EXCHANGE FLUCTUATION GAIN / LOSS – TAX PRESPECTIVE

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Introduction

Prior to the revision of Accounting Standard ('AS') – 11 in 2003, the following exchange differences were required to be capitalized to carrying value of fixed assets:-

- Liability towards whole or part of the cost of fixed asset; and
- Liability for repayment of the whole or part of the monies borrowed from any person, directly or indirectly, in foreign currency specifically for the purpose of acquiring fixed assets.

This was in line with erstwhile Schedule VI requirement which was omitted w.e.f. 31 March 2009. The treatment to be meted out to foreign currency items as per the amended AS – 11 of ICAI, notified by Central Government u/s 211(3C) of Companies Act is does not make any distinction between items of capital nature and revenue nature. Both are required to be recognized in the Profit & Loss Account. In view of the aforesaid amendment, there exists a divergence of views on the treatment to be meted out in the books of accounts and the Indian Tax Laws. Further, with an increased flow of inbound / outbound transactions and their complex dynamic structuring, the tax treatment of foreign exchange gains / losses has been surrounded by huge litigation and various Courts have discussed the same in great detail.

Exchange Fluctuation Difference – Tax Treatment

The captioned issue was discussed in great detail in the recent landmark ruling of Supreme Court in the case of **CIT vs Woodward Governor India P. Ltd (312 ITR 254)** where in the SC relied on the earlier judgment in the case of **Sutlej Cotton Mills Ltd vs. CIT (116 ITR 1)** which observed as follows :-

"The law may, therefore, now be taken to be well settled that where profit or loss arises to an assessee 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 a trading profit or loss if the foreign currency is held by the assessee on revenue account or as a trading asset or as part of circulating capital embarked in the business. But, if on the other hand, the foreign

currency is held as a capital asset or as fixed capital, such profit or loss would be of capital nature."

Further in the aforesaid ruling the Apex Court also affirmed the principles laid down in the ruling of **CIT vs. V.S.Dempo & Co Pvt. Ltd (206 ITR 291)** which are as below:

- A loss arising in the process of conversion of foreign currency which is part of trading asset of the assessee is a trading loss as any other loss.
- In determining the true nature and character of the loss, the cause which occasions the loss is immaterial; what is material is whether the loss has occurred in the course of carrying on the business or is incidental to it.
- If there is loss in a trading asset, it would be a trading loss, whatever be its cause because it would be a loss in the course of carrying on the business.
- Loss in respect of circulating capital is revenue loss whereas loss in respect of fixed capital is not.
- Loss resulting from depreciation of the foreign currency which is utilised or intended to be utilised in business and is part of the circulating capital, would be a trading loss, but depreciation of fixed capital on account of alteration in exchange rate would be capital loss.
- For determining whether devaluation loss is revenue loss or capital loss what is relevant is the utilisation of the amount at the time of devaluation and not the object for which the loan had been obtained. Even if the foreign currency was intended or had originally been utilised for acquisition of fixed asset, if at the time of devaluation it had changed its character and had assumed the new character of stock-in-trade or circulating capital, the loss that occurred on account of devaluation shall be a revenue loss and not a capital loss.
- The way in which the entries are made by an assessee in the books of account is not determinative of the question whether the assessee has earned any profit or suffered any loss. What is necessary to be considered is the true nature of the transaction and whether in fact it has resulted in profit or loss to the assessee.

The argument generally raised by the revenue authorities to deny deduction of exchange fluctuation loss was that if the loss is recognized on MTM basis w.r.t year end rates, it is notional or contingent in nature. Losses are allowable only on actual crystallization on payment/receipt. The aforesaid issue has now been settled by the SC which has held that the MTM loss recognized on the basis of recognized accounting standards is a real loss. As a corollary, gain

on revenue account recognized in books on MTM basis will also be taxable. The propositions laid down by the SC in CIT vs Woodward Governor India P. Ltd (supra) can be summarized as follows :-

- MTM loss is allowable in the year of recognition by debit to P&L A/c in terms of the mercantile method of accounting followed as per the mandatory Accounting Standards
- Though provisions of Section 37 refer to 'expenditure', the 'expenditure' may, in some cases, cover an amount which is really a 'loss', even though the said amount has not gone out from the taxpayer's pocket.
- Accounts regularly maintained by a taxpayer in the course of business are to be taken as correct unless there are strong and sufficient reasons to indicate that they are unreliable. Emphasis placed on requirement of adopting ordinary principles of commercial accounting, unless such principles stand superseded or modified by legislative enactments.
- Unless legislatively intervened or found by the Tax Authority to be not reflective of true and correct profits for valid reasons, the method of accounting consistently followed by a taxpayer is 'supreme'. Disallowance not permissible unless accounting system followed by taxpayer found to be incorrect.
- Judicial recognition accorded to AS-11.

The SC keeping in view the above principles laid out by their predecessors made the following conclusion, which may now be regarded as tests for determining the tax allowance of such items :-

"In conclusion, we may state that in order to find out if an expenditure is deductible the following have to be taken into account (i) whether the system of accounting followed by the assessee is mercantile system, which brings into debit the expenditure amount for which a legal liability has been incurred before it is actually disbursed and brings into credit what is due, immediately it becomes due and before it is actually received; (ii) whether the same system is followed by the assessee from the very beginning and if there was a change in the system, whether the change was bona fide; (iii) whether the assessee has given the same treatment to losses claimed to have accrued and to the gains that may accrue to it; (iv) whether the assessee has been consistent and definite in making entries in the account books in respect of losses and gains; (v) whether the method adopted by the assessee for making entries in the books both in respect of losses and gains is as per nationally accepted accounting standards; (vi) whether the system adopted by the assessee is fair and reasonable or is adopted only with a view to reducing the incidence of taxation."

Exchange fluctuation on capital account

Section 43A was introduced by Finance Act, 1967 in the backdrop of devaluation of INR vis-à-vis US $ and UK £. The same was introduced as a measure of relief to the tax payers by permitting them to capitalize exchange fluctuation loss in specific situations. It applies only when all the following conditions are fulfilled viz.

- exchange fluctuation difference is in respect of liability towards cost of capital asset or in respect of borrowing (including interest) in foreign currency specifically for the purpose of acquiring such capital asset;
- exchange fluctuation difference takes place after the acquisition of capital asset;
- the capital asset is acquired from outside India; and
- the capital asset is acquired for the purposes of business or profession of the assessee.

Prior to the amendment to Section 43A, there was controversy whether trigger point for adjustment u/s. 43A was on accrual basis or on payment basis. The same was settled in the Woodward Governor ruling by holding that adjustment was to be made on accrual basis. Post the amendment w.e.f. 1 April 2003, Section 43A has been amended to statutorily provide that adjustment will be made on payment basis. The amended Section 43A reads as follows:

" Notwithstanding anything contained in any other provision of this Act, where an assessee has acquired any asset in any previous year from a country outside India for the purposes of his business or profession and, in consequence of a change in the rate of exchange during any previous year after the acquisition of such asset, there is an increase or reduction in the liability of the assessee 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–

(a) towards the whole or a part of the cost of the asset; or

(b) towards repayment of the whole or a part of the moneys borrowed by him from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the asset <u>along with interest, if any,</u>

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 the payment, irrespective of the method of accounting adopted by the assessee, shall be added to, or, as the case may be, deducted from–

(i) the actual cost of the asset as defined in clause (1) of section 43; or……….

and the amount arrived at after such addition or deduction shall be taken to be the actual cost of the asset …..…"

With regard to the 'interest' in addition to repayment of loan, it is possible to adopt two views for the same. The first possible view could be that all the variations in interest liability due to exchange fluctuation are required to be adjusted in the actual cost of the capital asset. As per this view, variation in interest liability, including interest accruing after the date of acquisition of asset and upto the date the liability is fully discharged is required to be adjusted under section 43A. The alternative view could be that no part of exchange fluctuation in interest amount pertaining to the period after the acquisition of capital asset is required to be adjusted in the 'actual cost' of the capital asset. Exchange fluctuation in respect of interest liability existing at the time of acquisition of the asset alone is required to be adjusted to the cost of the asset. Accordingly, litigation cannot be ruled out on the same.

Section 43A applies only to assets acquired from outside India. Accordingly, no adjustment is possible for exchange fluctuation loss on foreign currency loan used for acquiring assets locally. In this context, the SC in **CIT vs. Woodward Governor India (P) Ltd (supra)** has upheld the static concept of 'actual cost' which is as below:

"Till the insertion of the unamended Section 43A there was no provision in the Income-tax Act for adjustment of the actual cost which was fixed once and for all, at the time of acquisition of the asset. Accordingly, no adjustment could be made in the actual cost of the assets for purposes of grant of depreciation for any increase/decrease of liability subsequently arising due to exchange fluctuation. Consequently, Section 43A was introduced in the Act by Finance Act, 1967 w.e.f. 1.4.1967 in the above terms to provide for adjustment in the actual cost of assets pursuant to change in the foreign currency exchange rates. As a consequence of the insertion of the said section, it became possible to adjust the increase/decrease in liability relating to acquisition of capital assets on account of exchange rate fluctuation, in the actual cost of the assets acquired in foreign currency and for, inter alia, depreciation to be allowed with reference to such increased/decreased cost. This position is also made clear by Circular No. 5-P dated 9.10.1967 issued by CBDT."

It is pertinent to note that AS-10, AS-26 and AS-11 do not permit such adjustment. However, it could be argued that the cost of an asset and cost of raising money for purchase of the asset are two different and independent transactions and the manner of repayment of loan should not affect the cost of the assets acquired by the assessee. For example, if the borrower defaults in repayment of a part of the loan, cost of the asset will not change. The plausible contentions in support of revenue loss could be as follows:

- Business income should, ordinarily, be computed in a manner a man in business understands it to be, unless specifically provided otherwise in the Act. P&L A/c prepared in terms of Companies Act should be given cognizance unless specific statutory provisions override.

- Section 211(3C) of Companies Act read with AS-11 (revised 2003) of Companies Act mandates a company to account for exchange fluctuation gain or loss in its profit and loss account regardless of the nature of underlying asset or liability – whether capital or revenue.
- A loan represents a liability; it cannot result in any asset or advantage of enduring nature. The Court also seems to have concluded that any expenditure connected with a loan can never bear character of a capital expenditure.
- Exchange fluctuation loss on foreign currency loan is intricately connected with a loan liability; in fact, it is in the nature of interest or borrowing cost for a borrower. Further, Section 36(1)(iii) provides deduction in respect of interest expenditure incurred in connection with the business of the assessee, even assuming that the amount is spent for acquisition of a capital asset.

Although the possible view that could be taken by the department against the revenue loss deductibility is that the loss is of capital nature on general principles and not in view of the contemporaneous accounting practice. An item does not shed its character as a capital item merely because an accounting standard requires it to be part of profit and loss account. Further, in view of Court decisions rendered in context of general law, it is difficult to suggest that the amount should be admitted as business loss under section 28 and/or 29 of the Act.

Foreign currency derivatives – Tax issues

Exchange fluctuation loss arising on forex derivatives is admissible as deduction if the underlying items covered by such derivative contract are of revenue nature. For example trade receivables, payables, interest and more. Conversely, if the underlying items are of capital nature, the exchange fluctuation loss on forex derivatives would also be capital in nature. Where such exchange fluctuation loss of revenue nature is recognized on marked-to-market (MTM) valuation as at year end, prior to the date of settlement thereof, is not contingent or notional loss. It is a real loss and is admissible for tax purposes as ruled in CIT vs. Woodward Governor India (P) Ltd (supra). Correspondingly, gain from exchange fluctuation ascertained on MTM basis would be chargeable as income of the year.

Explanation 3 of S.43A provides adjustment of exchange fluctuation on capital account in case of assets acquired from outside India with reference to forward rate if taxpayer enters into a forward contract to meet the liability towards cost of asset or borrowing in foreign currency to meet the cost of the imported asset.

Further, the provisions of relevance are s.43(5) which defines 'speculative transaction' for the purposes of the Act and Explanation 2 to s.28 which creates a fiction of speculative transactions being a separate business. Whether the transaction is speculative or not from tax perspective is crucial in view of the bar on setting off losses in such transaction with profit from other business income. In terms of s.73, speculative losses can be set off only against speculative profits and unabsorbed losses can be carried forward for a period of four years only. This results in higher tax incidence for a tax payer who needs to pay tax despite being saddled with losses

Section 43(5) states that "*"speculative transaction" means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips"*

The essential conditions of this section can be paraphrased as follows:

- The transaction should be a contract for purchase or sale.
- The subject matter of purchase or sale should be commodity, stocks or shares.
- The contract should be periodically or ultimately settled otherwise than by actual delivery or transfer of the commodity or scrips.

A plain reading of the same would seem to state that if a transaction is not settled by actual delivery, it will be deemed to be a speculative transaction for tax purposes even if there was no speculative intent. On the other hand, where actual delivery takes place, the transaction would not amount to a speculative transaction, however highly speculative in its nature it may be.

Further, in this connection, the impact of the recent **CBDT Instruction No. 3 of 2010 dated 23 March 2010** should also be considered which states that:

- MTM losses are notional and contingent – despite admitting that MTM restatement is a transparent accounting practice.
- Actual losses allowable as non-speculative only if the transactions qualify as 'eligible derivative transactions' under clause (d) of Proviso to s.43(5).
- Assessing Officers should examine the accounts to find out if derivative losses are camouflaged as 'financial charges', 'foreign exchange loss' or other similar head by making specific query and obtaining break up from the taxpayers.

In view of the above, the revenue authorities are likely to rely on the CBDT Instruction No. 3 to effect disallowance of forex derivative loss in all cases except where the following conditions are shown to have been fulfilled:-

- The derivative transaction is protected by proviso (d) to s.43(5)
- The loss has been ascertained on conclusion / settlement of the contract.

It may be argued that the CBDT Instruction is not binding on the taxpayers on the ground that the instruction is not in consonance with SC and HC rulings on the issues dealt therein. Further the tax payer may contend that the CBDT cannot interfere with quasi-judicial powers of the A.O and the CBDT cannot issue Circulars/Instructions u/s. 119 which are adverse to the taxpayer.

Though the CBDT Instruction is silent on taxation of gains, in appropriate cases, taxpayer may consider from the perspective of avoiding litigation whether to accept the position taken by CBDT on the MTM losses and urge that on parity of reasoning, MTM gains are not taxable. The CBDT Instruction does not deal with MAT implications of the derivative losses. It is fairly arguable that the forex derivative losses need not be added back in the computation of 'book profit' u/s. 115JB. Further, it is fairly arguable that the loss recognized on MTM basis does not constitute a provision for meeting unascertained liability nor a provision for diminution in the value of any asset.

Hence, in order to conclude, the advisable course to the taxpayers keeping in view the strict requirements of the revenue authorities and the diverse views on the captioned topic would be to maintain proper disclosure in accounts and return in order to mitigate penalty exposure, maintain robust documentation and obtain professional advice on the deductibility of exchange / derivative losses.