

2022/DHC/005364

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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

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Date of Decision: 02 December, 2022

+ **ITA 67/2018**

**PRINCIPAL COMMISSIONER OF INCOME
TAX, DELHI-2**

..... Petitioner

Through: Mr. Zoheb Hossain, Sr. Standing
Counsel with Mr. Vipul Agarwal
and Mr. Parth Semwal, Jr. Standing
Counsel.

Versus

SIMON INDIA LTD.

..... Respondent

Through: Mr. Piyush Kaushik, Advocate.

CORAM:

HON'BLE MR. JUSTICE VIBHU BAKHRU

HON'BLE MR. JUSTICE PURUSHAINDR KUMAR KAURAV

VIBHU BAKHRU, J.

1. The Revenue has filed the present appeal under Section 260A of the Income Tax Act, 1961 (hereafter '**the Act**') impugning an order dated 30.05.2017 (hereafter '**the impugned order**') passed by the Income Tax Appellate Tribunal, Delhi (hereafter '**the Tribunal**') in an appeal preferred by the Revenue (being ITA No.976/Del/2013) against the order dated 05.11.2012 (hereafter '**the appellate order**') passed by the learned Commissioner of Income Tax (Appeals) [hereafter '**CIT(A)**']

2. The Assessee had also preferred an appeal before the learned Tribunal against the appellate order being ITA 555/Del/2013, which was partly allowed and disposed of along with the Revenue's appeal, by the impugned order. The learned CIT(A) had passed the appellate order dated 05.11.2012, in an appeal preferred by the Assessee, impugning the assessment order dated 06.12.2011 passed under Section 143(3) of the Act for the assessment year 2009-10.

3. The Revenue has framed the following questions for consideration of this Court:

- “(I) Whether, on the facts and circumstances of the case, the Ld. ITAT was right in allowing the foreign exchange fluctuations loss on unmatured, matured and cancelled forward contracts?
- (II) Whether the losses on account of foreign exchange fluctuations on forward contracts are allowable under section 37(1) of the Income Tax Act and covered as hedging transactions under Section 43(5)(a) of the Act or should be disallowed as speculation losses under Section 43(5) of the Act in view of the CBDT Instruction No. 3/2010 dated 23.03.2010?
- (III) Whether the Ld. ITAT was right in restricting the disallowance under Section 14A on adhoc figures of Rs.1 lakh when the disallowance under rule 8D comes to Rs.853,916/-?
- (IV) Whether the finding given by the Ld. ITAT is perverse, in the facts and circumstances of the case?”

4. At the outset, it is relevant to note that question no. (III), as noted

above, does not arise for consideration in this appeal, because that was not the subject matter of appeal by the Revenue's appeal (ITA No.976/Del/2013) before the learned Tribunal. And as noted above, the Revenue has appealed the learned Tribunal's decision in ITA No. 976/Del/2013 and not the decision in ITA No. 555/Del/2013.

5. The sole controversy in ITA No.976/Del/2013 relates to whether the loss on Forward Cover Purchase Contracts for foreign exchange (hereafter '**Forward Contracts**') is allowable as a deduction from the income chargeable to tax for the relevant assessment year notwithstanding that the Forward Contracts have not closed.

6. Briefly stated, the relevant context in which the controversy arises is as under:

6.1 The Assessee is engaged in the business of providing engineering consultancy and related services like engineering designing, construction and commissioning of plants and installations.

6.2 The Assessee had filed its income tax return for the previous year 2008-09 on 25.09.2019, relevant for the assessment year 2009-10, declaring a taxable income of ₹3,94,83,380/-. The said return was initially processed under Section 143(1) of the Act, however, was subsequently picked up for scrutiny.

6.3 The Assessee claimed a sum of ₹9,20,62,226/- as loss against a Forward Contract, entered into to hedge the risk against foreign exchange fluctuations to cover the exports and imports. The Assessee

had entered into a contract with Saudi Basic Industries Corporation, Kingdom of Saudi Arabia based on the Letter of Intent dated 19.04.2008. The total contract value was 114 million USD and the contract was required to be completed within a period of twenty-seven months. The Forward Contracts were entered into to protect against foreign exchange fluctuations.

6.4 The appellate order records that out of the amount of ₹9,20,62,226/- booked as losses, Forward Contracts for a sum of ₹2,08,11,934 (₹51,20,000 + ₹1,56,91,934) had closed before the due date. The loss of ₹7,12,50,292 related to unmatured Forward Contracts.

6.5 The appellate order also records that the Assessee had placed a Forward Contract dated 13.05.2008 with Canara Bank for USD 11,250,000 on record of the assessment proceeding as an illustrative case. The Assessee had placed the following contracts in proceedings before the learned CIT(A):

- a) Agreement dated 13.05.08 with Canara Bank for booking Forward Purchases Contract-Export for USD 12,50,000/- delivery on 30.04.09.
- b) Agreement dated 13.05.08 with Canara Bank for booking Forward Purchases Contract-Export for USD 1,12,50,000/- delivery on 30.04.09 (already given to the AO, also enclosed with this appeal).
- c) Agreement dated 01.10.08 with Canara-Bank for booking Forward Purchase Contract-Export for USD 50,00,000/- delivery on 31.12.08

- d) Agreement dated 18.08.08 with ING Vysya Bank for booking Forward Purchase Contract- Export for USD 10,00,000/- delivery on 31.07.09

The Assessment Order

7. The Assessing Officer (hereafter '**the AO**') held that the loss on Forward Contracts was a speculative loss and was liable to be disallowed in terms of the Central Board of Direct Taxes (hereafter '**CBDT**') Instruction no.3/2010.

8. In terms of the CBDT Instruction no.3/2010, the AOs were instructed to examine the 'Marked to Market' losses. The said Instruction explained 'Marked to Market' as a concept where financial instruments are valued at market rate to report their actual value on the date of reporting. Such 'Marked to Market' losses represent notional losses and were required to be added back for the purposes of computing taxable income. CBTD also instructed the AOs to examine whether such transactions were speculative transactions where losses on account of forex-derivative transactions arise on actual transaction.

9. The AO held that since the Forward Contracts had not matured, the losses were required to be considered as notional losses and were required to be added back.

10. The Assessee had also received dividends from mutual funds aggregating to ₹46,20,578/-, which was not taxable. The Assessee claimed that it had not incurred any expenditure that was relatable to the said income. It claimed that the investment was a passive investment and was monitored and managed by a group company, Zuari Investments Ltd., without any charges. It claimed that there was no

employee cost attributable to making the said investment and hence the entire expenditure was incurred towards consultancy and project handling. The Assessee also stated that it had not incurred any expenditure on interest on any financial assistance availed by it, therefore, there was no question of any investment in mutual funds being made out of interest-bearing loans or advances. It stated that the amount debited in the profit and loss account as interest / bank charges was in the nature of bank guarantee charges. It also claimed that the dividends received from mutual funds were automatically re-invested and therefore, there were no direct administrative costs involved in obtaining the said dividends.

11. The AO did not accept that there were no inbuilt costs to earn from the “*passive investment*” and that there were bound to be incidental expenditure of “*collection, telephone, follow up even director’s time and energy.*” The AO, thereafter, proceeded to disallow ₹8,53,916/- under Section 14A of the Act. The AO calculated the amount of disallowance at 0.5% of the average investment (the mean of the opening and the closing investment calculated at ₹17,07,83,341/-).

The appellate order

12. The Assessee appealed the Assessment Order in respect of disallowance on the said two counts: disallowance of ₹9,20,62,226/- on account of loss claimed on Forward Contracts; and, ₹8,53,916/- under Section 14A of the Act.

13. The learned CIT(A) found that the AO had erred in disallowing

the loss on account of forward cover against foreign exchange fluctuations on the basis that it was a speculative loss. The AO had erroneously proceeded on the basis that the Assessee had not furnished any contract or agreement on record; however, the Assessee had placed the contract with Canara Bank for USD 11,250,000/- as an illustrative case.

14. The learned CIT(A) found that the Forward Contracts were for exports and imports and the Contracts specifically mentioned the delivery period, the project exports and contract / order Letter of Credit number and date. The said Forward Contracts were to hedge against the risk of forward exchange fluctuations on account of project export realization and foreign exchange outflow. The learned CIT(A) specifically noted that the Assessee had entered into a contract with Saudi Basic Industries Corporation, Kingdom of Saudi Arabia based on the Letter of Intent dated 19.04.2008. The underlying assets/liabilities in respect of which the forward cover was purchased, were debits and credits in respect of export realization, as well as for payments of imports for executing the projects. Admittedly, during the relevant previous year, the Assessee had suffered foreign exchange fluctuation loss of ₹9,20,62,226/-. Out of the aforesaid loss, an amount of ₹2,08,11,934/- was on account of two agreements that were closed prior to the due date and the remaining ₹7,12,50,292/- was on account of unmatured Forward Contracts.

15. The learned CIT(A) also noted that the Forward Contracts were recognized in the audited accounts in compliance with the Accounting

Standard-11 (hereafter 'AS-11').

16. In view of the above, the learned CIT(A) accepted the Assessee's appeal and set aside the disallowance of ₹9,20,62,226/- on account of Forward Contracts.

17. Insofar as disallowance of ₹8,53,916/- under Section 14A of the Act is concerned, the learned CIT(A) upheld the decision of the AO and rejected the Assessee's appeal.

18. The Assessee as well as the Revenue preferred their respective appeals before the learned Tribunal. The Assessee was aggrieved by the decision of the learned CIT(A) in affirming the disallowance of ₹8,53,916/- made by the AO under Section 14A of the IT Act. The Revenue preferred an appeal before the learned Tribunal to the extent the learned CIT(A) had deleted the addition of ₹9,20,62,226/- made by the AO.

The Impugned Order

19. The learned Tribunal concurred with the decision of the learned CIT(A) that the loss on Forward Contracts could not be treated as a loss which was disallowable in terms of the CBDT Instruction no.3 dated 23.03.2010. The learned Tribunal held that the said circular was not applicable as the transaction could not be considered as a speculative transaction.

20. The learned Tribunal also held that the case was covered by the decision of the Supreme Court in ***CIT v. Woodward Governor India***

Pvt. Ltd.: (2009) 312 ITR 254 (SC).

21. Insofar as the disallowance under Section 14A of the Act read with Rule 8D of the Income Tax Rules, 1962 is concerned, the learned Tribunal held that expenditure towards deployment of manpower for monitoring dividends from mutual funds and its subsequent re-development could not be ruled out. Considering the facts, the learned Tribunal reduced the disallowance from ₹8,53,916/- to ₹1,00,000/- on *ad-hoc* basis.

Reasons & Conclusions

22. It is relevant to mention that, apart from disallowing ₹9,20,62,226/-, being the forward cover transaction loss, the AO had also made an addition of ₹1,35,34,568/-. The said addition was deleted by rectifying the Assessment Order under Section 154 of the Act.

23. Mr. Zoheb Hossain, learned counsel appearing for the Revenue, submitted that the loss on Forward Contracts was booked on a 'Marked to Market' basis and therefore was merely a notional loss in the relevant assessment year. And, it was not permissible for the Assessee to book such notional loss.

24. It is material to note that the only specific ground, stated by the Revenue in its appeal in respect of the deletion of loss on Forward Contracts, reads as under:

“(C) Because the losses on account of foreign exchange fluctuations on forward contracts are

not allowable under Section 37(1) of the Income Tax Act and covered as hedging transactions under Section 43(5)(a) of the Act or should be disallowed as speculation losses under Section 43(5) of the Act in view of the CBDT Instruction No. 3/2010 dated 23.03.2010.”

25. Thus, according to the Revenue, the learned CIT(A) and the learned Tribunal had erred in finding that the loss on account of Forward Contracts is allowable under Section 37(1) of the Act and is covered as a hedging transaction under Section 43(5)(a) of the Act. The Revenue contends that the said loss is required to be disallowed as a speculative loss in terms of the CBDT Instruction no.3/2010.

26. The Revenue’s contention is unmerited. There is no dispute that the Forward Contracts were entered into by the Assessee to hedge against foreign exchange fluctuations resulting from inflows/outflows in respect of the underlying contracts for provisions of consultancy and project management. Concededly, the Assessee is not dealing in foreign exchange. Clearly, the said transactions were to hedge against the risk of foreign exchange fluctuations and thus, fall within the exceptions of proviso (a) to Section 43(5) of the Act. The Forward Contracts were to guard against any loss on account of future exchange fluctuations in respect of inflows and outflows relating to contracts for execution of the works entered into by the Assessee.

27. It is material to note that there is no allegation that the Assessee has not been following the system of accounting consistently. In **CIT v. Woodward Governor India Pvt. Ltd.** (*supra*), the Supreme Court had

referred to AS-11. In terms of AS-11, the exchange difference arising on foreign currency transactions are necessary to be recognized as income or expense in the period in which they arise, except in cases of exchange differences arising on repayment of liabilities for acquiring fixed assets.

28. In the present case, the Assessee had stated that it was reinstating its debtors and creditors in connection with execution of contracts entered into with foreign entities on the basis of the value of the foreign exchange. Thus, clearly the loss on account of Forward Contracts would require to be recognized as well.

29. It is also relevant to refer to the findings of the learned CIT(A) in this regard. Paragraph no.13 of the appellate order reads as under:

“13.It may be noted that the valuation-loss is reflected on the debit side of the P&L account whereas the corresponding valuation Gains resulting on the valuation of the debtors is reflected on the credit side included as part of sales / exchange Gains and in respect of imports as reduction in the import price on the debit of the Profit & Loss account. In other words, the entire transaction of either realization of debtors in foreign exchange / payment for imports in foreign exchange which are designated in foreign currency and the entering into Forward cover contract are integral part of the same transaction i.e. two sides of the same coin. By considering both sides of the P&L the correct net profit is worked out. Therefore, in order to ascertain the correct taxable profits of the appellant the loss has to be allowed as a business loss because it is due to the business exigency the forward contracts are entered into to

protect against any loss that might result due to foreign exchange currency fluctuation foreign currency fluctuation.”

30. Undisputedly, the Forward Contracts, in the present case, are hedging transactions. The Assessee has reinstated its debits and credits from the underlying transactions on the value of the foreign exchange on the due date. The corresponding losses/gains under the Forward Contracts, thus, were also required to be accounted for to arrive at the real profits. It would be anomalous if, on the one hand, debtors and creditors, in respect of current assets, are stated at the current value of foreign exchange and the corresponding loss on the hedging transaction is not accounted for. In essence, the Assessee has stated his income by taking into account the foreign exchange value as it stands on the due date. It is well settled that the CBDT Instructions and circulars which are contrary to law are not binding.

31. This Court finds no fault with the order of the learned CIT(A) as well as the learned Tribunal in finding that the loss, on account of Forward Contracts, cannot be considered as speculative and the AO had erred in disallowing the same. The questions raised (Questions I and II) are thus, covered by the decision of the Supreme Court in **CIT v. Woodward Governor India Pvt. Ltd.** (supra).

32. No substantial question of law arises from the ITA 976/Del/2013.

33. Insofar as disallowance under Section 14A of the Act is concerned, as noted above, the said issue does not arise from ITA

976/Del/2013. The said question was the subject matter of the Assessee's appeal ITA 555/DEL/2013 before the learned Tribunal. The Assessee had claimed that there was no expenditure that was incurred for earning the dividend income from mutual funds. The Assessee had substantiated its aforesaid claim by stating that the investments and the dividends earned were automatically re-invested. The Assessee further claimed that the investment is managed by a group company, which does not charge any fees for the same. It is also pointed out that there was no employee engaged in monitoring the said investments.

34. It is material to note that the AO had not found any material facts to controvert the above assertions. However, the AO had not accepted the Assessee's claim that no expenditure had been incurred for earning the dividend income; the AO observed that there would be incidental expenditure of "*collection, telephone, follow up even director's time and energy etc.*" The AO concluded that the expenses in relation to earning the income were embedded in indirect expenses. The AO, thereafter, proceeded to determine the expenditure attributable to earning dividend income at 0.5% of the value of average investment in terms of Rule 8D of the Rules.

35. It is not disputed that the AO can ascertain the expenditure attributable to earning tax-free income if he is not satisfied that the Assessee's allocation of expenses for earning the said income or otherwise and or is otherwise dissatisfied with the Assessee's explanation.

36. A plain reading of the impugned order passed by the learned Tribunal indicates that the Tribunal also did not find, as a matter of fact, that the Assessee had devoted any of its resources for managing the said investments or had otherwise incurred any expenditure for the same. It is relevant to note that the Assessee's assertion, that its investment was monitored by a group of company without levying any charge or fee, was not found to be incorrect.

37. In the circumstances, the learned Tribunal did not accept the AO's determination of ₹8,53,916/- as expenditure incurred for earning the exempt income. Notwithstanding the above, the learned Tribunal held that the deployment of manpower for monitoring the dividends from mutual funds cannot be ruled out. On this basis the learned Tribunal had reduced the disallowance from ₹8,53,916/- to ₹1,00,000/- per month on *ad-hoc* basis.

38. It is submitted on behalf of the Revenue that reduction on *ad-hoc* basis is not permissible. We are of the view that once the Revenue Authorities have found no reason to doubt the Assessee's claim that the investments have been managed by a group company without levy of charge, it may not be open for the tribunal to disallow expenditure on the basis that some deployment of manpower for managing the investment cannot be "ruled out".

39. However, the Assessee has not appealed against the said decision. As noted above, the present appeal has been filed against the impugned order passed in ITA No.976/Del/2013, whereby the learned

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Tribunal had dismissed the appellant's appeal. The Revenue's appeal before learned Tribunal was confined to disallowance of loss on account of Forward Contracts.

40. We are of the view that no substantial questions of law arise in this appeal. The appeal is, accordingly, dismissed.

VIBHU BAKHRU, J

PURUSHAINDR KUMAR KAURAV, J

DECEMBER 2, 2022

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