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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : Mar-23-2004

Reported in : (2004)89ITD235(Delhi)

Judge : V Gandhi, R Gupta, T Chopra

Appellant : Apollo Tyres Limited

Respondent : Acit

Judgement :

1. This Special Bench has been constituted under section 255 (3) of the Income Tax Act, 1961 to decide the following question arising out of the assessee's appeal in ITA No. 6177/Del/96 for assessment year 1993-94 : "Whether on facts and in law, the gains earned on cancellation of the Foreign Exchange Forward Contract are capital receipt or revenue receipt? If it is capital receipt, whether the same should be reduced from the cost of plant & machinery in connection with which the forward contract was entered into?" 2. At the outset, relevant facts having bearing on the point in issue may briefly be set out. The assessee company is a limited company engaged in the business of manufacture and sale of automobile tyres, tubes etc. The assessee imported certain plant and machinery for setting up a new tyre manufacturing plant near Baroda in Gujarat state during the year 1991. For financing the project, the assessee borrowed funds in US Dollars and Pound Sterling from US Exim Bank and Commonwealth Development Corporation (CDC, for short). The amount of loan disbursed ill the year under reference amounted to US $ 35,83,839 From Exim Bank and 35,58,074 and 11,15,000 from CDC. As per

the agreement with the Exim Bank, the repayment of loan was to commence on 15.4.1992 and to be made in 10 equal six monthly instalments. Similar terms of repayment were stipulated in respect of loan from CDC.3. The assessee company entered into forward contracts in foreign currency with the Indian bank on different dates in June/October, 1990 and July, 1991 to cover its liability on foreign currency loans against fluctuations in currency rates. These forward contracts, brought forward from the preceding year, were however cancelled on 30.4.1992 resulting into a gain of Rs. 14.06 crores. Reserve Bank of India had issued revised instructions on 27.3.1992 permitting the cancellation of the forward contracts in foreign currency. These instructions were issued in pursuance of the introduction of the Liberalized Exchange Rate Management System (LERMS) and with a view to creating greater depth in the foreign exchange market and also to enable market participants to have greater flexibility. RBI in its circular dated 27.3.1992 addressed to all authorised dealers in foreign exchange observed : "Customers may be permitted to cancel forward contracts and keep their exposures open o book fresh contracts, at later dates, if they so desire. It will also not be necessary to report these cancellations to the Reserve Bank of India Full particulars of cancellations of forward cover for the equivalent of US $ 500,000 and above should be kept on record with the authorized dealers for verification by the Exchange Control authorities if necessary. A contract booked with an authorized dealer and subsequent cancelled, may be booked again with another authorized dealer, if the customer so wishes. The authorized dealer booking the subsequent contract will have to verify suitable documentary evidence to ensue that a genuine transaction, permitted under the extant regulations, exist and that the customer continues to be exposed to exchange risk." From 11.5.1992 to 29.6.1992 the assessee again entered into forward contracts with regrd to US Dollars loans. Out of six contracts entered during this period, two contracts - One entered into on 13.5.1992 and the other on 29.6.1992 were again cancelled on 26.2.1993. The remaining four contracts were rolled over and continued to remain effective till the end of the year, i.e., on 31st March, 1993. It is relevant to note here that while the original contracts brought ward from the preceding year were in respect of US Dollars as well as Pound Sterling, fresh contracts entered during the year under reference were only in respect of US Dollars that is to say no fresh contracts wee

entered in relation to repayment of Pound Sterling loans. The assessee company credited the gain arising on cancellation of forward contracts relating to amount of interest liability in foreign currency to the profit and loss account but the gains arising on the cancellation of contracts relating to the principal amount were adjusted against the cost of plant and machinery.

The break up of profit of Rs. 11,06,00,000/- arising out of cancellation of contracts relating to principal amount as well as interest payable is as under :Surplus on cancellation of all contracts entered into before 27.3.92 and cancelled during the assessment year 1993-94Surplus on cancellation of contracts taken in financial year 1992-93 and cancelled during the very financial year1. Surplus on these amounts that to interest payable on foreign loan conceded and assessed as Revenue receipt.2. Calculation error by Citi Bank discovering that more of it was paid by mistake and accepted by the assessee The treatment of the aforesaid gains received as well as the roll over charges paid as per the books of account is as under : (i) Rs. 11.06,49,739/- received, on account of cancellation of contract for forward cover attributed to proposed repayment of principal amount of loans, were credited to the Plant & Machinery A/c (P&M a/c) thereby reducing the cost of the asset by like amount; (ii) Rs. 3,03,19,957/- received on cancellation of contract for forward cover attributed to the proposed payment of 'interest' on the foreign loans, were credited to the Profit & Loss A/c (P&L a/c); (iii) Rs. 2,30,67,615/- being roll over charges paid for extending the contracts for forward cover relatable to repayment of principal amount were debited to 'P&M' thereby increasing the cost of the assets; and (iv) Rs. 80,07,177/- being roll-over charges for contracts relatable to payment of interest when debited to 'P&L a/c'.

(i) Rs. 11,06,49,739/-, credited in 'P&M' a/c, reduced the cost of asset as reflected in the return of income; (ii) Rs. 3,03,19,957/-, credited to the 'P&M' a/c, was included in the total income exisible to tax; (iii) Rs. 2,30,67,615/-, bering roll over charges debited to 'P&M' a/c, was clained as revenue expense in the computation of income and (iv) Rs. 80,07,177/-, debited to 'P&L' a/c, was claimed as revenue expense in the computation of income.

4. The question which has been referred to the Special Bench has essentially two limbs as under: (i) Whether the gains earned on cancellation of the foreign exchange forward contracts are capital receipt or revenue receipt and (ii) If gains are capital receipt, whether the same should reduce the actual cost of plant and machinery by virtue of Explanation 3 to section 43A.5. During the course of hearing before us, Shri G.C. Sharma, Id. Senior Advocate appearing on behalf of the assessee, mainly focused his arguments on the first question and argued that when the forward exchange contracts were initially entered with the Indian bank with a view to guard against the currency losses on account of exchange rate flucuations, such contracts could not be cancelled in view of the Reserve Bank regulations. There was, therefore, no occasion for the assessee to entertain notions of Commercial gain while entering into such contracts. Such forward covers were duly permitted by the Reserve Bank of India in respect of genuine trade transactions in the capital filed in relation to outstanding liabilities in foreign currency.

According to the Id. Counsel, the assessee cancelled these contracts in April, 1992 in conformity with the revised instructions of the Reserve Bank of India since the assessee felt that the dollar rate of exchange would remain stable and the Rupee would not depreciate. Ld. counsel submitted that cancellation of the contract is not determinative of the factum of carrying out business or adventure in the nature of trade. It is further argued that the transaction of entering into foreign exchange forward contracts and subsequently canceling them cannot be classified as business carried on by the assessee per sent since no activity is involved in signing or canceling these contracts. It is further contended that there is, in any case, no direct nexus between the business carried on by the assessee which is the production and sale of tyres and tubes etc. and the entering into and cancellation of the foreign exchange forward contract. Ld. Counsel further added that the assessee is not an authorized dealer in foreign exchange and has not carried out any business of buying and selling foreign currency.

Any such activity would in fact be violative of the Foreign Exchange Regulation Act. In support of his contention. reliance is placed by the learned counsel on the following decisions : (i) G. Venkatswamy Naidu vs. CIT (2002-TAXINDIAONLINE-

179-SC-IT) 35 ITR 594 (SC); (iv) CIT vs. Tata Locomotive and Engineering Co. Ltd (2002-TAXINDIAONLINE-181-SC-IT) 60 ITR 405 (SC); 6. Mr. sharma next contended that section 43A was enacted only for the purpose of adjustment in the cost of acquisition in cases where the variation in the value of foreign exchange took place after the machinery had been acquired providing that the escalation in such cases would go to swell the actual cost or to diminish it if there was de-escalation in the value of foreign currency. Ld. Counsel contended that gains arising from the cancellation of the forward contracts are of the nature of capital receipt but these are not covered under the provisions of section 43A and, therefore, such receipts are not liable to be capitalized towards the cost of plant and machinery even if the foreign currency loans were raised for the purpose of acquisition of plant and machinery and the forward contracts were entered into to guard against currency losses on account of exchange fluctuations. In support of his contentions, Id. counsel placed reliance on CTT vs.

Elgin Rubber Product Ltd. 219 ITR 109 (Madras) and Beco Engineering Co.

Ltd. vs. CIT 236 236 ITR 344.

7. On behalf of the revenue, Shri Rajneesh Kumar, learned CIT (DR) and Shri Salil Gupta, learned Senior DR represented the Income-tax Department and also made written submissions in support of Department's case. Shri Rajneesh Kumar, learned CIT (DR) argued that the assessee company indulged in the adventure in the nature of trade and the gains of Rs. 11.06 crores are taxable profit. He argued that the foreign currency was not obtained under the forward contracts for remittances towards the foreign loans during the year. The assessee made remittances of $5,48,367 during the year under reference on 15.4.1992 and 15.10.92 towards repayment of dollar loans as per the agreement with the Exim Bank. However, the assessee opted for cancellation of all the exchange contracts on 30.4.1992 resulting in profits of Rs. 11.06 crores. He submitted that the assessee again entered into forward contracts in the months of May and June, 1992 for the Dollar loans and these contracts were not utilized for making remittances on 15.10.92.

The assessee in fact again proceeded to cancel two contracts on 26.2.1993 resulting in profits. Ld. DR contended that the entire conduct of the assessee, as evidenced by the aforesaid facts clearly indicate that the contracts were motivated by commercial considerations of profits and not for securing forward cover against enhanced liability of foreign loans due to exchange rate fluctuations. According to the ld. CIT(DR), the set of initial contracts entered into in the preceding years were admittedly intended as covers against exchange rate fluctuations and there was no profit motive in these contracts.

However, subsequent conduct of the assessee amply demonstrates that the entire activity of cancellation and execution of fresh contracts followed by cancellation was motivated by business considerations. In support of his arguments, ld. CIT(DR) placed reliance on the following decisions : 8. Ld. CIT DR further cited the decision of Supreme Court in CIT vs.

Sutlej Cotton Mills Supply Agency Ltd. 100 ITR 706 in support of the proposition that a single transaction of purchase and sale outside the assessee's line of business may constitute adventure in the nature of trade. Neither repetition nor continuity of similar transaction is necessary to constitute it an adventure in the nature of trade. Ld. CIT (DR) emphasized that the facts of the case of M/s. Regent Estates Ltd. vs. CIT 48 ITR 162 (Calcutta) are very near to that of the assessee company and in the said decision, the Court held the gains to be taxable profits.

9. Ld. CIT (DR) further argued that the case of the assessee is in any case hit by the provisions of section 43 (5) which defines speculative transaction as a transaction in which a contract for the purchase and sale of any commodity is periodically or ultimately settled otherwise than by the actual deliver. It is further submitted that once these transactions are held to be speculative transactions, the provision of Explanation 2 of section 28 of the Income-tax Act comes into play and gains from such transactions are liable to be treated as business income under section 28.

10. As regards the issue of capitalizing the gains towards the cost of the assets, ld. CIT (DR) argued that contracts for forward caver cannot be said to be a capital asset. Without prejudice to the department's case that the gains from cancellation

of contracts are revenue in nature, he argued that if the contracts are held to be capital in nature and gains arising therefrom are held to be intimately and inseparably linked to foreign loan amounts, section 43A would clearly be applicable and gains would be liable to be capitalized towards the cost of the assessee.

11. Shri Salil Gupta, ld. Sr. DR, reiterating the points made by Shri Rajneesh Kumar, CIT(DR), argued that even though is a fact that forward contracts entered into by the assessee initially were by way of hedging transactions against the enhancement of the liability of foreign loans due to exchange rate fluctuations, the conduct of the assessee after 27.3.1992 clearly indicate that what was initially a hedging mechanism has been used by the assessee for commercial gain. In the written submissions, Shri Salil Gupta, ld. DR, stated that the assessee was a holder of certain forward contracts at the beginning of the previous year on 1.4.1992. Consequent to the change in the RBI Policy on 27.3.1992, all there forward contracts were cancelled on 30.4.1992 and fresh forward contract obtained. The assessee had a liability to make repayment of half-yearly instalments to its lender Exim Bank on 15.4.1992 and 15.10.1992. Shri Salil Gupta submitted that all the forward contracts available with the assessee on 1.4.1992 were actually cancelled on 30.4.1992 and none were utilized for discharging the actual foreign exchange liability on 15.4.1992 and 15.10.1992.

Therefore, the purported purpose for taking forward contracts to hedge against the exchange rate fluctuations was defeated by the assessee's conduct as it engaged in a trading activity in the forward contracts.

He further urged that it would be seen from the assessee's paper book at page 37 that forward contracts had been taken as early as June, 1990 which had been successively rolled over to hedge against the exchange rate fluctuation corresponding to the date of repayment of liabilities.

However, after the change in the RBI Guidelines, the assessee cancelled all the open forward contracts and subsequent forward contracts have been taken by the assessee for only one month or less at a time, signifying a trading activity in the forward contracts as a profit making strategy. If the intention were ourely to use

the forward contracts as a hedging mechanism, ld. DR urged they should have been successively rolled over for the maximum permissible duration of six months at a time to correspond to the repayment schedule. The change in the pattern of taking forward contracts from a long term duration in the past to a short term duration after the RBI amendments lignifies a trading activity in these instruments. Since the forward contracts have not been used by the assessee as a hedging mechanism, the gain arising out of cancellation of forward contracts and issue of fresh ones becomes an adventure in the nature of trade and is a revenue receipt.

Further, the benefit of capitalization of the gain arising out of forward contracts as a reduction in the cost of the underlying capital asset, if available, is only permissible u/s 43A subject to satisfaction of prescribed conditions.

12. Regarding applicability of Explanation 3 to section 43A, Shri Gupta submitted that Explanation would be applicable if the forward transaction entered into initially are available at the time of exchange of underlying liability. He stated that at the time of entering into a fresh forward contract, the previous forward contract is effected and the rate of exchange specified therein loses its relevance. On these grounds, Shri Gupta contended that benefit of Explanation 3 to section 43A is not available in respect of gains arising from the cancellation of forward contracts, Ld. DR further placed reliance on the Full Bench decision of Gujarat High Court in the case of CIT vs. Gujarat State Fertilisers Co. Ltd. 259 ITR 526 and observed that the High Court held that the increase/reduction in the liability for making payments towards the whole or part of the cost shall be added or reduced from the cost of the asset on the actual date of repayment of the instalment of loan obtained for the purpose. Shri Gupta further added that in the instant case, the assessee has chosen to capitalize the gain in exchange rate fluctuation and such gain would, therefore, be not covered under Explanation 3 to section 43A.13. We have given our thoughtful consideration to the rival submissions as well as string of judicial authorities cited by Representatives on both sides. The basic question which falls for determitation before us is whether gains arising from cancellation of forward foreign exchange contracts are in the nature of capital receipts or revenue receipts.

Ld. Representatives on both sides took up the position that such receipts are not covered under. Explanation 3 to section 43A. It appear to us that ld. counsel for the assessee company, even while arguing that the foreign exchange contracts related to repayment of foreign loans taken for acquisition of plant and machinery and constituted capital receipt went on to argue that Explanation 3 did not apply so that gains would not be set off against the cost of plant and machinery. On the other hand, ld. DR disputed the application of Explanation 3 to section 43A to buttress the argument of the revenue that gains constitute taxable profit of the assessee company.

14. Before analyzing the rival contentions raised on behalf of the assessee company as well as the revenue, we feel that it would be useful to notice a few facts relating to forward contracts in foreign currency which have a crucial bearing on the controversy before us.

From the facts on record, it emerges that the assessee company, after purchase of machinery abroad, entered into 13 forward contracts in Sterling and Dollars so as to reduce the risk on account of fluctuations in exchange rates of these currencies. Out of these 13 contracts, 6 contracts related to repayment of interest liabilities on the foreign loans whereas the balance 7 contracts related to repayment of principal amounts of foreign loans. All these contracts brought forward from the preceding year were cancelled on 30.4.1992 pursuant to revised instructions of the Reserve Bank of India Dated 27.3.1992. The assessee again entered into 6 contracts in the month of May, 1992 and June, 1992 relating to repayment of US Dollars loan. No fresh contracts were entered into with regard to repayment of Sterling loans taken by the assessee. Out of 6 contracts, two contracts were cancelled on 26.2.1993 which related to repayment of interest liability in US Dollars Gains arising on cancellation of contracts during the year aggregated to Rs. 14.48,00,325/- which included gains relating to interest payable on foreign loans amounting to Rs. 3,03,19,957/- which has been treated by the assessee as revenue receipt. Thus, the balance amount of Rs. 1.06 crores relates to principle amount of foreign loans and has been capitalized by the assessee in the books in the plant and machinery account. Regarding the Sterling loans raised from CDC, no repayment to the CDC has been made during the year and Sterling

loan as on 31.3.1993 in the book aggregated to Rs. 22,44,15,367/- (equivalent to 4,09,172). Regarding US Dollars loan taken from Exim bank payments have been made on 16.4.1992 $ 4,21,625 and on 15.10.1992 $ 4,09,172.

These payments have been made out of cancellation of forward contract.

Outstanding liability of Dollar loan as on 31.3.1993 aggregated to Rs. 9,87,43,015/- (equivalent to US $ 30,15,402). The assessee is not a dealer in foreign currency and business of manufacture of tyres carried out by it is not connected with dealings in foreign exchange.

15. In so far as 13 forward contracts brought forward from the preceding year are concerned, these have admittedly been entered into to guard against foreign currency losses due to exchange rate variation in relation to repayment of foreign loans taken by the assessee for purchase of machinery. It is not disputed on behalf of the revenue before us that these contracts were entered into by the assessee to secure foreign exchange cover against exchange rate variation and there was no intention on the part of the assessee to carry out any commercial dealings in foreign exchange in the revenue account.

However, the case of the revenue is that after 27.3.1992, the assessee cancelled these contracts with the intention to earn profits and subsequent contracts entered into by the assessee and cancelled in succession were guided by the profit motive. On behalf of the assessee company, however, it is pleaded that forward contracts were meant for guarding against enhancement of foreign liabilities due to exchange rate variation and since such liabilities were connected with the acquisition of capital asset, the contracts were in the capital filed and gains arising from cancellation thereof represented capital receipt. Before us on either side, a large number of cases were cited with a view to support rival contentions. The distinction between capital accretion and income has been explained by Justice Rowlatt in Thew v. South West Africa Co. Ltd. (1924) 9 TC 141 (CA). The learned judge said that for the purpose of ascertaining whether profits made upon a sale of an article are taxable profits, the question to be asked is "Is the article acquired for the purpose of trade?" If it is, the profit arising from its sale must be brought into revenue account and that the profit is chargeable as capital gains if the sale is of a

capital asset, and as business profit if the sale is in the course of business or the transaction constitutes an adventure in the nature of trade. The line between capital sales and sales producing income has been drawn by Lord Justice Clerk in Californian Copper Syndicate v.Harris in passage which has become classical (1904) 5 TC 159 : "(It is quite a well-settled principle in dealing with question of assessment of income tax that where the owner of an ordinary investment chooses to realize it at, the enhanced price is not profit .... assessable to income tax.) But, it is equally well-established that enhanced values obtained form realization or conversion of securities may be so assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business...." The principles underlying the distinction between a capital sale and an adventure in the nature of trade were examined by the Apex Court in G.Venkataswami Naidu & Co. v. Commissioner of Income-tax (2002-TAXINDIAONLINE-179-SC-IT) 35 ITR 594 (SC), where it has been held that the character of a transaction cannot be determined solely on the application of any abstract rule, principle or test but must depend upon all the facts and circumstances of the case. Ultimately, it is a matter of first impression with the court whether a particular transaction is in the nature of trade or not. It has been said that a single plunge may be enough provided it is shown to the satisfaction of the court that the plunge is made in the waters of the trade; but mere purchase/sale of shares - if that is all that is involved in the plunge - may fall short of anything in the nature of trade. Whether it is in the nature of trade will depend on the facts and circumstances.

Where the purchase of any article or of any capital investment is made without the intention to resell at a profit, a resale under changed circumstances would only be a realization of capital and would not stamp the transaction with a business character (see Commissioner of Income-tax v. P.K.N. Co. Ltd. 60 ITR 65 (SC)).

(2002-TAXINDIAONLINE-180-SC-IT) 100 ITR 706, the Supreme Court, after detailed review of case law, observed that Where a purchase is made with the intention of resale, it depends upon the conduct of the assessee and the circumstances of the case whether the venture is on capital account or in the nature of trade. A transaction is not necessarily in the nature of trade because the

purchase was made with the intention of resale. The Court further held at page 712, as under.

"A capital investment and resale do not lose their capital nature merely because the resale was foreseen and contemplated when the investment was made and the possibility of enhanced values motivated the investment (see Leeming v. Jones (1930) 15 TC 333 (HL)) and also the decisions of this court is Saroj Kumar Mazumdar v. Commissioner of Income-tax(SC) and Janki Ram Bahadur Ram v. Commissioner of Income-tax An accretion to capital does not become income merely because the original capital was invested in the hope and expectation that it would rise in value; if it does so rise, its realization does not made it income. Lord Dunedin said in Leeming v. Jones 15 TC 333 (HL) at page 360: "The fact that a man does not mean to hold an investment may be an item of evidence bending to show whether he is carrying on a trade or concern in the nature of trade in respect of his investments but per se it leads to no conclusion whatever." 16. In the light of the principles above referred to, we have no hesitation in holding that gains from cancellation of forward exchange contractors were capital receipt and did not arise from any business of dealings in foreign exchange or any adventure in the nature of trade.

The forward contract in the instant case were entered into by the assessee with the sole purpose of acquisition of plant and machinery abroad and, therefore, gains arising from cancellation of the contract, to the extent these relate to principal amounts of outstanding loans would clearly fall in the capital filed. The essential characteristic which stamp the character of a revenue nature on any transaction, namely, multiplicity of transactions, a prior association of business and the existence of a scheme, system and business operations are totally conspicuous by their absence in the present case before us. In out considered opinion, the dominan intention, motive and purpose of entering into forward foreign exchange contracts and cancellation thereof were clearly to provide a hedging mechanism against enhancement of liabilities for repayment of foreign loans raised for the purpose of acquisition of capital asset by the assessee. The conduct of the assessee, as manifested in the facts and features of the case enumerated hereinabove, does not reflect profit motive in entering into forward contracts and

canceling the same thereafter. The crucial date is 27.3.1992 when he Reserve Bank of India lifted the barn on cancellation of foreign exchange contracts since Liberalized Exchange Rate Management System had been introduced by the Government. In the instant case before us, contracts have substantially been booked prior to 27.3.1992 and with regard to these contracts profits motive possibly cannot be attributed to the assessee. Even with regard to contracts entered into and cancelled after 27.3.1992, we notice that the transactions are a few in number and looking to the magnitude of the outstanding Dollar loan, the contracts entered into are only 6 in number out of which 2have been cancelled during the year. Gains arising from these 2 contracts have been shown by the assessee as revenue receipt since these contracts relate to payment of interest liabilities on Dollar loans. The entire factual matrix of the case concerning the execution and cancellation of forward contracts does not in out opinion stamp the transaction with a business character. Merely because the assessee company did not choose to all over the contracts beyond 30.4.92 would not alter the intrinsic nature of the contracts being in the capital field. If the contracts brought forward from the preceding year are accepted and acknowledged by the revenue authorities as being in capital account, mere cancellation on 30.4.92 would not have "denaturing" effect and divest them of inherent capital nature particularly when cogent reasons have been cited by the assessee for cancellation, namely, the emerging trends of the international monetary market and revised Reserve Bank of India regulations permitting cancellation of forward foreign exchange covers. In the changed scenario, the assessee felt that the rupee currency may not depreciate in the future. The dominant motive, purpose and intention of the assessee was clearly to hedge against enhancement of rupee liability for repayment of foreign currency loans. The learned DRs have made strong grievance of the fact that two instalment of repayment of U.S.Dollar loans fell due on 15.4.92 and 15.10.92 and forward contracts were not utilized for such payments. However, no such ground has been taken by the Assessing Officer or the learned CIT(A) against the assessee. When called upon to clarify the factual position by the Bench, Sh G.C. Sharma, learned counsel furnished the relevant details of payment which indicate that the two instalments of Dollar loans were paid on 16.4.92 and 15.10.92 out of U.S. Dollars received on cancellation of two

forward contracts No. 19803 (forward contract amount 900.000 U.S. $) and forward contract No. 21994 (Forward contract amount 20,00,000 U.S. $). The contention of the learned DR, is therefore, factually incorrect and forward contracts have been utilized for repayment of foreign loans by the assessee.

17. Viewed in the backdrop of the aforesaid facts and circumstances, we are inclined to accept the contention of Id. Counsel or the assessee that the entire activity of entering into and cancellation of forward contract, which are directly connected with the repayment of foreign currency loans fall in the capital filed and gains arising therefrom would therefore, be capital receipts.

18. It is now well-settled that where profits and loss arises to an assessee on account of appreciation or depreciation in the value of foreign currency held by it, on conversion into another currency, such profit or loss would ordinarily be treated as profit or loss if the foreign currency is held by the assessee on revenue account or as a trading asset on as part of circulating capital embarked in the business. But, on the other hand, if the foreign currency is held as a capital asset or as a fixed asset, such profit of loss would be of capital nature. The first decision of the Supreme Court on the issue in chronological order is that reported in CIT Vs. Tata Locomotive and Engineering Company Ltd. 60 ITR 406 relied upon by the learned counsel for the assessee. In this case the assessee, which was a limited company carrying on business of locomotive boilers and locomotives had for the purpose of its manufacturing activity to make purchases of plant and machinery in the United States. The assessee remitted a sum of $ 33,850 to the United States with the sanction of the Exchange Control Authorities for the aforesaid purpose of purchasing capital goods. The assessee also earned a commission of $ 36,123 as selling agent in the United States and the amount was retained in the United States for capital purposes after obtaining the sanction of the Reserve Bank of India. The court held that even though the amount of $ 36,123 was a revenue receipt in the assessee's business of commission agency, retention of this amount in the United States with the sanction of the Reserve Bank of India for buying capital goods fall in the capital filed and any profit accruing on subsequent repatriation of this amount on account of exchange variation was a capital profit.

19. The other decision to which we must refer as the one in CIT Vs.

Canara Bank Limited 63 ITR 328 (SC) relied upon by the learned counsel.

The assessee in this case was a public limited company carrying on the business of banking in India and it had opened a branch in Karachi on 15th November, 1946. The assessee did not carry on any business in foreign exchange in Pakistan. The amount of Rs. 3,97,221/- which was lying with the Karachi Bench remained idle there and was not utilized in any banking operation even within Pakistan. After the permission for remittance was granted by State Bank of Pakistan in July, 1953, the assessee remitted the amount of India. The assessee gained a surplus of Rs. 1,93,817/- on account of difference in the rate of exchange between the Indian Rupees and the Pakistan Rupee. The court held that the sum of Rs. 3,93,121/- was held ion capital account and the profit arising to the assessee on remittance of this account on account of alteration in the rate of exchange was not a trading profit but a capital accretion.

20. In Sutlej cotton Mills Ltd. Vs. CIT 116 ITR the Supreme Court has again reiterated its view that the question whether loss suffered by the assessee in the process of conversion of foreign currency into Indian currency due to exchange rate fluctuation would be a trading loss or a capital loss would be determined on the basis of facts whether the amounts in foreign currency were held as capital asset or as trading asset.

21. The Punjab & Haryana High Court, in Becc Engineering Co. Ltd. Vs.

CIT 236 ITR 344, examined a question whether the loss incurred due to fluctuation in the exchange rate in the repayment of foreign currency loan, which had been taken for a purchase of a machine from Germany was capital or business expenditure. The question was answered against the assessee on the ground that the payment related to the purchase of machinery. Similar view has been taken by Madras High Court in CIT Vs.

South India Viscose Ltd. 120 ITR 451, Gujarat High Court in Rohit Mills 219 ITR 228, Karnataka High Court in CIT Vs. Motor Industries company Limited 173 ITR

374 and Hindustan Machines Limited Vs. CIT 175 ITR 220.

21. At this stage, it would be useful to refer the legislative changes made by the Parliament reacting to the situation created by devaluation of Indian Rupees in 1966 by effecting amendments in the Income-tax Act, 1961, as well as Companies Act, 1956. The first legislative provision enacted to meet the situation was the insertion of section 437 in the Income -tax Act, 1961 by the Finance (No. 2) Act, 1967, with effect from April 1m 1967. The second statutory provision was an amendment of Schedule VI of the Companies. Act, 1956 in the form of a balance-sheet prescribed for companies. On perusal of the aforesaid provisions, it is clear that where an assessee had borrowed money for acquisition of any asset from a country outside India and in consequence of the change in the rate of exchange at any time after the acquisition of such asset there is a increase in the liability of the assessee as expressed in Indian currency in repayment of the whole or a part of the moneys borrowed by him from any person in any foreign currency specifically for the purpose of acquiring such asset, the amount by which the liability is so increased shall be added to the actual cost of the asset as defined in clause (1) of section 43 of the Act. This section specially provides for the treatment of increased liability of the assessee as expressed in Indian currency for repayment of the moneys borrowed by him from any person in foreign currency specifically for the propose of acquiring the asset. In the present case, the assessee had acquired a capital asset from a country outside India for the purpose of its business by making payment in foreign currency. For this specific purpose, it borrowed moneys in foreign currency from the Exim Bank and CDC and the liability in respect thereof was outstanding at the end of the relevant previous years. This liability and had increased on account of change in the rate of exchange. Thus, section 43A fully applies and the additional liability so created lad to be added to the cost of acquisition. This view is also in consonance with the clarification issued by the Ministry of Finance, but its letter of January 4, 1967, addressed to the Federation of Indian Chamber of Commerce and industry, the extracts of which have been reproduced in the judgment of the Supreme Court in CIT Vs. Arvind Mills Ltd. [1992 193 ITR 2558 at page 266. Para 2 of the above letter, which is relevant fro the present purpose, is reproduced below : "The Government agrees that for the purpose of the calculation of depreciation allowance, the cost of capital assets

imported before the date of devaluation should he written off to the extent of the fully amount of the addition rupee liability incurred on account of devaluation and not what is actually paid from year to year. The proposed legal provision in the matter is intended to be framed on this basis." 22. Section 43A also was considered at length by the Supreme Court in Arvind Mills' case [1992 193 ITR 255]. It was observed (at page 270) : "It is no doubt true that, but for the new section, various kinds of arguments could have been raised regarding the year in which such liability should be adjusted. But, we thin, arguments could also have been raised as to whether the actual cost calls for any adjustment at all in such a situation. It could have been contended that the actual cost can only be the original purchase price in the year of acquisition of the asset and that, even if there is any subsequent increase in the liability, it cannot be added to the actual cost at any stage and that, for the purpose of all the statutory allowances, the amount of actual cost once determined would be final and conclusive. Also section 43A provides for a case in which as in the present case, the assessee has completely paid for the plant or machinery in foreign currency prior to the date of devaluation but the variation in exchange rate affects the liability of the assessee (as expressed in Indiana currency) for repayment of the whole or part of the monies borrowed by him from any person, directly or indirectly, in any foreign currency specifically for the purposes of acquiring the asset. It is a moot question as to whether, in such a case on general principles, the actual cost of the assessee's plant or machinery would be the revised liability or the original liability. This is also a situation which is specifically provided for in the section..... As we had said earlier, there is not need to speculate on all the problems that might have arisen if section 43A has not been there because the statue has resolved these problems. It lays down, firstly that the increase or decrease in liability should be taken into account to modify the figure of actual cost and secondly that such adjustment should be made in the year in which the increase or decrease in liability arises on account of the fluctuation in the rate of exchange." 23. From the facts in the instance case before it is manifestly clear that the assessee has entered into foreign exchange contracts with a view to secure protection against enhancement of foreign loan liability and Explanation 3 to section 43A would come into play. The said Explanation reads as under : "Whether the assessee has entered into a

contract with an authorized dealer as defined in section 2 of the Foreign Exchange Regulation Act, 1947 (7 of 1947), for providing him with a specified sum in a foreign currency on or after a stipulated future date at the rate of exchange specified in the contract to enable him to meet the whole or any part of the liability aforesaid, the amount, if any, to be added to, or deducted from the actual cost of the asset or the amount of expenditure of a capital nature or, as the case may, be, the cost of acquisition of the capital asset under this sub-section shall, in respect of so much of the sum specified in the contract as is available for discharging the liability aforesaid, be computed with reference to the exchange specified therein." 24. Forward foreign exchange contracts entered into by the assessee are clearly covered under the aforesaid Explanation and, therefore, it would need to be read in conjunction with the provision enacted under section 43A(I). Section 43A (1) speaks of increase or reduction in the liability of the assessee as expressed in Indian currency for making payments towards the whole or part of the cost of the asset or for repayment of the whole or part of the money borrowed by him from any person in any foreign currency. Since the assessee has entered into forward contracts, as per the provisions of Explanation 3, increase or reduction of the liability of the assessee in repayment of the loan are liable to the ascertained on the basis of the forward contract. That part of the foreign liability for repayment of the loan which is covered under the forward contract would be determined on the basis of the exchange rate of the foreign currency into the Indian currency as specified in the contract. Any increase or reduction in the liability being the difference in the Rupees equivalent of original liability as well as the liability on the basis of the forward contract would be capitalized towards the actual cost of the assessee in consonance with the provisions of section 43A. Thus, gains arising on canceling of the forward contracts in the case of the assessee represent the reduction of the liability for repayment of the foreign loan which is liability to be adjusted in the cost of the asset as per section 43A(1). We are not persuaded to accept the argument of the Id. Counsel for the assessee that the forward contract have been cancelled by the assessee and are not covered under Explanation 3 to Section 43A. As we have already mentioned above, forward contract have been initially entered into by the assessee against repayment of foreign loan in Sterling as well as US Dollars and have been rolled over upto 30.4.1992 when the same

were cancelled in pursuance of relaxation of restriction against cancellation by the Reserve Bank of India. The fact that contracts were not rolled over beyond 30.4.1992 and the assessee consciously decided not to extend the security cover on maturity of the contracts would not by itself take these contracts out of the purview of Explanation 3.

Admitted facts re that these contracts have been entered into for providing the assessee with foreign currency on or after a stipulated future date at the fixed exchange rate. The contract are thus fully in conformity with the letter and spirit of Explanation 3. If the assessee has not opted for roll over of the contracts, this would not ipso facto make Explanation 3 inapplicable. The language of Explanation 3 does not contain any such qualification. The interpretation, suggested by Id.

Counsel would required the addition of the words "and the contract has been rolled over to the date of actual payment of instalment for foreign liability" after the words "to enable him to meet the whole on any part of the liability aforesaid" in the Explanation. There is nothing in the present language of the Explanation which makes it inapplicable to a case where the contracts have not been rolled over to the date of actual repayment of the liability. We are unable to accept the interpretation suggested by the Id. Counsel which in fact would cause grave violence to the language on the provisions. Any such interpretation would be contrary to well-accepted principles of interpretation namely, rule of literal interpretation as well as rule of purposive interpretation. It is an elementary principle of interpretation of statutes, reiterated by Courts time and again that the Court cannot read any thing into a statutory provisions which is plain and unambiguous. In our consideration opinion, the gain arising from cancellation of forward contracts which are connected with the foreign loans raised for purchase of machinery are capital in nature and are liable to be capitalized towards the cost of the machinery by virtue of section 43A (1) read with Explanation 3 thereto.

25. Shri Salil Gupta, learned Sr. DR, assailing the applicability of Explanation 3 to section 43A(1) put forward the argument in the written submissions filed by him that actual payments made by the assessee towards the repayment of foreign

loans during the year under reference is merely a small amount and gains arising from cancellation of forward contracts would, therefore, not be covered under section 43A(1) as well as Explanation 3 thereto. In support of his contention, he placed reliance on the Full Bench decision of the Gujarat High Court in the case of CIT Vs. Gujarat State Fertilizers Company Limited 259 ITR 520.

The contention of the learned Sr. DR is in direct conflict with the ratio of the decision of Supreme Court in CIT Vs. Arvind Mills Limited 193 ITR 255 which is a locus classicus on the interpretation of section 43A. In the said decision, it has been held by the Supreme Court that the amount of increase or decrease in the liability for repayment of foreign loans due to exchange rate fluctuation is liable to be adjusted against the actual cost of asset. The supreme court has taken note of the circular issued by the Central Board of Direct Taxes explaining the provisions of section 43A and extracted the following paragraph at page 266 of the report : "The above mentioned adjustment to the original actual cost of the assessee to the imported capita asset is to be made in respect of the previous year in which there is an increase or reduction in the assessee's liability in terms of Indian currency for payment of the whole or part of the cost of the asset or for repayment for the foreign loan against which the asset has been acquired. With reference to the recent devaluation of the rupee, this will be the previous year in which the date of devaluation, viz., 6th June, 1966, falls....." The Supreme Court, analyzing the provisions of section 43A, held that increase or decrease in liability in the repayment of foreign loans should be taken into account to modify the figure of actual cost in the year in which the increase or decrease in liability arises on account of the fluctuation in the rate of exchange. Thus, the adjustment in the actual cost are to be made irrespective of date of actual payment in foreign currency made by the assessee. Reference may further be made to the decision of Bombay High Court in the case of Padamjee Pulp and Paper Mills Ltd. Vs. CIT 210 ITR 97 and Patna High Court in the case of Usha Beltron Vs. CIT 238 ITR 133 wherein relying upon Arvinds Mills Limited's case (supra), a similar proposition has been laid down.

Regarding the Gujarat High Court decision in the case of Gujarat State Fertilizers Company Limited (supra) relied upon by the Id. Sr. DR, the said decision has been

rendered I the context of additional investment allowance on the increase in liability due to foreign exchange fluctuation and, therefore, does not advance the case of the revenue.

26. Before parting, we would like to point out that the view being taken by us for setting off the gains from cancellation of forward contracts towards cost of assets for which the foreign loans were raised by the assessee is, apart from the statutory provision contained under section 43A read with Explanation 3 thereto is also in conformity with accounting principles as formulated by the Institute of Chartered Accountant of India, which is an established and reputed body of professional experts in the filed of commercial accounting. The Institute has formulated accounting standards in conformity with the provisions of applicable laws, customs, usages and business environment of our country and also to fulfil the need to harmonise the diverse accounting policies and practices and also to integrate the same with the international accounting standards. Accounting Standard 11 which lays down the principles and guidelines for accounting for the effects of changes in foreign exchange rates set out the accounting treatment in respect of exchange difference son foreign currency transaction.

Paragraph 13, 14, and 15 of the text of the Accounting Standard 11 relate to foreign currency contracts set out the following guidelines : "13. An enterprise may enter into a forward exchange contract, or another financial instrument that is in substance a forward exchange contract, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The difference between the forward rate and the exchange rate at date of the transaction should be recognized as income or expense over the life of the contract, except in respect of liabilities incurred acquiring fixed assets in which case, such difference should be adjusted in the carrying amount of the respective fixed assets.

14. The difference between the forward rate and the exchange rate at the inception of a forward exchange contract is recognized as income or expense over the life of the contract. The only exception is in respect of forward exchange contracts related to liabilities in foreign currency incurred for acquisition of fixed

assets.

15. Any profit of loss arising on cancellation or renewal of a forward exchange contract should be recognized as income or as expense for the period, except in case of a forward exchange contract relating to liabilities incurred for acquiring fixed assets, in which case, such profit or loss should be adjusted in the carrying amount of the respective fixed assets." 27. From the aforesaid rules as laid down in the Accounting Standard 11, it clearly emerges that in case of a foreign exchange contract relating to foreign liability incurred for acquiring fixed assets any profit or loss on cancellation or renewal of a foreign exchange contract should be adjusted in the cost of the respective fixed assets.

Since, in the case of the present assessee, forward contracts relating to foreign loan liabilities incurred for acquiring plant and machinery from abroad have been cancelled, profits arising therefrom are required to be adjusted in the cost of the plant and machinery purchased by the assessee. It is to be noted that entries passed in the books of account by the assessee are in conformity with the aforesaid accounting standard as well as the statutory provisions enacted in the Income-tax Act, 1961 and the Companies Act. We have, therefore, no hesitation in answering the question referred to us as under : "the gains earned on cancellation of the foreign exchange forward contract by the assessee are capital receipts which should be reduced from the cost of plant and machinery in connection with which foreign loans were raised by the assessee." 28. The matter would now be placed before the Division Bench for being disposed of in accordance with our decision.

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