KPMG

TAX FLASH NEWS

16 December 2016

Foreign exchange gain realised on project receipts remained blocked for 11 years to be considered as capital receipt

Background

The Calcutta High Court in the case of SDB Infrastructure Private Limited[1] (the taxpayer) observed that the project receivables, bearing the character of revenue, had lost their character and became capital investment as it remained blocked for about 11 years with no chance of recovery. The High Court held that the foreign exchange gains realised thus partake the character of a capital receipt being return arising out of blocked funds.

Further, as the debt was written off, the cost of acquisition in the books of account had become zero and hence, the capital gain is to be computed without deduction of any cost of acquisition.

Facts of the case

- The taxpayer was engaged in undertaking construction works. It entered into a contract with the Republic of Iraq for carrying out civil construction works.
- The projects were stalled due to the Gulf crisis and sanctions imposed by the UN against Iraq. As on 31 March 1991, an amount of USD2.30 crore was recoverable against the project with no hope of recovery.
- In AY 1995-96, the taxpayer wrote off the said amount (approx.) INR45.05 crores.
- In May 2002, under a Government of India initiative, the project receivables were assigned in favour of the President of India against which the taxpayer was issued bonds to the tune of USD2.33 crores. The taxpayer received an excess payment of USD0.0323 crores, which was offered for taxation as a business receipt.
- The Bond upon conversion in Indian currency fetched a sum of INR83.59 crores.
- The taxpayer on account of foreign exchange rate difference received an excess to the tune of INR37.91 crores.
- The Assessing officer (AO) held that the excess of INR37.91 crores owing to forex fluctuations were on account of project receivables and therefore taxable as revenue receipts.
- However, the taxpayer contended that the aforesaid receipts were liable for long-term capital gains and upon indexation claimed a capital loss of INR0.76 crores. In computing the loss, the taxpayer considered the excess of project receivables of USD 0.80 crores (approx. INR 15.74 crores at prevailing exchange rate as on 31 March 1991) as cost of acquisition and applied indexation thereon.
- Both the AO and the CIT (Appeals) did not accept this treatment.

[1] CIT v. SDB Infrastructure Private Limited ITA No. 233 of 2009 (Cal); - Taxsutra.com
This decision also covers other issues. However, this Flash news only deals with the issue pertaining to whether excess amount received on account of foreign exchange fluctuations on blocked income would be considered as revenue or capital in nature.

- The Tribunal held that the excess constituted a capital receipt and not a revenue receipt, and did not examine the correctness of contention as regards cost of acquisition. The tax department chose to appeal before the High Court.

High Court's decision

- Relying on the Supreme Court decisions in the case of Canara Bank Ltd[2] and Sutlej Cotton Mills Ltd.[3] and the decision of the Calcutta High Court in the case of Indo-Burma Petroleum Co. Ltd.[4], the High Court observed as follows:
  - Amount held on revenue account may lose its character if the same is sterilised or blocked
  - Any return arising out of such sterilised or blocked funds would be a capital receipt
  - If a receipt arose in the course of trading operation, then the receipt is clearly a revenue receipt.
- The project receivables as on 31 March 1991 remained blocked for almost 11 years with no chance of recovery.
- Pursuantly, the project receivables being revenue in nature, lost their character and became a capital investment.
- The taxpayer did not cease to be a creditor merely because of writing off the debts.
- In view of the above, when such money was realised, it partook the character of a capital receipt.
- With respect to the cost of acquisition to be considered for computation of capital gains, the cost of acquisition in the books of accounts become zero by virtue of writing off the debt.
- Thus, the entire amount of INR37.91 crores is taxable as long-term capital gain without deduction of cost of acquisition.

Our comments

The taxability of differences arising out of foreign exchange fluctuations has been a matter of debate before the courts. The Supreme Court has on various occasions[5] examined the nature of gains/losses arising on account of forex fluctuations and has laid down various guiding principles.

Normally, the subject of 'capital v/s. revenue' is essentially driven by the factual matrix of each particular case. In this case, the Calcutta High Court held that the foreign exchange gains realised on the trade receivables, which remain blocked for a fairly long period of time with no certainty of recovery, partake the character of capital receipt.

However, in view of Income Computation and Disclosure Standard –IV[6] (ICDS VI), the revenue authorities may seek to tax the gains arising out of forex fluctuations on monetary items as revenue in nature. It would be interesting to see how the courts interpret the provisions of ICDS vis-à-vis the existing jurisprudence laid by the courts, including the Supreme Court.

[2] CIT v. Canara Bank Ltd. [1967] 63 ITR 328(SC)
[3] Sutlej Cotton Mills Ltd v. CIT [1979] 116 ITR 1 (SC)
[4] Indo Burma Petroleum Co. Ltd v. CIT [1982] 136 ITR 251 (Cal)

[5] Sutlej Cotton Mills v. CIT [1979] 116 ITR 1(SC); Tata Locomotive & Engineering Company Ltd [1996] 60 ITR 405 (SC); CIT v. Woodward Governor India (P) Ltd [2009] 312 ITR 254 (SC); Challapalli Sugars ltd v. CIT [1975] 98 ITR 167 (SC); India Cements Limited v. CIT [1966] 60 ITR 52 (SC); CIT v. Tata Iron and Steel Co [1998] 231 ITR 285 (SC)
[6] ICDS VI deals with effects of changes in Foreign exchange rates

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.