

**D. Kishorekumar and Co. Vs. Dy. Cit**

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**Court :** Income Tax Appellate Tribunal ITAT Mumbai

**Decided On :** Mar-31-2005

**Reported in :** (2005)2SOT769(Mum.)

**Appellant :** D. Kishorekumar and Co.

**Respondent :** Dy. Cit

**Judgement :**

This is an appeal filed by the assessee, and is directed against CIT(A)'s order dated 31-3-1997, in the matter of assessment under section 143(3) of the Income Tax Act, 1961, for the assessment year 1993-94.

The assessee's grievance, as raised in this appeal before us, is two fold - first that the CIT(A) erred in confirming the adjustment made by the assessing officer of reducing 90% of the premium received on cancellation of forward contracts of the foreign exchange, for the purpose of computing depreciation allowable under section 80HHC of the Act; and - second, against CIT(A)'s holding the 90% of the interest on fixed deposits is to be reduced for the purpose of computing section 80HHC deduction.

We will take up the second grievance first. As far as second grievance of the assessee, is concerned, learned representatives have fairly agreed that this issue is now covered by the Special Bench decision of the Tribunal in the case of *Lalsons Enterprises v. Dy. CIT* (2004) 89 ITD 25 (Del). Learned Departmental Representative, however, dutifully relies upon the orders of the authorities below.

The Special Bench decision being a binding judicial precedent for us, we respectfully follow the same, and, accordingly, we direct the assessing officer to recompute the deduction under section 80HHC in the light of the principles laid down by the aforesaid Special Bench decision. In effect, the assessing officer shall, while computing the deduction under section 80HHC, exclude 90% of only take the net amount i.e., interest received as reduced by interest paid on the invested funds on which the interest is so received. The matter is hereby restored to the file of the assessing officer with these directions.

Ground No. 11, which sets out the above grievance, is thus allowed for statistical purposes.

We now come back to the first grievance. So far as this grievance of the assessee is concerned, the material facts of the case are as follows. The assessee is a diamond exporter. In the course of this business, the assessee imports rough diamonds, cuts and polishes the same and exports the cut and polished diamonds. The payments for imports of diamonds is required to be made, on due dates, in US Dollars. With a view to minimise the risk of increased cost of imports, due to fall in value of rupee vis-a-vis US Dollars, the assessee entered into forward contracts for the foreign exchange. These contracts ensured that the assessee has availability of the foreign exchange at a fixed rate on the date on which foreign exchange payments fall due. However, in the prevailing market conditions in the foreign exchange market, the assessee considered it appropriate to cancel the forward contracts and book the profits, i.e., realize the difference between agreed forward contract price and prevailing market price. On this cancellation of forward exchange contracts, or, put it differently, realization of difference between the contracted price of dollars vis-a-vis the prevailing market price of the foreign exchange, the assessee received a sum of Rs. 10,30,305. The assessee's claim was that this receipt of Rs. 10,30,305 was an integral part of its export business profits. The assessing officer, however, was of the view that 90% of the aforesaid receipt is liable to be excluded from the profits of the business under clause (baa) of Explanation to section 80HHC. The assessing officer also observed that "the criterion for reducing 90% of certain receipts is not whether the receipt is business or non business but whether the particular receipt has any

turnover element..." The assessing officer also noted that the gain on cancellation of foreign exchange contract is "not derived from the business activity of the assessee as the same is not springing from, or arising from, or flowing from, an activity of the business carried out by the assessee, and are not transactions of the business within the meanings of 'profits or gains of business'." The assessing officer went on to add the said income "could not be brought within the ambit of 'as derived from the business activity of the assessee'. Hence, the contention of the assessee is rejected".

Aggrieved by the action of the assessing officer, the assessee carried the matter in appeal before the CIT(A) but without any success. The CIT(A) confirmed the action of the assessing officer and also observed as follows : Moreover, both these receipts do not qualify for allowance of deduction as per provisions of section 80HHC(1) as well as 80HHC(2) for following reasons viz : (i) Neither these receipts are earned out of trading of commodity in the international market, in other words by export of commodity; (ii) Both these receipts are received in India and these are not received outside India in any convertible foreign exchange as required under sub-section (2) of section 80HHC. The assessee is not satisfied by the order of the CIT(A) also and is in second appeal before us.

We have heard Shri Shivaram, learned counsel for the assessee, and Shri Sarangal, learned Departmental Representative. We have also carefully perused the orders of the authorities below, as also the paper book filed before us, and duly considered factual matrix of the case as also the applicable legal position.

We must first of all address ourselves to the nature of these forward exchange contracts, and the question whether or not these transactions can be considered to be an integral part of the export business or whether or not these transactions are to be considered as a business by itself. As learned Departmental Representative has very rightly pointed out, in case we come to the conclusion that these forward exchange contracts, and their settlement without delivery, is a separate business by itself, the profits on these transactions will have to be treated as profits of speculation business distinct and separate from that of export business. But then, the authorities below have only excluded 90% of these profits,

in computing the deduction under section 80HHC, whereas learned DR's contention being accepted will mean that entire profits are required to be excluded. That will mean that the assessee will be worse off as a result of having come up in this appeal before. While such a result is certainly not permissible under the law, this aspect of the matter, for the reasons we shall now state, is entirely academic in the present context.

The details of forward exchange contract were filed before us at page 31 of the paper book. These details 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 section 43(5), describing speculative transactions, are clearly fulfilled, the requirement of Explanation 2 to section 28 is not fulfilled inasmuch as it cannot be concluded that the transactions are such a 'nature' as to constitute a business by itself. In our understanding. of the situation, 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-a-vis domestic currency, and when the foreign exchange value is so increasing the ultimate payment made in foreign exchange by the assessee also increases. In the case, the value of foreign currency was not to go up, there would

not have been gains on cancellation of contracts but then the actual costs, in terms of domestic currency, that the assessee pays when he has to pay for imports in foreign currency does not also go up. 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. We have noted that all these contracts were cancelled on 13-4-1992, when the prevailing market price was INR 100 = US\$ 3.235, as against the forward contract rate of INR 100 = US \$ 3,840 and the rates of INR 100 = US \$ 3.68 to 3.7325 prevailing on the date of imports. The due dates of payment at that point of time were only 16 days to 77 days away, as evident from the chart showing the due dates-which was also contained in page 31 of the paper-book. 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, we are of the considered view that the credit shown in the profit & loss account as 'profit on cancellation of forward contracts' is as integral part of the export business, as purchases or imports. As it effectively controls and reduces the cost of imports, and is integral part of the export business profits, and as, in our considered view, the exclusion clause under clause (baa) of Explanation to section 80HHC cannot apply to these profits, the authorities below were indeed not justified in holding that 90% of these profits is required to be excluded from

profits of export business. This amount is not covered by any of the categories which are covered by the aforesaid clause in Explanation to section 80HHC. We, therefore, uphold the contention of the assessee, and direct the assessing officer to recompute the deduction under section 80HHC by, inter alia, not excluding 90% of the profit realized on cancellation of forward foreign exchange contracts, from the profits of export business. The assessee succeeds on this issue.

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