



## The Supreme Court rules on foreign exchange fluctuation losses

### Background

The Supreme Court (SC) in case of M/s Woodward Governor India Private Limited<sup>1</sup> and others delivered its long awaited decision on foreign exchange fluctuation losses. The SC held that in terms of mercantile method accounting, the exchange fluctuation loss arising on mark-to-market restatement of liability in foreign currency at the year end is an allowable loss, where the liability is on revenue account. Further with respect to capital loss case the SC held that, prior to the amendment of section 43A of the Income tax Act, 1961(the Act) with effect from 1 April 2003, the adjustment of increased liability to the cost of asset was required to be made on the basis of mark-to-market loss and not on the basis of actual payment of the said liability. The SC held that the said amendment is not clarificatory in nature and is applicable prospectively i.e. only for the period after the date of amendment.

### Issues before the SC:

Broadly the following two issues were discussed before the SC:

- Exchange differences arising in foreign currency transaction on revenue items. (M/s.Woodward Governor India Private Limited)
- Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets. (M/s Honda Siel Power Products Limited.)

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<sup>1</sup> CIT v. M/s Woodward Governor India Private Limited and CIT v. M/s Honda Siel Power Products Limited

## **M/s Woodward Governor India Private Limited**

The taxpayer filed its return of income for the Assessment Year 1998-99 after claiming a deduction of unrealised loss due to foreign exchange fluctuation on the last date of the accounting year.

The Assessing Officer (AO) disallowed the aforesaid claim of the taxpayer on the pretext that the liability as on the last date of the previous year under consideration being a contingent liability was not an ascertained liability and consequently it had to be added back to the total income of the taxpayer. The order of the AO was upheld by the Commissioner of Income-tax (Appeals) [CIT(A)]. The Income-tax Appellate Tribunal (the Tribunal) relying on its earlier decision in the case of the taxpayer<sup>2</sup> held that the claim of the taxpayer for deduction of unrealised loss due to foreign exchange fluctuation as on the last date of the previous year had to be allowed. This decision of the Tribunal was upheld by the Delhi High Court.

In view of the above, the appeals were filed by the tax department before the SC.

### ***Tax Department's Contentions***

- The claim of deduction by the taxpayer is under the provisions of Section 37 of the Act, which is a residuary provision, since there is no specific provision dealing with the adjustment based on foreign exchange fluctuations on the revenue account.
- Section 37 of the Act allows the deduction in respect of any revenue expenditure which is "laid out or expended", wholly for business purpose. The expenditure is therefore, allowable only if it is paid or gone out irretrievably from the taxpayer's pocket.
- The expression 'expenditure' is 'what is paid out' and 'something which is gone irretrievably'<sup>3</sup>. The increase in liability at any point of time prior to the payment cannot fall within the meaning of the word 'expenditure' in Section 37(1) of the Act. Further, the requirement of money being 'expended or laid out' is also not satisfied and thus the additional liability arising on account of fluctuation in foreign exchange rate is not deductible under Section 37(1) of the Act.

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<sup>2</sup> For the AY 1995-96, 1996-97 and 1997-98

<sup>3</sup> In this connection, the AO placed reliance on the judgment of SC in case of Indian Molasses Co. (Private) Ltd. v. CIT 37 ITR 66 (SC)

### ***Taxpayer's Contentions***

- Under the mercantile system of accounting so followed by the taxpayer, whenever an amount is credited to the account of a payee, the liability stands incurred by the taxpayer even though the amount is actually not paid reference in this regard, was drawn to the definition of the word 'paid' in Section 43(2) of the Act<sup>4</sup>.
- The fact that the tax department had taxed the gains on fluctuation as income on the basis of accrual whilst disallowing the loss on a similar basis, indicates the double standards adopted by the tax department.
- Section 145 of the Act ties down the AO to the accounting system followed by the taxpayer. The AO, having accepted the accounting system of the taxpayer in the past, cannot depart from the same, without giving reasons for such departure.
- The existence of a liability stands crystallised on the date of the contract. It has nothing to do with the payment and valuation of liability at a later date.

### ***The SC Ruling***

- The expression 'any expenditure' as occurring in Section 37 of the Act, may in particular circumstances, cover an amount which is really a 'loss', even though the said amount has not gone out from the pocket of the taxpayer<sup>5</sup>.
- Section 145 of the Act recognises the right of a trader to adopt either the cash system or the mercantile system of accounting. The accounting method followed by an taxpayer continuously for a given period of time needs to be presumed to be correct till the AO comes to the conclusion for reasons to be given that the system does not reflect true and correct profits.
- Accounting Standard 11 stipulates effect of changes in exchange rate vis-à-vis monetary items denominated in a foreign currency to be taken into account for giving accounting treatment on the balance sheet date.
- The profit or loss arising to an taxpayer on account of appreciation or depreciation in the value of foreign currency held by it, on conversion into another currency, would ordinarily be a trading

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<sup>4</sup> Section 43(2) of the Act defines the term 'paid' as actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under the head "Profits and gains of business or profession".

<sup>5</sup> The SC relied on *M.P. Financial Corporation v. CIT* 165 ITR 765 (MP) and *Madars Industrial Investment Corporation Limited v. CIT* 225 ITR 802 (SC)

profit or loss, if the foreign currency is held by the taxpayer on revenue account<sup>6</sup>.

- The SC, while accepting taxpayer's contentions laid down the following tests for an expenditure to be deductible under the provisions of the Act:
  - Whether the system of accounting followed by the taxpayer is mercantile system, which brings into debit the expenditure amount for which a legal liability has been incurred before it is actually disbursed and brings into credit what is due, immediately before it becomes due and before it is actually received.
  - Whether the same system is followed by the taxpayer from the very beginning and if there was a change in the system, whether the change was bona fide.
  - Whether the taxpayer has given the same treatment to losses claimed to have accrued and to the gains that may accrue to it.
  - Whether the taxpayer has been consistent and definite in making entries in the account books in respect of losses and gains.
  - Whether the method adopted by the taxpayer for making entries in the books both in respect of losses and gains is as per nationally accepted accounting standards.
  - Whether the system adopted by the taxpayer is fair and reasonable or is adopted only with a view to reducing the incidence of taxation.

### **M/s Honda Siel Power Products Limited**

The key issue for consideration in this case was whether the taxpayer was entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange at each balance sheet date, pending actual payment of the varied liability<sup>7</sup>.

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<sup>6</sup> Sutej Cotton Mills Limited v. CIT 116 ITR 1 (SC) relied on

<sup>7</sup> The issue relates to the year, when the provisions of Section 43A of the Act stood prior to its amendment by Finance Act 2002, w.e.f. 1 April 2003;

### ***Tax department's Contention***

- Under the pre-amended Section 43A of the Act<sup>8</sup>, the effect of increase or decrease of liability arose only at the point of payment, because the point of accrual shifted to the point of payment.
- The expression “towards the whole or a part of...” makes it clear that Section 43A as it stood, referred to whole or a part of the payment and therefore to the point of payment.
- In case of a contingent liability, like that of a foreign exchange fluctuations, the point of accrual and point of payment become the same. Under the pre-amended Section 43A of the Act, the effect of increase or decrease of liability could arise only at the point of payment, as the point of accrual shifts to the point of payment.
- The amendment to Section 43A is clarificatory and not amendatory, notwithstanding the fact that the amendment operates w.e.f. 1 April 2003.

### ***Taxpayer's Contentions***

- Pre-amended Section 43A of the Act, permits adjustment with regard to the increase/decrease in liability relating to acquisition of capital assets on account of exchange rate fluctuation, in the actual cost of the assets acquired in foreign currency and for depreciation to be allowed with reference to such increased/decreased cost;
- The provisions of pre-amended Section 43A of the Act, are *pari-materia* with Paragraph 10 of Accounting Standard 11, which *inter alia* provides for adjustment in the carrying cost of fixed assets acquired in foreign currency, due to foreign exchange fluctuation at each balance sheet date<sup>9</sup>;

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<sup>8</sup> Section 43A of the Act, as it stood prior to the amendment by Finance Act 2002, read as below: “*Notwithstanding anything contained in any other provision of this Act, where an taxpayer has acquired any asset from a country outside India for the purposes of his business or profession and, in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there is an increase or reduction in the liability of the taxpayer as expressed in Indian currency for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of the moneys borrowed by him from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the asset (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability aforesaid is so increased or reduced during the previous year shall be added to, or, as the case may be, deducted from, the actual cost of the asset as defined in clause (1) of section 43 or ..... aforesaid*”

<sup>9</sup> In this connection, reliance was placed on the judgment of SC in the case of CIT v. Arvind Mills Limited (193 ITR 255) (SC)

### ***The SC ruling:***

- The SC relied upon its observation in the case of *Arvind Mills Limited*<sup>10</sup> that the adjustments in the actual cost are to be made irrespective of the date of actual payment in foreign currency made by the taxpayer.
- Section 43A was introduced in the Act by Finance Act 1967 w.e.f. 1 April 1967 to provide for adjustment in the actual cost of assets pursuant to change in the foreign currency exchange rates. As a consequence of the insertion of the said section, it became possible to adjust the increase/decrease in liability relating to acquisition of capital assets on account of exchange rate fluctuation, in the actual cost of the assets acquired in foreign currency<sup>11</sup>.
- Under the pre-amended Section 43A of the Act, adjustment to the actual cost took place on the happening of change in the rate of exchange whereas under the amended Section 43A of the Act, the adjustment in the actual cost is made on a cash basis. The words used in the pre-amended Section 43A of the Act were ‘for making payment’ and not ‘on payment’ which is now brought in by the amendment to Section 43A of the Act *vide* Finance Act, 2002 with effect from 1 April 2003 is amendatory and not clarificatory.

### **Our Comments**

The SC ruling has set at rest the controversy in favour of the taxpayer, with respect to the deductibility of foreign exchange losses arising on revenue account in the mercantile method of accounting. The ruling also highlights the importance of accounting principles and the role of mandatory accounting standards in determining the tax treatment of expenses/loss, especially when the Act does not provide for the same. It is to be noted that with respect to capital loss; since section 43A has been amended with effect from 1 April 2003, this ruling may have limited application to the extent of pending cases.

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<sup>10</sup> Arvind Mills Limited 193 ITR 255 (SC)

<sup>11</sup> This position is also made clear by Circular No. 5-P dated 9 October 1967 issued by Central Board of Direct Taxes

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