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Loss incurred on forward contracts to hedge losses on forex receivables is a business loss, and not a speculative loss

In brief

In a recent ruling in the case of **London Star Diamond Company (I) P. Ltd.**¹, the Mumbai Bench of the Income-tax Appellate Tribunal (Tribunal) has held that forward contracts entered into with banks for hedging foreign exchange loss on outstanding receivables in foreign currency are integral or incidental to the exports. Therefore, loss on such forward contracts is by nature a business loss rather than a speculative loss.

Facts

- London Star Diamond Company (I) P. Ltd (the Company or the taxpayer) was engaged in the business of trading and manufacturing rough and polished diamonds, in respect of which it had outstanding receivable in foreign currency.
- To hedge the possible foreign exchange loss on exports, the Company had entered into forward contracts (FCs) with banks.
- Before the tax officer (TO), the Company submitted that the net loss, being an integral part of the export business, constituted a business loss and was not a speculative transaction. The TO disallowed this claim.

¹ London Star Diamond Company (I) P. Ltd v. DCIT [2013] 38 taxmann.com 338 (Mumbai-Trib.)

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the TO's order. Aggrieved by this order, the Company appealed to the Tribunal.

Issue before the Tribunal

- Whether exchange loss incurred on account of the FCs was a business loss.

Taxpayer's contentions

- The Company entered into FCs with banks as an integral part of its export business to safeguard against losses that could arise due to foreign exchange fluctuations on account of the receivables from export. As such, FCs were not speculative transactions.
- There was a one-to-one correlation between FCs and export invoices, though this did not go down to the last rupee and precise dates².
- Reliance was placed on judgments³ where it had been held that FCs entered with banks to hedge the foreign exchange loss, if any, in respect of core business transactions constituted an integral part of the business, and loss or gains were allowable as business loss or gains as the case may be.
- Section 43(5) of the Income-tax Act (the Act) was invoked validly only if FCs constituted a "commodity". However, an FC is not a commodity and therefore there was no provision in law to treat FCs as speculative transactions. FCs, being hedging transactions, are not speculative business.

² Reliance in this regard is placed on the judgments in the case of CIT v. Friends and Friends Shipping Pvt Ltd [2013] 35 taxmann.com 553 (Gujarat) and CIT v. Panchmahal Steel Ltd [2013] 215 Taxman 140 (Gujarat)

³ D Kishore Kumar & Co Ltd v. DCIT [2005] 2 SOT 769 (Mumbai-Trib) and CIT v. Badridas Gauridu Pvt Ltd [2004] 134 Taxman 376 (Bombay)

- If the transactions were not linked to the Company's export business, the FC transactions must not be treated as speculation business.
- Alternatively, loss on cancellation of FCs constituted a payment of damages for breach of contract, which was allowable as a business loss rather than as a speculation loss⁴.

Revenue's contentions

- The company's case does not satisfy the test of transactions that have been excluded under the extant provisions as deemed speculative transactions as:
 - it had not demonstrated that the hedging transactions were with respect to raw materials or merchandise;
 - the provisions were applicable only to a member of a forward market or an exchange.
- The Company had failed to demonstrate that the transactions in question were hedging transactions.
- FCs on certain dates were of higher value than the export receivables. As such, the Company has not demonstrated rupee-to-rupee and date-specific correlation between the FCs and the export invoices.
- A few FCs were cancelled before the maturity date, which was a characteristic of speculation activity.
- Relying on some judgments⁵, it was held that foreign exchange transactions could not have any nexus with the export of diamonds.

⁴ Reliance placed on the Supreme Court decision in CIT v. Shantilal Pvt Ltd [1983] 144 ITR 57 (SC)

⁵ Delhi Flour Mills Co Ltd v. CIT [1974] 95 ITR 151 (Delhi-HC)

Tribunal ruling

- FCs were a commodity⁶.
- FCs, when entered into with banks for hedging losses with respect to foreign exchange fluctuations of the export proceeds, had to be considered integral or incidental to the assessee's export activity. As such, the losses and gains constituted business loss or gains, as opposed to speculation loss or gains. The fact that forward contracts were prematurely cancelled could not alter the nature of the transaction⁷.
- The law does not require one-to-one correlation between the FCs and export invoices. Where total value of the FC does not exceed the total outstanding receivable in foreign exchange, the claim is sustainable as a business loss.
- Considering the documents/ analysis of transactions put forth by the company, FCs were an integral part, or incidental to, the core business of exporting diamonds. Therefore, FCs constituted 'hedging transactions' and not 'speculative contracts'.
- In view of the above findings, the Tribunal held as under:
 - Losses arising on cancellation of matured FCs, being integral or incidental to business of export of diamonds, was allowable as a business loss.

- Loss on premature cancellation of FCs (up to 3 days of maturity), occurred as the maturity date of some such FCs fell during week-end days. This being an acceptable explanation, such loss is allowable as a business loss, subject to verification of facts by the TO.
- Loss on premature cancellation of FCs (prior to three days of maturity) was remanded back to the TO to:
 - Obtain an explanation from the Company for premature termination of contract and, in absence of any specific explanation, to disallow the loss; and
 - Examine the Company's contention *vis-a-vis* facts and evidence that the loss in question was in the nature of 'damages' payable to the banks for breach of contracts or settlement of the contracts.

Conclusion

- This decision has re-emphasised the principle that exchange loss on FCs is allowable as a business loss if the FCs are integral or incidental to the Company's business. Further, premature cancellation of FCs should be substantiated with commercial and factual evidence/ justification.

⁶ Reliance is placed on the decision of the Bombay High Court in the case of CIT v. Badridas Gauridu Pvt Ltd [2004] 134 Taxman 376 (Bombay) and CIT v. Soorajmull Nagarmull [1981] 129 ITR 169 (Cal)

⁷ Reliance is placed on D Kishore Kumar & Co Ltd v. DCIT [2005] 2 SOT 769 (Mumbai-Trib), CIT v. Badridas Gauridu Pvt Ltd [2004] 134 Taxman 376 (Bombay) and CIT v. Soorajmull Nagarmull [1981] 129 ITR 169 (Cal)

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Our offices

<p>Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000</p>	<p>Bangalore 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000</p>	<p>Chennai 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006, India Phone +91 44 4228 5000</p>	<p>Hyderabad #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600</p>	<p>Kolkata 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-033 - 2357 9101/4400 1111 Fax: (91) 033 - 2357 2754</p>
<p>Mumbai PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000</p>	<p>Gurgaon Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000</p>	<p>Pune GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444</p>	<p>For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com</p>	

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