



Foreign exchange fluctuation loss on outstanding foreign currency loans is allowed as business expenditure under the Income-tax Act

Background

Recently, the Pune Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Cooper Corporation Pvt. Ltd.¹ (the taxpayer) held that loss recognised on account of foreign exchange fluctuation as per notified accounting standard is an accrued and subsisting liability and not merely a contingent or a hypothetical liability. Further such loss imposed upon the taxpayer bears no nexus or relation to the acquisition to the assets. The action of the taxpayer is tied up to its underlying objective i.e. saving in interest costs, hedging its revenue receipts, etc. which are undoubtedly on revenue account. Accordingly, such loss is allowed as a deduction under Section 37(1) of the Income-tax Act, 1961 (the Act).

Facts of the case

- The taxpayer is a private limited company, primarily engaged in the foundry business, manufacturing cylinder liners/heads, flywheels and other automobile components, etc. besides generation of electricity through windmills.
- It was noticed by the Assessing Officer (AO) that in its financial statement, the taxpayer had *inter alia* shown outstanding loans received in foreign currency at the end of the year. It was further noticed that the taxpayer has claimed a

deduction of an amount of INR13.99 million on account of devaluation of Indian currency qua foreign currency on outstanding foreign currency loans under Section 37(1) of the Act.

- It was contended before the AO that the taxpayer had obtained various loans in foreign currency to take benefit of the low interest rate regime on foreign currency loan. It was further contended that as per Accounting Standard - 11 (AS-11)², the outstanding foreign currency loan is required to be translated into Indian Rupees by applying the foreign exchange rate as on the closing day of reporting period and the net exchange difference resulting on such translation is required to be recognised as income or expense for the respective financial period.
- Overriding provision of Section 43A of the Act has no application in the instant case since the assets were not acquired from a country outside India. Such loans so converted are for the purpose of business and therefore, the loss incurred due to fluctuation in the rate was correctly claimed as business loss in the course of carrying on of business.

¹ Cooper Corporation Pvt. Ltd. v. DCIT (ITA No. 866/PN/2014) – Taxsutra.com

² 'Effect of changes in foreign exchange rates' issued by Institute of Chartered Accountants of India (ICAI)

- However, the AO held that the loss is merely a notional loss and not an actual loss incurred by the company. Even presuming that increased liability for repayment of foreign currency loans has been saddled on the taxpayer, still the same will be a payment of capital in nature since impugned loans were obtained for acquiring the capital asset. Therefore, loss claimed on account of fluctuation in the foreign exchange rate could not be allowed as revenue expenditure.
- The Commissioner of Income-tax (Appeal) [CIT(A)] held that since the purpose of loans raised was to acquire capital assets, the taxpayer is not entitled to fluctuation loss.

Tribunal's ruling

- It was noticed that there was no dispute on the fact that the acquisition of capital assets/expansion of projects, etc. from the term loans taken were already complete and the assets so acquired had been put to use. As a consequence, the loss occasioned from foreign currency loans so converted was a post facto event subsequent to capital assets having been put to use.
- There was no adverse finding from the tax department about the correctness or completeness of accounts of the taxpayer. In other words, the profits/gains from the business have been admittedly computed in accordance with generally accepted accounting practices and guidelines notified.
- The taxpayer had *inter alia* applied AS 11 dealing with effects of the changes in the exchange rate to record the losses incurred owing to fluctuation in the foreign exchange. AS 11 enjoins reporting of monetary items denominated in foreign currency using the closing rate at the end of the accounting year. It also requires that any difference, loss or gain, arising from such conversion of the liability at the closing rate should be recognised in the profit & loss account for the reporting period.
- Similarly, CBDT notification³ on Income Computation and Disclosure Standards (ICDS) also *inter alia* deals with recognition of exchange differences. The notification also sets out that the exchange differences arising on foreign currency transactions have to be recognised as income or business expense in the period in which they arise subject to exception as set out in Section 43A of the Act or Rule 115 of the Income-tax Rules, 1962 (the Rules) as the case may be.
- In view of the various provisions of the Companies Act and the Act, it was mandatory to draw accounts as per AS 11. Thus, the loss recognised on account of foreign exchange fluctuation as per notified AS 11 is an accrued and subsisting liability and not merely a contingent or a hypothetical liability.
- A legal liability also exists against the taxpayer due to fluctuation and loss arising therefrom. Actual payment of loss is an irrelevant consideration to ascertain the point of accrual of liability. The tax department has committed error in holding the liability as notional or contingent.
- A bare reading of Section 43A of the Act, which opens with a non-obstante and overriding clause, would show that it comes into play only when the assets are acquired from a country outside India and does not apply to acquisition of indigenous assets. Another notable feature is that Section 43A of the Act provides for making corresponding adjustments to the costs of assets only in relation to exchange gains/losses arising at the time of making payment.
- It therefore deals with realised exchange gain loss. The treatment of unrealised exchange gain loss is not covered under the scope of Section 43A of the Act. It is thus apparent that specific provision of Section 43A of the Act had no application to the facts of the

³ S.O. 892 (E), dated 31 March 2015

case. Section 43A of the Act nowhere specifies that any gain or loss on foreign currency loan acquired for purchase of indigenous assets will have to be reduced or added to the costs of the assets.

- Therefore, the issue whether, the loss was on revenue account or a capital one is required to be tested in the light of generally accepted accounting principles, pronouncements and guidelines, etc.
- The Tribunal relied on the Supreme Court decision in the case of Tata Iron and Steel Co. Ltd.⁴ where it was held that cost of an asset and cost of raising money for purchase of asset are two different and independent transactions. Thus, events subsequent to acquisition of assets cannot change price paid for it. Therefore, fluctuations in foreign exchange rate while repaying installments of foreign loan raised to acquire an asset cannot alter actual cost of assets.
- Thus, it is evident the variation in the loan amount has no bearing on the cost of the asset as the loan is a distinct and independent transaction as in comparison with acquisition of assets out of said loan amount borrowed. The actual cost of the corresponding fixed asset acquired earlier by utilising the aforesaid loan will not undergo any change owing to such fluctuation.
- The manner of utilisation of loan amount has nothing to do with allowability of any expenditure in connection with loan repayment. Both are independent and distinct transactions in nature. Similar analogy can be drawn from Section 36(1)(iii) of the Act which also reinforces that utilisation of loan for capital account or revenue account purpose has nothing to do with allowability of corresponding interest expenditure.
- The fluctuation loss therefore has a direct nexus to the saving in interest costs without bringing any new capital asset into existence. Thus, the business exigencies are implicit as well explicit in the action of the taxpayer.
- The Supreme Court in the case of Woodward Governor India (P) Ltd. has observed that AS 11 is mandatory in nature.
- The decision in the case of Sutlej Cotton Mills Ltd. relied upon by the tax department was of no assistance to the tax department. The Supreme Court therein stated the principle of law that where any profit or loss arises to the taxpayer on account of devaluation in foreign currency held by him on conversion from another currency, such profit and loss would ordinarily be trading loss if the foreign currency held by the taxpayer on revenue account as trading asset or as a part of circulating capital embargo in business.
- However, if the foreign currency is held as a capital asset, the loss should be capital in nature. The aforesaid principle of law is required to be applied to the facts of the case to determine whether the foreign currency is held by the taxpayer on revenue account or as a part of circulating capital. In the present case, fluctuation loss inflicted upon the taxpayer bears no nexus or relation to the acquisition to the assets. The action of the taxpayer is tied up to its underlying objective i.e. saving in interest costs, hedging its revenue receipts, etc. which are undoubtedly on revenue account. Thus, the loss generated in impugned action bears the character of revenue expenditure.
- Similarly, a decision of the Supreme Court in the Case of Tata Iron and Steel Co. also weighs in favour of the taxpayer. The Tribunal observed that reliance placed by the CIT(A) on Elecon Engineering Co. Ltd. is misplaced. The decision concerns applicability of Section 43A of the Act in the facts of that case and thus clearly distinguishable.

⁴ CIT v. Tata Iron and Steel Co. Ltd. [1998] 22 ITR 285 (SC).

- In the absence of applicability of Section 43A of the Act to the facts of the case and in the absence of any other provision of the Act dealing with the issue, claim of exchange fluctuation loss in revenue account by the taxpayer in accordance with generally accepted accounting practices and mandatory accounting standards notified by the ICAI and also in conformity with CBDT notification cannot be faulted.
- No inconsistency with any provision of Act or with any accounting practices has been brought to our notice. Otherwise also, in the light of the fact that the conversion in foreign currency loans which led to loss were dictated by revenue considerations towards saving interest costs, etc., loss being on revenue account is an allowable expenditure under Section 37(1) of the Act.

Our comments

The issue of claiming loss arising due to fluctuation in foreign exchange rate as on balance sheet date under Section 37(1) of the Act has been subject of considerable litigation. There are various judicial precedents⁵ which have allowed the deduction of such losses under Section 37(1) of the Act based on the principles given by the Supreme Court in the case of Woodward Governor. Based on the accounting treatment regularly followed by the taxpayer, the foreign exchange fluctuation loss was allowed as revenue expenditure by the Supreme Court.

The Pune Tribunal in this case allowed the loss on account of foreign exchange fluctuation under Section 37(1) of the Act. It was observed that the taxpayer has followed the accounting standards and provisions of the Act. It has been reiterated that loan is a distinct and independent transaction in comparison to acquisition of assets out of said

loan amount borrowed, and if such loan is tied up with its underlying objective of revenue in nature, such foreign exchange fluctuation losses bear the character of revenue expenditure. Further such loss is an accrued and subsisting liability and not merely a contingent or a hypothetical liability. The Tribunal has also dealt with the relevant ICDS and still observed that the exchange differences arising on foreign currency transactions have to be recognised as income or business expense in the period in which they arise.



⁵ Woodward Governor India (P) Ltd [2009] 179 taxman 326 (SC), DCIT v. Kotak Mahindra Investment Ltd. [2013] 35 taxmann.com 225 (Mum), Reliance Industries Limited v. CIT [2013] 40 taxmann.com 431, Oil & Natural Gas Corpn Ltd v. CIT [2010] 189 taxman 292 (SC), ADIT v. British Bank of Middle East [2011] 44 SOT 109 (URO) (Mum)

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