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Treatment of Gain/Loss on Foreign Exchange Fluctuations – Income Tax Perspective

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The increase in global trade and dependency on the foreign capital for the purposes of conduct of business in India has led to various transactions with the entities which are situated outside India. The business is conducted with such entities in the foreign currency unlike the Indian currency which is used for conduct of trade with entities located in India. As all are aware that since the rate of foreign currency is market driven, there may always be a difference in the value of foreign currency at which the transaction takes place and at which the transaction gets settled or closed for the purposes of accounting at the Indian entity. The difference arising from such value between the transaction date and settlement/closure date would give raises to gains or losses depending upon the rate of foreign currency on both such dates. The treatment of such foreign exchange (for brevity 'forex') gain/loss from the perspective of provisions of Income Tax Act, 1961 (for brevity 'IT Act') is the main object of this article. Let us proceed, to understand the treatment of forex gain/loss under the various provisions of IT Act.

Introduction:

The treatment of forex gain/loss under the provisions of IT Act is guided by the residuary provisions and general provisions for majority of the time. The gains were taxed under the charging section that dealt with PGBP[1] and losses were claimed under Section 37 of IT Act. However, the gains that were arising from transactions which are capital in nature, the tax payer was not ready to offer any tax stating that such gains are capital profits and not to be taxed. On a similar footing, the Revenue tried to disallow losses arising from transactions which are capital in nature, stating that capital losses are not allowed.

However, the challenge was when a loss/gain is treated as arising from capital or revenue transaction to determine its exclusion or allowability for computation of income.

Let us say, commission income earned in foreign currency retained with the agent of service provider outside India for the purposes of procurement of capital goods, when repatriated to India, since the procurement did not happen and on such repatriation, if the commission income yielded a gain, whether such a gain is to be treated as gain arising on revenue transaction (earning commission income) or on capital transaction (retained for procurement of capital goods)?

Another example would be, where profits of a foreign branch of Indian company when repatriated to India and on such repatriation, there was a loss, whether such loss amounts to capital transaction (repatriation of reserves) or revenue transaction (profits from trading activity)?

Whether the loans taken from foreign country for the purposes of procurement of capital assets, and loss on fluctuation at the time of repayment or at the time of reinstatement amounts to capital

[1] Profits and Gains from Business or Profession

transaction (since loan used for procurement of capital assets) or revenue transaction (loss arising due to fluctuation in the ordinary course of business and not dependent upon the asset)?

Questions like the above have occupied courts on various occasions and the courts have dealt them in their own way. The introduction of Section 43A, which dealt with treatment of forex loss/gains in specific instances namely in cases of imported assets has settled issues to a certain extent, leaving the scope of litigation for other forex items namely for treatment of forex loss where foreign loans have been used for procurement of non-imported assets or treatment of forex loss where foreign loans have been used for revenue transactions and others.

Further, things would appear to ease down with introduction of Section 43AA with effective from 01st April 17, which states, when read with ICDS[2] -06[3], that any forex loss/gain pertaining to monetary items has to be treated as income or loss, however, unsettles certain settled issues, which we will be dealing at appropriate place.

In this article, we try to formulate certain issues and then answer them at the end of the write-up looking the impact under different regimes namely prior and post Section 43A, prior and post to Section 43AA. In this exercise, we would not be concluding any aspect unless, we take the help of jurisprudence available.

<u>Issues:</u>

As stated above, the taxation of forex fluctuations always centred around whether the said fluctuation is a capital or revenue in nature. However, to decide, whether a fluctuation arises from a capital or revenue item is not an easy thing for the courts. The said matter was visited by courts again and again leading to formulation of certain principles. Till the introduction of Section 43A with effect from 01st April 1967, the courts were occupied with the following questions:

- Whether the forex fluctuation arising out of loans taken which were used for procurement of capital assets were capital or revenue in the nature?
- Whether the forex fluctuation arising out of loans taken which were used for purposes of revenue items were to be treated as capital or revenue in nature?

As stated earlier, let us examine certain important judgments which have tried to answer the above said questions. Since the courts would have dealt all or any of the questions in their respective judgments, we would not be examining the judgments qua above listed questions, but attempt at the end answering the above questions in light of the principles laid down by courts. Before proceeding to examine the judgments, let us understand the board legal position pre and post April 2017.

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[2] Income Computation and Disclosure Standards

[3] Effects of Foreign Exchange Rates

Position - Pre April 2017:

Treatment of Forex Gain/Loss – Instances covered under Section 43A:

Section 43A deals with a situation where any asset is acquired from a country outside India for the purposes of business and if there is an increase or reduction in liability as expressed in Indian Currency (as compared to the liability existing at the time of acquisition of the asset) at the time of making payment towards the whole or part of the cost of the asset or towards repayment of whole or part of money borrowed by him from any person directly or indirectly, in any foreign currency specifically for the purposes of acquiring the asset along with interest, if any, the amount by which the liability as aforesaid is so increased or reduced during such previous year and which is taken into account at the time of making payment, irrespective of method of accounting adopted by the assessee, shall be added to, or as the case may be deducted from the actual cost of asset and the amount arrived at after such addition or deduction shall be taken as actual cost of the asset.

Hence, the provisions of Section 43A shall be applicable only if an asset is acquired from a country outside India and at the time of payment, there is a difference in liability, instead of treating the same as income or loss, the same shall be adjusted to the actual cost of the asset and the balance shall be taken as actual cost. This is the stark contrast between Section 43A and Section 43AA. Except for instances mentioned in Section 43A, all other instances would require treatment under Section 43AA.

Treatment of Forex Gain/Loss – Other than Section 43A:

As stated in the introduction, all through this period, that is right from the inception of 1922 Act till April 17, broadly, the courts held that if forex gain/loss is on a revenue item, it would be taken for the purposes of computation and in all other case, the said forex gain/loss will not be taken into consideration for the purposes of computation, only exception being the instances mentioned in Section 43A.

Position – Post April 2017:

Treatment of Forex Gain/Loss – Instances covered under Section 43A:

No major changes post April 2017 qua this section. The position as stated under 'Position – Pre April 2017' will hold good here too.

Treatment of Forex Gain/Loss – Other than Section 43A:

Section 43AA of IT Act deals with taxation of Forex fluctuation. The said section states that subject to the provisions of Section 43A, any gain or loss arising on account of any change in foreign exchange rates shall be treated as income or loss, as the case may be, and such gain or loss shall be computed in accordance with ICDS notified under Section 145(2)[4].

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[4] ICDS were initially notified vide NN 32/15 to be effective from 1st April 15. Later, NN 32/15 was rescinded vide NN 86/16. Later, the same ICDS were notified vide NN 87/16 notifying 10 ICDS w.e.f AY 17-18. The said notifications were challenged as ultra vires the provisions of the Act, principally on ground that such ICDS were aimed at nullifying various judicial precedents of Supreme Court and High Courts and CBDT does not have such powers. The challenge was made before Delhi High Court in the matter of Chamber of Tax Consultants [2017 (11) TMI 465], where the High Court struck down the notifications stating that they are ultra vires the Act. To overcome this decision, the IT Act was amended by introducing certain sections such as 43AA, 43CB and 145A vide Finance Act, 2018 retrospectively to make them effective from 01st April 17. However, CBDT has not notified the ICDS again and the ICDS are still in force vide the NN 87/16 which was struck down. Hence, ICDS will not come into effect unless same are notified again. To such an extent ICDS lacks full force as on date.

Section 43AA is applicable for all forex transactions including those relating to monetary, non-monetary, translation of Financial Statements of Foreign Operations, Forward Exchange Contracts and Foreign Currency Translation Reserves. In other words, except for situations stated in Section 43A, for all other situations, the gain/loss arising from forex transactions is to be dealt in accordance with Section 43AA read with relevant ICDS.

Section 145(2) of IT Act has notified 10 ICDS with effective from Assessment Year (AY) 2017-18. ICDS - 06 deals with Effects of Foreign Exchange Rates. Para 1 of ICDS – 06 states that said standard deals with inter alia, treatment of transactions in foreign currencies. The treatment of foreign exchange fluctuations for monetary items and non-monetary items is different.

Para 2(k) of ICDS-06 defines 'monetary items' are money held and assets to be received or liabilities to be paid in fixed or determinable amounts of money. Cash, receivables and payables are examples of monetary items. Para 2(l) defines 'non-monetary items' assets and liabilities other than monetary items. Fixed Assets, inventories and investment in equity shares are examples of non-monetary items. Further, Para 2(g) defines 'Foreign Currency Transaction' is a transaction which is denominated in or requires settlement of foreign currency, including transactions arising when a person:

- buys or sells goods or services whose price is determined in a foreign currency or
- borrows or lends funds when amounts payable or receivable are denominated in foreign currency or
- becomes a party to an unperformed forward exchange contract or
- otherwise acquires or disposes of assets, incurs or settles liabilities, denominated in a foreign currency

Initial Recognition:

Para 3(1) states that a foreign currency transaction shall be recorded on initial recognition in the reporting currency, by applying the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of transaction.

Conversion at Last Date:

Para 4(a) states that at last day of previous year foreign currency monetary items shall be converted into reporting currency by applying the closing rate. Para 4(c) states that, for non-monetary items in a foreign currency, they shall be converted into reporting currency by using the exchange rate at the date of transaction.

Recognition of Exchange Differences:

Para 5(i) states that in respect of monetary items, exchange differences arising on the settlement thereof or on conversion thereof at last day of previous year shall be recognised as income or expense in that previous year. Para 5(ii) states that in respect of non-monetary items, exchange differences arising on conversion thereof at the last day of previous year shall not be recognised as income or expense in that previous year.

Exception to Initial Recognition, Conversion and Recognition of Exchange Differences:

Para 6 states that notwithstanding anything contained in Para 3, 4 and 5, initial recognition, conversion and recognition of exchange difference shall be subject to the provisions of Section 43A.

Hence, from the above, it is evident that except for the circumstances as described in Section 43A, the gain or loss arising from forex fluctuations on monetary items has to be treated as income or loss in terms of ICDS-06 read with Section 43AA. With this understanding, let us proceed to examine, the instances which would attract the provisions of Section 43A.

Now, with the position prior and post April 2017 in the background, we shall examine various judgments which would help out to answer the issues framed.

In the matter of Tata Locomotive and Engineering Co Limited – Supreme Court:

In the facts of this matter, the assessee is in the business of manufacture of locomotives boilers and locomotives, for the purpose of manufacturing activity had to make purchases of plant and machinery in USA. With the sanction of Exchange Control Regulator, it had remitted to its agent in USA an amount of $33,850. As selling agent for Baldwin Locomotives Works of USA for the sale of their products in India, the assessee incurred certain expenses and also earned commission of $36,123. With the permission of Exchange Control Regulator, the Assessee has requested the Baldwin to deposit the commission and reimbursement of expenses with its agent M/s Tata Inc, New York.

The letter written to Exchange Control Regulator, the assessee has stated that the said amounts will be used for purchase of capital goods and not for any other purposes. The commission income earned is however offered to tax in India in respective assessment years. The pound sterling and with it the Indian Rupee were devalued on September 1949. Thereafter, the assessee found it would be more expansive to buy American goods and also noted that the Government of India has put some sanctions on purchase of goods from USA.

The assessee then permission with Exchange Control Regulator has brought back the amounts retained with its agent into India. The said amounts when brought back have led to realisation of profits due to exchange fluctuations.

The Revenue contends that the said profits were pertaining to commission income, which was earned by assessee from Baldwin, which would be revenue in nature and accordingly the profit arising from such revenue item would be subjected to tax, since it is a profit incidental to business. The assessee however contends that since the amounts were retained outside India for the purposes of procurement of capital goods, any gain arising on forex account pertains to fixed capital and accordingly not subjected to tax.

The tribunal has not agreed with the view of the assessee and accordingly upheld the order of AO[5]. The matter travelled to SC[6], wherein the court stated that the act of retaining the monies in USA for capital purposes after obtaining the sanction of Reserve Bank was not a trading transaction in the business of manufacture of locomotive boilers and locomotives, it was clearly a transaction of accumulating dollars to pay for capital goods, the first step to the acquisition of capital goods. Hence, the surplus attributable to $36,123 was capital accretion and not profit taxable in the hands of assessee.

Take-Aways:

The SC stated that once the amounts are retained with the agent for the purposes of procurement of capital goods, the said amount would lose its character of revenue even though the amounts retained

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[5] All through the article, we refer the first authority as 'AO' – Assessing Officer, for the convenience of reader.

[6] Honourable Supreme Court

were from originally from a revenue item like commission income. The SC stated that Revenue would not had any issue, if the amounts were remitted to India and then sent back to New York for the purposes of procurement of capital goods. Since, in the case, with permission of RBI since the assesse has retained such amounts for the purposes of capital goods, the same would obtain the nature of capital even though the said capital goods were not ultimately purchased. The SC has culled out the intention of retention from the letter written by assessee to RBI and accordingly held that the gain arising due to forex fluctuation is capital in nature and no tax is to be paid. The SC further referred to the decision of European Court in the matter of Davies (H.M Inspector of Taxes) v. The Shell Company of China Limited7 and arrived at the above conclusion.

<u>In the matter of Bestobell (India) – Supreme Court:</u>

In the facts of this matter, the assessee has taken loan from parent company for the purposes of execution of works in India. The terms of the contract state that the loan has to be repaid within one year or availability of funds whichever is earlier. On the balance sheet date, the loan was outstanding and the fall in rupee made assesse to account for additional loss for the repayment of loan.

The assessee claimed that such loss is revenue in nature and should be allowed. However, the Revenue claims that such loss is arising out of capital transaction and hence capital loss. The court held that the loss arising from devaluation of rupee on outstanding loan cannot be considered as extra expenditure to be incurred for meeting the debt like postal expenses or bank charges or as extra expenditure resulting in a business loss of revenue nature. If there had been a devaluation in favour of the assessee as a result of which the assessee had to pay less to its creditors, the surplus would arising would have been of capital nature and could not have been assessed in the hands of assessee as a business profit. Conversely, as a result of the exchange rate going against the assessee, the loss which the assessee incurred cannot be held to be revenue loss.

<u>Take-Aways:</u>

Even though, this judgment is post Tata Locomotive and Engineering Co. Limited's verdict, the SC has not referred the later for arriving at the said conclusion. The SC went to state that since the loss arising was not similar to the expenditure a company would incur on postal expenses or bank charges, the said loss cannot be allowed as revenue in nature. Further, the SC went on to state that the same is also not allowed as revenue in nature since, if there was a gain, the assessee would not have offered it to tax. From the above judgment, it is clear that the SC has not undertaken the analysis as to whether the forex loss was arising out of a capital or revenue nature but simply concluded that the forex loss cannot be allowed as revenue nature despite the said loan is used for the purposes of working capital/business. Hence, to this extent, this judgment needs a re-look.

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[7] The assessee involved therein was a British Company which carried on the business of sale and distribution of petroleum products in China and it employed a number of Chinese Agents to whom such petroleum products were consigned. Each agent is required to deposit certain sums in Chinese Dollars and the company was empowered to use the deposit it liked. The deposit carried an interest at fixed rate. The Company has deposited the Chinese Dollars in Shanghai Banks. When war broke out between China and Japan, the Company has sold the Chinese Dollars for Sterling and deposited such amount with its parent company. Subsequently, when the Company closed its business through Chinese Agents, had to repay the deposit amounts and then due to depreciation of the Chinese Dollars qua Sterling, the Company gained profits due to incurring of lower amounts in Chinese Dollars for settlement of their claims. The said profit was not offered to tax and the Revenue wanted to charge tax on said amount and the Company claimed that the same was Capital Profit and not subjected to tax. The Court held that the same was not trading profit, but simply equivalent to appreciation of capital asset not forming part of the assets employed as circulating capital in trade and therefore not assessable to tax.

In the matter of Sutlej Cotton Mills Limited – Supreme Court:

In the facts of this matter, the assessee was engaged in the business of manufacture and sale of cotton fabrics. The assessee had a cotton mill in West Pakistan and such cotton mill has earned good amount of profit for the period ended 31st March 1954. Since the assesse was taxed on accrual basis, the profits of West Pakistan branch has been included in the profits of Indian Company and tax was paid accordingly after taking the benefit of double taxation relief in accordance with treaty existed therein.

When the profits were offered to tax in India, the exchange rate between Pakistan and India stood at 100 Pakistani Rupees being equal to 144 Indian Rupees. Later when Indian company has applied for repatriation of certain amounts of profits lying at West Pakistan branch, the exchange rate existed was 100 Pakistani Rupee being equal to 100 Indian Rupees and accordingly the Indian company, realised the same amount that has been applied for repatriation.

The Indian company hence claimed a loss of amount due to foreign exchange fluctuation under Section 10(1)[8] of Income Tax Act, 1922. The tax was paid at 144 Pakistan Rupees but realisation happened at 100 Pakistan Rupees. The Income Tax Officer has not allowed such deduction which has arisen due to foreign exchange fluctuation stating that such loss is due to state action and not relating to the business of assessee. The assessee has approached the High Court against such an order but could not succeed. Then the assessee has approached the SC.

The SC after placing reliance on various English Judgements has held that any devaluation of foreign exchange on account of trading asset would be trading loss and on account of capital asset would be capital loss. The SC also formulated a test in a way by asking the question whether the loss was in respect of circulating capital[9] or in respect of fixed capital. If it was pertaining to circulating capital, then it would be revenue loss which should be allowed and if it was pertaining to fixed capital, then it would be capital loss which should not be allowed as deduction.

Accordingly the SC remanded the matter to the lower authority to examine, whether the amounts which the assessee Indian company repatriated constitutes ‘circulating capital’ or ‘fixed capital’ to determine the deductibility of the loss. This judgement forms base for all the future judgments till date.

Take-Aways:

The SC has rightly held that in order to decide whether a forex gain or loss is taxable or allowable, the important question that needs to be addressed is whether the said gain or loss is arising from the fixed capital or circulating capital. The SC has referred and followed the principle laid down by European Court in The Shell Co of China Limited (supra) [which was also relied by SC in the matter of Tata Locomotive and Engineering Co Limited (supra)]. This judgment lays down an important observation to decide the fate of forex gain/loss. If the forex gain/loss is arising from a fixed capital, the same would be capital in nature and not allowed as loss or taxed. In other cases, the same is to be treated as arising from circulating capital and accordingly to be allowed as deduction or taxed.

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[8] Akin to Section 37(1) of IT Act, 1961

[9] The court further proceeded to refer to Adam Smith’s ‘Wealth of Nations’ to describe ‘fixed capital’ and ‘circulating capital’. A ‘fixed capital’ as what the owner turns to profit by keeping it in his own possession and ‘circulating capital’ means capital employed in the trading operations of the business and the dealings with it comprise trading receipts and trading disbursements, while ‘fixed capital’ means capital not so employed in the business, though it may be used for manufacturing purposes of business, but does not constitute capital employed in the trading operations of the business.

<u>In the matter of Union Carbide Limited – Supreme Court:</u>

In the facts of this matter, the assesse took a loan from Export Import Bank of Washington for making payment in United States of America (USA), the price of capital, plant and machinery purchased for new project. The loan was taken and repayable in dollars. Out of this loan, payment was made to various supplier in USA for purchase of such assets. On the balance sheet date, the value of rupee devalued and accordingly liability to pay loan has increased.

The assessee has claimed the said loss as expenditure, whereas AO has not accepted stating that the loss was on loan which was used for purchase of capital assets and hence capital in nature. The Appellate Commissioner and Tribunal followed the AO's order. The SC following the earlier decision in Sutlej Cotton Mills Limited (supra), has held that since loss was arising on account of fixed capital, the same cannot be allowed as revenue expenditure.

<u>Take-Aways:</u>

The SC held that, where profit or loss arises on account of appreciation or depreciation in the value of foreign currency held by it, on conversion into another currency, such profit or loss would ordinarily be trading profit or loss if the foreign currency is held on revenue account or as a trading asset or part of circulating capital embarked in the business. But, if on the other hand, the foreign currency is held as capital asset or as fixed capital, such profit or loss would be of capital nature. The SC has followed the ratio laid down in its earlier decision of Sutlej Cotton Mills Limited and stated that since the loan is taken for purchase of assets, the same is not to be allowed as revenue expenditure. The issue in the current case pertains to Assessment Year 1967-68 and the Section 43A being inserted with effect from 01.04.1967, it appears the SC has used only Section 43A for the purposes of interpretation of another issue involved in the same matter dealing with development rebate.

<u>In the matter of Bharath General Textile Industries Limited – Calcutta High Court:</u>

In the facts of the matter, the assessee has borrowed a certain amount of Japanese Yen for setting up a capital asset. The said loan was repayable in instalments in Japanese Yen. In order to repay the instalments of price of machinery purchased on deferred payment basis, the assessee has to pay and additional amount due to day to day fluctuation in the exchange rate. The assessee has claimed the said loss, which was negatived by AO but allowed by Tribunal. The assessee conceded that the loss on account of devaluation is covered by Section 43A and since in the instant case, the loss was due to fluctuation and not devaluation and accordingly such loss has to be allowed as revenue expenditure.

Further, the assessee has purchased a capital asset and the purchase price was converted into loan which was repayable in instalments. Thus the expenditure was on capital account and cannot be deductible. Followed the SC decision in Sutlej Cotton Mills Limited (supra).

<u>Take-Aways:</u>

The Calcutta HC stated that there is no qualitative difference in additional expenditure incurred due to the fluctuation or devaluation in the exchange. But whether the expenditure involving this additional liability will be allowable or not in computing the profit will depend on whether the expenditure is on capital or revenue account. It is the nature and character that would determine the question. The HC following the decision of SC in the matter of Sutlej Cotton Mills Limited (supra) has rejected the allowability of expenditure. A Special Leave Petition was filed before SC was dismissed.

In the matter of Periyar Chemicals Limited – Kerala High Court:

In the facts of the matter, the assessee was a public limited company carrying on the business of manufacture and sale of chemicals. The company imported machinery from Germany and for that purpose, it had availed of a foreign currency loan of Deutsche Marks 7,36,855 from a German company through the ICICI Bank.

The loan was to be repaid in German currency in instalments spread over a number of years. At the time when the loan was taken, the exchange rate was Rs. 2,258 for one Deutsche Mark. During the accounting year ending on June 30, 1975, the assessee had paid an instalment of 1,13,700 Deutsche Marks. On the date of payment due to forex fluctuation, the assessee has to incur additional amount to repay the instalment. Such additional amount was claimed as revenue deduction for which the AO has not accepted and Tribunal has upheld the AO's order. The matter when reached the HC, the court held that such an expenditure pertains to the capital asset and accordingly disallowed the expenditure.

Take-Aways:

The Kerala HC following the decisions of Supreme Court in Tata Locomotive and Engineering Co Limited, Sutlej Cotton Mills Limited and Union Carbide India has not allowed the said expenditure as revenue.

In the matter of Calcutta Electric Supply Corporation Limited – Calcutta High Court:

The assessee, a foreign company, claimed the following deductions - the extra amount remitted for purpose of distribution of dividend on account of devaluation of the Indian rupee, additional expenses incurred due to devaluation in redeeming its sterling debentures.

The AO has disallowed the expenditure stating that such an expenditure was not stated in Section 36 and since this was not an expenditure incurred wholly for the purposes of business, the assesse cannot claim the forex loss on dividends under Section 37. The Court held that once dividend was declared, the assessee as a company was bound to pay the same to the shareholders and a liability arose which had to be met by the assessee. The extra amount which had to be paid on account of devaluation of the Indian rupee was laid out for purposes of business and was deductible as such.

The Court held that it had been found that the money borrowed on debentures had been utilised for financing a capital expenditure programme. The extra amount paid on account of devaluation of the Indian rupee in redeeming its debentures was capital expenditure. It was not deductible. Followed the Bestobell (India) Limited judgment.

Take-Aways:

This is one of the matters where the court has an occasion to examine the allowability of forex loss as deduction arising on a revenue item. The Court stated that once the dividends are declared, the company is under statutory obligation to pay the same and accordingly forex loss on such dividends is allowable expenditure. Whereas, the forex loss arising on money borrowed on debentures which has been utilised for purpose of capital expenditure programme was disallowed stating that the same was capital in nature by following the Bestobell (India) judgment (supra).

In the matter of Tata Iron & Steel Co Limited – Supreme Court:

In the facts of the matter, the assessee-company has reduced the forex gain while repaying the instalments of the foreign loan, from the actual cost of the asset and claimed deprecation on the balance. Further, in the same year, the assessee-company has increased the actual cost by adding the forex loss on capital account and claimed depreciation on the same.

This was pertaining to Assessment Year 1960-61, at time where the provisions of Section 43A were not on the statute book. The HC has allowed the claim of the assessee-company by following its own decision in the matter of Tata Hydro-Electric Power Supply Co Limited[10]. The revenue went on appeal before SC stating that the HC has relied on the judgment which deals with Section 43A and in the instant case, for the assessment years in question, the provisions of Section 43A does not apply and accordingly reliance by HC was unwarranted. The SC interestingly accepted the contention of the Revenue but continued to hold that the conclusion of HC was not erroneous.

Take-Aways:

The SC has stated that what is actual cost must depend upon the amount paid by the assessee to acquire the asset. The amount may have been borrowed by the assessee, but even if the assessee did not repay the loan it will not alter the cost of the asset. What has to be borne in mind is that the cost of asset and the cost of raising money for purchase of the asset are two different and independent transactions. The SC held that mode of repayment of loan has nothing to do with the actual cost of asset. It further stated that raising of loan for the purposes of purchase of asset is different from the purchase of asset and both of them are two different transactions. By stating so, the SC has stated that for all the matters which are not coming after the introduction of Section 43A, the actual cost cannot be altered based on a subsequent event, that is forex fluctuation. This was an interesting view which did not surface till that point of time.

In the matter of Woodward Governor India Private Limited – Supreme Court:

The SC had another occasion to deal with the issue whether the loss arising out of foreign exchange fluctuations in terms of revenue items can be allowed under Section 37(1) for the purposes of income tax at each balance sheet date despite of the fact that the payment for such item has not arisen. Further, the loss arising out of foreign exchange fluctuations on balance sheet date in terms of capital items can be adjusted to the actual cost in terms of Section 43A despite of the fact that the same was not paid during the year.

The SC has stated that for the purposes of Section 37, the word 'expenditure' includes 'loss' and the assessee can be allowed deduction of loss which was arising out of adoption of AS-11 for the revenue items and there is no necessity that the loss has to be allowed on actual incurred basis. As far as the capital assets are concerned, the SC has allowed the loss to be adjusted to the actual cost despite

[10] In this matter, the Bombay HC was dealing with depreciation allowance qua forex loss arising on loans which were used for purchase of capital assets. The forex fluctuations were added to the actual cost and depreciation was claimed in accordance with Section 43A. The Revenue argued that the provisions of Section 43A are applicable prospectively and in the instant case, since the capital assets were purchased prior to introduction of Section 43A, the provisions of said section cannot be applied to assets which were purchased prior to introduction of such section. The Bombay HC stated that there is no doubt to state that the provisions of Section 43A are applicable prospectively, however, there is nothing in the text of Section 43A, which stated that the said provisions will be applicable only for assets which are acquired post introduction of Section 43A. Hence, the forex loss which arose after introduction of Section 43A qua assets which are purchased prior to Section 43A are allowed to be added to actual cost and accordingly depreciation on such increased actual cost should be allowed.

there being no payment during the year. The SC has held that the amendment to Section 43A which allows changes to actual cost based on payment is prospective and does not apply to the period under consideration.

Take-Aways:

The SC has held that forex loss on revenue items can be claimed as expenditure under Section 37 in the year which such loss was accrued and need not wait till the date of actual payment. The forex loss on revenue items can be claimed on accrual basis. Further, the SC has also cleared that the amendment to Section 43A which allows changes to actual cost based on the actual payment is prospective.

In the matter of Cooper Corporation (P) Limited – Pune ITAT[11]

The facts in the matter of this case, is that a foreign currency loan was availed by the assessee and utilised the same for acquisition of assets and expansion of project. On the year end, the outstanding foreign currency loan is required to be translated into Indian Rupees by applying the foreign exchange rate as on closing day of reporting period and the net exchange difference resulting in translation is required to be recognized as income or expense for the respective financial period as per the Accounting Standard -11 issued by ICAI.

The assessee has initially availed loans from Indian Banks and the said loans are converted to foreign currency loans in order to take benefit of lower rate of interest on such foreign currency loans vis-à-vis loans in Indian currency, leaving an exposure to changes in foreign exchange. Because of stronger US Dollar, the assessee at year end has incurred a loss on such foreign currency loan. The said loss was claimed as deduction under Section 37(1) of the Act. The AO has rejected the plea of the assessee on various grounds, one of them being that such loss is on account of loans used for purposes of acquisition of capital assets and accordingly the loss is capital in nature and the same cannot be allowed under the provisions of Section 37(1) of the Act.

The ITAT has held that in absence of applicability of Section 43A and in absence of any provisions of the Income Tax Act dealing with issue, claim of exchange fluctuation loss in revenue account in accordance with generally accepted accounting standards notified by ICAI, conversion of foreign currency loans which led to loans, were dictated by revenue considerations towards saving interest costs etc., the loss can be allowed under Section 37(1) of the Act.

Take-Aways:

The ITAT has held that such loans were initially taken in Indian currency and later converted them to the foreign currency in order to save interest and on assumption that there will be no loss arising on foreign exchange fluctuation. The ITAT has also stated that there was no dispute the fact that the acquisition of capital assets/expansion of projects etc from the term loans taken are completed and the assets so acquired have been put to use. As a consequence, the loss occasioned from foreign currency loans so converted is post facto subsequent to capital assets having been put to use. The ITAT also has examined the provisions of Section 43A and stated that the same would not be applicable to the facts of the instant case for the reason that the assets are procured within India, whereas Section 43A shall be applicable in case of asset purchase outside India. Then the ITAT has proceeded to examine

[11] Income Tax Appellate Tribunal

the issue, whether the loss is on revenue or capital account has to be tested in light of generally accepted accounting principles, pronouncements and guidelines etc.

The ITAT has proceeded thereafter to examine the provisions of Section 43(1) of IT Act which deals with 'actual cost'. The ITAT has stated that despite there are number of explanations dealing with 'actual cost' in various circumstances, there is no explanation which deals with any gain or loss on foreign currency loan acquired for purchase of indigenous assets will have to be added or reduced to the cost of assets. ***Accordingly, ITAT has stated that nothing can be added or reduced to actual cost of assets except a situation which is envisaged in Section 43A because of its non-obstinate clause. Thereafter, the ITAT has referred to the decision of Honourable Supreme Court in the matter of Tata Iron & Steel Company Limited (supra) and stated that the activity of loan repayment and actual cost of asset are two different things and cannot be read one into another****. Then, the ITAT proceeded to examine the provisions of Section 36(1)(iii) and stated that the utilisation of loan for capital account or revenue account purpose has nothing to do with allowability of interest expenditure. The only restriction to Section 36(1)(iii) is that interest till the date of asset being put to use is not allowed as revenue deduction. In other words, the ITAT has held that interest is allowed as revenue expenditure after the asset is being put to use even though the interest expenditure is pertaining to capital account. The ITAT then stated that impugned fluctuation loss therefore has a direct nexus to the saving in interest costs without bringing new capital asset into existence. Since the business exigencies are implicit as well as explicit in the action of the assessee and the argument that the act of conversion has served a hedging mechanism against revenue receipts from exports also portrays commercial expediency, the interest can be held to be related to revenue account and accordingly eligible for deduction under Section 37(1).*

<u>In the matter of TVS Motor Company Limited – Chennai ITAT</u>

In the facts of this matter, the assessee has taken external commercial borrowing (ECB). The actual loss on exchange difference in repayment of ECB which was used toward non-imported assets was claimed as revenue expenditure. The Revenue has disallowed such expenditure and allowed depreciation on the extent of loss instead of completely allowing the loss.

The assessee claimed before the Tribunal that the actual loss on exchange difference in repayment of ECB should be allowed as revenue expenditure on the ground that provisions of Section 43A shall not be applicable and placed reliance on judgement of Cooper Corporation (supra). However, AO invoked the provisions of the Section 43A and accordingly allowed depreciation. The ITAT placing reliance on Cooper Corporation (supra) has allowed the actual loss as revenue expenditure.

<u>Take-Aways:</u>

The ITAT has relied upon the judgment of ITAT Pune in Cooper Corporation (supra)[12] and passed order in favour of assessee. The ITAT has not made any specific observations as to the actions of AO invoking provisions of Section 43A.

[12] The same judgment was followed by Pune ITAT in the matter of Neuman & Esser Compressor Application Centre Private Limited [2019 (6) TMI 1434 – ITAT Pune], Sri Ramadas Paper Boards (P) Limited [2019 (8) TMI 613- ITAT Hyderabad] and Hueco Electronics (I) Pvt Limited [2020 (2) TMI 419 – ITAT Pune]

<u>In the matter of Country Club Hospitality & Holidays Limited – Hyderabad ITAT:</u>

In the facts of the matter, the assessee company has raised term funds from international market by issuing Foreign Currency Convertible Bonds (FCCB), which is having the convertible option to equity shares or repayment of bonds after 5 years. The assessee has incurred forex loss of Rs 21.92 Crores on FCCB and the assessee has re-instated the bonds at currency rates prevailing at year end and the difference is transferred to 'Foreign Currency Monitory Translation Difference Account' to be written off over a period of 3 years accordingly for the relevant assessment year under consideration, the assessee has written off 1/3rd of such loss to profit & loss account.

The AO in light of CBDT Circular stated that where the financial instruments are valued at market price so as to report the actual value on the reporting date which is required from the point of view of transparent accounting practices for the benefits to the shareholders of the company, but is notional loss as the asset continues to be owned by the company and accordingly held that was a notional loss and cannot be allowed. The ITAT by placing reliance on judgement of Supreme Court in the matter of Woodward Governor India Private Limited (supra) has held that such loss is not a notional loss and accordingly can be allowed.

The AO has disallowed the loss on the other ground stating that loss on FCCBs is capital loss and not a revenue loss. The ITAT following the decision of M/s Crane Software India Limited has held that the expenses relating to FCCBs till they get converted into equity are to be considered as revenue and accordingly allowed the loss.

<u>Take-Aways:</u>

The ITAT has followed the decision of Woodward Governor India Private Limited (supra) and held that loss on balance sheet is not a notional loss and can be claimed.

<u>Responses to Issues:</u>

Geared up with above rationale from various judgements, now let us proceed to examine each issue and try to address them under different regimes namely, pre and post Section 43A and pre and post Section 43AA.

Whether the forex fluctuation arising out of loans taken which were used for procurement of capital assets were capital or revenue in the nature?

Regime	Treatment
Pre-Section 43A	• The Supreme Court in the matter of Tata Locomotives & Engineering Co Limited (supra) has held that once it is identified that the purpose of retention of forex was for the procurement of capital goods, any forex fluctuation thereof shall be on capital account. • The Supreme Court in the matter of Sutlej Cotton Mills Limited (supra) has held that the taxability of forex fluctuations is completely dependent upon, whether such fluctuations arise on account of fixed capital or circulating capital. If the same is on account of fixed capital, the loss cannot be allowed and gain cannot be charged. However, if the same is on account of circulating capital, then the loss can be allowed and gain shall be charged.

	• The Supreme Court in Union Carbide Limited (supra) has held that loan which was taken for the procurement of assets would be capital in nature by following the decision of Sutlej Cotton Mills Limited (supra). • Hence, from the above, it is evident that the position pre-Section 43A would be, that if the forex loss (because of re-instatement or actual loss) is arising on loans used for procurement of capital assets, then such loss would be treated as capital loss and accordingly not allowed. If the loans would have resulted in forex gain (because of re-instatement or actual gain), the same would be not subjected to tax.
Post – Section 43A	• If the loan falls under the ambit of Section 43A, then the loss or gain shall be adjusted to the actual cost of the asset and on the revised value, the assessee can claim depreciation. This is better when compared to previous position, since in the previous case that is prior to Section 43A, the loss is not even considered for depreciation.
Pre – Section 43AA	• If the loan does not falls under the ambit of Section 43A, then the loan has to be dealt in accordance with the general provisions of the Income Tax Act. • If one adopts the rationale of Honourable Supreme Court in Sutlej Cotton Mills Limited (supra) and other decisions which followed it, since the forex fluctuation is as a result of loan which has been used for procurement of capital asset, then such forex fluctuation would assume the character of capital. • Once the same is to be treated as capital, the loss cannot be claimed as expenditure under Section 37 since the said section does not allow claiming of expenditure which is capital in nature. • A question may arise that, whether loss if at all can be claimed under Section 37, since the said section deals with expenditure but not loss. However, the Supreme Court in the matter of Woodward Governor India Private Limited (supra) has held that the phrase 'expenditure' which was used in Section 37 covers 'loss' also. Hence, the forex loss cannot be claimed under Section 37. • Since the same cannot be claimed as loss under Section 37, a question may arise, whether the said loss can be adjusted to actual cost, in order to arrive at revised actual cost and accordingly claim depreciation on the same, in similar terms as done for Section 43A. • This cannot be done because, there is no section which permits the same. In certain cases, AO has resorted to such an action, but the same is doubtful in absence of any specific provision to support such an action. • However, if one adopts the decision of Supreme Court in the matter of Tata Iron and Steel Co Limited, the loss/gain can be adjusted against actual cost and depreciation can be claimed on the revised actual cost. The Supreme Court in the subject matter held that repayment of loan has nothing to do with actual cost of asset. It stated that raising of loan for the purpose of purchase of asset is different from the purchase of asset and both of them are two different transactions and one cannot influence the other. But it appears that while coming to the above conclusion, the Supreme Court has not referred to any of the previous judgments of its own and proceeded to lay down a new law. Hence, this judgment has to be taken with such caution.

	• Further, by adopting and following the above judgment, the Pune ITAT in the matter of Cooper Corporation (P) Limited (supra) has held that in absence of any provisions of IT Act to deal with treatment of loss arising from loans which are used for procurement of assets and Section 43A being not applicable, the forex loss should be taken under revenue account by adopting the accounting standards issued by ICAI. • However, in Cooper Corporation (P) Limited (supra), the ITAT has also observed that the loss was arising on loans which were used for procurement of capital assets/expansion of project and such assets were put to use. In other words, the forex loans on loss was arising on re-instatement of loans which were used for procurement of assets and such forex loss was pertaining to the period where post such assets were put to use. • Whether this particular fact made the ITAT to lean in favour of allowing the forex loss as revenue loss is not clear from the text of the judgement. However, the judgment makes reference to Section 36(1)(iii) and states that the utilisation of loan for capital or revenue account purpose has nothing to do with the allowability under Section 36(1)(iii) and only restriction vide proviso to said section is that, the interest cannot be claimed as deduction till the period such asset was put to use and once the asset is put to use, the interest is allowed as deduction despite the fact that such interest pertains to the funds used for purpose of acquisition of capital assets. • The fact is that following Cooper Corporation (P) Limited, there are many judgments which has held that such forex loss can be claimed as revenue loss under Section 37.
Post – Section 43AA	• After introduction of Section 43AA, if the loss is pertaining to a monetary item, the same shall be allowed as deduction in computation of profits and gains. • Since the foreign currency loan is a monetary item in terms of definition laid out in ICDS-06, the loss arising from such foreign currency loan shall be allowed as deduction irrespective of the fact that the same is used for procurement of capital assets. In a way, the treatment under Section 43AA nullifies the decision of Supreme Court in the matter of Sutlej Cotton Mills Limited (supra) and upholds the decision of Supreme Court in the matter of Tata Iron & Steel Co Limited and Pune ITAT's decision in the matter of Cooper Corporation (P) Limited. • However, the story goes good as long as the forex fluctuation is loss. If the forex fluctuation ends up in gain and if the assese is asked to pay tax in terms of ICDS-06 read with Section 43AA, then the assessee may turn on to place reliance right from Supreme Court judgments from Tata Locomotive and Engineering Co Limited, Sutlej Cotton Mills Limited and various others and claim that such profits are not taxable. • The assessee can take aid of the preamble of ICDS-06 which states that in case of conflict between provisions of IT Act and ICDS, the provisions of the IT Act shall prevail. Accordingly, since capital items are not subject matter of tax, the assessee can very well claim that to such an extent the provisions of ICDS will not be applicable and accordingly such forex gains may not be brought to tax. However, this has to be tested in the days yet to come.

Whether the forex fluctuation arising out of loans taken which were used for purposes of revenue items were to be treated as capital or revenue in nature?

<table>
<tr><th>Regime</th><th>Treatment</th></tr>
<tr><td>Pre-Section 43A</td><td>The Supreme Court in the matter Bestobell (India) (supra) has examined the subject issue. In the said matter, a loan was taken for the purposes of execution of certain works in India by a subsidiary company from the parent company. The loss arising on forex fluctuations was not allowed as deduction stating that the forex loss cannot be considered as extra expenditure for meeting the debt like postal expenses or bank charges or as extra expenditure resulting in business loss of revenue nature.
Basis above rationale, the Supreme Court held that forex loss on loans which were used for purposes of execution of works (which leads to revenue profits) as capital loss. Well, this judgement is prior to the judgment of Supreme Court in the matter of Sutlej Cotton Mills Limited, where the principle of fixed capital and circulating capital was discussed. Hence, the judgment in Bestobell (India) has to be taken with such caution.</td></tr>
<tr><td>Post – Section 43A</td><td>Since the loan is used for the purposes of revenue items, the provisions of Section 43A would not have any role to play and accordingly there would not be any impact on such forex fluctuation arising of such loans even after introduction of Section 43A.</td></tr>
<tr><td>Pre – Section 43AA</td><td>In continuation to the position under ‘Pre-Section 43A’, the assessee can very well now make arguments that based on the judgement of Supreme Court in the matter of Sutlej Cotton Mills Limited (supra) and argue that since the forex loss is arising out of loan which is used for working capital or revenue items, the same would be on account of circulating capital and accordingly should be allowed as loss. Further, reliance can be placed on the judgement of Calcutta Hight Court in the matter of Calcutta Electric Supply Corporation Limited (supra), where in the forex loss arising on payment of dividends is held to be on revenue account and thereby allowed the same as deduction. The assesse can also place reliance
The assessee can also take a plea that when the forex loss arising on loans used for procurement of capital assets was itself allowed as revenue expenditure under Section 37 in the matter of Cooper Corporation (P) Limited (supra), TVS Motor Company Limited (supra) and various other judgements that followed Cooper Corporation (P) Limited, the forex loss arising on revenue items has to be definitely allowed.
One another challenge that the assessee would face is that the forex loss if it is on account of re-instatement at the year end, then the AO may deny the loss stating that the same is notional loss and not on actual account. Since, Section 37 allows actual loss and not notional loss, the deduction may be disallowed under Section 37 despite of the fact, that AO has accepted such loss to be revenue loss in the first place.
However, the assesse can rely on the judgment of Honourable Supreme Court in the matter of Woodward Governor India Private Limited, wherein it was stated that loss which was recognised as a consequence of Accounting Standard -11 is not a notional or contingent loss and should be allowed as deduction under Section 37.</td></tr>
</table>

Post – Section 43AA	• There would not be any issue post introduction under Section 43AA because the said section states that forex fluctuations arising from monetary items has to be taken for the purposes of computation of income. The above treatment would put rest to certain judicial precedents like Bestobell (India) Limited and others which followed them.