

**आयकर अपीलीय अधिकरण, विशाखापटणम पीठ, विशाखापटणम**  
**IN THE INCOME TAX APPELLATE TRIBUNAL,**  
**VISAKHAPATNAM BENCH, VISAKHAPATNAM**

श्री वी. दुर्गाराव, न्यायिक सदस्य एवं  
श्री जी. मंजुनाथा, लेखा सदस्य के समक्ष  
BEFORE SHRI V. DURGA RAO, JUDICIAL MEMBER &  
SHRI G. MANJUNATHA, ACCOUNTANT MEMBER

आयकर अपील सं./I.T.A.No.487/Vizag/2012  
(निर्धारण वर्ष / Assessment Year: 2009-10)

ACIT, Circle-1,  
Rajahmundry Vs. Sri Ramalingeswara Rice & Oil Mill,  
Velpur  
[PAN: AAIFS3902M]  
(अपीलार्थी / Appellant) (प्रत्यार्थी / Respondent)

अपीलार्थी की ओर से / Appellant by : Shri Aravindakshan, DR  
प्रत्यार्थी की ओर से / Respondent by : Shri G.V.N. Hari, AR

सुनवाई की तारीख / Date of hearing : 08.09.2016  
घोषणा की तारीख / Date of Pronouncement : 07.10.2016

**आदेश / O R D E R**

**PER G. MANJUNATHA, Accountant Member:**

This appeal filed by the revenue is directed against order of the  
CIT(A), Guntur, dated 3.10.2012 and it pertains to assessment year  
2009-10.

2. The brief facts of the case are that the assessee is a partnership firm carrying on business of rice mill and forward contracts, filed its return of income for the assessment year 2009-10 on 29.9.2010 declaring loss of ₹ 2,51,48,852/-. The case has been selected for scrutiny through CASS, and accordingly, notice u/s 143(2) & 142(1) of the Income Tax Act, 1961 (hereinafter called as 'the Act') were issued. In response to notices, the authorized representative of the assessee appeared from time to time and furnished details and other information called for. During the course of assessment proceedings, the A.O. observed that in this case, a survey operation u/s 133A of the Act was conducted on 16.11.2010. During the course of survey operation, books of accounts, registers and documents have been found and impounded. The impounded books of accounts reveals that the assessee is maintaining gate passes for inward of materials purchased and on verification of the gate passes maintained by the assessee, it was noticed that the assessee is not maintaining serial number, name of the farmer from whom the paddy was purchased, village, details of goods purchased, weight in quintals, mode of transport/vehicle numbers, date of purchase and signature of receiving person. Since the books of accounts maintained by the assessee are found with discrepancies, the A.O. opined that purchases shown in the books of accounts are not

correct. Keeping these facts into consideration, disallowed 5% of paddy purchases which works out to ₹ 1,19,53,700/-. Similarly, the A.O. observed that the assessee has claimed various expenditures, however, failed to file bills and vouchers and other relevant details in support of expenditure claimed, therefore, disallowed 10% expenditures under the head freight charges, travelling & conveyance expenses, administrative expenses, vehicle maintenance expenses, repairs & maintenance, processing & packing, printing & stationery and added back to the total income.

3. The A.O. further observed that, during the year, the assessee firm is engaged in the business of export of Agri commodities. After the procurement of export order from the prospective buyers at a fixed rate, the firm will procure goods locally and the shipment of the goods will be dispatched to foreign countries. In its business of export of agri commodities, the assessee firm used to enter into forward contracts with their bankers to hedge the currency risk to mitigate the possible fluctuation in currency. During the year, the assessee firm has entered into forward exchange contracts with its banker. The A.O. observed that the assessee has entered into a forward exchange contract without there being any exports turnover to hedge the possible loss in foreign

currency. The A.O. further observed that the assessee has entered into forward contracts to deal in currency, therefore, opined that forward contract entered by the assessee are in the nature of speculative transactions. Therefore, issued a show cause notice and asked to explain why the loss incurred under the head "Exchange loss" shall not be disallowed.

4. In response to show cause notice, the assessee submitted that it is in the business of export of agri-commodities and in the process, it has entered into forward exchange contracts to hedge the fluctuation in foreign currency. The assessee firm entered into forward contracts with their bankers to mitigate future losses in fluctuation in foreign currency. The assessee further submitted that the firm has done export turnover of more than ₹ 80 crores in the preceding financial year, however, during the current financial year, its export turnover became nil because of unexpected ban imposed by Government of India on export of rice. The assessee further submitted that the Government of India has imposed ban on export of rice in the beginning of the financial year for a period of 3 months, however, it has been further extended to the whole financial year. The assessee was on bonafide belief that the ban imposed by the Government on export of rice is temporary, once the

ban is lifted, the firm can resume its operations and continue its exports. The assessee further submitted that it has entered into forward exchange contracts in the previous financial years and the same were continued during the current financial year. Since there was no export turnover, it has closed forward exchange contracts with its bankers and the resultant loss on account of fluctuation in foreign currency has been recognized as business loss, therefore, it cannot be held as speculative transaction.

5. The A.O. after considering the explanations of the assessee, held that the expenditure claimed by the assessee under the head "exchange loss" is not allowable as a business expenditure, as it is only a notional loss, but not crystalised loss. The A.O. further observed that the assessee has entered into forward exchange contracts without there being any underlying exposure i.e. export turnover, therefore, the loss incurred by the assessee is a speculative loss which cannot be allowed as a normal business loss. The A.O. has discussed at length the term speculative loss, derivatives and forward exchange contracts and came to the conclusion that loss against currency fluctuations, crystallization of liability will not be there. The A.O. further observed that the assessee has failed to correlate the hedging of foreign currency with the

necessary expenditures on merchandise for sale i.e. export obligation. In the absence of such export obligation, it can be inferred that the hedging of profits by way of forward contracts is not related to the business activity of the assessee. Though assessee claims that it had export turnover in the immediately preceding financial year, during the current financial year, it has achieved 'zero' export turnover. The explanation of the assessee that ban on export of rice is temporary, it can continue its export once ban is lifted cannot be accepted, as the facts remains that the assessee could not do any exports and also it has purchased forward contracts even after ban was imposed by the Government. Therefore, it cannot be held that the assessee has entered into forward exchange contracts to hedge the possible loss in currency fluctuations. With these observations, disallowed loss claimed by the assessee and added back to the total income.

6. Aggrieved by the assessment order, the assessee preferred an appeal before the CIT(A). Before the CIT(A), the assessee reiterated the submissions made before the A.O. The CIT(A) after considering the explanations of the assessee, partly allowed appeal filed by the assessee. The CIT(A) deleted additions made towards disallowance of 5% paddy purchases, by holding that documentary evidences produced

in support of paddy purchases shows that there was no inflation of purchase of paddy or suppression of the quantity of paddy purchases during the year under report. As sought to be highlighted by the assessee, no defects in the books were pointed out by the A.O. nor did the same stand rejected. Further, no defects in the form B register were mentioned and no points were raised on the purchase price paid by the appellant. The only defect pointed out by the A.O. is irregular maintenance of gate passes. During the course of appellate proceedings, the assessee has filed copy of the order of the Government announcing Minimum Support Price (MSP) of paddy and also the order passed by the agricultural marketing committee, wherein the quantity recorded by the assessee in its books of accounts and quantity assessed by the authority are one and the same. As regards disallowance of travelling & conveyance expenses, administrative expenses and vehicle maintenance, the CIT(A) has sustained additions to the extent of ₹ 2 lakhs and balance is directed to be deleted. As regards disallowance of repairs & maintenance, processing expenses and printing & stationery, sustained additions of ₹ 4,50,000/- and balance amount is directed to be deleted. With regard to disallowance of loss on forward contracts, the CIT(A) held that the loss claimed by the assessee is not a notional loss and the loss is incurred on termination/renewal of forward exchange

contracts. The A.O. disallowed the loss on the ground that the loss claimed by the assessee is marked to market losses (MTM), however, on perusal of details filed by the assessee, it was observed that the losses have been debited by the bankers on termination of forward contracts, therefore, the A.O. was not correct in disallowing the loss incurred by the assessee. Aggrieved by the CIT(A) order, the revenue is in appeal before us.

7. The first issue that came up for our consideration is disallowance of 5% paddy purchases. The A.O. disallowed 5% paddy purchases for the reasons that gate passes maintained by the assessee are not giving true and correct position of purchases. The A.O. was of the opinion that during the course of survey operation, impounded documents reveals that the assessee is not maintaining proper gate passes for recording purchases of paddy. According to the A.O., the assessee is not mentioning serial number and other details in the gate passes, therefore, opined that the assessee has inflated paddy purchases. It is the contention of the assessee that its paddy purchases are supported by valid bills & vouchers and also it has paid agricultural marketing cess, according to which there is no difference in paddy purchases recorded in its books of accounts and order passed by the agricultural marketing



committee. We find force in the arguments of the assessee for the reason that during the course of appellate proceedings, the assessee has furnished copy of order passed by agricultural marketing committee and reconciled the quantity of paddy purchases with MSP to its books of accounts. The CIT(A) has recorded categorical finding of facts that the purchases recorded by the assessee and purchases as per the AMC reports are matched. The revenue failed to prove the finding of facts recorded by the CIT(A) is incorrect. Therefore, we are of the view that the CIT(A) has rightly deleted additions made towards disallowance of paddy purchases. We do not see any error or infirmity in the order of CIT(A). Hence, we inclined to upheld CIT(A) order and reject ground raised by the revenue.

8. The next issue that came up for our consideration is disallowance of certain expenditure on adhoc basis. The A.O. disallowed adhoc disallowance of 10% expenditure under the head freight charges, travelling and conveyance, administrative expenses, vehicle maintenance, repairs & maintenance expenditure, processing & packing and printing & stationery. The A.O. disallowed expenditure on the ground that the assessee has failed to substantiate expenses with necessary bills & vouchers. The A.O. observed that the assessee has

maintained self-made vouchers and the vouchers maintained by the assessee are not having serial numbers, signature of the managing partner and no revenue stamps are affixed and in few vouchers, the recipient signature is not obtained, therefore, opined that the vouchers maintained by the assessee are not susceptible for verification. It is the contention of the assessee that it has maintained proper bills & vouchers in support of all expenses. The assessee further submitted that due to huge volume of transactions, the cashier has been preparing single vouchers when the nature of payment comes under the same head by taking the entire recipients signature on the same vouchers. As regards not affixing the revenue stamp on the vouchers, it was submitted that due to non-availability of revenue stamp, the firm had not been affixed revenue stamp on the vouchers. The assessee further submitted that considering its total volume of businesses, the expenditure claimed under the head 'freight charges and other expenses' is meager in nature and also all the expenditures are covered by fringe benefit tax, therefore, there was no reason for the A.O. to doubt the genuineness of the expenditure. We find force in the arguments of the assessee for the reason that considering huge volume of business of the assessee, the expenditure incurred by the assessee under freight charges and other expenditure is meager in nature. We further observed that all the

expenditure is covered under fringe benefit tax. The A.O., while assessing the fringe benefit tax has accepted the expenditure claimed by the assessee as genuine in nature. Therefore, we are of the view that once the expenditure has been accepted as genuine, there is no reason for the A.O. to doubt the same for the purpose of allowing deduction against business income. The CIT(A) after considering the relevant facts, has rightly sustained part of the additions and directed the A.O. to delete the remaining additions. We do not find any error or infirmity in the order passed by the CIT(A). Hence, we inclined to uphold the CIT(A) order and reject the ground raised by the revenue.

9. The next issue that came up for our consideration is disallowance of expenditure incurred under the head 'exchange loss'. The facts relating to the issue are that the assessee is involved in the business of export of rice and agri commodities. In the process, the assessee has entered into forward exchange contracts with its bankers to hedge the possible fluctuation in foreign currency. During the financial year relevant to assessment year 2009-10, the assessee has claimed an amount of ₹ 2,57,66,856/- loss on account of exchange loss and claimed as revenue expenditure. During the course of assessment proceedings, the A.O. observed that the assessee has claimed exchange loss,

however, failed to substantiate the loss with necessary underlying exposure i.e. export turnover. The A.O. further observed that during the financial year relevant to assessment year 2009-10, the assessee has achieved zero export turnover and when there is no exports, the question of hedging currency does not arise. Accordingly, opined that forward contracts entered by the assessee are in the nature of speculative transactions and hence, the loss is not allowable as a business loss etc. The A.O. has discussed at length the modus operandi of the assessee. The A.O. also discussed the terms forward contracts, derivatives, speculative loss and crystallization losses. According to the A.O., the loss claimed by the assessee is a notional loss. The A.O. further observed that only crystallized losses are allowable as a deduction, but not notional losses. The A.O. further observed that the assessee has failed to correlate the forward contracts with export orders on hand so as to justify the need for hedging the foreign currency.

10. It is the contention of the assessee that these forward exchange contracts are entered in the previous financial year and matured during the current financial year. The assessee further contended that during the previous financial year, it has achieved more than ₹ 80 crores export turnover, however, in the current financial year because of unexpected

ban imposed by the Government of India, on export of rice, it could not achieve any export turnover. It was further submitted that since the forward exchange contracts have been entered in the previous financial year, on closure of these forward exchange contracts, the banker has debited the loss incurred on account of fluctuation in currency and the same has been claimed as expenditure. The assessee further claims that the loss incurred under the head 'exchange loss' is a crystallised loss, therefore, the A.O. was not correct in holding that the loss incurred is a notional loss.

11. We have heard both the parties, perused the materials available on record and gone through the orders of the authorities below. The A.O. disallowed loss incurred on forward contracts for the reason that the loss claimed by the assessee is a notional loss. The A.O. further observed that the assessee has failed to correlate exchange loss to export turnover to hedge the currency fluctuations, therefore, opined that the loss claimed by the assessee is not allowable deduction. According to the A.O., only crystallized loss on account of closure of forward contracts is allowable as a deduction. In the present case on hand, the assessee has pre-closed forward exchange contracts because of non-availability of export turnover and hence, the loss incurred is a

speculative loss within the meaning of section 43(5) of the Act and hence, it cannot be allowed as a deduction.

12. Before we, go in to the facts of the present case, let us understand, forward contracts, speculative transactions, hedging, foreign exchange loss and treatment of loss in the books of accounts. A forward contract is a agreement between an enterprises and a banker to purchase or sell a particular quantity of currency for a mutually agreed price at a particular date. These forward contracts are used by exporters to get their export receivables hedged against adverse currency movements. Hedging is defined as to enter in to transactions to reduce the risk of adverse movement of currency. Any person having exposure to foreign currency may enter into hedging to fix his cost and profits at a particular level. Therefore, forward contracts means entering into agreement with bankers to hedge the currency fluctuations to mitigate the loss in the course of import/export business. Forward exchange contracts and treatment of any profit/loss arising on cancellation or renewal of such forward exchange contracts has been dealt by Accounting Standard-11 issued by the Institute of Chartered Accountants of India, in para 36, 37, 38 & 39. According to the AS-11, of ICAI, any forward exchange contracts entered to hedge the foreign currency exposure, to mitigate

unexpected loss with its import/export business has to be regarded as business loss and income as the case may be. In case of such forward exchange contract is not in the nature of hedging, then such loss should be ignored.

13. Similarly, the provisions of section 43(5) of the Act defines the term speculative transactions, means a transaction in which a contract for the purchase or sale of any commodity, including stock and shares is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scripts. Sub-clause (a) of section 43(5) of the Act, excludes certain transactions within the meaning of speculative transaction. According to the sub-clause (a), a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchandising 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. A plain reading of sub-clause (a) of section 43(5) of the Act, makes it clear that any forward exchange contracts entered into in its business of import or export of goods to hedge the possible fluctuation in foreign currency, then such transactions are kept outside the purview of the definition of speculative transactions. Therefore, to see whether a

particular transaction is a speculative transaction or a mere hedging transaction, there should be export or import of goods or merchandise at least to the extent of value of forward exchange contracts.

14. The treatment to be given to foreign currency items as per the amended AS – 11 of ICAI, notified by Central Government u/s 211(3C) of Companies Act, does not make any distinction between items of capital nature and revenue nature. Both are required to be recognized in the Profit & Loss Account. In view of the aforesaid amendment, there exists a divergence of views on the treatment to be meted out in the books of accounts and in the Indian Tax Laws. Further, with an increased flow of inbound / outbound transactions and their complex dynamic structuring, the tax treatment of foreign exchange gains / losses has been surrounded by huge litigation and various Courts have discussed the same in great detail. Exchange Fluctuation Difference and tax treatment of the captioned issue was discussed in great detail in the recent landmark ruling of Supreme Court in the case of CIT vs Woodward Governor India P. Ltd (312 ITR 254) where in the SC relied on the earlier judgment in the case of Sutlej Cotton Mills Ltd vs. CIT (116 ITR 1), observed that the law may, therefore, now be taken to be well settled that where profit or 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 a trading profit or loss if the foreign currency is held by the assessee on revenue account or as a trading asset or as part of circulating capital embarked in the business. But, if on the other hand, the foreign currency is held as a capital asset or as fixed capital, such profit or loss would be of capital nature.”

15. Further in the aforesaid ruling the Apex Court also affirmed the principles laid down in the ruling of CIT vs. V.S.Dempo & Co Pvt. Ltd (206 ITR 291), wherein it was held that a loss arising in the process of conversion of foreign currency which is part of trading asset of the assessee is a trading loss as any other loss. In determining the true nature and character of the loss, the cause which occasions the loss is immaterial; what is material is whether the loss has occurred in the course of carrying on the business or is incidental to it. · If there is loss in a trading asset, it would be a trading loss, whatever be its cause because it would be a loss in the course of carrying on the business. Loss in respect of circulating capital is revenue loss whereas loss in respect of fixed capital is not. Loss resulting from depreciation of the foreign currency which is utilised or intended to be utilised in business

and is part of the circulating capital, would be a trading loss, but depreciation of fixed capital on account of alteration in exchange rate would be capital loss. For determining whether devaluation loss is revenue loss or capital loss what is relevant is the utilisation of the amount at the time of devaluation and not the object for which the loan had been obtained. The way in which the entries are made by an assessee in the books of account is not determinative of the question whether the assessee has earned any profit or suffered any loss. What is necessary to be considered is the true nature of the transaction and whether in fact it has resulted in profit or loss to the assessee. Therefore, once loss incurred on account of fluctuation in foreign currency, then the loss suffered shall be allowed as business loss, unless it is in the nature of speculation loss.

16. Having said that, let us come to the facts of the present case. In the present case on hand, the assessee is into the business of export of rice and other commodities. During the previous financial year, it has achieved export turnover of about ₹ 80 crores. The forward exchange contracts are entered in the previous financial year, which was not disputed by the A.O. Though there is no export turnover for the current financial year, this is because of a ban imposed by the Government of

India, on export of rice and other commodities. As rightly pointed out by the Ld. A.R. for the assessee, the Government of India imposed ban on export of rice for a temporary period. Although the ban was extended for a further period i.e. up to end of financial year 2008-09, the assessee was on the bonafide belief that the ban on export is temporary and Government may review the ban, therefore, it can continue its exports and accordingly it has continued its forward exchange contracts with the banks. Since the ban was continued for the whole financial year and also fact that during the same period, the Indian currency had a dramatic fall in the international market, the assessee has closed forward exchange contracts and suffered loss. The assessee being a prudent business person entered foreign exchange contracts with a hope that the Indian currency may recover and it may recoup the losses. But, ultimately when things are not turned around, it has cancelled forward exchange contracts, which results into loss. Therefore, the loss suffered by the assessee cannot be considered as speculative loss within the meaning of section 43(5) of the Act.

17. Coming to the allegations of the A.O. The A.O.'s main allegation is that loss claimed by the assessee is MTM loss or notional loss as the loss is not crystallized in the books of accounts. The A.O. observed that only

crystallized loss is allowable as deductions, but not notional loss. As the forward contracts have been entered into against currency fluctuations, there would not be any crystallization of liability. The A.O. further observed that loss incurred by the assessee is a MTM losses, which is in the nature of notional loss cannot be allowed as deductions. The A.O. referred to AS-30 issued by the ICAI and CBDT circular and observed that MTM loss provided in the books of accounts cannot be allowed. We do not find merits in the findings of the A.O., for the reason that in the present case on hand, the A.O. himself has accepted that the loss claimed by the assessee are on account of cancellation/renewal of forward exchange contracts, which has been debited by the bankers. The assessee has filed details of forward exchange contracts and bank accounts. On perusal of the bank statements, we find that the losses incurred by the assessee is on account of cancellation/renewal of forward exchange contracts, which is crystallized and debited by the bankers. Considering facts and circumstances of this case, we are of the view that foreign exchange loss incurred by the assessee on account of entering into forward contracts with banks for the purpose of hedging loss in connection with its import/export business has to be regarded as business loss. The CIT(A) after considering the relevant explanations rightly deleted the additions made by the A.O. We do not see any

reasons to interfere with the order of CIT(A). Hence, we inclined to uphold the CIT(A) order and reject the ground raised by the revenue.

18. In the result, the appeal filed by the revenue is dismissed.

The above order was pronounced in the open court on 7<sup>th</sup> Oct'16.

Sd/- (वी. दुर्गराव) <b>(V. DURGA RAO)</b> न्यायिक सदस्य/JUDICIAL MEMBER	Sd/- (जी. मंजुनाथा) <b>(G. MANJUNATHA)</b> लेखा सदस्य/ACCOUNTANT MEMBER
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विशाखापटणम /Visakhapatnam:

दिनांक /Dated : 7.10.2016

VG/SPS

आदेश की प्रतिलिपि अग्रेषित/Copy of the order forwarded to:-

1. अपीलार्थी / The Appellant – The ACIT, Circle-1, Rajahmundry
2. प्रत्यार्थी / The Respondent – M/s. Sri Ramalingeswara Rice & Oil Mills, Dr.No.2-153, Rice Mill Street, Velpur, West Godavari Dist.
3. आयकर आयुक्त / The CIT, Rajahmundry
4. आयकर आयुक्त (अपील) / The CIT (A), Guntur
5. विभागीय प्रतिनिधि, आय कर अपीलीय अधिकरण, विशाखापटणम / DR, ITAT, Visakhapatnam
6. गार्ड फ़ाईल / Guard file

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वरिष्ठ निजी सचिव (Sr.Private Secretary)  
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ITAT, VISAKHAPATNAM