DERIVATIVES

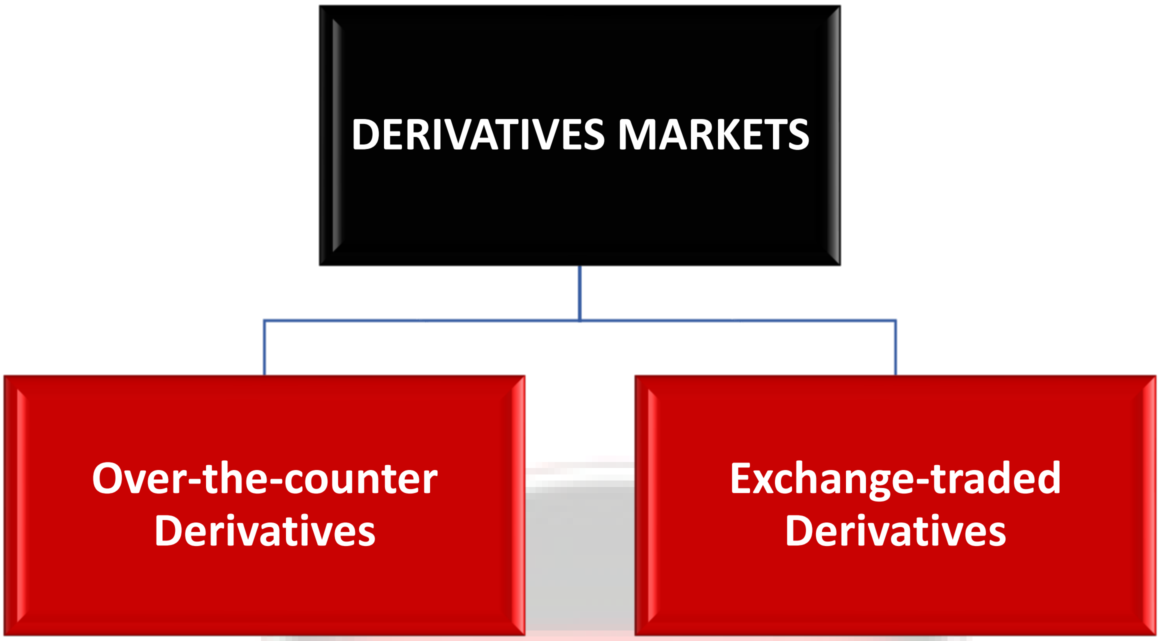
MEANING OF DERIVATIVE

- These are **financial instruments** whose **value is derived from an underlying asset** or a group of assets like **stocks, bonds, commodities, currencies.**
- They are used to manage risk, speculate on price movements, and provide leverage in financial markets.

FUNCTIONS OF DERIVATIVES

- It **manages and mitigate risks** associated with **price fluctuations, in the is underlying asset.**
- They help in **transferring risks** from risk **adverse people to risk oriented people.**
- Derivatives improve the **liquidity of the underlying instrument**.
- They increase the **volume traded in markets** because of participation of **risk adverse people in greater numbers**.
- They increase **savings and investment in the long run**.

DERIVATIVES MARKETS



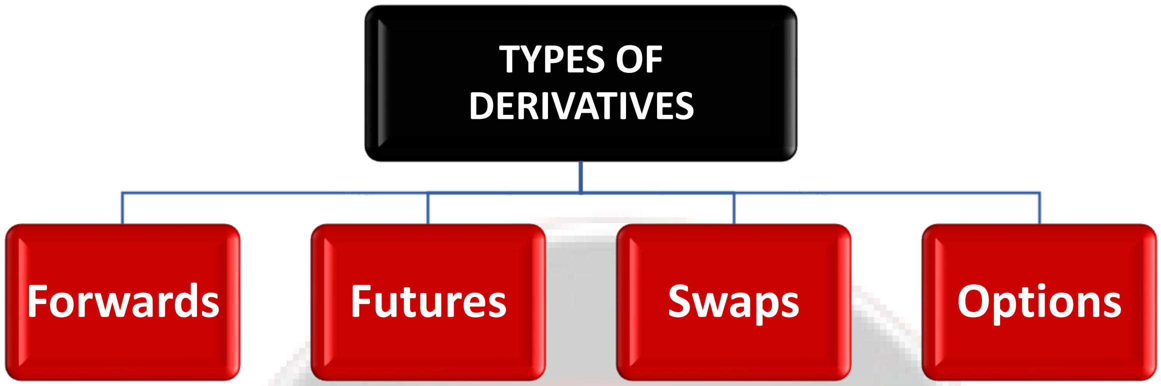
OVER THE COUNTER (OTC) DERIVATIVES

- These are derivatives are **privately negotiated contracts** that are traded **directly between two parties** outside of organized exchanges.
- In OTC derivatives, **the parameters of the contract** like the contract **size, maturity date, and other terms**, are not set according to standardized rules.
- These parameters are determined **through mutual agreement between the parties involved in the contract**.

EXCHANGE-TRADED DERIVATIVES

- Exchange-traded derivatives are **financial instruments** that are **standardized and traded on regulated exchanges**.
- The **Exchange standardises the size and maturity** of these derivatives.
- Trade in these derivative products **can be done only through a member of the exchange.**

TYPES OF DERIVATIVES



FORWARDS

- It is a customized contract **between two entities**, where settlement **takes place on a specific date in the future** at today's pre-agreed price.
- These are OTC contracts, and they are useful **in avoiding liquidity risk, price variations and avoiding losses** in case of a downside.

FUTURES

- A futures contract is an **agreement between two parties** – a buyer and a seller – **to buy or sell something at a future date**.
- Futures contracts are **special types of forward contracts** in the sense that the former are standardized exchange-traded contracts

OPTIONS

- These contracts provide the b**uyer with the right, but not the obligation**, to buy or sell an underlying asset at a specified price within a predetermined period.
- These can be used for hedging, speculation, or income generation.
- The **price paid by the buyer** to the seller in exchange for acquiring the right to buy or sell an underlying asset is **known as Premium**.

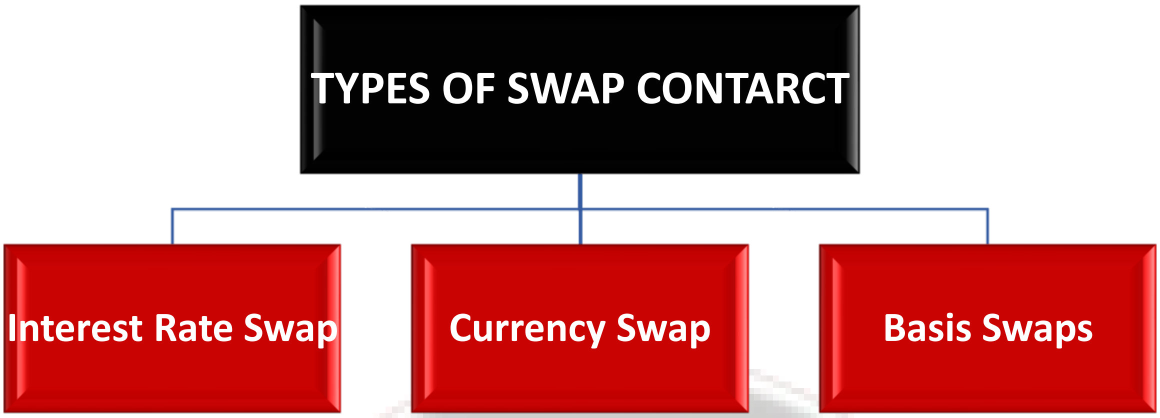
TYPES OF OPTION

A **call option** gives the holder the right, but not the obligation, to **buy the underlying asset** at a predetermined price within a specified period of time.

A **put option** gives the holder the right, but not the obligation, **to sell the underlying asset** at a predetermined within a specified period of time.

SWAPS

A swap is a type of **financial contract between** two parties that involves the **exchange of cash flows or financial instruments**.



Interest Rate Swap

- An interest rate swap is a financial contract between **two parties that involves the exchange of interest rate payments**.
- It is an agreement to swap or **exchange cash flows based on a notional principal amount**.

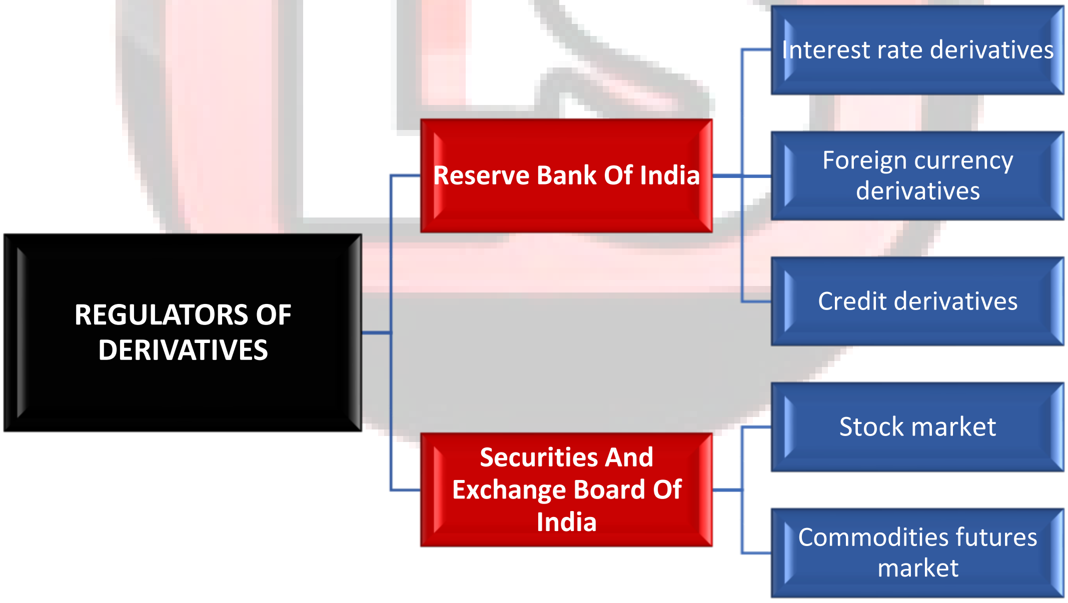
Currency Swap

- It is a financial **agreement between two parties** to exchange a **principal amount and interest payments** in different currencies.

- It allows entities to manage foreign **currency exposure, hedge against exchange rate fluctuations etc**.

Basis Swaps

It is a **derivative contract** where two parties **agree to exchange variable interest rates** that are based on different money market reference rates.



USERS OF DERIVATIVES

HEDGER

- They are **individuals or entities** who use derivatives **to manage or hedge risks associated** with their assets, liabilities, or positions.
- They aim to protect themselves against **adverse price movements** by taking offsetting positions in derivatives.

SPECULATORS

- They are individuals or entities who actively engage in **derivatives trading to earn profit from price fluctuations**.
- They take positions in derivatives **based on their expectations of future market movements.**

TRADERS

- Traders may identify and **exploit price discrepancies or inefficiencies** in the **market through derivative arbitrage strategies**.
- Arbitrage involves simultaneously **buying and selling related derivative products** to take advantage of price differentials and generate risk-free profits.

IMPORTANT DERIVATIVE PRODUCTS IN INDIAN FINANCIAL MARKET

Equity Derivatives

- Equity derivatives are financial instruments w**hose value is derived from an underlying equity asset**, typically shares of a publicly traded company.

- These derivatives allow investors to he**dge risks, speculate on price movements, or gain exposure to equity markets.**

Currency Derivatives

- Currency derivatives allow participants to **trade in currency pairs such as USD/INR, EUR/INR, GBP/INR,** etc.
- These derivatives provide a **platform for hedging foreign exchange risks** or speculating on currency movements.

Interest Rate Derivatives

- Interest rate derivatives enable market **participants to manage interest rate risks.**
- Products such as interest rate futures and interest rate swaps are used to **hedge against fluctuations in interest rates**.

Commodity Derivatives

- These derivatives are used to trade in **various commodities such as gold, silver, crude oil**, natural gas, agricultural commodities, etc.
- These derivatives provide a means for **hedging against price fluctuations in commodities.**

Credit Derivatives

- These are financial derivative **that allow market participants to transfer or manage credit risk** associated with debt securities or loans.
- These derivatives are specifically designed to **provide protection against credit events**, such as default or non-payment by a borrower.

Q:1 Which of these is not a function of derivative products?

a) Derivatives manages and mitigate risks associated with price fluctuations, in the is underlying asset.
b) Derivatives help in transferring risks from risk adverse people to risk oriented people.
c) Derivatives are typically used as a means of raising capital for companies
d) Derivatives improve the liquidity of the underlying instrument.

Q:2 Which of this statement defines Over the counter derivatives?

a) These are financial contracts privately negotiated between two parties without the involvement of organized exchanges.
b) OTC derivatives allow for customized terms and conditions tailored to the specific needs and risk profiles of the parties involved.
c) OTC transactions may involve higher counterparty credit risk since they lack the protection of a clearinghouse.
d) All of the above

Q:3 Which of this statement is correct regarding exchange traded derivatives.

I. These are financial contracts standardized and traded on organized exchanges.
II. These derivatives have fixed terms, including contract size, expiration dates, and settlement procedures.
III. These derivatives benefit from high liquidity and price transparency due to being traded on public exchanges.
IV. These derivatives are only available to institutional investors and are not accessible to retail traders.

a) I, III, IV
b) II, III, IV
c) I, II, III
d) I, II, III, IV

Q:4 In a forward contract for Rice, if the forward price is set at Rs 5000 per bushel, what does this price represent?

a) The price at which the Rice is currently trading in the market.

b) The price at which the Rice will be bought and sold on the future date.
c) The price at which the Rice will be delivered immediately.
d) all of the above

Q:5 The option contract is an important type of derivative product. Which of this statement not defines Option contract?

a) Options contracts grant the buyer right to buy or sell an underlying asset on a predetermined price.
b) Options contracts obligate the buyer to buy or sell the underlying asset.
c) The right to buy or sell an underlying asset must be exercise by buyer within a predetermined period.
d) They serve purposes such as hedging against risk, speculating on price movements, or generating income.

Q:6 Imagine you are interested in purchasing shares of Company XYZ, which are currently trading at 50 per share. You believe the stock price will rise in the near future, so

you buy option contract expiring in three months, for a premium of 2 per share. This option gives you the right, but not the obligation, to buy 100 shares of XYZ before the option expires. This represents which option contract?

a) Call Option
b) Put Option
c) Forward Contract
d) Swap Contract

Q:7 Which of this statement is correct regarding Interest rate swap?

I. It is a financial contract between two parties that involves the exchange of interest payments.
II. One party typically pays a fixed interest rate, while the other pays a floating rate tied to a reference benchmark.
III. In interest rate swaps, the principal amount is also exchanged between the parties.
IV. Interest rate swaps are widely employed for managing and mitigating exposure to interest rate fluctuations.

a) I, II, IV
b) II, III, IV
c) I, II, III
d) I, II, III, IV

Q:8 After the merger of the Forward Markets Commission (FMC) with SEBI in 2015, which organization became responsible for regulating commodities derivatives?

a) Reserve Bank of India (RBI)

b) Forward Markets Commission (FMC)

c) Securities and Exchange Board of India (SEBI)

d) National Stock Exchange (NSE)

Q:9 ___________are individuals or entities who use derivatives to manage risks associated with their assets, liabilities, or positions. They aim to protect themselves against adverse price movements by taking offsetting positions in derivatives.

a) Hedgers

b) Speculators

c) Traders

d) All of the above

Q:10 The Reserve Bank of India (RBI) plays a crucial role in regulating derivatives related to__________.

a) Interest rate derivatives

b) Foreign currency derivatives

c) Credit derivatives

d) All of the above

TAXATION, INCOME TAX, DEFERRED TAX, TDS, TCS

TAX

A tax is a **mandatory fee or financial charge levied by any government on an individual or an organization** to collect revenue for public works providing the best facilities and infrastructure.

FEATURES

Mandatory Taxes are **compulsory payments** imposed by the government on **individuals, businesses, or other entities**.

Government Authority Taxes are **collected by government authorities,** whether at the national, state, or local level, depending on the jurisdiction.

Legally Enforceable Tax laws and regulations **define the rights and obligations of taxpayers**. **Failure to comply with tax laws** can result in penalties, fines, or other legal consequences.

Redistribution of Wealth Taxes can be used as a tool for **redistributing wealth and reducing income inequality**. Progressive tax systems impose **higher tax rates on individuals with higher incomes**, aiming to create a more **equitable distribution of resources**.

TYPES OF TAX

DIRECT TAX

- These are taxes that are **imposed directly on individuals or entities** and **cannot be transferred or shifted to others**.
- These taxes are typically **levied on income, wealth, or property and** are paid directly by the taxpayer to the government.

INDIRECT TAX

- These are taxes that are imposed **in Indirectly on individuals or entities** and **can be transferred or shifted to others**.
- These taxes are typically levied on the **consumption, expenditure, or transactions of goods and services**.

INCOME TAX

- This is a tax **imposed on individuals or businesses** in respect of the income or profits earned by them.

- Income tax is a **central subject according to the Constitution of India.** It means income tax is levied by only **central government of India.**
- The provisions governing the Income-tax are covered in **the Income-tax Act, 1961.**

IMPORTANT TERMS IN INCOME TAX

ASSESSEE [Sec. 2(7)]

- A person by whom **any tax or any other sum of money is payable** under this Act.
- To every person in respect of whom **any proceeding under this Act** has been taken for the **assessment of his income or loss** or the amount of refund due to him.
- A person who is assessable **in respect of income or loss of another person**
- Every person who is **deemed to be an Assessee** under any provision of this Act.

PERSON [SEC. 2(31)]

Individual

An individual refers to a **natural person, a human being**, and is considered a separate entity for tax purposes.

Hindu Undivided Family (HUF)

- HUF is a specific type of **joint family structure** recognized under Hindu law.

- It consists of all persons **lineally descended from a common ancestor** and living together as a joint family.

Company

It refers to any **Indian company or a foreign company** registered under the Companies Act, 2013. It includes both **public and private companies.**

Partnership Firm

- A partnership firm, including limited liability partnerships (LLPs), is **considered a person for taxation purposes**.
- It consists of **two or more individuals who join together** to carry on a business and share its profits or losses.

Association of Persons (AOP)

AOP refers to **a group of persons** who come **together for a common purpose**, such as **carrying on a business or profession**.

Body of Individuals (BOI)

A BOI can be formed by **two or more individuals** who come together **for a common purpose**, such as carrying on **a business, profession, or other activities.**

Local Authority

Local authorities include **municipal corporations, panchayats, or other governmental bodies** at the local level, are considered persons for tax purposes.

Artificial Juridical Person

If an Assessee does not **fall under any of the other categories** that are included in the definition of Person, then it is **regarded as an Artificial Juridical Person.**

HEADS OF INCOME [SEC. 14]

Income From Salary

- **Income earned through employment contracts** is subject to taxation under the category of "Income from Salaries."
- This encompasses any **financial compensation received** for the services rendered in the **capacity of an employee**.
- It includes **salary, advances, benefits, bonuses**, commissions, pensions, and other forms of remuneration.

Income From House Property

- It refers to the **rental income earned by an individual** from a property they own or have a legal interest in.
- The primary component of **income from house property is the rental income received** by the property owner from tenants who occupy the property.

- In certain cases, if the **property is not let out,** it is still considered to **generate deemed rental income**, which is based on the potential rental value of the property.

Income From Profits And Gains From Business Or Profession

- The profits that you earn from any kind of **business or profession are taxable under this head.**
- You can **subtract your expenses** from the total income in order to determine the amount on which tax is chargeable.

Business income

This includes profits and gains **derived from operating a business**. Income from **sales, fees, commissions**, and other business-related transactions fall under this category.

Professional income

This involves income earned by professionals who provide **specialized services in fields** such as **law, medicine, accounting etc. Professional** income is typically derived from fees charged for services rendered.

Income From Capital Gains

- It refers to the profit earned **from the sale or transfer of capital assets.**
- Capital assets include various types of investments, such as **stocks, bonds, real estate, precious metals**, artwork.

Short-term Capital Gains

These are gains from the **sale of capital assets held for one year or less** and Tax rate is high on **short term capital gain**.

Long-term Capital Gains

These are gains from the sale of capital assets held for more than one-year Long-term capital gains are often **taxed at lower rates compared to short-term gains.**

Income From Other Sources

It refers to any **earnings that do not fall under the specific categories** of income, such as salary, business profits, capital gains, or house property.

ASSESSMENT YEAR

- It means the period of **twelve months commencing on the first day of April** every year and ending on 31st March of the next year.
- A year in which an assessee is **liable to pay tax on the income of the previous year**.

PREVIOUS YEAR

It means the fi**nancial year immediately preceding the assessment year**. In other words, the year in which income is earned is known as previous year.

TAX DEDUCTED AT SOURCE(TDS)

- It is a **mechanism used by the government to collect income tax** in advance from individuals or entities who are making payments to others.
- The **person or entity making the payment** is **responsible for deducting a certain percentage of tax** from the payment and remitting it to the government.
- TDS is applicable to various types of payments, such as salary, **interest, rent, professional fees, and dividend**s, among others.

Section	Nature of Payment	Threshold	TDS Rate
192A.	Payment of accumulated balance of provident fund which is taxable in the hands of an employee	50,000	10%
193	Interest on securities	2,500	10%
194	Dividend	5,000	10%
194B	Winnings from lotteries, crossword puzzles, card games and other games of any sort	10,000	30%
194EE	Payment in respect of deposit under National Savings scheme	2,500	10%

194H	Commission or brokerage	15,000	5%
194J	Sum paid or payable towards fees for technical services	30,000	2%

TAX COLLECTED AT SOURCE (TCS)

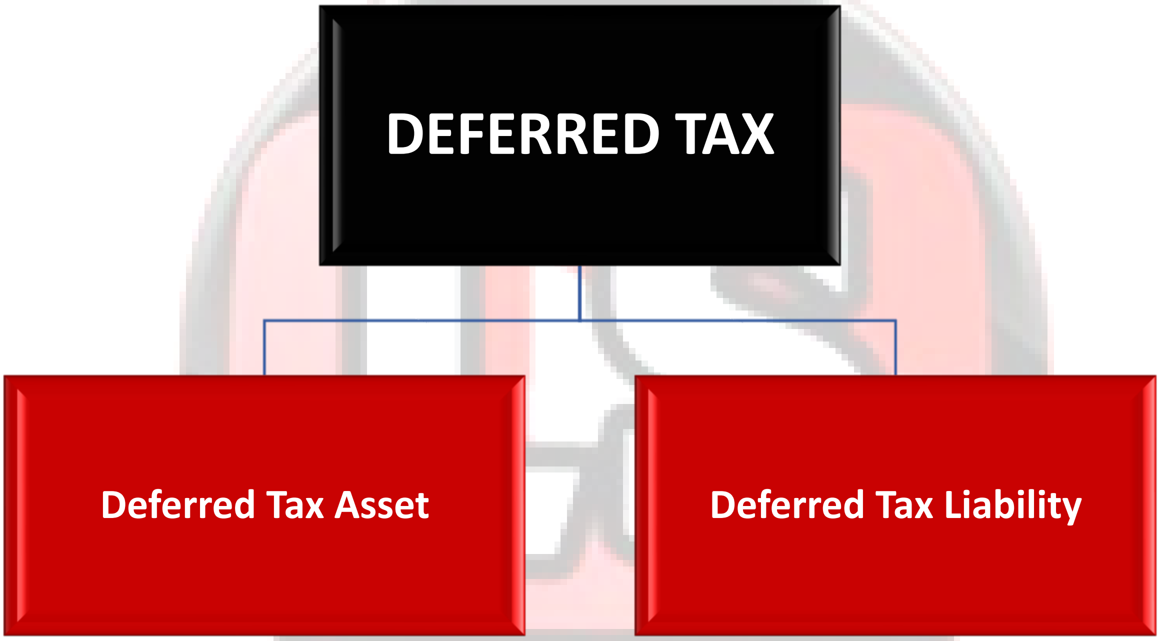
- It is a concept in the **Indian tax system**, which requires certain **specified persons to collect tax from the buyers** at the time of sale of specified goods or provision of specific services.
- The person collecting tax at source is **required to deposit the collected tax with the government**.

Good purchased	TCS rates
Tendu leaves	5%
Alcohol	1%
Timber wood from a forest on lease	2.5%
Motor vehicles worth more than Rs.10 lakh	1%
Toll plaza, quarry, mine, and parking lot	2%
Metals (including iron ore, lignite, and coal)	1%
Forest produce (excluding tendu leaves and timber)	2.5%

DEFERRED TAX

- It arises due to differences **between taxable income and accounting income.**

- **Taxable income** is determined based on **tax laws**, while **accounting income** is calculated using **accounting policies**.
- The **variance** between the tax calculated by the company and the tax assessed by tax authorities is **referred to as deferred tax**.



DEFERRED TAX ASSET

- A deferred tax asset is an item on the balance sheet that results from the **overpayment or the advance payment of taxes**.
- It is shown on company's balance sheet that **reduces its tax payment in the future**.
- The value of deferred tax assets is calculated by taking the **difference between the book income and the taxable income**.

DEFERRED TAX LIABILITY

- A deferred tax liability represents an **obligation to pay taxes in the future.**
- It is shown company's balance sheet that **increases tax payment in the future.**
- The value of deferred tax liability is calculated by taking the **difference between the book income and the taxable income**.

TYPES OF DIFFERENCE

Permanent Differences

- It refers to **differences between financial reporting and tax reporting** that arise in a particular period and **do not get reconciled or reversed in subsequent periods.**
- These differences occur from items or transactions that are recognized in **either the financial statements or the tax return, but not in both.**

Example

if the tax law does not allow an item of expenditure, the disallowed amount will result in a permanent difference.

Timing Differences

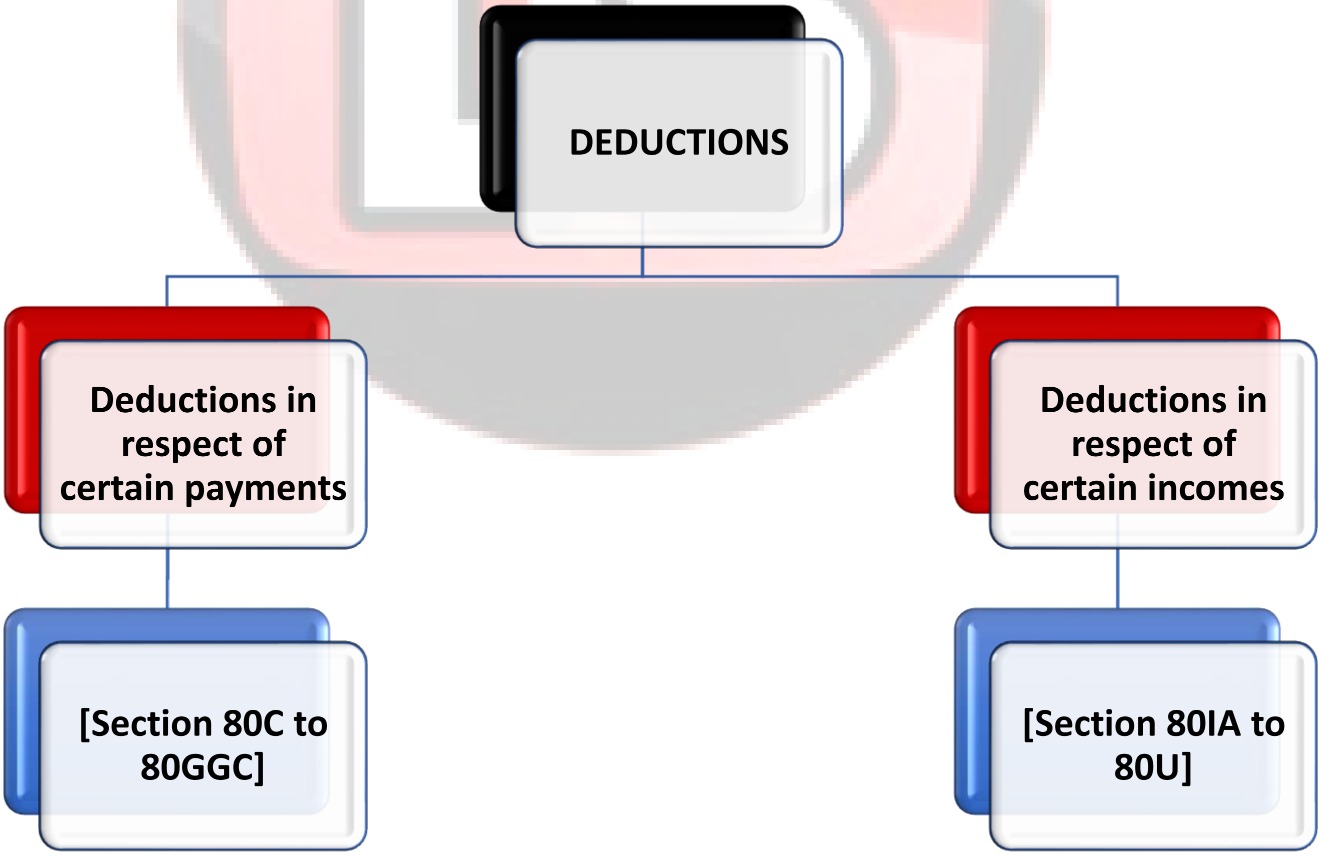
These are differences that will **reverse over time and result in taxable or deductible amounts in future periods**.

Example

Differences in the depreciation or amortization expenses recognized for financial reporting and tax purposes due to different methods, rates, or useful lives applied.

DEDUCTIONS FROM GROSS TOTAL INCOME

- Tax deductions are the sum of money that can be **reduced from the total taxable income**.
- To get the **net income of a taxpayer**, the deduction amount is first included in the gross total income and then subtracted from it.



DEDUCTIONS IN RESPECT OF CERTAIN PAYMENTS

Total amount deposited in various ap**proved savings schemes or Rs. 1,50,000 p.a.** allowed as deduction whichever is less. This limit of Rs. 1,50,000 also includes the amount of deduction **allowable to the assessee us 80CCC and 80CCD.**

PAYMENTS	SECTION
Deposits Made In Provident Funds	**80C**
Payment Of Life Insurance Premium	**80C**
Amount Invested In National Savings Certificates	**80C**
Amount Deposited with National Housing Bank	**80C**
Deposit In Sukanya Samridhi Account	**80C**
Term Deposits with Banks	**80C**
Deduction In Respect of Contribution to Pension Fund	**80CCC**
Deduction In Respect of Interest on Loan Taken for Studies	**80E**
Deduction In Respect of Purchase of An Electric Vehicle	**80EEB**
Deduction In Respect of Donations To Certain Funds, Charitable Institutions Etc	**80G**

Sr no.	**Questions**	**Answer**

1	What is tax?	Mandatory payment to government
2	Who collects taxes?	Government authorities
3	What happens if someone fails to comply with tax laws?	They face penalties or fines
4	Which type of tax can be shifted to others?	Indirect tax
5	Which tax is typically paid directly by the taxpayer to the government?	Income tax
6	What is the main basis for imposing Income Tax ?	Income Tax
7	What is the meaning of income Tax?	Tax on earnings.
8	What type of tax system is generally used for income tax?	Progressive tax system.
9	Who is responsible for paying income tax?	individuals and corporations.
10	How is the amount of income tax determined?	Based on income brackets.
11	What is the purpose of income tax revenue?	fund government programs.
12	How often do individuals need to file tax returns for income tax?	File annual tax returns.

13	What factors are considered when calculating taxable income?	Taxable income
14	A person liable to pay tax or any other sum of money under income Tax Act is known as______________.	Assessee
15	In Income Tax Individuals, Hindu Undivided Family (HUF), companies, partnership firms, Association of Persons (AOP), Body of Individuals (BOI), local authorities, or an artificial juridical person termed as________________.	Person
16	Earnings received through employment contracts subject to taxation is known as________________.	Income from salary
17	Rental income earned by property owners taxed under ______________head of Income.	Income from house property
18	Earnings not falling under specific income categories Known as_________________.	Income from other sources
19	Financial year immediately preceding the assessment year is known as_______________.	Previous year
20	Natural person, a separate entity for tax purposes is known as_______________.	Individual
21	Joint family structure recognized under Hindu law is known as_________________.	Hindu Undivided Family

22	Two or more individuals carrying on a business and sharing profits or losses _______________.	Partnership Firm
23	Potential rental value of a property not let out but considered taxable income is known as_______________.	Deemed Rental Income
24	Tax Deducted at Source (TDS) is a mechanism used by the government to collect income tax in advance from individuals or entities making payments to others.	True
25	TDS is only applicable to salary payments and no other types of payments.	False
26	The person or entity making the payment is responsible for deducting a certain percentage of tax from the payment and retaining it with them.	False
27	Tax Collected at Source (TCS) requires specified persons to collect tax from buyers at the time of sale of specified goods or provision of specific services.	True
28	The person collecting tax at source is not required to deposit the collected tax with the government	False
29	Assessment is the process conducted by the IT department to validate the information provided by an individual in their tax return	True

30	The assessment process involves determining the tax liability or refund applicable to the taxpayer.	True
31	Recovery refers to the amount of tax refund received by the taxpayer.	False
32	Deferred tax arises due to differences between taxable income and accounting income	True