Forex loss on borrowings allowed as revenue expenditure as it has direct nexus with interest cost savings, held not covered by section 43A

May 20, 2016

In brief

In a recent ruling, the Pune bench of the Income-tax Appellate Tribunal (Tribunal) upheld the taxpayer’s claim that foreign exchange fluctuation loss has a direct nexus with savings in interest costs and no new capital asset was brought into existence. The Tribunal observed that foreign exchange fluctuation loss utilised for acquiring indigenous assets was not covered by section 43A of the Income-tax Act, 1961 (the Act). It further noted that the taxpayer was mandatorily required to draw its accounts as per Accounting Standard (AS) - 11 in terms of the Companies Act, 1956 as well as the Act. The Tribunal rejected Revenue’s contentions that such loss was capital in nature and also notional and contingent.

In detail

Facts

- The taxpayer\(^1\) was engaged in the foundry business, manufacturing of cylinder liners/ heads, flywheels and other automobile components as well as the generation of electricity through windmills.
- The taxpayer had claimed a deduction of foreign exchange fluctuation loss on outstanding foreign currency loans under section 37(1) of the Act.
- The taxpayer had initially availed the loans in Indian rupees for acquisition of indigenous assets and for expansion of projects in India.
- The taxpayer later converted the local currency loans into foreign currency loans to take benefit of lower rate of interest.
- The Tax Officer (TO), during regular assessment proceedings, disallowed the foreign exchange fluctuation loss on the ground that such loss was a notional loss and capital in nature, since the loans were availed to acquire capital assets.

Issue before the Tribunal

Was the foreign exchange fluctuation loss on account of restatement of an outstanding foreign currency loan revenue or capital in nature?

\(^1\) TS-265-ITAT-2016(Pune)
Taxpayer’s contentions

- The conversion of rupee term loans into foreign currency loans was essentially to save interest costs, since a foreign currency loan could be availed at much lower interest rates.

- Due to a fall in the value of the Indian Rupee vis-à-vis the US Dollar, it suffered foreign exchange losses on outstanding loans repayable in foreign currency.

- Furthermore, its treatment was in line with the requirements of AS-11 (required to be followed mandatorily) issued by the Institute of Chartered Accountants of India (ICAI), under which it was mandatory to show the effect of the restatement of outstanding foreign currency loan in the profit and loss statement.

- The treatment of foreign exchange fluctuation losses was dealt with only by section 43A of the Act, and this section did not apply in this case, as the rupee term loans initially taken were not utilised for acquiring capital assets from outside India.

- The taxpayer also relied on the Income Computation and Disclosure Standards (ICDS), notified by the Central Board of Direct Taxes (CBDT), for substantiating its stand of charging the foreign exchange fluctuation loss to the profit and loss statement.

- It also referred to a Supreme Court (SC) judgment, wherein it had held that the foreign exchange fluctuation losses had accrued and crystallised to it, and following the mercantile system of accounting, the loss was rightly claimed as revenue loss.

- The taxpayer also contended that the exposure it took in foreign exchange helped it hedge a part of revenue derived from exports.

- Based on these arguments, the taxpayer contended that the foreign exchange fluctuation loss was revenue in nature.

The Revenue’s contentions

- The conversion of a rupee term loan into a foreign currency loan made no difference to the nature of the loan. Accordingly, the foreign exchange fluctuation loss on account of a loan availed for acquiring capital assets should have been capital in nature.

- To controvert the judicial pronouncement relied on by the taxpayer, the Revenue relied on the SC ruling in Sutlej Cotton Mills Limited4.

- The foreign exchange fluctuation loss was notional and contingent in nature, with no actual outgo.

Tribunal’s ruling

- The Tribunal observed that it was an undisputed fact that the taxpayer had already completed the acquisition of assets/ expansion of the project, and the conversion of the loans was a post facto event after the capital assets had been put to use.

- Furthermore, the taxpayer had actually demonstrated that conversion of rupee term loans into foreign currency loans had actually benefited it in terms of savings in interest costs.

- The Tribunal held that section 43A of the Act had no application in cases of purchase of indigenous assets and accordingly, this case needed to be determined in the light of generally accepted accounting principles, pronouncements and guidelines.

- It placed reliance on the SC’s ruling in Tata Iron and Steel Co. Limited5 and went on to hold that the foreign exchange fluctuation loss on a foreign currency loan acquired for the purchase of indigenous assets was not required to be added to the cost of the assets as per section 43(1) of the Act once the assets were put to use.

- The Tribunal also observed that the taxpayer was mandatorily required to follow AS-11 and the mercantile system of accounting as per provisions of the Companies Act, 1956.

- The Tribunal affirmed the taxpayer’s argument that the impugned fluctuation loss had a direct nexus with the saving in interest costs without bringing any new capital asset into existence, and the conversion of rupee term loans into foreign currency loans had served as a hedging mechanism against revenue receipts from exports, and portrayed commercial expediency.

- The Tribunal distinguished the case relied upon by the Revenue, viz., Sutlej Cotton Mills Limited4, as the issue under consideration in that case had a direct nexus with the acquisition of capital asset.

- The Tribunal placed reliance in the SC’s ruling in the case of Woodward Governor India (P) Limited3 and held that the loss

---

3 Notification No.S.O.892(E) dated 31-03-2015
4 Sutlej Cotton Mills Limited v. CIT [1979] 116 ITR 1 (SC)
arising on foreign exchange fluctuation has been rightly accounted as revenue expense in the profit and loss statement in accordance with AS-11.

- Accordingly, the Tribunal held that the taxpayer’s claim that the foreign exchange fluctuation loss was a revenue loss was justified.

**The takeaways**

- Interestingly, the Tribunal has held that the loss resulting from foreign exchange fluctuation on loans availed for acquiring the assets in India is revenue in nature, as the same is not covered within the ambit of section 43A of the Act, though *prima facie*, the loss is capital in nature.

- It is worth noting that, absent specific treatment in the Act, the Tribunal has given due consideration to ICDS (though not applicable for the year under dispute) and generally accepted accounting principles.

- This ruling is a welcome one for taxpayers who are involved in litigation on similar issues.

**Let’s talk**

For a deeper discussion of how this issue might affect your business, please contact:

**Tax & Regulatory Services – Direct Tax**

Gautam Mehra, *Mumbai*
+91-22 6689 1154
gautam.mehra@in.pwc.com

Rahul Garg, *Gurgaon*
+91-124 330 6515
rahul.garg@in.pwc.com