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This issue contains:

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Drowned in debt, sinking deeper

by
Huzaima Bukhari & Dr. Ikramul Haq

Pakistan, drowned deep in debt, is sinking deeper and deeper with each passing moment. The situation, if not remedied on a war footing, will eventually lead the country to an economic collapse. During the last three months, the debt burden has soared by Rs. 980 billion—an unprecedented increase pushing the total domestic debt up to Rs. 15 trillion. This does not include borrowing from the International Monetary Fund (IMF) to avert a serious balance of payment crisis. The Muslim League Nawaz (PML-N) was very critical of the Pakistan People's Party (PPP) government for increasing the debt burden of the country by 100% in five years, but its own record during three months is more deplorable—adding Rs. 11 billion a day is awfully gruesome!

On 30 June 2013, the federal government's total domestic debt was Rs. 14 trillion which as of today stands at Rs15 trillion. Increase of one billion in three months is terrifying. The total debt burden—internal Rs. 15 trillion and external $ 62 billion—is not debated in the Parliament. The members seem more obsessed about arguing whether Hakimullah Mehsud, killed in a drone attack, is a martyr or not. For them drone attacks are violation of sovereignty but begging from USA, its allies and international donors is a matter of honour! One needs to remind them Allama Iqbal's famous verse:

Taqdeer Ke Qazi Ka Ye Fatwa Hai Azal Se
Hai Jurm-e-Zaeefi Ki Saza Marg-e-Mafajat!

[T'is the immutable decree of the Judge of destinies—
That weakness is a crime, punishable by death].

Nobody in the National Assembly or Senate is worried about erosion of our resources largely consumed largely by debt servicing and how to come out of 'debt prison' that is main cause of political subjugation. They are wasting words and energies on non-issues.

When the PPP government was borrowing on an average Rs. 3-4 billion a day, Senator Ishaq Dar was very critical and now he is resorting to Rs. 9-10 billion a day—still he keeps on accusing his predecessor regime for all the ills! This monstrous debt burden is going to further enhance allocation for debt servicing in the next budget. In the current year it is Rs. 1154 billion, 61% of target assigned to Federal Board of Revenue (FBR) and double the defence budget of Rs. 627 billion. The surge of Rs. 325 billion in external debt and one trillion in domestic debt during July-September 2013 portrays an alarming situation. The continuous accumulation of internal debt—insatiable desire to get funds from commercial banks and State Bank of Pakistan (SBP)—besides depriving

the private sector from much-needed funds for investment is giving rise to inflation that touched the level of 9.5% by the end of October 2013.

The data released by SBP for the first quarter of the current fiscal year reveals that:

- domestic debt increased from Rs. 9.52 trillion to Rs. 10.16 trillion in just three months, showing an increase of Rs. 635 billion or 6.7%. Within the domestic debt, the short-term debt ballooned by Rs. 611 billion or 11.7%.
- short term debt that was Rs. 5.2 trillion in June 2013 increased to Rs. 5.8 trillion. The biggest jump came in the market treasury bills after the commercial banks refused to reschedule their loans.
- debt under the market treasury bills for replenishment of cash increased from Rs. 2.27 trillion to Rs. 3.1 trillion, a net increase of Rs. 750 billion or 33%.
- external debt increased by Rs. 325 billion or 7.3%—as against June 30 level of Rs. 4.48 trillion whereby the external debt increased to Rs. 4.83 trillion. Out of the total external debt, the major increase was in the long-term debt that increased from Rs. 4.48 trillion to Rs. 4.8 trillion, a jump of Rs. 325 billion or 7.3%.
- 7% devaluation of local currency against the US dollar resulted in massive jump in the long-term foreign debt. By end June the US dollar was equal to Rs. 99.20 that devalued by Rs. 6.90 to Rs. 106.1 a dollar by end September 2013.

It is worth mentioning that even entering into a tough deal with IMF has not helped Pakistan to convince other international lenders to be 'generous'. The World Bank delayed sanction of one billion dollars making it conditional with energy and taxation reforms. Two development policy credits—Jobs and Growth & Power Sector Reforms—each worth $500 million are lingering on for want of approval by the Board of Directors of the World Bank. The upfront disbursement of these, in a single tranche, could help strengthen Pakistan's reserves. The government after IMF programme hoped to receive these immediately to improve the fast dwindling foreign currency reserves that plunged to $ 4.299 billion—insufficient to meet even one month's import bill. The massive dip in foreign currency reserves, despite IMF's payout, has left Pakistan and the IMF bewildering!

At the time of signing the IMF 6.7 billion programme, Pakistan expected to receive additional $6 billion to $8 billion from the World Bank, the Asian Development Bank, the Islamic Development Bank and other bilateral donors over a period of three years. These institutions, after the termination of IMF programme in 2010, stopped lending to Pakistan. Now even after the renewed IMF programme, the World Bank has subjected approval of its funds with accelerating of FBR's efforts for tax

compliance by the rich, revamping of Planning Commission and power sector-specific reforms. The linkage of these funds with taxation reforms has already dampened the hopes of the government as broadening of tax base received a serious setback in the first three months—**FBR's lack of agility**, *Business Recorder,* October 25, 2013.

The only way to come out of prevalent mess is to accelerate growth, generate employment, enhance tax revenues, and stop financing luxuries of elites and losses of public sector enterprises (PSEs). But the present government like PPP-coalition government is not serious about it. During its election campaign, Muslim League Nawaz (PML-N) made tall claims that on assuming power it will get rid of the "cancer of external debts". However, PML-N government is knocking the doors of international lenders more vigorously than PPP.

Internal debt has already breached the limit of 60% imposed under the Fiscal Responsibility and Debt Limitation Act 2010. The law requires the government to prepare and revise the debt management policy every year in January but nothing has been done as there is no debt reduction plan. Making things worse, the government is not inclined to impose fiscal discipline and reckless borrowing continues to pay off liabilities of the corruption-ridden inefficient PSEs. According to SBP, the funding of PSEs has inflicted economy heavily, increasing the stock of total debt & liabilities (TDL) by Rs. 500-600 billion.

All the governments—civil of military alike—have failed to end debt enslavement by raising revenues even to the extent of Rs. 6 trillion, though actual potential is not less than Rs. 8.5 trillion [**FBR's *Year Book 2012-13***, *Business Recorder,* September 27, 2013]. Unless it is done, Pakistan can never come out of the 'debt prison'. The Senate was informed on January 23, 2013 that over 3.39 million individuals had National Tax Numbers (NTNs), but only 885,999 filed their returns. The former Finance Minister, Abdul Hafeez Sheikh admitted that the number of income tax filers had drastically reduced to 1.6 million by 31 December 2012. The Senate was told that "a large number of businesses and individuals, who were regularly filing their income tax returns, are now avoiding their legal obligations by either under-declaring or incorrectly declaring their assets and incomes".

After admitting widespread tax non-compliance, no action was taken against any official of FBR. There is no will to eliminate wasteful spending on monstrous government machinery and inefficient PSEs. The way the government is behaving, our foreign debt would reach US$ 75 billion in 2015 and domestic debt would be Rs. 20 trillion. The policies of appeasement towards tax evaders, money launderers and plunderers of national wealth and monopolization of resources by *Riasti Ashrafiya* (State Aristocracy) have pushed the country towards disaster. The word 'austerity' is not available in the dictionary of the State Aristocracy—indomitable militro-judicial-civil complex and men in power. The habit of living beyond means—our national addiction—has turned the nuclear-

powered Pakistanis into a nation with a beggar's bowl. When foreign lenders see the lifestyle of our ruling elite, they immediately show indignation—it is hard to believe for them that the rulers of a nation surviving on borrowed funds and on the brink of bankruptcy are capable of displaying such flamboyance.

Reluctance to collect taxes from the rich and mighty, rather giving them free benefits and perquisites at State's expense, is worsening the miseries of the poor. There is no scarcity of resources as propagated by the rulers to shift blame on others, but the real cause is outlandish living of the elites off taxpayers' money. Look at residences of judges, generals and high-ranking civil officials with army of servants and fleet of cars. Wasteful spending on State Aristocracy and unwillingness to tax the rich is playing havoc with the economy. Behind the present chaotic socio-economic and political situation in Pakistan, amongst other factors, is an ever widening gulf between the rich and the poor. With every passing day more and more people are being pushed below the poverty line, our rulers unashamedly waste billions on their comforts and personal security.

The present crisis testifies to the failure of power-hungry, money-greedy politicians and incompetent, inefficient and corrupt bureaucrats. Even the so-called technocrats always take the first flight to Washington after creating a mess and tearing apart the economic fabric of the country—where are Shaukat Aziz and Abdul Hafeez now? In this bleak scenario, *Riasti Ashrafiya* is not ready to surrender extraordinary perks and privileges enjoyed by them at the cost of taxpayers' money. How can rulers and bureaucrats living in fortified containments, completely oblivious of the ordinary people's plight, feel the pinch of life's hardships?

We cannot come out of debt-enslavement unless we restructure our State on the principle enshrined in Article 3 of the Constitution—**from each according to his ability, to each according to his work**. For this, everyone should be given work with a fair reward in return. There should be a complete change in the style of governance—the President, Governors, Prime Minister, Chief Ministers, ministers, parliamentarians, and high-ranking government officials should be given 'consolidated pay' liable to tax just like the income of an ordinary citizen. Palatial residences occupied by them should be sold or converted into income-yielding assets, and all perquisites of civil servants and public office-holders should be monetized to remove the burden off our country's broken financial back.

Cayman

Cayman's Finance Minister Comments on G8 Action Plan

The Minister for Financial Services in the Cayman Islands, Wayne Panton, issued a statement on the commencement of the territory's G8 Action Plan on November 04, 2013.

"On 31 October, the UK announced a proposal for a public register of beneficial ownership information, following the results of its public consultation," he said. "If implemented, the register conceivably would allow a citizen of any country to access information on the beneficial owners of UK-registered entities.

"In the Cayman Islands, we also are assessing our regime on beneficial ownership. In our action plan on the misuse of companies and other legal structures, published immediately following the June G8 Summit, we committed to assess whether a central registry of beneficial ownership is the most appropriate and effective way to improve transparency. Further to that commitment, our public consultation document will be issued this November.

"Along with our consultation, we will continue to monitor the global response to the UK's announcement and any proposals that are made by other G8 countries, the G20 and other relevant international bodies on matters related to transparency. Universal success will be predicated on a fair, and level, playing field in which all jurisdictions adhere to accepted and recognized standards.

"As evidenced in our April 2013 Phase 2 Peer Review Report by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, information relating to beneficial owners is available in Cayman. Through our recognized legal and regulatory infrastructure, that information has been collected and updated in the jurisdiction for more than a decade.

"The UK's proposal to consider a public register on beneficial ownership continues the UK's strong political stance on tax and transparency matters and expands the public discourse on the best way to facilitate a global standard.

"The Cayman Islands will continue to engage in the discussion, and to support the UK and the global financial industry in developing effective standards. Our record demonstrates this; for example, we will shortly be signing a FATCA-style agreement with the UK to automatically share financial information with the UK

on UK taxpayers who hold Cayman Islands accounts. Our signing of a FATCA Model 1 IGA with US also is imminent.

"Furthermore, following the Cayman Islands' formal request for the UK to extend its membership in the Convention on Mutual Administrative Assistance in Tax Matters, the convention will become effective in Cayman on January 01, 2014.

"In April this year we agreed to participate in the G5 pilot on multilateral automatic exchange of information. To date, Cayman also has signed tax information exchange agreements with 31 jurisdictions, and negotiations are either completed, or underway, with a further 18 jurisdictions.

"As the global discussion on beneficial ownership continues, we note that our legislative and regulatory framework has been assessed favorably by several supranational bodies, and that this is a matter of public record. The Cayman Islands intends to stay the course that has led to this high regard, and we will continue to both consider and adopt standards that are practiced worldwide." – *Courtesy tax-news.com*

OECD

Andorra Signs OECD Mutual Tax Assistance Convention

The Andorran Government has announced the signing of the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

Adopted in Strasbourg on January 25, 1998, and modified by an amending protocol in May 2010, the agreement was signed in Paris by the Ambassador of Andorra to France, Maria Ubach, on behalf of the Andorran Government.

According to the Andorran Government, the signing of the Convention forms part of ongoing policy, sealed back in 2009 with the signing of the Paris Declaration, reflecting Andorra's commitment to international standards on financial transparency and representing "a new expression of this political will." The policy aims to consolidate the reputation and strength of the Principality's financial center, thereby expanding its growth potential.

Concluding, the Andorran Government emphasized that the existing 21 bilateral tax information exchange agreements concluded by Andorra will remain in place in their current form.

The OECD agreement will now be subject to the constitutional ratification process in order to take effect, the Government ended.

The OECD recommended back in 2009 that all countries sign the Convention. However, following the review that took place in 2010, the instrument became the main and most advanced tool for mutual assistance in tax matters, facilitating the establishment of a level playing field.

The Multilateral Convention provides for all forms of mutual assistance: exchange on request, spontaneous exchange, tax examinations abroad, simultaneous tax examinations, and assistance in tax collection, while protecting taxpayers' rights. It also provides the option to undertake automatic exchange, requiring an agreement between the parties interested in adopting this form of assistance.

OECD Secretary-General Angel Gurria welcomed Andorra's steps to strengthen international tax cooperation after it became the 60th signatory to the Multilateral Convention.

Gurria said: "Andorra has taken many positive steps towards greater tax transparency in the past four years."

Alluding to the fact that the signing marks "an important signal that Andorra is seriously committed to the international fight against offshore tax avoidance and evasion," Gurria noted that the rapid increase in signatories to the Convention reflects "the growing levels of international support for exchange of information on request, and foreshadows that automatic exchange of information will become the new international standard." – *Courtesy tax-news.com*

Cayman – United Kingdom

Cayman, UK Sign 'FATCA'-type Agreement

The Cayman Islands signed an intergovernmental agreement (IGA) with the United Kingdom on November 05, 2013, laying the foundation for the automatic exchange of financial information about UK taxpayers who hold accounts in the Cayman Islands.

The IGA is modeled on agreements made under the Foreign Account Tax Compliance Act introduced by the United States to ensure tax compliance among its citizens with international interests.

The Premier of the Cayman Islands, Alden McLaughlin, said that the government is working on setting up the legislative and operational framework needed to implement the IGA, and it will issue guidance on implementation.

"Entering into this agreement with the UK builds on our shared history of cooperation in tax and transparency matters; furthermore, it strongly indicates our mutual support for a single, global standard for the automatic exchange of information," McLaughlin said.

The Cayman Islands and the UK will monitor the outcomes of the IGA to ensure that it remains effective in tackling tax evasion without burdening financial institutions with added compliance costs, according to Wayne Panton, the Minister of Financial Services in the Caymans.

The IGA compels financial institutions in the Cayman Islands to report information on financial accounts that are "substantially owned by persons with UK tax-reporting obligations" to the Cayman government, which will in turn pass the information on to the British government.

UK Chancellor of the Exchequer, George Osborne, commented: "We welcome this signing with the Cayman Islands, the first Overseas Territory to sign this type of agreement with the UK. This demonstrates our shared commitment to tackling tax evasion.

"Alongside the significant investment that this government has made in HMRC's anti-avoidance and evasion work, these agreements will help them to clamp down further on those individuals who seek to hide their assets offshore. Our message is very clear: it is only fair that people pay the tax they owe. If you are trying to evade tax, we are coming after you."

In October the Isle of Man became the first British dependent territory to sign an agreement with the UK extending the automatic disclosure of tax information. – *Courtesy tax-news.com*

Smuggled fabric worth Rs 20 million seized, two arrested

Directorate of Intelligence and Investigation, FBR, Karachi on Wednesday said that it seized huge quantity of smuggled fabric worth Rs 20 million from Tariq road area and arrested two persons. According to sources, Director Manzoor Memon received information that some unscrupulous elements were going to offload smuggled fabric at Dubai Shopping Mall on Tariq road in the limits of Ferozabad police station.

Reacting on the information, a team of the Directorate conducted a raid on early Wednesday morning when the smugglers were busy in unloading the smuggled fabric from a 40-ft container. They said that fabric imported under Afghan Transit Trade (ATT) was reportedly unloaded in the country. They said two accused were arrested besides seizure of huge quantity of fabric worth Rs 20 million. Further investigation was underway. – *Courtesy Business Recorder*

Rs 2.4 trillion revenue target ambitious, unrealistic: FBR

The Federal Board of Revenue has termed the revenue collection target of Rs 2,475 billion for 2013-14 as unrealistic and ambitious while the tax machinery is making efforts to overcome revenue shortfall through documentation, withdrawal of exemptions, reforms, customs modernisation and enforcement actions.

Sources told on Wednesday that the FBR had provisionally collected Rs 635 billion during July-October (2013-14) against the target of Rs 670 billion, reflecting a shortfall of Rs 35 billion. The FBR has been assigned a target of Rs 2,475 billion for the year 2013-14. The required growth over last year's actual collection is 27.4 percent. The target is unrealistic and ambitious as it has been based on the assumption that the FBR collection would be Rs 2007 billion in 2012-13, whereas the collection stood at Rs 1,939 billion. Thus the base has eroded by Rs 68 billion from the beginning of fiscal year (2013-14). However, the FBR is making all-out efforts to bridge this gap through tax administration measures. Hectic efforts are being made towards broadening the tax base, effective audit and restrictions of bogus refunds through automation, etc.

Sources said the FBR has devised various strategies to meet revenue collection target in 2013-14. The government had already taken a host of revenue measures in the budget for enhanced resource mobilisation. This is a gigantic step as it would improve

the tax-GDP ratio from 8.5 percent in 2012-13 to 9.5 percent in one financial year. Moreover, 0.7 percent increase in each fiscal year during 2014-15 and 2015-16 has also been planned which will further improve tax-GDP ratio and bring the country close to the competing/emerging economics. In order to achieve these goals, the FBR is committed to broadening its tax base and improve tax administration significantly. For the purpose, the FBR has chalked out a comprehensive plan for 2013-14.

For broadening the tax base several initiatives have been taken and some are in the pipeline. Initially, the objective is to incorporate 300,000 new taxpayers under the documentation strategy. In this regard 10,000 notices have already been issued, and 100,000 notices will be issued by June 30, 2014. Similarly, a detailed plan for outreach programme including provisional assessment, collection procedures, penal actions and prosecution proceedings has been chalked out, sources said.

Sources said the initiatives for administrative improvement in all the taxes are being finalised and implementation strategy shall be developed and launched within 6 months. To do away with the SRO culture a comprehensive plan for rationalisation of concessionary SROs and phasing out of special exemptions in all the taxes has been made. Certain policy reforms have already been taken and GST coverage has been expanded. Exemptions have been restricted to food items, health, education and agriculture produce. For tariff rationalisation a Committee headed by Chairman, FBR would submit the plan by December 31, 2013. To resolve issues relating to sales tax FBR has successfully prepared and implemented Computerised Risk Based Evaluation of Sales Tax (Crest).

Sources said that it has also been planned to quantify the tax expenditures and initiate risk based audit plan. The plan is to strengthen audit to accompany the self assessment scheme to overcome the weak tax compliance. Substantial progress has been made for infrastructure up-gradation and development with the introduction of the integrated tax management system (ITMS), which is available to all the field formations.

Customs modernisation reforms have been introduced with the aim of simplifying, standardising and automating customs clearing procedures supported with strong post clearance audit controls. An integrated, risk-based automated customs clearance system (WeBOC) has been indigenously developed which minimises

interaction between taxpayers and tax collectors, thereby minimising any chance of corruption. Human Resource Management has been improved and major structural initiatives have been taken by FBR in its organisational reform program.

It is expected that the assigned target for the remaining period of 2013-14 with the enforcement of the said measures would be achieved, sources said.

Sources added that Pakistan has confronted difficult challenges in the past few years, external and domestic economic shocks, political uncertainty and security problems have rocked the economy badly. Continued security issues, two major floods and large fiscal deficit have contributed to make inflation persistently high and limit growth and employment generation. On the other hand energy crisis played havoc with the manufacturing sector which is a tax base for domestic taxes such as FED and domestic sales tax. Resultantly, growth in the large scale manufacturing sector was very low; therefore, revenue realisation from the manufacturing sector and related businesses has also been badly affected. – *Courtesy Business Recorder*

E&T offices being computerised in Punjab

The offices of Excise and Taxation department are being computerised in Multan, Gujranwala, Faisalabad, Lahore and Rawalpindi to facilitate the tax payers. "E&T department is going to sign MoUs with commercial banks particularly Bank of Punjab to provide on-line payment facility to tax payers," Secretary Excise and Taxation, Shahid Ashraf Tarar said this while addressing the traders and industrialists at Multan Chamber of Commerce and Industry (MCCI).

Director General Excise Punjab, Nasim Sadiq and Director Excise Multan, Jam Siraj were accompanied by him. He said that South Punjab is paying Rs 480 million as cotton cess which is an appreciable contribution to government revenue.

He said proposed rates of property tax, valuation tables are under consultative process and would be finally imposed after due consultation with the business community and approval of Punjab chief minister.

He invited nomination of some members from MCCI and traders representatives to include in the committee being constituted to finalise the rate of property tax and valuation tables.

Earlier, in his welcome address MCCI President, Khawaja Muhammad Usman said that Multan is the fifth industrial hub and third largest revenue generation city in the country. He said that proposed tax rate for immovable properties is not acceptable to the business community. Moreover, 'A' Category could not be applied for Multan and tax amount will be increased from Rs 20,000 to Rs 120,000 with the proposed valuation tables. – *Courtesy Business Recorder*

2013 TRI 1797 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
MUMBAI "D" BENCH, MUMBAI

Vijay Pal Rao, Judicial Member and D. Karunakara Rao, Accountant Member

FACTS/HELD

Loss on foreign exchange forward contracts is incidental to the exports business and not a "speculation loss". However, if the contract is prematurely cancelled, the assessee has to justify the loss

1. The assessee, an exporter of diamonds, entered into forward contracts with Banks to hedge the exchange loss, if any, in respect of the outstanding receivable in foreign currency. The assessee suffered a loss of Rs. 4.69 crore on account of the maturity & premature cancellation of the said forward contracts. The AO & CIT(A) held that the forward contracts constituted a "speculative transaction" u/s 43(5) and that the loss suffered thereon was a "speculation loss" which could not be set-off against the other income. On appeal by the assessee to the Tribunal HELD:

   (i) Though a forward contract for purchase or sale of foreign currency falls in the definition of "speculation transaction" u/s 43(5) as it is settled otherwise than by the actual delivery or transfer of the commodity, it cannot be regarded as constituting a "speculation business" under Explanation 2 to s. 28. A forward contract, entered into with banks for hedging losses due to foreign exchange fluctuations on the export proceeds, is in the nature of a "hedging contract" and is integral or incidental to the export activity of the assessee and cannot be considered as an independent business activity. Therefore, the losses or gains constitute business loss or gains and do not arise from speculation activities. The fact that there is a premature cancellation of the forward contract does not alter the nature of the transaction. There is also no requirement in the law that there should be a 1:1 correlation between the forward contracts and

the export invoices. So long as the total value of the forward contracts does not exceed the value of the invoices, the loss has to be treated as a business loss (Sooraj Mull Magarmull 129 ITR 169 (Cal), Badridas Gauridu 261 ITR 256 (Bom), Panchamahal Steel 215 Taxman 140 (Guj) and Friends and Friends Shipping (Guj) followed; contrary view in S. Vinodkumar Diamonds (ITAT Mum) referred);

(ii) On facts, the loss arising on cancellation of matured forward contracts is allowable as it is attributable to the genuine failure of the trade debtors to comply with the credit terms and conditions. As regards the loss arising on account of premature cancellation of the forward contracts, the assessee requires to explain the reason for the premature cancellation. The explanation that the maturity of date of some of such premature cancelled forward contracts fell during the week-end and therefore they were cancelled three days prior to the due date is acceptable and the loss is allowable. The explanation that some other forward contracts were prematurely cancelled due to business reasons and to avoid higher loss requires to be examined by the AO. The correspondence with the banks and the RBI guidelines on the issue as well as the accounting treatment by the banks also requires to be examined. The assessee's alternative argument that the said loss is "damages" payable to the banks for breach of contracts or settlement of the contracts also requires examination by the AO.

Appeal partly allowed .

I.T.A. No.6169/M/2012 (Assessment Year: 2009-2010)

Heard on: 30th August, 2013.

Decided on: 11th October, 2013.

Present at hearing: Soli Dasture and Nikhil Ranjan, for Appellant. Dr. Dipak Ripote, DR, for Respondent.

JUDGMENT

Per D. Karunakara Rao:– (Accountant Member)

This appeal filed by the assessee on 9.10.2012 is against the order of the CIT (A)-9, Mumbai dated 10.7.2012 for the assessment year 2009-2010.

2. In this appeal, assessee filed the grounds of appeal, which was subsequently revised vide letter dated 5.10.2012. The said revised grounds filed by the assessee read as under:

"1.A. The Ld CIT (A) erred in fact and law in confirming the disallowance of Forward Exchange Loss of Rs. 4,69,42,680/- claimed by the appellant in the course of business incurred due to fluctuation in foreign exchange for which the appellant had booked forward contracts with the bank against their export receivables treating the same as speculation transaction & not hedging transactions as claimed by the appellant.

B. The Ld CIT (A) further erred in fact and in law in not allowing this forward contract loss of Rs. 4,69,42,680/- to be set off against the Profit and Gains on account of exchange fluctuations on realization / revaluation of the said receivables, this being directly related to the same business transaction and which has been assessed to tax.

C. The CIT (A) erred in fact and in law in considering this losses as speculative without taking into account the appellants contention on the issue viz;

i) These contracts were booked as permitted by RBI Regulations.

ii) The transactions were covered by the exception provided in section 43(5)(a) on the Income Tax Act, 1961."

3. Briefly stated relevant facts of the case are that the assessee is engaged in the business of trading and manufacturing of rough and polished diamonds and filed the return of income declaring the total income of Rs. 35,29,042/-. Assessment was completed u/s 143(3) of the act determining the total income of Rs. 5,04,71,720/-. Assessing Officer made addition of Rs. 4,69,42,680/-. Relevant facts leading to the said addition include that the assessee being an exporter, made export of diamonds and outstanding receivable in foreign currency and entered into forward contracts with the Banks to hedge the exchange loss if any. Further, in accordance with the statutes, he also revalued the outstanding export receivable too. The total gain on account exchange difference on exports is Rs. 679.75 lacs on account of both actual realization and revaluation of outstanding receivables. The loss incurred on account of forward contracts to safeguard the outstanding receivables is Rs. 469.43 lacs. Accordingly, assesse set off the loss against the said gain and credited the net amount/ profit of Rs. 210.14 lacs to the profit and loss account. During the assessment proceedings, AO made various enquiries with regard to this credit entry and in response, assessee filed letters dated 29th and 30th November, 2011 which formed part of the assessment order. In these letters, the assessee provided numerous statistical data to justify its stand. In brief, total forward contracts entered into during the year works out to Rs. 135.99 Crs and the total cancellation is Rs. 126.3 Crs,

the net forward contract is Rs. 9.95 Crs. The total exports in the year works out to Rs. 107.57 Crs. Total outstanding receivable in foreign exchange is much higher than any of these figures. Briefly, the stand of the assessee is that it entered into forward contracts with the banker to safeguard against the exchange fluctuations of export considerations/sale profits. It is the stated reasoning of the assessee, being an exporter, he has outstanding receivables whose value in US dollar is always subjected to market fluctuations internationally. Therefore, he needs to hedge the receivable against the exchange loss if any. Accordingly, he entered into the forward contracts with the Banks as per the RBI guidelines. Thus, the gains as well as the loss constitute business gains and loss and entitled for set off before the net gains is credited to the P and L Account. In this regard and before the AO, the assessee relied on the exemptions provided in clause (c) of the proviso to section 43(5) of the Act which provides for the definition of "speculation transaction". Clauses (a) to (e) of the said section provides for exemption of certain facts from the definition of 'speculation transaction". Thus, the assesse contended that the impugned loss is outside the scope of the 'speculation transaction"' and the loss being integral part of the export business constitutes 'business loss'. Consequently, the same is eligible for set off against the foreign exchange gains earned by the assesse both on account of actual realizations and revaluation of the outstanding receivables. Eventually, AO considered the above submissions of the assessee and also examined the applicability of the provisions of section 43(5) of the Act in general and clause (c) of the proviso to section 43(5) in particular and held that the impugned transactions do not satisfy in all the conditions specified in the said provisions. Relevant discussion is given in para 9 of the assessment order. AO dismissed the applicability of clause (a) of the proviso to section 43(5) stating that the assessee failed to demonstrate that the impugned transactions were incurred for hedging the risk against the raw material or merchandize. Similarly he rejected the applicability of clause (b) of section 43(5) of the Act too. AO opined that the same applies to the stocks and shares. On the applicability of clause (c) to section 43(5), AO dismissed the submissions of the assessee stating that the said provisions apply only to a case of contract entered into by a member of a forward market or an exchange which is not the case here. Finally, on the applicability of clause (d) of the proviso to section 43(5), AO ruled out the same considering the unfulfillment of the conditions specified therein. Thus, the AO concluded that the foreign exchange contracts constitute speculative transactions u/s 43(5) of the Act. AO also discussed the provisions of Explanation 2 to section 28 of the Act which provides for the explaining the deemed 'speculation business" and held that the profit and loss arising from such transactions have to be computed separately and treat the same as per the provisions relating to the 'speculation business'. In this context he also referred to the provisions of Explanation to section 73 relating to 'speculation loss'.

Relying on the principles relating to the onus AO held that the assessee failed to demonstrate that the transactions in question relates to hedging transactions. AO analyzed the principles laid down by the AAR-New Delhi, in the case of *Sopropha S.A.*, re [2004] 268 ITR 37 and held that the said principles are found unfulfilled for calling the impugned transactions as hedging transactions. On the burden of proof issues, AO relied on the judgment of the Hon'ble Supreme Court in the case of *CIT vs. Joseph John* [1968] 67 ITR 74 (SC). Referring to the Delhi High Court judgment in the case of *Delhi Flour Mills Co. Ltd vs. CIT* [1974] 95 ITR 151 (Delhi), AO opined that the foreign exchange transactions cannot have any nexus with the export of diamonds. In this regard, AO is of the opinion that the person selling cotton cannot enter into forward contract, say for gold. He also discussed the judgment of Bombay High Court in the case of *CIT vs. Arjan Khimji & Co.* [1980] 121 ITR 421 (Bom). Thus, AO concluded by stating that the foreign exchange / currency derivative transactions are not covered by the exclusions provided in the proviso to section 43(5) of the Act. Further, he held that assessee failed to the establish that the transactions in question have the nature of hedging transactions and he treated the loss of Rs. 4,69,42,680/- as the speculation loss and made the addition. So far as the profit earned on actual realization of export proceeds and the profits on revaluation of the outstanding receivable is concerned, the AO taxed the as the business income of the assesse and accordingly, denied the set off of the loss of Rs. 4,69,42,680/- against the gains of Rs. 679.75 lacs. Aggrieved with the same, assessee filed the present appeal before the CIT (A).

Before the CIT (A)

4. During the proceedings before the first appellate proceedings, assessee made written submissions and mentioned that the impugned forward contracts (FCs) are linked or incidental to the export invoices of the year and the outstanding receivables related to the exports and therefore, these are hedging transactions and constitutes business contracts. Assessee mentioned that, leaving 50% of the contracts which are settled by delivery, rest of the transactions are either terminated by the Bank on due / maturity dates due to commercial reasons because of non realization of exports from the debtors. Further, the assesse mentioned that out of the forward contracts cancelled prior to the due dates, some of these contracts are cancelled three days prior in view of the week end holidays. Referring to the terminated and cancelled Forward contracts on the due date or later, the assessee reasoned that it directly imply the integral part of the export business and therefore, the related loss constitutes 'business loss'. Referring to the rest of the loss-yielded FCs, which are cancelled prior to the due date, assesse mentioned that they are cancelled to reduce the loss and it is a business decision of the assesse. Further, assessee argued that the provisions of section 43(5) are not applicable to this case as it applied only to the commodity including stocks and shares and relied on the decision of the ITAT, Delhi

in the case of Munjul Showa Ltd vs. DCIT, 94 TTJ 227 (Delhi Tribunal). As per the assesse the forward contracts do no constitutes 'commodity', which is precondition for invoking the said subsection (5) of section 43 of the Act. Even if it is applied, the impugned FCs being hedging in nature are covered by clause (a) to the proviso to section 43(5) of the Act. The outstanding receivables are always higher than the forward contracts cumulatively. In large number of transactions, the cancellation of contracts was done only on the maturity and therefore, there are no speculative contracts. Assessee relied on the Bombay High Court judgment in the case of CIT vs. Badridas Gauridu Pvt Ltd 261 ITR 256 and Ors and mentioned that the said judgment applied to the case of the assessee. Regarding the AO's reliance on AAR Ruling in the case of Sopropha S.A. in re (supra), assessee submitted that considering the fact that the assessee fulfills couple of conditions and the impugned transactions must be treated as hedging transactions. Further, assessee relied on RBI Circular dated 13.12.2006 and the CBDT Circular No.23D dated 12.9.1960 and mentioned that RBI has no problem with the impugned contracts as they are undergone to guard the risk of underlying receivables and the claim of the assessee needs to be accepted. Assessee also relied on the Dollar rate fluctuations from April 2008 to March 2009, which registering per dollar appreciation from Rs. 39.9668 to Rs. 51.2062 during the year. Eventually. CIT (A) considered and rejected above arguments of the assesse. Eventually, assessee's appeal was dismissed upholding the conclusions of the AO. Aggrieved with the decision of CIT (A), assessee filed the present appeal before the Tribunal vide ground imported above.

BEFORE THE TRIBUNAL
Ld AR"s Arguments

5. Mr Soli Dasture and Mr. Nikhil Ranjan, Ld Counsels for the assessee appeared before us. To start with, the back-ground facts of the case and the issues raised before the Tribunal were explained. He mentioned that the CIT(A) erred in treating the business transactions as the speculation one in nature and eventually erred in not treating the loss of Rs 4,69,42,680/- as business loss of the assessee. Briefly mentioning the grievances, Ld Counsel mentioned that, as claimed in the return of income, AO should have allowed the claim of set off of the said loss against the profits of the foreign exchange earned on actual realizations and revaluation of the outstanding receivables in foreign exchange. He also relied on the exclusions provided in the proviso to section 43(5) and also the RBI guidelines.

6. Elaborating the disputes and the issues, Ld Counsel submitted that the assessee entered into the Forward Contracts (FCs) with the Banks as integral part of the export business with the aim to safeguard against the foreign exchange fluctuation of the US dollar vis avis the Indian currency and therefore, the FCs are not speculative transactions

or speculation business. To substantiate the same, he mentioned that the total worth of the FCs entered during the year are Rs. 135.99 Crs and same constitute merely around 3% of the 'Outstanding Receivable of export proceeds in foreign currency' in the beginning of the year. At no point of time, the same exceeded the said trade receivables in currency.

7. *One-to-One Correlation between the FCs vs Invoices*: Further on the FCs being the integral part of the export business, Ld counsel mentioned that the FCs and the export invoices are closely correlated and such correlation need not be to the last rupee and the precise dates. In this regard, he relied on the judgments in the case of M/s Friends and Friends Shipping Pvt. Ltd, supra, and M/s Panchasheel Ltd, supra and the CBDT Circular. To substantiate the same, Ld counsel filed a statement of comparison between the dates and values of the FCs qua the export invoices raised in the year. Ld Counsel submitted that 1:1 correlation between the export invoices and foreign exchange contracts is not required and broad matching should be sufficient.

8. Loss on cancellation of the FCs constitutes Business loss: Ld Counsel explained the facts of the binding coordinate bench decision in the case of D Kishore kumar and Co (2 SOT 769 (mum) and the judgments in the case of Badridas Gauridu Pvt Ltd (supra) and mentioned that the FCs entered into with the Banks to hedge the foreign exchange loss if any in respect of the core business transactions constitutes its integral part and loss or gains is allowable as business loss or gains as the case may be. Referring to the said decision in the case of D Kishore kumar and Co supra, Ld Counsel mentioned that the 'the fact of premature cancellation cannot alter the nature of the transaction'. In this case, the issue was if the gains from the FCs constitutes 'business profits' and eligible for deduction u/s 80HHC without invoking the Clause (baa) of the its Explanation. Hon'ble Tribunal held that the FCs constitutes 'integral part' and the gains are treated as 'profits of the business' and in favour of the assessee. Referring to the binding judgment of the Bombay High Court in the case of *CIT vs. Badridas Gauridu Pvt* (supra), Ld Counsel mentioned that the losses earned by assessee, exporter of cotton & not dealer in foreign exchange, relating to the FCs entered into with the Banks, constitutes business loss and allowable for set off against the business profits. In the process, judgment in the case of *Sooraj Muill Magarmull* 129 ITR 169 (para 3) from Calcutta High court is followed. Thus, Ld Counsel is critical of the conclusions of the CIT (A) and manner of distinguishing the said binding judgment on frivolous grounds. Ld Counsel is also critical of the CIT (A)'s conclusions, who mistook the impugned FCs as currency derivatives, and mentioned that these derivatives should have been treated differently in view of the specific definition provided to derivatives in section 2(ac) of Securities Contract Regulation Act, 1956.

9. Meaning of the expression "Commodity" used in section 43(5) of the Act: Further, elucidating the provisions of section 43(5) relating to the definition of 'speculation transaction', Ld Counsel made various propositions stating that foreign exchange contract is not a commodity and therefore, there is no provision in law to treat the impugned FCs as speculation transaction. He relied on the decision of the Tribunal in the case of *M/s. Gill & Co. Ltd vs. JCIT* vide ITA No.216/M/2002 (AY 1996-97), dated 21st February, 2003, *Voltas International Ltd vs. ACIT* vide ITA No.2931/M/2005 (AY 1996-97) dated 18.7.2008; and *Munjal Showa Ltd. vs Deputy Commissioner Of Income Tax* (2005) 94 TTJ Delhi 227, dated 26 June, 2003. However, Ld Counsel fairly mentioned that the Hon'ble Calcutta High Court in the case of *CIT vs. Sooraj Mull Nagarmull* [1981] 129 ITR 169 held differently and FCs are treated as 'commodity'. The Provisions of section 43(5) are invoked validly only if the FCs constitutes the "commodity".

10. Clause (a) of section 43(5) of the Act - Meaning of the expression "in respect of..": It is the argument of the assessee that the assessee is not a dealer in the foreign exchange; but he is exporter of diamonds and the contracts are entered into with the Bank in respect of the export invoices. The FCs, being the hedging transactions, covered by the provisions of clause (a) of section 43(5) of the Act are outside the scope of the speculation business. He also explained the meaning of the expression —in respect of" in connection with export contracts of the assessee and relied on the judgment of the Hon'ble Supreme Court in the case of *Renusagar Power Company Ltd vs General Electric Company And Anr* [1984] SCC (4) 679 dated 16 August, 1984 and judgment in the case reported in AIR 1997 SC 1302 assuming that these are not covered by the said clause (a) of the proviso to section 43(5) of the Act.

11. Referring to the Explanation 2 to section 28 of the Act: In this regard, Ld Counsel mentioned that for constituting the speculation transaction as a speculation business, the transaction must be of that nature of speculation and in that case, the deemed business shall be deemed as distinct and separate from any other business carried on by the assessee. If the transactions are not linked to the export business of the assessee, the speculation transactions must not be treated as speculation business. Therefore, incidentality or integral nature of the FCs becomes relevant. Elaborating the same, Ld counsel mentioned that the provisions of section 73(1) will swing into operational only in case of speculation business and not speculation transactions.

12. Damages on settlement of FCs- allowable deduction: Ld Counsel submitted that the impugned losses are incidental to the FCs, which are integral part of the export proceeds, should be treated as contracts. The loss on breach of contract if any constitutes damages. Therefore, the payment to bank constitutes a payment of damages for such breach of contracts, which again allowable as business loss and not as speculation

loss. In this regard, Ld Counsel relied on the judgment of the Hon'ble Supreme Court in the case of *CIT v. Shantilal (P) Ltd* [1983] 144 ITR 57 (SC) and the one reported in 207 ITR 198.

13. Distinguishing the decision in the case of *S. Vinodkumar Diamonds Pvt. Ltd*: Bringing our attention to the decision of the ITAT, Mumbai in the case of *S. Vinodkumar Diamonds Pvt. Ltd vs. Addl.CIT* vide ITA No.506/M/2013, Ld Counsel distinguished by stating that the loss on account of cancellation of FCs was actually allowed by the AO and therefore, there is no dispute on this issue. However, the dispute in this case revolves around if the 'loss on revaluation of outstanding FCs' whose maturity date falls in the next years'. On mentioning that the said decision is not relevant for the impugned disputed here, Ld counsel filed a copy of the MA arising from said ITA No.506/M/2013 and the same is pending for adjudication before the Tribunal.

14. Factum of foreign exchange fluctuations – Need for hedging transactions: Referring to the page 15 of the paper book, Ld Counsel mentioned that during the year, the foreign exchange rate of the dollar varied from Rs. 39.97 to Rs. 51.21 registering the variations nearly Rs. 12/- during the year. He also demonstrated that the assessee has allowed to take the exposure on past performance up to the average of previous three Financial Years actual turnover of the year which is higher. Further, Ld Counsel mentioned that in case of noncancellation of said contracts by the assessee, the banker will in any way terminate the same on the seventh working day after the maturity day (page 21 of the paper book). Referring to the assessee's failure to make extensions instead of cancellation, Ld Counsel mentioned that such extensions procedurally involve opening fresh FCs on the cancellation of the contracts. Thereby it does not make any difference so far as the final loss is concerned.

Ld DRs Arguments:

15. Dr Deepak Pote, IRS appeared for the Revenue and made various arguments substantiating the conclusions of the AO and the CIT(A). In this regard, Ld DR filed a write up to summarize the Revenue's stand. As per the same, the assessee's business is trading and manufacturing of rough and polished diamonds. Ld DR questioned the assessee's submission that the transactions of forward contracts are a guard against outstanding receivables and questioned the assessee's failure to discharge the onus in this regard. He also questioned the claim of exclusions claimed by the assessee from the clauses to the proviso to section 43(5) of the Act. He also mentioned that the assessee failed to demonstrate the said claims and therefore, failed to discharge the onus as held by the Supreme Court in the case of *CIT v. Joseph John* [1968] 67 ITR 74 (SC). He also submitted certain data to show that the total FCs on certain dates is more than the exports receivable and also questioned the asssessee's failure to demonstrate the paisa to paisa and date wise correlation between the FCs and the Export Invoices. Relying on some

statements filed by the assessee, Ld DR pointed out that the period of forward contracts is not 4-6 months in all cases and pointed out certain contracts cancelled after a day or a few days, which is one of the facets of speculation activity. He strongly relied on the order of the AO and the CIT (A). Further, relying on the order of the CIT (A), Ld DR distinguished the judgment of the jurisdictional High Court in the case of Badridas Gauridu Pvt Ltd (supra) and the list of such distinguishing features include (i) discharge of onus with regard to correlation of FCs with the export invoices; (ii) failure of exports; (c) Soorajmull Nagarmull case, supra which was relied by Bombay HC was decided on Income Tax 1act, 1922; (d) facts about the RBI clearances were not demonstrated by the assessee etc.

Decision of the Tribunal

16. The issues for adjudication in this order include (i) if the FCs entered into with the Bank constitutes the integral or incidental to the activity of export of the diamonds by the assessee, who is not the dealer in foreign exchange. (ii) Further, we need to examine if the AO is justified in not setting off against the profits on actual realization or revaluation as speculation profits.

Scope of the Speculation Transactions and Business

17. Before declaring the decisions of the Tribunal on the issues raised before us, we find it relevant to scan the relevant provisions ie section 43(5) of the Act, Explanation to section 28 etc.

Definitions of the speculation transaction on speculation business:

18. The provisions of section 43(5) provides for definition of **'speculation transactions'**. The said provisions read as under:

> *—43. (1)…*
>
> *(2)….*
>
> *(3)…*
>
> *(4)….*
>
> *(5) "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:*
>
> *Provided that for the purposes of this clause–*
>
> *(a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for actual*

delivery of goods manufactured by him or merchandise sold by him; or

(b) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or

(c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; [or]

[(d) an eligible transaction in respect of trading in derivatives referred to in clause [(ac)] of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) carried out in a recognised stock exchange; [or]]

(e) an eligible transaction in respect of trading in commodity derivatives carried out in a recognised association,

shall not be deemed to be a speculative transaction……."

19. The above provision provides that a transaction in which a contract in respect of trading of 'any commodity' including stocks and shares is settled otherwise than by the actual delivery or transfer of commodity / scrips. Here the meaning of expression "any commodity" is a matter of debate. This definition provides for exclusion of certain specified contracts discussed in clause (a) to (e) of the proviso to section 43(5) of the Act. Clause (a) of the proviso deals with the hedging contracts entered into in the course of manufacturing and merchandizing of the business to guard against the losses through future price fluctuations in respect of contracts for actual deliver. Clause (b) deals with the contracts entered into by dealer or investor in respect of Stock Exchange and Clause (d) deals with an eligible transaction in respect of trading derivatives carried out in a recognized Stock Exchange. Clause (e) deals with eligible transactions in respect of the trading in commodity derivatives carried out in a recognized association. These five types of contracts / eligible transactions shall not be deemed as speculative transactions. Although there is decision of the Tribunal where it is held that the FCs are not commodities, considering the judgment of Hon'ble High court of Calcutta in the case of Sooraj Muill Magarmull supra, which was followed by the judgment of jurisdictional High Court in the case of Badridas Gauridu Pvt Ltd (supra), needs to be followed by us. The principle of 'judicial discipline' assumes importance and therefore, the 'commodity' includes the 'forward contract'. Thus, in principle, the forward contracts, being commodity, should fall in the definition of 'speculation transaction' and the same is subjected to fulfillment of other conditions specified in sub-section (5) of section 43 of the Act. Having held so, we shall now examine if the impugned contracts/transactions constitute "hedging transactions" and covered by the exclusion provisions

of clause (a) to the proviso to section 43(5) of the Act. The clause (a) of the proviso to section 43(5) provides for exclusion of the 'hedging transaction' from the definition of the 'speculation transactions'. There are number of judgments in support of the assessee and relevant 'ratios' or conclusions are discussed in the succeeding paragraphs.

20. Before taking up these discussions, we shall now take up the provisions of the Explanation to section 28 of the Act, which also provide definition of 'Speculative Business'. The said explanation reads as under:

> ***Explanation 2.***– *Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business (hereinafter referred to as —speculation business") shall be deemed to be distinct and separate from any other business*

21. Explanation to section 28 uses the expression ' speculative transactions carried on by an assessee are of such a nature as to constitute a business', and thus, considering the nature of these transactions, the impugned FCs cannot be deemed as the speculation business without going into the "nature of the transactions". For analyzing the nature, we need to examine why the FC transactions are entered, how these transactions are dealt with during their sustenance till they are cancelled by the assessee or terminated by the Banks and if they constitute hedging transactions etc. Basing on the "nature", certain speculation transactions shall constitute as speculation business and such speculation business shall be deemed to be distinguished and separate from any other business. Further, the provision of section 73 relating to —loss in speculation business" is another relevant provision in this regard. Thus, the Explanation 2 to section 73 also deals with deemed speculation business where there is some trading activity of shares by the assessee being other business activity. Now, we shall take up relevant judgments on the subject raised before us.

22. Relevant judgmental laws: In this regard, relevant decisions include the decision in the case of D Kishore kumar and Co supra, binding judgment of the Bombay High Court in the case of CIT vs. Badridas Gauridu Pvt Ltd (supra), judgment in the case of Sooraj Muill Magarmull 129 ITR 169 (para 3) from Calcutta High Court. The judgments from the High Court of Ahmedabad in the cases of Friends and Friends Shipping Pvt. Ltd (supra) and in the case of Panchamahal Steel Ltd (supra) are also relevant. These decisions / judgments are unanimously relevant for the proposition that the FC transactions, when entered into with the banks for hedging the losses due to foreign exchange fluctuations on the export proceeds, are to be considered integral or incidental to the export activity of the assessee. Therefore, the losses or gains constitute the business loss or gains and not the speculation activities. In the preceding paragraphs of the order, in the portions assigned to the AR's arguments, we have analyzed these issues and the DR has not provided any reasons to reject the said arguments of

Ld Counsel for the assessee. Therefore, in principle, we agree with the arguments of Ld Counsel for the assessee. Further, we also agree with the Ld Counsel's argument that the 'fact of premature cancellation cannot alter the nature of the transaction'. Thus, Ld Counsel's comments on CIT(A) conclusions on treating or equating the FCs as 'derivatives' of currency is also allowed considering the specific definition provided to derivatives in section 2(ac) of Securities Contract Regulation Act, 1956 and it is not the requirement of the law that the 1:1 correlation between the FCs and the export invoices should exist and should be established by the assessee. So long as the total value of the FCs does not exceed, the claim of the assessee is sustainable as business loss. We have also analyzed the decisions relied on by Ld DR and find they are distinguishable. Now, we shall proceed to import some conclusions of the said decisions.

Relevant judgmental laws – Conclusions & Held portions

23. Relevant extracts from the cited judgments are inserted in the succeeding paragraphs here as under:

A. Held portion in the case of D. Kishorekumar 2 SOT 769 (Mum)

"The details of forward exchange contract clearly show that all the forward exchange contracts were in respect of each specific import order placed by the assessee. The purpose of these transactions was clearly to minimise assessee's risk on account of fall in value of rupee, but the quantum of foreign exchange covered by these forward contracts was limited to the extent of assessee's actual exposure in respect of import value commitments. That aspect is not disputed. On these facts, even though the transactions having been settled without delivery, the conditions of s. 43(5), describing speculative transactions, are clearly fulfilled, the requirement of Expln. 2 to s. 28 is not fulfilled inasmuch as it cannot be concluded that the transactions are such a „nature" as to constitute a business by itself. These transactions are genuine business transaction to hedge against increased cost of purchases of rough diamond imports. It is a commonly accepted part of the financial management practices today that the risk element, due rise in value of foreign currency in respect of the import transactions entered, is minimised by entering into forward contracts for purchase of that currency. This is particularly necessary in a market in which the value of domestic currency is falling, which is evident from the fact that the assessee realized profits on cancellation of those contracts. These transactions are integral part of the export business and cannot be considered in isolation of the export business in the course of which the transactions have been entered into. As a matter of fact, this profit on cancellation of forward contracts is generally revenue neutral

because the question of profit on cancellation of forward contracts can only arise in a situation when the value of foreign currency is increasing vis-avis domestic currency, and when the foreign exchange value is so increasing the ultimate payment made in foreign exchange by the assessee also increases. …… Since it is an undisputed position that the imports, in connection with which the assessee had entered into forward contracts, actually took place, this profit on cancellation of forward foreign exchange contracts effectively only reduces the costs of purchases in respect of those imports, and cannot be, by any logic, construed as transactions independent of assessee's business of importing rough diamonds and exporting cut and polished diamonds. There is one more aspect of the matter, and that is the reason as to why the forward contracts were cancelled midway and the profits were booked on the same instead of using these contracts to actually meet the foreign exchange requirements at the time of paying the import bills……. The due dates of payment at that point of time were only 16 days to 77 days away. The decision as to whether further hedging against the increase in foreign currency is warranted or not is essentially a commercial decision which depends on a number of factors, most important factor being the trend of currency markets at that point of time and businessman"s perception about future trends of the currency market. For example, when a businessman perceives that the market value of foreign currency vis-a-vis the domestic currency will not go any higher or when the market starts the declining trend, he may see business expediency in cancellation of contract. The fact of premature cancellation, therefore, cannot alter the nature of transaction. For all these reasons, the credit shown in the P&L a/c as 'profit on cancellation of forward contracts' is as integral part of the export business, as purchases or imports….. The assessee succeeds on this issue. In the result, the appeal is allowed."

24. Although, the said decision was pronounced in the context of section 80HC of the Act, the ratio of the said decision is of paramount importance.

B. <u>*Bombay High Court judgment in the case of CIT vs. Badridas Gauridu (P) Ltd. [2004] 134 Taxman 376 (Bom.)*</u>

25. In this case, Honble High Court of Bombay answered the following question in favour of the assesse and the question reads that,-

"Whether, where assessee, not being a dealer in foreign exchange but an exporter of cotton, had booked foreign exchange in forward market with bank in order to hedge against losses, to claim deduction in respect of loss suffered by it as a business loss"- Held yes.

25.1. Relevant finding is discussed in para 3 of the judgment and the same reads as follows:–

> *"3. The assessee was not a dealer in foreign exchange. The assessee was a cotton exporter. The assessee was an export house. Therefore, foreign exchange contracts were booked only as incidental to the assessee"s regular course of business. The Tribunal has recorded a categorical finding to this effect in its order. The Assessing Officer has not considered these facts. Under section 43(5) of the Income Tax Act, "speculative transaction" has been defined to mean a transaction in which a contract for the purchase or sale of commodity is settled otherwise than by the actual delivery or transfer of such commodity. However, as stated above, the assessee was not a dealer in foreign exchange. The assessee was an exporter of cotton. In order to hedge against losses, the assessee had booked foreign exchange in the forward market with the bank. However, the export contracts entered into by the assessee for export of cotton in some cases failed. In the circumstances, the assessee was entitled to claim deduction in respect of Rs. 13.50 lakhs as a business loss. This matter is squarely covered by the judgment of the Calcutta High Court in the case of CIT vs. Sooraj Mull Nagarmull (1981) 129 ITR 169."*

> **Judgment of Calcutta High Court in the case of *CIT vs. Sooraj Mull Nagarmull* [1981] 129 ITR 169 (Cal.)**

> *Held: The assessee used to carry on export and import of jute business. In the course of normal business it used to enter into foreign exchange contracts in order to cover up loss and difference in foreign exchange valuation. The assessee utilized part of the amount of the foreign exchange covered. This finding of fact has not been challenged. If in the course of normal carrying on of business certain loss or obligation or interest arise these must be deferrable to the carrying on the business and these must be incidental to the carrying on of the business. Undoubtedly, the contract for foreign exchange as such can be treated as a contract for commodity……."*

> ***The Conclusion of this judgment as reported reads as under:***

> *Where in the normal course of business of import and export of jute, the assessee entered into foreign exchange contract to cover up the losses and differences in exchange valuation, the transaction is not a speculative transaction.*

26. The above extracts unanimously support that the FCs entered by the assessee, an exporter and not the dealer in foreign exchange, with the Banks as incidental to the export business, are business transactions and

loss or gains is not of speculation nature. The only relevant decision cited by Ld DR is the one delivered in the case of S.Vinodkumar Diamonds Pvt. Ltd, (supra) and in this case, AO allowed the relevant loss as business loss and relevant portion is extracted as under:

> *"4……He further held that losses incurred by the assessee during the year on account of change in value of currencies at the time of payment was allowed while finalising the assessment, that M to M losses were of notional losses and contingent in nature. Finally, loss on a/c. of outstanding forward contract as on 31.03.2008 were disallowed by him……."*

27. We have so far analyzed the scope of the legal propositions and relevant judgments. Now, we shall apply the same to the issues raised in the appeal.

Analysis of the claims of the assessee and disputes etc.,

28. The details of the claim made by the assessee in the return are tabulated as under:

	Gains (in Rs)	Loss (in Rs)	Difference (in Rs)
Profit on payment of realisation of export receivables	4,31,44,019		
Loss on cancellation of FCs		**4,69,42,680**	
Profits on revaluation of o/s debtors as on 31.3.2009	2.48,13,534		
	6,79,57,553	4,69,42,680	2,10,14,873

29. Thus, the assessee credited Rs 2,10,14,873/- to the P & L account for the year after set off and the same is the subject matter of dispute between the parties as the AO did not allow such set off.

30. As explained earlier, AO treated whole of the loss of Rs 4,69,42,680/- as the speculation loss of the assessee. The profile of the total forward contracts (FCs) booked and cancellation of the FCs and the timing thereof are tabulated as under:

Total Amt of FCs (US$)	Amount of Cancelled FC (US$)	Loss on FCs Cancelled on/after due date (INR)	Loss on FCs Cancelled 3 days prior from due date (INR)	Loss on FCs Cancelled prior to more than 3 days (INR)	Total of 3+4+5 (INR)
1	**2**	**3**	**4**	**5**	**6**
19,444,000	10,704,760	41,488,805	4,218,940	1,892,078	46,942,680

31. Thus, the above table suggests that out of the total loss, loss of Rs. 4,14,88,805/- was to the Banks on account of loss on cancellation of matured FCs i.e., cancelled on or after the due date. This loss is payable to the Bank as part of the termination of contracts after the full period of contract. It is attributable to the genuine failure of the trade debtors, who failed to comply with the credit terms and conditions. In other words, they are not the cases of premature termination or cancellation of the

impugned FCs. Whereas the other loss of Rs 42,18,940/- in column 4 of the above table, it is stated that the assessee cancelled the contracts three days in advance as the contract due dates fell in the weekend days, where the books remain closed. Finally the loss of Rs 18,92,078/- is relevant to the FCs cancelled prematurely and there is no specific explanation from the assessee in this regard. However, the standard explanation revolves around the commercial nature of decision of the assessee, which he can take after considering the facts and circumstances and the said decision is taken for prevention of further losses if any.

32. Fluctuations – Related facts:- Further, the facts relating to Dollar fluctuations are undisputed. The perusal of the chart furnished by the assessee reflecting the dollar value in rupees in the month of April and found that the fluctuations are varying from Rs. 39.8550 to Rs. 40.6550 in the month of April. Further, assessee also furnished another chart for the FY under consideration showing changing the dollar value for the year and it is the fact that the dollar value per INR varied from Rs. 39.85 to Rs. 51.21 per $ registering the variations nearly Rs. 12/- during the year.

33. Correlation of forward contracts vis-à-vis export invoices: Assessee filed a chart furnishing the export invoices raised in the year under consideration and related forward contracts booked and matured in the year under consideration. The details suggest that there is a broad connection is established and of course it is not up to the extent of rupee. It is the case of the Revenue that the correlation should be precise to the last rupee of the invoice amount. The said argument was made out by the assessee relying on the judgment of the Gujarat High Court in the case of Friends and Friends Shipping Pvt. Ltd (supra) and Panchamahal Steel Ltd (supra). Considering the above stated scope of the relevant provisions on one side and the precedents on the other, now we shall take up the core issue of adjudication of the grounds raised in the appeal and the fate of the impugned losses of Rs. 4,69,42,680/-. Relevant portion from the judgment of the Gujarat High Court in the case of Friends and Friends Shipping Pvt. Ltd (supra) is as follows:

> *"It is true that the CIT (A) has made some observations which would prima facie suggest that there was no direct co-relation between the exchange document and the precise contract. However, such observations cannot be seen in isolation…….*
>
> *…….We find that the decisions of the Bombay High Court and the Calcutta High Court noted above would cover the situation.*

34. From the above analysis and summary of judgments, it is safely concluded that the impugned FCs are "commodities". However, considering the fact that these FCs are integral part or incidental to the

core business of export of diamonds or the outstanding receivables of export proceeds, in principle, the impugned FCs constitute „hedging transaction" and not the 'speculative contracts'. As such, the banks do not entertain FCs of speculative nature with the customers like the assessee, the exporter. As such, the extention of FCs, in case of non-receipt of export proceeds on the due dates, is not allowed without canceling the existing FCs. However, the onus is on the assessee to explain satisfactorily why the assessee resorted to premature cancellation of some FCs. Further, it is not the requirement that there must be 1:1 precise correlation between FC and the corresponding export invoice. So long as the total FCs does not exceed the exports of the year plus outstanding export receivable, the FCs can constitute 'hedging transaction'. Further also, the 'premature cancellation of FCs may not alter the above conclusions so long as the assessee has valid and acceptable explanation for such cancellations. It should not be the case, to start with, FC can be a 'hedging transaction' but the ending of such FC is 'speculation'. In the light of this synopsis of our views in the matter, we shall not deliberate on the impugned losses.

35. The subdivisions of the loss of Rs. 4,69,42,680/-: we have already tabulated above the three subdivisions of the impugned losses based on the timing of the cancellation of the FCs. Broadly the loss is divided into two types and the adjudication of the each subdivision of loss is given as under:

(a) Loss on Cancellation of Matured FCs amounting to Rs 4,14,88,805/- relates to the FCs cancelled or terminated on or after the due date. In other words, the FCs booked as integral part of the export invoices lived its booking period in full and they were either terminated by the Bank on or after due date of maturity date of the contract as the actual realization were not received in time. These are not premature cancellations by the assessee and therefore, in our considered view, the said loss of Rs 4,14,88,805/-, being related to the FCs which are integral or incidental to the exports of the diamonds, should be allowed as business loss in view of the binding High Court or Tribunal decisions/judgments in the case of D Kishore kumar and Co (supra), Badridas Gauridu Pvt Ltd (supra), Sooraj Muill Magarmull, (supra) etc. Thus, loss arising from cancellation of the matured contracts is allowed in favour of the assessee. Thus, this part of the ground of the assessee is allowed.

(b) (i) Loss on Cancellation of Pre-matured FCs is the other segment of loss relates to the FCs cancelled prior to the date of maturity. The question to be answered by the assessee relates to the acceptability of the explanation for such premature cancellation of the FCs before the due date of maturity of the contract. It is a settled issue that the assessee has to discharge the onus on why he had to resort to premature cancellation. In this case, the explanation of the assessee revolves around the fact that

the maturity of date of some of such premature cancelled FCs fell during the week-end days and therefore, the assessee cancelled such FCs three days prior to the due date. Related loss is quantified at Rs 42,18,940/-. In our opinion, the explanation of the assessee is acceptable and the AO is directed to allow the claim and of course, after due verification of the factum of week-ends. Thus, this part of the ground of the assessee is allowed as above without going into the alternate arguments relating to "damages".

(ii) The other shade of loss of premature cancellation of FCs relates to the FCs cancelled prior to longer than three days constitutes another fraction of the loss and the assessee's explanation in this regard revolves around the general explanation of reduction of losses. Relevant loss is worked out at Rs 18,92,078/-. This segment of losses relates to premature cancellations of the FCs and the explanation of the assessee is very general. As such, premature cancellations should also be allowed as business loss in view of the decisions discussed in the preceding paragraphs, so long as the related FCs are integral part of the exports. However, there is something called for is the assessee's explanation and its credibility and acceptability by the AO. In our opinion, these explanations were not examined by the lower authorities of the Revenue. Assessee needs to answer as to why it went for premature termination and the onus is on the assessee as per the ratio of the SC judgment in the case of Josef John (supra). Further, during the proceedings before us, on this issue, Ld Counsel for the assessee put forwarded various new arguments describing the impugned loss as 'damages' payable to the Banks for breach of contracts or settlement of the contracts. These aspects are not emanating from the orders of the lower authorities. One needs to study the correspondence with the Banks and the RBI guidelines on the issue whether such payments to bank should be treated as damages for breach of contract. One needs to examine who the bank treats the same and relevant accounting principles. In this regard, Ld Counsel also filed written submission too. In principle, this part of the losses relating to premature cancellations of FCs amounting to Rs 18,92,078/- should be remanded to the file of the AO for want of speaking order on this issue after considering the cited judgments like Shantilal (P) Ltd [1983] 144 ITR 57 (SC) and others on this issue. AO is directed to disallow this loss in the absence of specific explanation, if any. As such, impugned order is deficient on these aspects of the issue. Thus, this part of the ground is allowed pro-tanto.

36. In the result, the appeal of the assessee is partly allowed.

Order pronounced in the open court on 11th October, 2013.