes	Yes	Yes	No	8 years
Speculation Business	Yes	No	Yes	No	4 years
Capital Gain (Short-Term)	Yes	No	Yes	No	8 years

Now, here is a set of drawbacks for declaring your business income –

1.**Potentially high taxes** – If you fall under the 30% tax slab, you will effectively pay 30% of all your trading profits as taxes

2. **ITR Forms** – Declaring business income would mean having to use an ITR4 or 4S, which would mean needing help of a CA to file your IT returns. This can be an added effort and cost especially for those salaried people who might have been using the very easy ITR 1 or ITR 2 (we will discuss more on this topic in the chapter on ITR forms)

3. **Audit** – Having to maintain the book of accounts which will need to be audited if your turnover goes above Rs 1 crore for a year or if your profit is less than 8% of your turnover (we will discuss more on this topic in the chapter on Turnover)



3.3 – What are you? Trader, Investor, or Both?

Coming back to our original discussion, according to CBDT

Investor: anyone who invests with the intention of earning through dividends

Trader: anyone who buys and sells with the intention of profiting from the price rise.

As an investor, you can claim all your delivery based equity gains/profit to be capital gains. But as a trader, it becomes your business income which has its own pros and cons as discussed above.

The rule is very clear with **respect to F&O trading, and intraday equity trading**. F&O trading has to be considered as a non-speculative business, and intraday equity as a speculative business. So if you trade these instruments, you have to use ITR 4 for filing IT returns. So even if you are salaried, you have to compulsorily use ITR4 and declare this income (profit or loss) from trading as a business.

Unlike what most people think, losses also have to be **declared compulsorily**. Hiding trading activity on the exchange from the IT department could mean trouble, especially in case of any IT scrutiny (IT scrutiny is when the assessing income tax officer (AO) demands you to meet him and give an explanation on your IT returns). The chances of getting a call for scrutiny is higher when the IT department systems/algorithms pick up trading activity on your PAN, but the same not declared on your ITR.

For **equity delivery based investments**, if you are holding stocks for more than a year, you would have received some kind of dividend and even if you didn't, you can show them all as investments and claim exemption under the long term capital gain. If you are **buying and selling stocks frequently** (yes it is an open statement, but there is no rule which quantifies 'frequent') for shorter terms, it is best to declare that as non-speculative business income instead of STCG.

Another thing to keep in mind is that if investing/trading on the markets is your only source of income, and even if your trading activity is moderate, it is best to classify income from all your equity trades as a business income instead of capital gains. On the other hand, if you are salaried or have some other business as your primary source of business, it becomes easier to show your equity trades as capital gains even if the frequency is slightly higher.

Thankfully one thing that the circular clarified was that you can be a trader and investor both at the same time. So you can have stocks meant as investment for long term, and stocks meant for shorter term trades. Just because you indulge in a lot of shorter term trades, wouldn't necessarily convert all your longer term holdings or investments into trades and therefore bring those long term gains under business income. But it is important to clearly demarcate your trading and investment portfolio while filing returns.

Similarly, if you are trading F&O or intraday equity trading, you compulsorily have to classify yourself as a trader, but you can still show your long term investments under the capital gains head to get the benefit of LTCG being exempt from taxes.

So, you can be an investor, trader, or both, but make sure to keep the above points in mind, and **do consult a chartered accountant before filing returns.**

Even though this might seem confusing, rules are made for 1% of the population that is trying to break them. As long as your intent is right, you know the basic concerns of the IT department and keep those in mind while filing IT returns, it is quite simple. But stay consistent with the way you classify yourself, don't keep switching between being an investor or trader to declare your equity short term trades.

If you follow these simple rules, let me assure you – there is no need to fear the taxman.

Before we wrap this chapter, here are some interesting links that you should read through.

CBDT circular on distinction between trades and investments.

Business Standard – Is your return from stocks capital gains or business income?

Economic Times – Are you a stock trader or an investor?

Taxguru – Income from share trading – Business or capital gain?

Moneycontrol- Investor or trader: The argument continues

Economic Times – Budget 2014 clarifies that commodity trading on recognized exchanges is non-speculative

Economic times – New data mining tool may access PAN-based information of taxpayers, help check evasion

Key takeaways from this chapter

1. Trading F&O (Equity, currency, commodity) is considered non-speculative business
2. Trading intraday equity is considered speculative business
3. Equity holdings for more than 1 year is considered Long term capital gain (LTCG)
4. Equity holdings between 1 day to 1 year with low frequency of trades is considered Short term capital gain (STCG), else in case of high frequency of trades it should be considered as non-speculative business income

Disclaimer – Do consult a chartered accountant (CA) before filing your returns. The content above is in the context of taxation for retail individual investors/traders only.

CHAPTER 4

Taxation for Investors

4.1 – Quick recap

In continuation of previous chapter: Classifying your market activity

You can consider yourself an **investor** when –

- ➡ Buying and selling stocks after taking delivery to your DEMAT account not frequently or
- ➡ Equity holdings were purchased with an idea to earn dividends or with a plan of holding it for long term.

If the frequency of transactions (buy/sells) is high, it is best to consider them as trades and not investments. If considered as trades, any income is **non-speculative business income**, whereas if these are investments, then it falls under **capital gains**.

Keeping this in perspective, you may have few questions –

- ➡ What is long term?
- ➡ What is considered high frequency of transactions (buy/sells)?

We discussed this in the previous chapter, but just to refresh your memory – there is no set rule from the IT department to quantify 'frequency' or determine 'long term'.

As long as your intent is right, and you are consistent across financial years in the way you identify long term or high frequency, there is nothing to worry.

Do note, if you are indulging in equity delivery based trades as frequent as a **few times every week**, it would be best to consider all of them as 'trades' and classifying income from them as business income instead of capital gains.

Reiterating again that if investing/trading on the markets is the only source of income, and even if you are trading with moderate frequency, it is best to classify income from all your equity trades as a business income instead of capital gains.

On the other hand, if you are salaried or have some other business as your primary source of business, it becomes easier to show your equity trades as capital gains even if the frequency of trades is slightly higher.

So essentially,

1. Stocks that you hold for more than 1 year can be considered as investments as you would have most likely received some dividends and also held for longish time

2. Shorter term equity delivery buy/sells can be considered as investments as long as frequency of such buy/sells is low

3. Shorter term equity delivery buy/sells ideally has to be considered as trades (trading/business income) if your frequency of such trades is as high as few times every week

The focus of this chapter is on investing; hence we will keep the discussion limited to just points 1 and 2. We will talk about taxation when trading/business income in the next chapter.

4.2 – Long term capital gain (LTCG)

When you buy & sell (long trades) or sell & buy (short trades) stocks within a single trading day then such transactions are called intraday equity/stock trades.

Alternatively if you are buying stocks/equity and wait till it gets delivered to your DEMAT account before selling it, then it is called 'equity delivery based' transactions.

Any gain or profit earned through equity delivery based trades or mutual funds can be categorized under capital gains, which can be subdivided into:

➡ **Long term capital gain (LTCG)**: equity delivery based investments where the holding period is more than 1 year

➡ **Short term capital gain (STCG):** equity delivery based investments where the holding period is lesser than 1 year

Taxes on long term capital gains for equity and mutual funds are discussed below –

For stocks/equity – 0% or NIL tax

It is NIL only if the transactions (buy/sells) are executed on recognized stock exchanges where STT (Security transaction tax) is paid. As discussed above, LTCG is for holding period more than 1 year.

If the transactions (buy/sells) are executed through off-market transfer where shares are transferred from one person to another via delivery instruction booklet and not via a recognized exchange then LTCG is 20% in case of non-listed stocks, and 10% on listed stocks. (Listed are those which trade on recognized exchanges). Do note that when you carry an off-market transaction Security Transaction Tax (STT) is not paid, but you end up paying higher capital gains tax. A typical example of an off-market transaction could be a father transferring equity holdings to his son via a 'delivery instruction booklet'.

For equity mutual funds (MF) – 0% or NIL tax

Similar to equity delivery based trades, any gain in investment in equity oriented mutual funds for more than 1 year is considered as LTCG and exempt from taxes. A mutual fund is considered as equity oriented if at least 65% of the investible funds are deployed into equity or shares of domestic companies.

For non-equity oriented/Debt MF – flat 20% on the gain with indexation benefit

Union budget 2014 brought in a major change to non-equity mutual funds. As opposed to 1 year in equity based funds, you have to stay invested for 3 years in non-equity/debt funds for the investment to be considered as long term capital gain. If you sell the funds within 3 years to realize a gain, then that gain is considered as STCG.

4.3 – Indexation

When calculating capital gains in case of non-equity oriented mutual funds, property, gold, and others where you are taxed on LTCG, you get the indexation benefit to determine your **net capital gain.**

I guess we would all agree that inflation eats into most of what is earned as profits by investing into capital assets such as the ones mentioned above.

For someone wondering what that inflation is, here is a simple example to help you understand the same –

All else equal, if a box of sweets priced at Rs.100 last year, chances are the same could cost Rs.110 this year. The price differential is attributable to Inflation, which in this example is 10%. Inflation is the % by which purchasing value of your money diminishes.

Assuming the average inflation rate in India of around 6.5%, if you had invested into a debt fund, wouldn't a big portion of your long term capital gain at the end of 3 years get eaten away by inflation?

For example assume you had invested Rs.100, 000/- into a debt fund, and you got back Rs 130,000/- at the end of 3 years. You have a long term capital gain of Rs.30,000/-. But in the same period assume purchasing value of money is dropped by 18k because of inflation. Should you still pay long term capital gain on the entire 30k? Clearly this does not make sense right?

Indexation is a simple method to determine the true value from sale of an **asset after considering the effect of inflation**. This can be done with help of **Cost inflation index (CII)** which can be found on the income tax website.

Let me explain this with an example of a purchase/sale of a debt mutual fund.

Purchase value: Rs.100,000/-

Year of purchase: 2005

Sale value: Rs 300,000

Year of sale: 2015

Long term capital gain: Rs 200,000/-

Without indexation I would have to pay tax of 20% on the capital gains of Rs 200,000/-, which works out to Rs 40,000/-.

But we can reduce the LTCG by considering indexation.

To calculate indexed purchase value, we need to use the cost inflation index (CII). Find below the cost inflation index from the income tax website until 2014/15.

Financial Year	CII
Before 1/4/1981	100
1981-82	100
1982-83	109
1983-84	116
1984-85	125
1985-86	133
1986-87	140
1987-88	150
1988-89	161
1989-90	172
1990-91	182
1991-92	199
1992-93	223
1993-94	244
1994-95	259
1995-96	281
1996-97	305
1997-98	331
1998-99	351
1999-00	389
2000-01	406
2001-02	426

Financial Year	CII
2002-03	447
2003-04	463
2004-05	480
2005-06	497
2006-07	519
2007-08	551
2008-09	582
2009-10	632
2010-11	711
2011-12	785
2012-13	852
2013-14	939
2014-15	1024

Going back to the above example,

CII in the year of purchase (2005): 497

CII in the year of sale (2015): 1024

Indexed purchase value = Purchase value * (CII for year of sale/ CII for year of purchase)

So –

Indexed purchase value = Rs 100000 * (1024/497)

= Rs 206036

Long term capital gain = Sale value – Indexed purchase value

Therefore, in our example

LTCG = Rs 300,000 – Rs 206,036

= Rs 93,964/-

So the tax now would be 20% of Rs 93,964 = Rs 18,792, much lesser than Rs 40,000/- you would have had to pay without the indexation benefit.

Like I had said earlier, the indexed purchase value can be calculated using the above method for all long term capital gains which are taxable like debt funds, real estate, gold, FD, among others. You could use the IT department's Cost inflation index utility to check on indexed purchase value of your capital assets instead of having to calculate manually.

Interesting thing to note in regards to 20% after indexation for non-equity oriented or debt funds: Most of these funds return between 8 to 10% and typically inflation in India has been around that for the last many years. So with the indexation benefit, you typically won't have to pay any tax on LTCG of non-equity oriented funds.

4.4 – Short term capital gain (STCG)

Tax on short term capital gains for equity and mutual funds are discussed below –

For stocks/equity: 15% of the gain

It is 15% of the gain if the transactions (buy/sells) are executed on recognized stock exchanges where STT (Security transaction tax) is paid. STCG is applicable for holding period less than 1 year (365 days) and more than 1 day.

If the transactions (buy/sells) are executed via off-market transfer (where shares are transferred from one person to another via delivery instruction booklet and not on the exchange) where STT is not paid, STCG will be taxable as per your applicable tax slab rate. For example, if you are earning over Rs.10,00,000/- per year in salary, you will fall in the 30% slab, and hence STCG will also be taxed at 30%.

For equity mutual funds (MF): 15% of the gain

Similar to STCG for equity delivery based trades, any gain in investment in equity oriented mutual funds held for lesser than 1 year is considered as STCG and taxed at 15% of the gain. Do note a fund is considered Equity based if 65% of the funds are invested in domestic companies.

For non-equity oriented/Debt MF: As per your individual tax slab

Union budget 2014 brought in a major change to non-equity mutual funds. You have to now stay invested for 3 years for the investment to be considered as long term capital gain. All gains made on investments in such funds held for less than 3 years are now considered as STCG. STCG in this case has to be added to your other business income and tax paid according to your income tax slab.

For example, if you are earning around Rs 800,000/- per year in your normal business/salary and you had STCG of Rs 100,000/- from debt funds, you will fall in the 20% slab as your total income is Rs 9,00,000/-. So effectively in this example you will pay 20% of STCG as taxes.

4.5 – Days of holding

For an investor, the taxation difference between LTCG and STCG is quite huge. If you sold stocks 360 days from when you had bought, you would have to pay 15% of all gains as taxes on STCG. The same stock if held for 5 days more (1 year or 365 days), the entire gain would be exempt from taxation as it would be LTCG now.

It becomes imperative that you as an investor keep a tab on the number of days since you purchased your stock holdings. If you have purchased the same stock multiple times during the holding period, then the period will be determined using FIFO (First in First out) method.

Let me explain –

Assume on 10th April 2014, you bought 100 shares of Reliance at Rs.800 per share, and on June 1st 2014 another 100 shares were bought at Rs.820 per share.

A year later, on May 1st 2015, you sold 150 shares at 920.

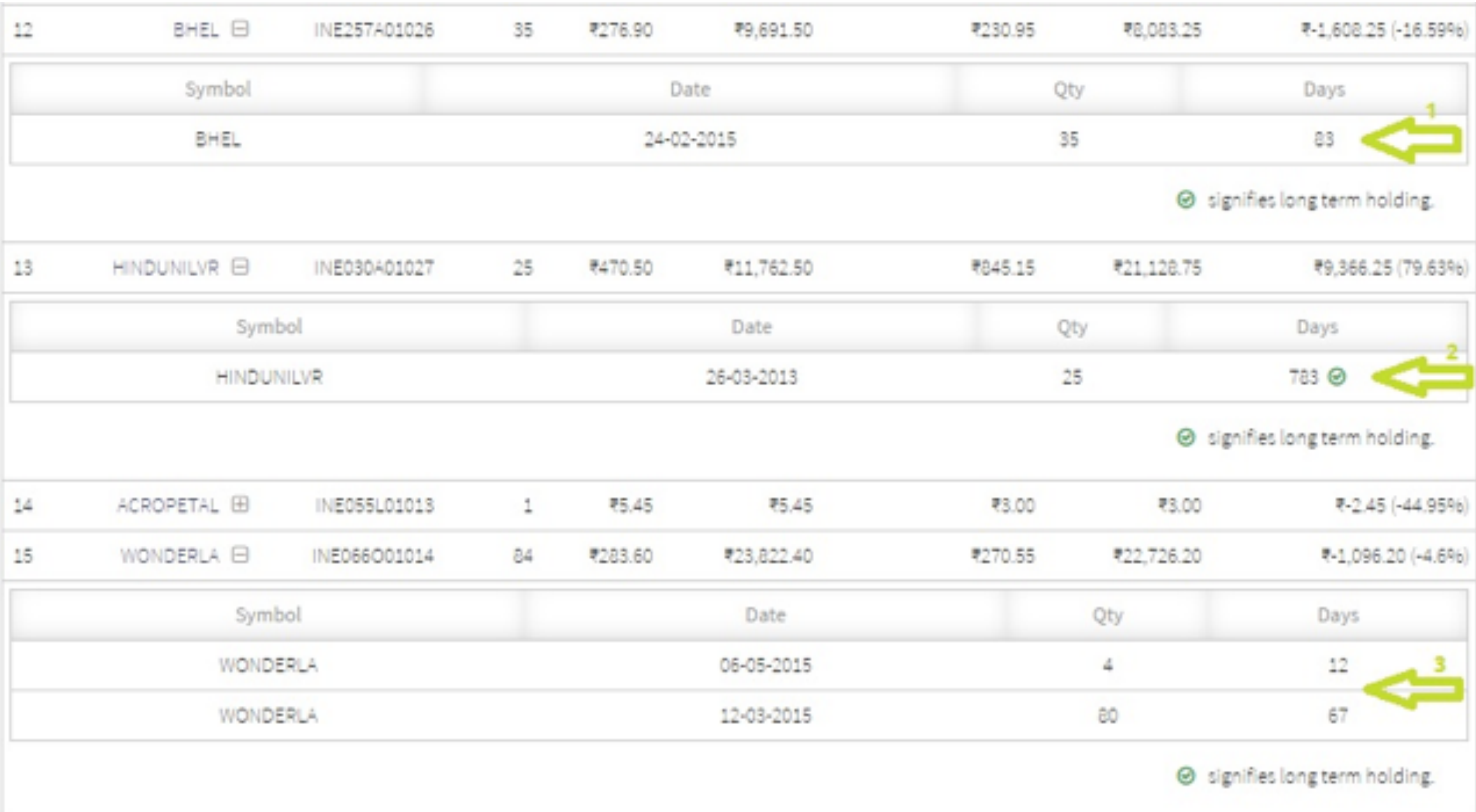
Following FIFO guidelines, 100 shares bought on 10th April 2014 and 50 shares from the 100 bought on June 1st 2014 should be considered as being sold.

Hence, for shares bought on 10th April 2014 gains = Rs 120 (920-800) x 100 = Rs 12,000/- (LTCG and hence 0 tax).

For shares bought on June 1st, Gain = Rs 100 (920-820) x 50 = Rs 5,000/- (STCG and hence 15% tax).

Small little sales pitch here – if you are trading at Zerodha the holdings page in our back office assistant Q will keep a tab for you on number of days since your holdings were purchased, and even a breakdown if bought in multiple trades.

Here is a snapshot of the same –



The highlights shows –

1. Day counter
2. A green arrow signifying holdings more than 365 days, selling which won't attract any taxes.
3. If you have bought the same holdings in multiple trades, the split up showing the same.

Besides Zerodha Q, equity tax P&L is probably the only report offered by an Indian brokerage which gives you a complete breakdown of speculative income, STCG and LTCG.

4.6 – Quick note on STT, Advance Tax, and more

STT (Securities Transaction Tax) is a tax payable to the government of India on trades executed on recognized stock exchanges. The tax is not applicable on off-market transactions which is when shares are transferred from one DEMAT to another through delivery instruction slips instead of routing the trades via exchange. But off market transactions attracts higher capital gains tax as explained previously. Current rate of STT for equity delivery based trades is 0.1% of the trade value.

When calculating taxes on capital gains, STT can't be added to the cost of acquisition or sale of shares/stocks/equity. Whereas brokerage and all other charges (which includes exchange charges, SEBI charges, stamp duty, service tax) that you pay when buying/selling shares on the exchange can be added to the cost of share, hence indirectly taking benefit of these expenses that you incur.

Advance tax when you have realized capital gains (STCG)

Every tax payer with business income or with realized (profit booked) short term capital gains is required to pay advance tax on 15thSept, 15th December, and 15th March. Advance tax is paid keeping in mind an approximate income and taxes that you would have to pay on your business and capital gain income by the end of the year. You as an individual are required to pay 30% of the expected annual tax that you are likely to pay for that financial year by 15th Sept, 60% by 15th Dec, and 100% by 15th March. Not paying would entail a penalty of annualized interest of around 12% for the period by which it was delayed.

When you are investing in the stock markets, it is very tough to extrapolate the capital gain (STCG) or profit that will be earned by selling shares for an entire year just based on STCG earned for a small period of time. So if you have sold shares and are sitting on profits (STCG), it is best to pay advance tax only on that profit which is booked until now. Even if you eventually end up making a profit for the entire year which is lesser than for what you had paid advance tax, you can claim for a tax refund. Tax refunds are processed in quick time by the IT department now.

You can make your advance tax payments online by clicking on Challan No./ITNS 280 on https://incometaxindiaefiling.gov.in/.

Which ITR form to use

You can declare capital gains either on ITR 2 or ITR4

ITR 4: When you have business income and capital gains

ITR 2: When you have salary and capital gains or just capital gains

4.7 – Short and long term capital losses

We pay 15% tax on short term capital gains and 0% on long term capital gains, what if these were not gains but net losses for the year.

Short term capital losses if filed within time can be carried forward for 8 consecutive years, and set off against any gains made in those years. For example if the net short term capital loss for this year is Rs.100,000/-, this can be carried forward to next year, and if net short term capital gain next year is say Rs.50,000/- then 15% of this gain need not be paid as taxes because this gain can be set off against the loss which was carried forward. We will still be left with Rs Rs.50,000 (Rs.100,000 – Rs.50,000) loss which be carried forward for another 7 years.

Long term capital losses can't be used to set off against long term gains as in the first place long term capital gains is exempt from any tax. So long term capital loss is a dead loss, and can't be set off or carried forward.

Key takeaways:

1. LTCG : Equity: 0%, Equity MF: 0%, Debt MF: 20% after indexation benefit

2. STCG: Equity: 15%, Equity MF: 15%, Debt MF: as per individual tax slab

3. You can use cost inflation index to determine and get the benefit from the indexed purchase value

4. Index purchase price = Indexed purchase value = Purchase value * (CII for year of sale/ CII for year of purchase)

5. If you have bought and sold the same shares multiple times then use FIFO methodology to calculate holding period and Capital gains

6. STT is payable to the Govt and cannot be claimed as expense when investing

Interesting reads:

Livemint: If you pay STT STCG is 15% otherwise as per tax slab

Income tax India website – Cost inflation index utility

Taxguru – Taxation of income & capital gains for mutual funds

HDFC- Debt mutual funds scenario post finance bill (no2), 2014

Disclaimer – Do consult a chartered accountant (CA) before filing your returns. The content above is in the context of taxation for retail individual investors/traders only.

CHAPTER 5

Taxation for Traders

5.1 – Quick Recap

Reiterating from the previous chapter –

You can classify yourself as an Investor if you hold equity investments for more than 1 year and show income as long term capital gain (LTCG). You can also consider yourself an investor and gains as short term capital gains (STCG) if your holding period is more than 1 day and less than 1 year. We also discussed on how it is best to show your capital gains as a business income if frequency of trades is higher or if investing/trading is your primary source of income.

In this chapter we will discuss on all aspects of taxation when trading is declared as a business income, which can be categorized either as:

1. **Speculative business income** – Income from intraday equity trading is considered as speculative. It is considered as speculative as you would be trading without the intention of taking delivery of the contract.
2. **Non-speculative business income** – Income from trading F&O (both intraday and overnight) on all the exchanges is considered as non-speculative business income as it has been specifically defined this way. F&O is also considered as non-speculative as these instruments are used for hedging and also for taking/giving delivery of underlying contract. Even though currently almost all equity, currency, & commodity contracts in India are cash settled, but by definition they give rise to giving/taking delivery (there are a few commodity future contracts like gold and almost all agri-commodity contracts with delivery option to it).Income from shorter term equity delivery based trades (held for between 1 day to 1 year) are also best to be considered as non-speculative business income if frequency of such trades executed by you is high or if investing/trading in the markets is your main source of income.

5.2 – Taxation of trading/business income

Unlike capital gains there is no fixed taxation rate when you have a business income. Speculative and non-speculative business income has to be added to all your other income (salary, other business income, bank interest, rental income, and others), and taxes paid according to the tax slab you fall in. You can refer to chapter 1 for tax slabs as applicable for FY 2015-16.

Let me explain this with an example:

- ➡ My salary – Rs.1,000,000/-
- ➡ Short term capital gains from deliver based equity – Rs.100,000/-
- ➡ Profits from F&O trading – Rs.100,000/-
- ➡ Intraday equity trading – Rs.100,000/-

Gives these incomes for the year, what is my tax liability?

In order to find out my tax liability, I need to calculate my total income by summing up salary, and all business income (speculative and non-speculative). The reason capital gains is not added is because capital gains have fixed taxation rates unlike salary, or business income.

Total income (salary + business) = Rs.1,000,000 (salary income) + Rs.100,000 (Profits from F&O trading) + Rs.100,000 (Intraday equity trading) = Rs 12,000,000/-

I now have to pay tax on Rs 12,000,000/- based on the tax slab –

- ➡ 0 – Rs.250,000 : 0% – Nil
- ➡ 250,000 – Rs.500,000 : 10% – Rs.25,000/-
- ➡ 500,000 – Rs.1,000,000 : 20% – Rs.100,000/-,
- ➡ 1,000,000 – 1,200,000: 30% – Rs.60,000/-
- ➡ Hence total tax : 25,000 + Rs.100,000 + Rs.60,000 = **Rs.185,000/-**

Now, I also have an additional income of Rs.100,000/- classified under short term capital gains from deliver based equity. The tax rate on this is flat 15%.

STCG: Rs 100,000/-, so at 15%, tax liability is **Rs.15,000/-**

Total tax = Rs.185,000 + Rs.15,000 = **Rs.200,000/-**

I hope this example gives you a basic orientation of how to treat your income and evaluate your tax liability.

We will now proceed to find a list of important factors that have to be kept in mind when declaring trading as a business income for taxation.

5.3 – Carry forward business loss

If you file your income tax returns on time (July 31st for non-audit case – extended to Aug 31st this year (2015), and Sept 30th for audit case) you can carry forward any business loss that is incurred.

Speculative losses can be carried forward for 4 years, and can be set-off only against any speculative gains you make in that period.

Non-speculative losses can be set-off against any other business income except salary income **the same year**. So they can be set-off against bank interest income, rental income, capital gains, but only in **the same year**.

You carry forward non-speculative losses to the next 8 years; however do remember carried forward non-speculative losses can be set-off only against any non-speculative gains made in that period.

For example consider this – my hotel business income is Rs 1,500,000/-, my interest income for the year is Rs.200,000/-, and I make a non-speculative loss of Rs 700,000. In such case my tax liability for the year would be –

My gain is Rs 1,500,000/ from business and Rs.200,000/- from interest, so total of Rs.1,700,000/-.

I have a non speculative business loss of Rs.700,000/-, which I can use to offset my business gains, and therefore lower my tax liability. Hence

Tax liability = Rs.1,700,000 – 700,000 = **Rs.1,000,000**/-

So I pay tax on Rs.1,000,000/- as per the tax slab I belong to, which would be –

- ➡ 0 – Rs.250,000 : 0% – Nil
- ➡ 250,000 – Rs.500,000 : 10% – Rs.25,000/-
- ➡ 500,000 – Rs.1,000,000 : 20% – Rs.100,000/-,

Hence, Rs.125,000/- goes out as tax.

5.4 – Offsetting Speculative and non-speculative business income

Speculative (Intraday equity) loss can't be offset with non-speculative (F&O) gains, but speculative gains can be offset with non-speculative losses.

If you incur speculative (intraday equity) loss of Rs. 100,000/- for a year, and non-speculative profit of Rs. 100,000/-, then you cannot net-off each other and say zero profits. You would still have to pay taxes on Rs. 100,000/- from non-speculative profit, and carry forward the speculative loss.

For example consider this –

- ➡ Income from Salary = Rs. 500,000/-
- ➡ Non Speculative profit = Rs. 100,000/-
- ➡ Speculative loss = Rs. 100,000/-,

I calculate my tax liability as –

Total income = Income from Salary + Gains from Non Speculative Business income

= Rs.500,000 + Rs.100,000 = **Rs. 600,000/-**

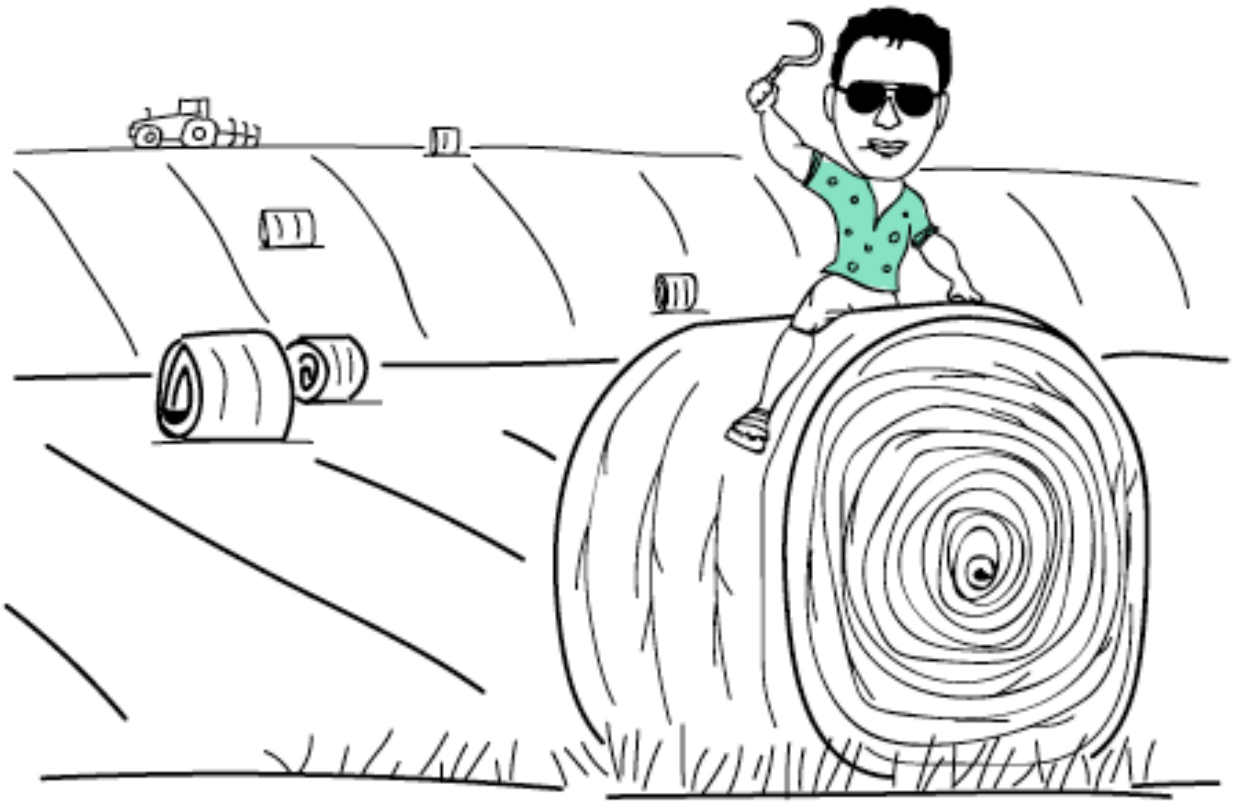
I'm required to pay the tax on Rs.600,000 as per the slab rates –

- ➡ 0 – Rs.250,000 : 0% – Nil
- ➡ 250,000 – Rs.500,000 : 10% – Rs. 25,000/-
- ➡ 500,000 – Rs.600,000 : 20% – Rs. 20,000/-,

Hence total tax = Rs.25,000 + Rs.20,000 = **Rs .45,000/-**

I can carry forward speculative loss of Rs.100,000/-, which I can set-off against any future (upto 4 years) speculative gains. Also to reiterate, speculative business losses can be set-off only against other speculative gains either the same year or when carried forward. Speculative losses can't be set-off against other business gains.

But if I had speculative gain of Rs. 100,000/- and non-speculative loss of Rs. 100,000/- they can offset each other, and hence tax in the above example would be only on the salary of Rs. 500,000/-.



5.5 What is tax loss harvesting?

Towards the end of a financial year you might have realized profits and unrealized losses. If you let it be, you will end up paying taxes on realized profits, and carrying forward your unrealized losses to next year. This would mean a higher tax outgo immediately, and hence any interest that you could have earned on that capital which goes away as taxes.

You can very easily postpone this tax outgo by booking the unrealized loss, and immediately getting back on the same trade. By booking the loss, the tax liability for the financial year would reduce. We at Zerodha are the only brokerage in India presently giving out a tax loss harvesting report, which will spot all opportunities for you to harvest losses. Click here to learn more.

5.6 – BTST (ATST) – Is it speculative, non-speculative, or STCG?

BTST (Buy today Sell tomorrow) or ATST (Acquire today sell tomorrow) is quite popular among equity traders. It is called BTST when you buy today and sell tomorrow without taking delivery of the stock.

Since you are not taking delivery, should it be considered as speculative similar to intraday equity trading?

There are both schools of thought, one which considers it to be speculative because no delivery was taken. However I come from the second school, which is to consider it as non-speculative/ STCG as the exchange itself charges the security transaction tax (STT) for BTST trades similar to regular delivery based trades. A factor to consider is if such BTST trades are done just a few times in the year show it as STCG, but if done frequently it is best to show it as speculative business income.

5.7 – Advance tax – business income

Paying advance tax is important when you have a business income. Like we discussed in the previous chapter, advance tax has to be paid every year – 30% by 15th Sep, 60% by 15th Dec, and 100% by 15th March. I guess the question that will arise is % of what?

The % of the annual tax that you are likely to pay, yes! When you have a business income you have to pay most of your taxes before the year ends on March 31st. The issue with trading as a business is that you might have a great year until September, but you can't extrapolate this to say that you will continue to earn at the same rate until the end of the financial year. It could be more or less.

But everything said and done, you are required to pay that advance tax, otherwise the penalty is 12% annualized for the time period it was not paid for. The best way to pay advance tax is by paying tax for that particular time period, so Sept 15th pay for what was earned until then, and by March 15th close to the year end, you can make all balance payments as you would have a fair idea on how you will close the year. You can claim a tax refund if you end up paying more advance tax than what was required to pay for the financial year. Tax refunds are processed in quick time by IT department.

You can make your advance tax payments online by clicking on Challan No./ITNS 280 on https://incometaxindiaefiling.gov.in/

Also, here is an interesting link that helps you calculate your advance tax – http://www.incometaxindia.gov.in/Pages/tools/advance-tax-calculator.aspx. You can also check this link to see how exactly interest or penalty is calculated for non-payment of advance tax.

5.8 – Balance sheet and P&L statements –

When you have trading as a business income, you are required to like any other business create a balance sheet and P&L or income statement for the financial year. Both these financial statements might need an audit based on your turnover and profitability. We will discuss more on this in the next chapter.

5.9 – Turnover and Tax audit

When is audit required?

An audit is required if you have a business income and if your business turnover is more than Rs.1 Crore for the given financial year. Audit is also required as per section 44AD in cases where turnover is less than Rs.1 Crore but profits are lesser than 8% of the turnover.

We will discuss this in detail in the next chapter.

However let us understand what audit really means.

The dictionary meaning of the term "audit" is check, review, inspection, etc. There are various types of audits prescribed under different laws like company law requires a company audit; cost accounting law requires a cost audit, etc. Likewise the Income-tax Law requires the taxpayer to get the audit of the accounts of his business/profession from the view point of Income-tax Law if he meets the above mentioned turnover criteria.

Check this link for FAQ's on tax audit on the income tax website for more.

Audit can also be defined as having an accountant verify if you have filed everything right. In this case it is getting an accountant check if you have created a correct balance sheet and P&L statement for the year. Ideally this audit should be done by the IT department itself, but considering the number of balance sheets out there it is surely impossible for IT department to audit each one of them. Hence we need a Chartered accountant (CA), who is a qualified professional and authorized by Income tax department to perform audits on balance sheet and P&L statements. You the tax payer can use any CA of your choice.

What role should a CA play?

Ideally a CA is required to only audit and sign on the balance sheets and P&L statements. But a CA also typically ends up creating your balance sheets and P&L statements and will audit them only if required. We will in the next chapter briefly explain how a CA typically creates these two statements.

The importance of the audit process by a CA cannot be understated, apart from all the reporting requirements an audit also helps traders/investors know their financial health, ensure it faithfully reflects the income and claims for deduction are correctly made. It also helps lenders evaluate credibility, and act as a check for any fraudulent practices.

Which ITR form to use? – ITR 4, we will discuss more on this in the last chapter. I have come across incidents where people have declared both speculative and non-speculative as capital gains to avoid having to declare business income, and not having to use ITR4. Taking a shortcut like this could mean a lot of trouble if called for an IT scrutiny.

Business expenses when trading – Advantage of showing trading as a business is that you can show all expenses incurred as a cost which can then be used to reduce your tax outgo, and if a net loss for the year after all these costs, it can be carried forward as explained above.

Following are some of the expenses that can be shown as a cost when trading

➡ All charges when trading (STT, Brokerage, Exchange charges, and all other taxes). I hope you remember that STT can't be shown as a cost when declaring income as capital gains, but it can be in case of business income.

➡ Internet/phone bills if used for trading (portion proportionate to your usage on the bill)

➡ Depreciation of computer/other electronics (used for trading)

➡ Rental income (if the place used for trading, if a room used – portion of your rent)

➡ Salary paid to anyone helping you trade

➡ Advisory fees, cost of books, newspapers, subscriptions and more…

Key takeaways from this chapter

1. Speculative business income if trading intraday equity.
2. Non-speculative if trading F&O, or short term equity delivery actively.
3. Speculative losses can't be set-off against non-speculative gains.
4. Advance tax has to be paid when trading as a business – 30% by Sep 15th, 60% by Dec 15th and 100% by Mar 15th.
5. Can claim all expenses if income from trading shown as a business income.

Disclaimer – Do consult a chartered accountant (CA) before filing your returns. The content above is in the context of taxation for retail individual investors/traders only.

CHAPTER 6

Turnover, Balance Sheet, and P&L

6.1 – Turnover & Tax Audit

In the previous chapter, we discussed briefly on tax audit, and when it is required if you are declaring trading as a business income. To determine if an audit is required or not, we need to first determine the turnover of your trading business.

Reiterating – the requirement of calculating turnover arises only when treating trading P&L as a business income (An audit is not required if you only have capital gains income irrespective of the turnover). Turnover is only to determine if a tax audit is required or not. **Your tax liability does not get affected by your turnover.**

An audit is required if –

➡ **1 Crore mark** – Turnover for the year crosses the Rs 1 crore mark

➡ **Section 44AD** – If the turnover is less than 1 crore, and if **profit less than** 8% of turnover

I am sure the first thing that came to your mind after reading turnover is contract turnover, i.e

➡ Nifty is at 8000, you buy 100 Nifty

➡ Buy side value = 8000 * 100 = Rs.800,000/-

➡ Nifty goes to 8100, you square off the 100 Nifty

➡ Sell side value = 8100 * 100 = Rs,810,000/-

➡ Turnover = Buy side value + Sell side value = 800,000 + 810,000 = **1,610,000/-**

But it is **not** the contract turnover the IT department is interested in; they are interested in your **business turnover.**

Read below on how business turnover can be calculated –

The method of calculating turnover is a debatable issue and what makes it a grey area is that there is no guideline as such from the IT department. One article of great help though is the guidance note on tax audit under Section 44AB by ICAI (Institute of Chartered accountants of India, the governing body for CA's). The article on Page 23, Section 5.12 of this guidance note has a guideline on how turnover can be calculated. It says:

➡ **Delivery based transactions**

For all delivery based transactions, where you buy stocks and hold it more than 1 day and sell them, total value of the sales is to be considered as turnover. So if you bought 100 Reliance shares at Rs 800 and sold them at Rs 820, the selling value of Rs 82000 (820 x 100) can be considered as turnover.

But remember that the above calculation of turnover for delivery trades is only applicable if you are declaring equity delivery based trades also as a business income. If you are declaring them as capital gains or investments, there is no need to calculate turnover on such transactions. Also, there is no need of an audit if you have only capital gains irrespective of turnover or profitability.

➡ **Speculative transactions (intraday equity trading)**

For all speculative transactions, aggregate or absolute sum of both positive and negative differences from trades is to be considered as a turnover. So if you buy 100 share of Reliance at 800 in the morning and sell at 820 by afternoon, you make a profit or positive difference of Rs 2000, this Rs.2000 can be considered as turnover for this trade.

➡ **Non-speculative transactions (Futures and options)**

For all non-speculative transactions, the article says that turnover to be determined as follows –

➡ The total of favorable and unfavorable differences shall be taken as turnover

➡ Premium received on sale of options **is also** to be included in turnover

➡ In respect of any reverse trades entered, the difference thereon should also form part of the turnover.

So if you buy 25 units or 1 lot of Nifty futures at 8000 and sell at 7900, Rs.2500 (25 x 100) the negative difference or loss on the trade is turnover.

In options, if you buy 100 or 4 lots of Nifty 8200 calls at Rs.20 and sell at Rs.30. Firstly, the favorable difference or profit of Rs 1000 (10 x 100) is the turnover. But premium received on sale also has to be considered turnover, which is Rs 30 x 100 = Rs 3000. So total turnover on this option trade = 1000 +3000 = Rs 4000.

The above calculations (points 1 to 3) are fairly straight forward; the next important thing to decide though is if you want to calculate turnover scrip wise or trade wise.

Scrip wise is when you calculate the turnover by collating all trades on the particular contract/scrip for the financial year, find average buy/sell value, and then determine the turnover using the above 3 rules with the total profit/loss or favorable/unfavorable difference on this average price.

Trade wise is when you calculate the turnover by summing up the absolute value of profit and loss of every trade done during the year, and following the above rules.

Let me explain both with some examples –

1. 100 Nifty Jan future bought at 8000 and sold at 8100 on 1st Another 100 Nifty Jan future bought at 8100 and sold at 8050 on 10th Jan. Determine turnover

Using scrip wise:

Average Nifty Jan Fut buy: 200 Nifty Buy at 8050

Average Nifty Jan Fut sell: 200 Nifty Sell at 8075

Total profit/loss = 200 x Rs 25 = Profit of Rs 5000 = Turnover of Nifty Jan Futures

Using trade wise:

100 Nifty Buy at 8000, Sell at 8100, Profit = Rs 10,000

100 Nifty Buy at 8100, Sell at 8050, Loss = Rs 5000

Turnover of Nifty Jan futures = Rs 10,000 + Rs 5000 (absolute sum of the loss) = Rs 15000

2. 100 Nifty Dec 8000 puts bought at 100 and sold at 50 on Dec 3rd. Another 100 Nifty Dec 8000 puts bought at 50 and sold at 30. Determine turnover

Using scripwise:

Average of Nifty Dec 8000 puts buy: 200 puts at 75

Average of Nifty Dec 8000 puts sell: 200 puts at 40

Total profit/loss = 200 x Rs 35 = Loss of Rs 7000

Total Selling value of options = 200 x Rs 40 = Rs 8000

Total Turnover for Dec 8000 puts = Rs 7000 + Rs 8000 = Rs 15000

Using tradewise:

Trade 1

100 Nifty Dec puts bought at 100 and sold at 50, Loss = Rs 5000

Selling value of options =100 x Rs 50 = Rs 5000

Turnover = Rs 10000

Trade 2

100 Nifty Dec puts bought at 50 and sold at 30, Loss = Rs 2000

Selling value of options = 100 x Rs 30 = Rs 3000

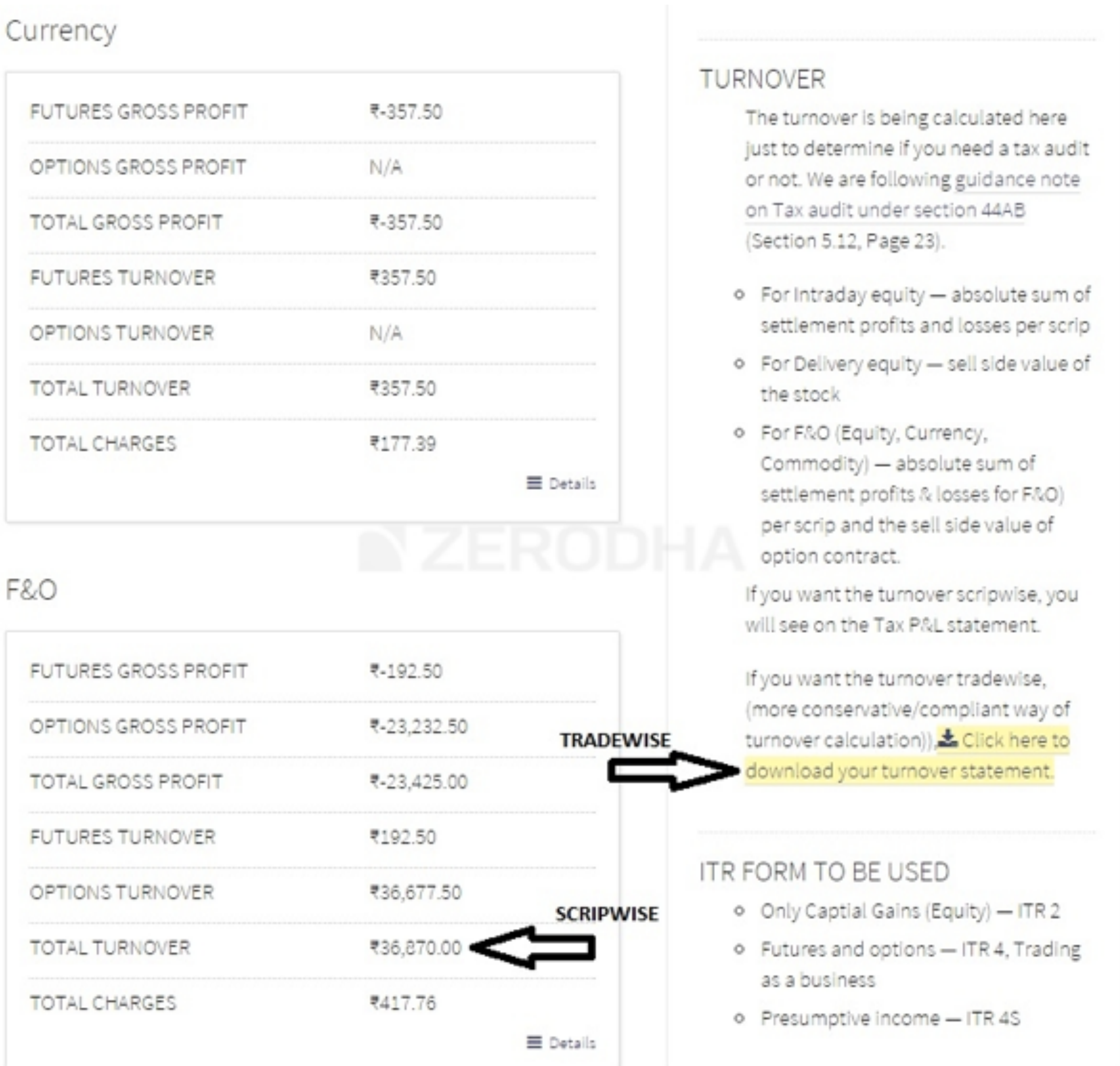
Turnover = Rs 5000

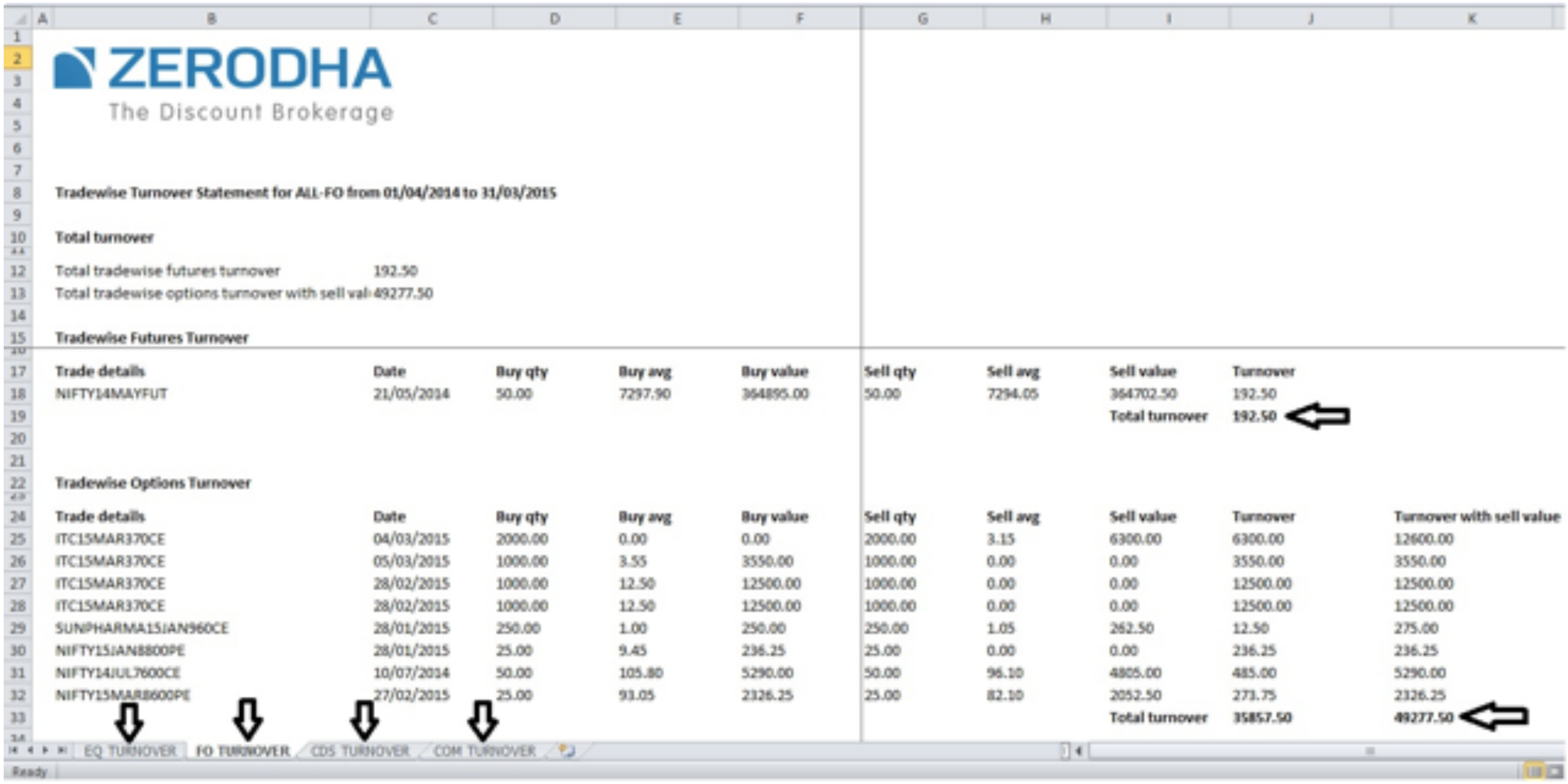
Total turnover = turnover of (trade 1+trade2) = Rs 15000

Which of the methods scrip wise or trade wise should I follow?

Calculating turnover trade wise is the most compliant way of determining turnover. The tricky bit calculating trade wise turnover though is that **no broker (other than us at Zerodha)** currently offers trade wise turnover report. All brokers provide a P&L with an average buy/sell price, which can be used to calculate scrip wise turnover. If you are not trading at Zerodha and are looking at calculating turnover tradewise, you will have to download all trades done during the year on an excel sheet and calculate turnover manually.

Here is the scrip wise and trade wise turnover reports on Q (Zerodha's reporting tool)





ZERODHA
The Discount Brokerage

Tradewise Turnover Statement for ALL-FO from 01/04/2014 to 31/03/2015

Total turnover

Total tradewise futures turnover	192.50
Total tradewise options turnover with sell val	49277.50

Tradewise Futures Turnover

Trade details	Date	Buy qty	Buy avg	Buy value	Sell qty	Sell avg	Sell value	Turnover
NIFTY14MAYFUT	21/05/2014	50.00	7297.90	364895.00	50.00	7294.05	364702.50	192.50
							Total turnover	192.50

Tradewise Options Turnover

Trade details	Date	Buy qty	Buy avg	Buy value	Sell qty	Sell avg	Sell value	Turnover	Turnover with sell value
ITC15MAR370CE	04/03/2015	2000.00	0.00	0.00	2000.00	3.15	6300.00	6300.00	12600.00
ITC15MAR370CE	05/03/2015	1000.00	3.55	3550.00	1000.00	0.00	0.00	3550.00	3550.00
ITC15MAR370CE	28/02/2015	1000.00	12.50	12500.00	1000.00	0.00	0.00	12500.00	12500.00
ITC15MAR370CE	28/02/2015	1000.00	12.50	12500.00	1000.00	0.00	0.00	12500.00	12500.00
SUNPHARMA15JAN960CE	28/01/2015	250.00	1.00	250.00	250.00	1.05	262.50	12.50	275.00
NIFTY15JAN8800PE	28/01/2015	25.00	9.45	236.25	25.00	0.00	0.00	236.25	236.25
NIFTY14JUL7600CE	10/07/2014	50.00	105.80	5290.00	50.00	96.10	4805.00	485.00	5290.00
NIFTY15MAR8600PE	27/02/2015	25.00	93.05	2326.25	25.00	82.10	2052.50	273.75	2326.25
							Total turnover	35857.50	49277.50

EQ TURNOVER FO TURNOVER CDS TURNOVER COM TURNOVER

Ready

Once you determine the turnover, you will know if you need an audit or not, that is if a visit to a CA and have him verify your balance sheet and P&L statements is compulsory or not.

6.2 – Section 44AD

An audit is also required as discussed above if your profit is less than 8% of the turnover. By turnover I am referring to all business turnover (speculative, non-speculative, and any other business you have), and by profit I am referring to only your net business profits(not including, salary, capital gains, and others). This means that if you are trading as a business and incur a loss, you will most likely have to get the books audited.

But an important thing to remember is that if your turnover is less than 1 crore and if your profit is less than 8% of turnover an audit is not required if your total tax liability for the year is zero. That means if your total income (Salary + Business income + capital gain) is less than Rs 2.5lks (minimum tax slab), you have no tax liability and hence audit not required.

Applying section 44AD for trading as a business income is causing huge inconvenience for the retail trading community. Turnover in an ordinary business to turnover while trading on the markets is hugely different. Unlike an ordinary business where there is a fixed margin every time there is a transaction, in the business of trading there is no such guarantee. This section is an unnecessary burden that indirectly gets most small retail traders to have their books audited. We at Zerodha have petitioned to the government through this campaign on Change.org, make sure to support it and also get your trading friends to do the same.

When you show trading as a business income, you will have file using ITR4, which would mean that like any other business you are required to create and maintain –

➡ Balance Sheet

➡ P&L statement

➡ Books of Accounts

Like discussed above, these will need to be audited based on your turnover (either turnover crosses the 1 Crore mark or in case the turnover is less than 1 Crore and your profits is less than 8% of the total turnover). Creating balance sheet, P&L, and maintaining books of account is quite simple for individuals with just trading as a business income, it is explained below in brief.

6.3 – Balance sheet, P&L, Book of accounts

Balance sheet

A personal balance sheet provides an overall snapshot of your wealth at a specific period in time. It is a summary of your assets (what you own), your liabilities (what you owe) and your net worth (assets minus liabilities).

Creating a personal balance sheet is fairly simple first pull together all of these information:

➡ Your latest bank statements

➡ Loan statement

➡ House loan statement

➡ Personal loan statements

➡ Principal balance of any outstanding loans

➡ Demat holding statement

Once you have all of that information available, start developing your balance sheet by listing all of your assets (financial and tangible assets) with its respective values. Typical examples of the assets could be –

➡ Cash (in the bank, in hand , deposits with Bank)

➡ All investments (mutual funds, Shares , Debt investment)

➡ Property value (Cost of Purchase + Duty any paid + Interiors etc)

➡ Automobile value (Motor Car + Two wheeler)

➡ Personal Property Value (jewelry, household items, etc)

➡ Other assets (Computers, Loans to friends , plot of land etc)

The sum of all of those values is the total value of your **assets.**

Next, you can look at your liabilities, which should be everything you owe. Here are some common liability categories:

➡ Remaining mortgage balance (Loan Statement)

➡ Car loans

➡ Student loans

➡ Any other personal loans

➡ Credit card balances

The sum of all of the money you owe is your **liabilities.**

The difference between your assets and your liabilities is your **net worth**.

That's it; this is your balance sheet. Instead of creating one at the end of every financial year, it probably makes sense to update once every few months.

Profit & Loss statement

Profit and loss will summarize your revenue streams and your expenses for the financial year.

To create your P&L for the given Financial Year, you will have to list down all revenues and expenses.

Revenue –

➡ Realized sale value from your stock holdings (Capital gains)

➡ The Income from F&O, Intraday, or Commodity Trades. (Speculative and non-speculative business income)

Remember that you can't add your salary income (if you are working elsewhere) into you revenue stream on the P&L.

Expenses –

➡ Salaries, if you have people helping you trade.

➡ Rent, if you are using an office or any space for trading activity for which you are paying a rental income

➡ Brokerage charges, taxes, and all other trade related expenses.

➡ Advisory fees, consultancy, depreciation of computer, and etc (read the expenses section in the chapter on taxation-traders)

Revenue minus the Expense equals profit.

A **Balance sheet** helps you understand your networth between two dates and the **P&L** will give you the reasons why your networth went up or down in that period. Maintaining financial discipline is the key to long term personal wealth creation. A personal balance sheet and P&L will ensure that you are constantly in touch with reality – your assets and liabilities.

Book of accounts/Book-keeping

Maintaining book of accounts and Book-keeping seem like very complex tasks, and typical reactions I have seen from traders is to get scared of the word and try postponing the decision to learn more on the topic. Again for an individual with only trading as a business income and/or salary, it is super simple- you just need to maintain two books.

Bank book: Take an excel download of all your bank statements, and make a note next to every entry to identify the nature of the transaction. It is also best to keep a copy of all the bills in case of expenses.

Trading book: This should be automatically getting maintained for you by the broker where you trade. The broker should be able to give you a P&L statement including all expenses for the year, ledger statement, and an online repository of contract notes if required. Unlike what many people think, contract notes aren't really required unless a scrutiny by the IT department, and even then if only asked for the same.

As a person who has traded with over 10 online brokers in India, the ledger and P&L statements with all expenses on it will show up any hidden charges by the broker.

At Zerodha, **we take great pride in the transparency we bring in as a business.** Every charge other than brokerage is captured on the other credits/debits section on the tax P&L on Q. We also give you a summary with value of all your open option positions starting April 1st and closing March 31st. This is extremely useful when you are trying to tally your ledger with your P&L statement.

Open option positions on 01/04/2014					
Contract	**Exchange**	**Type**	**Quantity**	**Closing price**	**Value**
NIFTY14APR7100CE	NSE-FO	B	500.00	11.45	5725.00
NIFTY14APR6500PE	NSE-FO	B	100.00	38.85	3885.00
AXISBANK14APR1600CE	NSE-FO	B	250.00	14.65	3662.50
				Total buy premium	**13272.50**
Contract	**Exchange**	**Type**	**Quantity**	**Closing price**	**Value**
NIFTY14APR6400PE	NSE-FO	B	100.00	24.30	2430.00
				Total sell premium	**2430.00**
				Total premium present on 01/04/2014	**10842.50**
				Ledger balance on 01/04/2014	**694692.03**
				Opening ledger balance on 01/04/2014	**705534.53**
Open option positions on 31/03/2015					
Contract	**Exchange**	**Type**	**Quantity**	**Closing price**	**Value**
HINDALCO15APR135CE	NSE-FO	B	2000.00	3.50	7000.00
ASHOKLEY15APR70CE	NSE-FO	B	8000.00	5.35	42800.00
ASHOKLEY15APR67.5PE	NSE-FO	B	8000.00	0.90	7200.00
HDIL15APR100PE	NSE-FO	B	4000.00	4.75	19000.00
ASHOKLEY15APR70PE	NSE-FO	B	8000.00	1.60	12800.00
				Total buy premium	**88800.00**
Contract	**Exchange**	**Type**	**Quantity**	**Closing price**	**Value**
				Total sell premium	**0.00**
				Total premium present on 31/03/2015	**88800.00**
				Ledger balance on 31/03/2015	**182449.82**
				Opening ledger balance on 31/03/2015	**271249.82**

EQ-TAX-PNL | FO-TAX-PNL | CDS-TAX-PNL | COM-TAX-PNL | OTHER CREDITS AND DEBITS | **OPEN OPTION POSITIONS**

We are almost done with the taxation module. The last chapter will have an explanation on what kind of ITR forms to use, and also an excel download of a sample ITR 4 form with all details as an easy reference.

Key takeaways from this chapter –

1. Audit of the books is required if turnover is more than INR 1 Crore mark
2. Audit of the books is required if turnover is less that INR 1 Crore but if the profits is less than 8%
3. Audit of the books is NOT required if turnover is less than INR 1 Crore and profits higher than 8% of the turnover
4. Turnover does not take into consideration the regular contract turnover
5. Turnover refers to the business turnover
6. Business turnover (for trading as a business) can be calculated scripwise or tradewise
7. Trade wise turnover is the most compliant way of declaring turnover.
8. If you are declaring trading as a business then one needs to use the ITR4 form to file tax returns
9. ITR4 requires you to have Balance Sheet and Profit and Loss statement along with books of account
10. Balance sheet equation states that Net worth = Assets – Liabilities
11. P&L statement details the revenues and expenses
12. If trading as a business maintaining 2 books of account becomes mandatory – Bank Book and Trade book
13. It is advisable to maintain and update Balance Sheet, P&L, and books of account once in every quarter.

Disclaimer – Do consult a chartered accountant (CA) before filing your returns. The content above is in the context of taxation for retail individual investors/traders only.

CHAPTER 7

ITR Forms (The Finale)

7.1 – Income Tax Return (ITR) Forms

The last step of taxation is filing your Income tax returns (ITR), and this can be done using ITR forms. Find below brief explanation on everything important on ITR that you need to know as an investor/trader.

I have noticed from my interactions with many that they are confused between the two actions i.e 'paying income tax' and 'filing income tax'. Many are of the opinion that if they pay income tax the act of filing income tax is not really necessary. This is not true, let me explain why.

Paying Income tax – If you are employed and draw a salary you very clearly know that your employer on your behalf deducts tax (based on your tax slab) and pays the income tax on your behalf. This is usually called **'Tax Deducted at source (TDS)'**. Now what if you have an income sources besides your salary?

For example for the given year assume besides drawing a salary, you also made a profit by actively trading delivery based equity trading. As we now know this activity falls under "Non-speculative Business Income". Since the employer is not privy to this activity it becomes your responsibility to declare this source of income to the Income tax department and paying the appropriate amount as tax.

Filing Income tax returns – Filing income tax returns is a mandatory way of communicating to the IT department all the sources of income you have including your salary. An **Income Tax Return Form (ITR**) form is simply a form that you need to fill up declaring your sources of income. There are different ITR forms for different sources of income. You may wonder why I should file my returns when I don't have any other source of income besides salary. Well, in such a case by virtue of filing your income tax returns (via appropriate ITR form) you are officially communicating to the income tax department that you do not have any other source of income.

So in essence, the act of filing your returns is your official communication to IT department about all the source of income that you have along with the tax you have paid against that income. You do this via the prescribed **ITR forms.**

More formally, an ITR is a prescribed form through which the particulars of income earned by a person in a financial year and taxes paid on such income are communicated to the Income-tax Department. There are different types of ITR forms, one needs to select the appropriate ITR form, based on the different sources of income. These forms can be downloaded from here https://incometaxindiaefiling.gov.in/

7.2 – ITR forms and its uses

In the context of this module, which is focused towards individuals having investments as capital gains or trading as a business income, the important ITR forms to know about are:

ITR 1 – when you have only salary, interest income, or rental income from only one house property, you can use ITR 1 forms to file your income tax returns. This is the most common type, but if you have capital gains or trading as a business income, you can't use this ITR form.

ITR 2 – when you have salary, interest income, income from house property or **income from capital gains**, you can use ITR 2. So if you are an individual who only invests in the market (remember investor, hence capital gains), you need to use ITR2

ITR 4 – when you have salary, interest income, income from house property, income from capital gains, and income from business/profession, you can use ITR 4.

So if you are an individual who is declaring trading as a business income, you have to use ITR 4. If you are an investor and trader, you can show trading under business income and investments as capital gains on the same ITR 4 form.

ITR 4S (Sugam) – this is similar to ITR4 but with presumptive scheme if section 44AD and 44AE used for computation of business income. ITR 4S can't be used if you have speculative business income (intraday equity); losses to be carried forward, or short term capital gains tax (STCG). So you can use ITR 4S only if you have non-speculative trading income, but it is best avoided.

7.3 – Exploring ITR 4S

The advantage of ITR 4S is that it can be used by tax payers who do not maintain regular book of accounts or want it to be audited (refer chapter 2) provided your turnover is lesser than Rs 1 Crore for the year.

You can get away without maintaining books or getting audited if you firstly calculate turnover based on section 44AD (check the previous chapter) and then declare 8% of this turnover as your presumptive income. You have to then pay taxes adding this 8% of the turnover to your other income and pay tax as per the slabs.

So if you are a trader with turnover less than Rs 1 Crore for the year and profit less than 8% of the turnover with only non-speculative business income (not possible if you have speculative business income or short term capital gain), you can declare presumptive income of 8% of the turnover, and get away from the need to get your books audited. There is no need to pay advance taxes if you are using ITR4S, but you are not allowed to deduct any business expenses against your income.

For example, assume my salary was Rs.500,000/- for the last FY, and I had incurred F&O loss of Rs.25,000/- on a turnover of Rs.400,000/-. Since my profit is less than 8% (25,000/400,000) of my turnover I will need to use ITR4, maintain books, and have them audited. Instead of this, I could use ITR4S and declare 8% of Rs.400,000/- (business turnover) or Rs.32,000/- as my presumptive trading business income even though I have incurred a loss.

My total income for the year is Rs 500,000 (salary) + R 32,000 (business income) = Rs.532,000/-. Therefore my tax liability would be as follows –

Upto Rs.250,000 – No Tax

Between Rs.250,000 to Rs.500,000 – 10% – Rs.25,000/-

Between Rs.500,000 to Rs.532,000 – 20% – Rs.6,400

Total tax = Rs.25,000 + Rs.6,400 = Rs.31,400/-

Here, by virtue of declaring a presumptive business income of Rs.32,000/- I'm paying additional tax of Rs.6,400/-. This works out to be a much cheaper alternative than getting an audit done for which the CA fees could have been Rs.15,000/- and above. So using ITR4S would make sense only if your turnover is low, hence declaring 8% of turnover as income would work out cheaper than paying an audit fees to the CA.

7.4 – Quick FAQ and notes

How to file the return of income electronically?
Income-tax department has established an independent portal for e-filing of return of income. You can log on to www.incometaxindiaefiling.gov.in for e-filing the return of income. Check this very nice video on e-filing put by the IT department.

Is it necessary to attach documents along with return of income?
ITR return forms are attachment less forms. Hence along with the ITR form (whether filed manually or filed electronically), you are not required to attach any document (like proof of investment, TDS certificates, etc) unless if you fall under the audit case.

However, these documents should be retained by you and should be produced before the tax authorities when demanded in situations like assessment, inquiry, scrutiny etc. But in audit cases, soft copy of balance sheets, P&L, and any notes along with the audit report needs to be attached.

What is the difference between e-payment and e-filing?
E-payment is the process of electronic payment of tax (i.e., by net banking or SBI's debit/credit card)

E-filing is the process of electronically furnishing (filing) of return of income.

Using the e-payment and e-filing facility, payment of tax and furnishing of return is quick, easy, and hassle free.

Is it necessary to file return of income when I do not have any positive income?
If you have sustained a loss in the financial year, which you propose to carry forward to the subsequent year for adjustment against subsequent year(s) positive income, you must make a claim of loss by filing your return before the due date.

What are the due dates for filing returns of income/loss?
If no audit: July 31st (Extended to Aug 31 this year of 2015)

If audit: September 30th

If I fail to furnish my return within the due date, will I be fined or penalized?
Yes, if you have not furnished the return within the due date, you will have to pay interest on tax due. If the return is not filed up to the end of the assessment year, in addition to interest, a penalty of Rs. 5,000 shall be levied under section 271F.

Can return be filed after the due date?
Yes you can. Return filed after the prescribed due date is called as a belated return. If one could not file the return of income on or before the prescribed due date, then he can file a belated return. A belated return can be filed within a period of one year from the end of the assessment year or before completion of the assessment, whichever is earlier. A belated return attracts interest and penalty as discussed in previous FAQ.

For Example – In case of income earned during FY 2013-14, the belated return can be filed up to 31st March, 2016. However, if return is filed after 31st March, 2015, penalty under section 271F can be levied.

If I have committed any mistake in my original return, am I permitted to file a revised return to correct the mistake?
Yes, provided the original return has been filed before the due date and the IT Department has not completed the assessment. It is expected that the mistake in the original return is of a genuine and bona fide nature and not rectification of any deliberate mistake. However, a belated return (being a return filed after the due date) cannot be revised.

Return can be revised within a period of one year from the end of the relevant assessment year or before completion of the assessment whichever is earlier.

Example, in case of income earned during FY 2013-14, the due date of filing the return of income (considering no audit) is 31st July, 2014. If the return of income is filed on or before 31st July, 2014 then the return can be revised upto 31st March, 2016 (assuming assessment is not completed by that date). However, if return is filed after 31st July, 2014, then it will be a belated return and a belated return cannot be revised.

ITR forms are typically Microsoft Excel sheets where you can fill all the relevant details, and the calculations happen automatically.

Find attached an ITR 4 form with all types of income, salary, capital gains, trading as a business, and rental income. This should act as an easy reference if you are trying to fill this on your own. This is the ITR4 form from AY 14/15(FY 13/14).

XLS Sample ITR4 Form.

Key takeaways from this chapter

1. The act of paying your taxes is called "Tax Payment", which can be done via e-payment
2. The act of communicating different sources of income and tax paid against that is called "Income Tax Return filing"
3. Filing income tax returns is mandatory, even though you have paid taxes
4. An ITR form should be used to file taxes
5. Use different ITRs for different sources of income
6. ITR 4S for presumptive business income. Use this to lower your cash outflow (paying taxes versus audit fees)

Phew! That brings us to the end of the taxation module. Keeping it simple is most challenging, especially a topic like this where almost every other word is a jargon. Hopefully I have done a decent job with it, and this module acts as your ready reckoner for everything on taxation when trading and investing.

Financial discipline is the key to long term wealth creation, and it starts with compliant filing of your income tax returns. It is best not to avoid or postpone especially with advancement of technology and reach of our income tax department.

Do help spread the word,

Happy Trading,

Nithin Kamath
Zerodha

Special thanks to Tax IQ for providing valuable inputs throughout this module.

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