आयकर अपीलीय अधिकरण, "ए" खंडपीठ मुंबई

INCOME TAX APPELLATE TRIBUNAL,MUMBAI - 'A' BENCH.

सर्वश्री डी .मन्नमोहन, उपाध्यक्ष **एवं** राजेन्द्र, लेखा सदस्य

Before S/Sh.D.Manmohan, Vice-President & Rajendra,Accountant Member

आयकर अपील सं/.ITA No.5631/Mum/2012 ,निर्धारण वर्ष/Assessment Year-2009-10

Araska Diamond Pvt. Ltd., 101, Mehta Mahal, 15-Mathew Road, Opera House, Mumbai-400004	Vs.	ACIT 5(1), Mumbai.
PAN: AAGCA7875C		

(अपीलार्थी/ Appellant) (प्रत्यर्थी / Respondent)

निर्धारिती ओर से / Assessee by : Shri Manish J. Sheth

राजस्व की ओर से/ **Revenue by : None**

सुनवाई की तारीख/ Date of Hearing : 01-09-2014

घोषणा की तारीख / Date of Pronouncement **:** 17-10-2014

आयकर अधिनियम,1961 की धारा 254(1)के अन्तर्गत आदेश

Order u/s.254(1)of the Income-tax Act,1961(Act)

Per Rajendra,AM लेखा सदस्य राजेन्द्र के अनुसार:

Challenging the order dt.09.07.2012 of the CIT(A)-9,Mumbai,assessee-company has raised following Grounds of Appeal:

1. On the facts and in the circumstances of the case and in law, the Ld. CIT(A) erred in confirming disallowance of loss of Rs.2,98,48,551/- on account of cancellation of foreign currency forward contract by treating it as speculation loss

2. On the facts and in the circumstances of the case and in law, the Ld. CIT(A) erred in believing that forward contracts are not relatable to any specific export bills of the assessee

3. On the facts and in the circumstances of the case and in law, the Ld. CIT(A) ought to have considered that foreign currency is not a "Commodity"

4.On the facts and in the circumstances of the case and in law, the Ld. ClT(A) erred in not relying on the case of CIT vs Badridas Gauridu (P.) Ltd.261 ITR 256 Bom, Bench: 5 Kapadia, J Devadhar and DCIT v. Intergold (I) Limited (2010) 1 ITR 2571 27 50T 239 (ITAT-MUM) which are on identical facts of the assessee

5. The assessee craves Your Honour leave to add, alter or amend or delete any of the above grounds.

2.Assessee-company,engaged in the business of trading of cut and polished diamonds,filed its return of income on 26.09.2009 declaring loss at Rs.2,19,91,359/-.Assessing officer(AO)finalised the assessment u/s.143(3) of the Act,on 29.12.2011,determining the total income of Rs.78,57, 190/-.

Effective ground of appeal is about disallowance of loss of Rs.2,98,48,551/- on account of cancellation of foreign currency forward contract.During the assessment proceedings,the AO found that the assessee had debited loss on account of exchange rate fluctuation amounting to Rs. 2.98 Crores. He directed the assessee to furnish details on account of exchange rate difference and of forward contracts.After considering the explanation filed by the assessee, the AO observed that any loss incurred by an assessee on entering into currency derivatives,due to forward contract of foreign exchange(FE)rate,had to be taken as forex derivative loss, that such loss had to be on account of dealing in forex derivatives which had actually been incurred by way of settling the difference at the end of the expiry of period of derivative contract or its termination, that assessee had to prove that currency derivative losses incurred was on account of hedging (reducing) risk

and had not been undertaken as a speculative transaction to earn more profit.He referred to the provisions of section 43(5), 28(2), 72 and 73.
He further held that the assessee had entered into 24 forward contracts, that total forward contract cancelled order were of Rs.28 Crores(approximately),that the total sales during the year was of Rs.27.78 Crores.Referring to circular no. 23d dated 12.09.1960 of the CBDT, he held that the intention of the assessee was to speculate,that the table furnished by the assessee proved that out of US $ 70,50,000 book transaction worth US $ 64,45,623 were cancelled,that none of the booking were utilised,that most of them were cancelled,that all the contracts had been honoured by cancellation,that delivery of currency had not taken place,that the assessee had not hedged its outstanding receipts by way of these forward contracts and due to cancellation of assessee's obligation to pay, that the assessee dealing in diamond and these contracts were in currency,that the assessee had not entered into certain number of contracts against specific bills or in the same commodity- diamond and out of those contracts of few were cancelled, that the transaction undertaken by the assessee did not suggest that those contracts were part of normal business activity of the assessee and the cancellation was incidental to the business,that none of the transaction could be categorised as hedging transaction, that the forward contracts were not relatable to the specific bills of the assessee, that the assessee could not relate any single bill to any of the contracts, that no purchase order had been provided during the course of assessment proceedings against which the forward contracts bad been booked, that the transaction in forward contracts cancellation had been carried out by the assessee were in a systematic manner,that the volume of transaction was quite substantial,that the volume and frequency of the assessee's transaction proved that it had systematically and in an organized manner carried out the business activity in currency forwards. The AO further referred to the instruction no.3 of 2010 issued by the CBDT. Defining the term hedging transaction,the AO held that the contracts in not in respect of material or merchandise to which the assessee generally dealt with,that same were the currency contracts and were purely speculative in nature.He AO also referred to proviso –D to section 43(5) of the Act that was inserted w.e.f. 01.04.2000. He held that the proviso excluded certain derivative transaction,that the proviso strengthened the view that the transaction in the derivative were basically speculative in nature,that only certain transaction were treated as non-speculative, that section 43(5) of the Act was amended w.e.f. AY 2006-07, that the proviso D of the section provided that such transaction had to be carried out through a recognised stock-exchange if same were to be treated as non-speculative transaction.

Finally,he held that transactions of forex derivative undertaken by the assessee for the year under consideration did not satisfy any of the conditions given in proviso (d) to section 43(5) of the Act, that forex derivative transaction were speculative in nature, that any Profit & Loss arising from such transaction had to be computed separately in view of the explanation 2 to section 28 of the Act,that the loss on such transaction had to be dealt with in accordance with section 73 of the Act. The AO referred to the decision of Soprophasa (268 ITR 37) and Josheph John (67 ITR 74).

3.Aggrieved by the order of the AO,the assessee filed an appeal before the First Appellate Authority (FAA).After considering the submissions of the assessee and the assessment order he held that the it had claimed loss of Rs.2,98,48,551/- on account of forward exchange contracts,that the assessee was not a dealer in foreign exchange,that it was an importer-exporter of diamonds,that the assessee had cancelled relevant forward contracts of foreign exchange,that not a single forward contract was settled by actual delivery.Referring to the provisions of section 73 and 43(5) of the Act,he defined the term speculation loss.He also made a reference to the cases of Seksaria Riswan Sugar Factory(121ITR196)Budge Budge Investment Co. Ltd (73 ITR 722) and Davenport & Co (P) Ltd. (100 ITR 715).
He further held that the expression 'Speculative transaction' meant and included a transaction of

any commodity, including stocks and shares, periodically or ultimately settled otherwise than by actual delivery, that the expression commodity was not defined under the Act,that that the word commodity meant an article of trade or commerce which was tangible in nature,that the expression commodity would cover all articles of trade including stocks and shares,that section 43(5) did not seek to expand the scope of expression commodity,that it merely emphadized that the transaction in commodity included transactions in stocks and shares,that transactions in future contracts, like transactions in stock and shares, when settled otherwise than by actual delivery would be speculative transactions u/s.43(5) of the Act,that derivatives could be used as insurance cover against certain types of business risks such as fluctuations in the rate of foreign exchange, fluctuations in the rate of interest on borrowings, fluctuations in the value of specified assets etc., that derivatives were assets whose values were derived from valuation of underlying assets,that those underlying assets could be commodities, metals, energy resources and financial assets such as shares, bonds, foreign currencies,that even after insertion of clause (d), all transactions in derivatives are not taken outside the purview of Section 43(5) of the Act,that it was only those derivative transactions which were covered under clause (d) that were outside the purview of Section 43(5) and rest of the transactions in derivatives were covered u/s.43(5) of the Act.
The FAA relied upon the decision of the Hon'ble Bombay High Court delivered in the case of Bharat R Ruia(HUF)and held that only exchange traded derivatives are covered under clause (d), that the derivatives under dispute were not eligible transactions in respect of trading in derivatives,that the assessee had cancelled all relevant forward contracts in US Dollars which were booked during accounting year relevant to assessment year 2009-10 which resulted into net loss,that in respect of export of diamonds, the assessee had entered into forward contract in respect of foreign exchange to be received as a result of export,that it had undertaken the transactions to avoid the risk of loss due to foreign exchange fluctuation,that the assessee at the time of agreeing to export took into consideration its cost in rupees and also considered the spot price of rupee against foreign exchange,that during the course of assessment proceedings and during the course of appellate proceedings the fact remained uncontroverted that loss shown by the assessee was exclusively due to forward contracts against which no actual delivery of foreign exchange was made,that the forward contract was to be settled either by delivery or the difference was either credited or debited by the banker,that in the matter under appeal all relevant forward contracts were cancelled,that same were never settled by actual delivery or by transfer of the commodity.
He distinguished the cases relied upon by the assessee.He held that in the case of Badridas Gauridu Pvt. Ltd (261ITR256), the Contract was linked with the assessee's business and on account of forward booking contracts with the banks with respect of assessee's export orders,that in the instant case the AO had given a finding that booking and cancellation of forward contracts of exchange were not in respect of specified export or import orders,that in the present case all contracts had been cancelled,that the facts of the present case were clearly distinguishable from the facts mentioned in the case of Badridas Gauridu Pvt. Ltd(supra).He cited cases of Shree Capital Services Ltd.(121 ITD 498),Bengal & Assam Co. Ltd vs. CIT (227 CTR 399),AJWA Fund World & Resorts Ltd.(9 SOT 354).He finally held that the burden of proof was upon the assessee to show that transactions were merely hedging transactions within the meaning of proviso to section 43(5) of the Act,that where the assessee had not produced any evidence to show that the transactions in question were only hedging then the transactions must be held to be speculative transaction.In the result,he upheld the order of the AO.

4.Before us,Authorised Representative(AR)stated that the assessee was dealing in diamonds,that it had to cancel certain deals and had suffered losses,that total outstanding matched with total exports,that loss suffered by the assessee was not speculative loss,that facts of case of Bharat Ruia were different from the case under consideration.He referred to page no.10-16,30 of the paper

book.He relied upon the cases of Intergold(I)Ltd.(ITA/1440&1900/Mum/2004),Bombay Diamond Co. Ltd.(ITA/7488/Mum/2007),Balar Export,Surat(ITA/131/2013).and the judgments of Hon'ble High Courts of Bombay and Gujarat in the cases of Badridas Gauridu(261ITR256),Panchmahal Steel Ltd.(Tax Appeal 131 of 2013) and Friends and Friends Shipping Pvt.Ltd.(Tax Appeal 251 of 2010).Departmental Representative(DR)argued that the assessee had not matched the transaction with the export bills,that facts of the cases relied upon by the assessee were distinguishable from the facts of the present case.

5.We have heard the rival submissions and perused the material before us.Undisputed facts of the case are that the assessee is dealing in diamonds,it had entered in to 24 forward contracts,that total forward contract cancelled were of Rs.28 Crores(approximately),that the total sales during the year amounted to Rs. 27.78 Crores,that the AO and the FAA had held such transaction were speculative in nature and had disallowed the claim made by the assessee,that the assessee was of the opinion that transactions entered into by it were not speculative transactions.We find that the amount involved in the forward contract (FC) is more than 100% of the turnover of the assessee,that FC were not relatable to specific bills,that the assessee had not related any single bill to any of the contract and had not provided any purchase order during the assessment or appellate proceedings.

As per the accepted principles of business and commercial world a forward contract is an agreement between a buyer and seller getting the seller to deliver a specified asset of specified quality and quantity to the buyer on a specified date at a specified place and the buyer in turn is obligated to pay the seller a pre-negotiated price in exchange of the delivery.FC can be entered in to for exports also.In such transactions when the actual export is made, spot price may differ from the spot price on the date on which the appellant expected an export order. On the date or receipt of foreign exchange, if the spot price of rupee against foreign exchange increases/ decreases then the assessee may make profits or suffer losses.As per the details filed by the assessee it had entered into 24 such transaction during the year under consideration.It was claimed on behalf of the assessee that these transaction were not speculative transactions as held by the departmental authorities,as stated earlier.Concepts of speculative transaction/hedging transactions are not new concepts of tax laws.Distinction between the two type of transactios is vital and both have different consequences in determining the tax liability arising out of them.

In our opinion,the definition of 'speculative transaction' in section 43(5) of the Act,gives a simple test for deciding,for the purpose of Act,as to what a speculative transaction means.If a contract for sale or purchase is ultimately settled and no actual delivery of the goods is effected under the settlement then it has to be treated a speculative transaction.The requirement of section 30 of the Indian Contract Act of the existence of the intention of the parties even at the time of the original contract not to give or take delivery of the goods in order to make it a speculative/ wagering transaction is dispensed with for the purpose of the Act.Secondly,if actual delivery is not given/taken under the settlement of contract, then the intention of the parties at the time of the contract becomes immaterial.The true test is delivery of commodities/goods as per the contract, including a FC.Profit/loss in respect of unperformed contracts is considered speculation profit or loss.In short, in order that a transaction may fall within the scope of the expression 'speculative transaction',it must be a transaction in which a contract for purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity/scrips.

Here,it would be useful to appreciate as to how hedge transactions are commercially understood before determining the true scope,width and nature of proviso(a) to Sec. 43(5) of the Act.Hedge

contracts are those contracts which hedge against prejudicial price fluctua -tions.The technique of hedge trading can be understood in simple terms.It is said that the hedge contract is so called because it enables the persons dealing with the actual commodity to hedge themselves, i.e., to insure themselves against adverse price fluctuations.A dealer or a merchant enters into a hedge contract when he sells or purchases a commodity in the forward market for delivery at a future date.His transaction in the forward market may correspond to a previous purchase or sale in the ready market or he may propose to cover it later by a corresponding transaction in the ready market,or he may offset it by a reverse transaction on the forward market itself.Hedging contracts need not succeed the contracts for sale and actual delivery of goods manufactured,but the latter may be subsequently entered into, provided they are within reasonable time.In order to be genuine and valid hedging contracts of sales, the total of such transactions should not exceed the total stocks of the raw materials or the merchandise on hand which would include existing stocks as well as the stocks acquired under the firm contracts of purchase. As per the accepted commercial norms object of a hedging contract is to secure oneself against loss in a future delivery contract.But,such transactions cannot be regarded as inter-connected. Each one is independent of the other.So far as the profit or loss arising from a future delivery contract is concerned,it is determined on the date of actual delivery irrespective of the date on which the contract was entered into.In respect of a hedging contract, profit/loss arising there from can be ascertained or crystallised at fixed intervals of the term when the clearance takes place.By resorting to counterbalancing transactions in the market for the ready commodity on the one hand and in the hedge market on the other hand, the hedger seeks to safeguard his position. The movement of prices in the two markets may not always follow an identical course and the hedger might at times gain and at times lose but such a gain or loss would be marginal and far less than what it would be if the person had not hedged at all. While, however, the hedging operation protects the hedger against loss arising from adverse fluctuations in prices, it also prevents him from making windfall profit owing to favourable fluctuations in prices as well. The forgoing of such a possible windfall profit is the price which he pays for the insurance against loss. This well-known technique, of hedge trading clearly implies forward contracts both ways, namely, for sale and purchase with a view to guarding against adverse price fluctuations. These forward contracts by way of hedge transactions usually afford a cover to a trader inasmuch as his loss in the ready market is offset by a profit in the forward market and vice versa. It, therefore, follows that in order to effectively hedge against adverse price fluctuations of the manufactured goods or merchandise, a manufacturer or merchant has necessarily to enter into forward transactions of sale and purchase both, and without these contracts of sale and purchase constituting hedge transactions, there would be no effective insurance against the risk of loss in the price fluctuations of the commodity, manufactured or the merchandise sold.

Hedging contracts are dealt in Clause (a) of the proviso to section 43(5) of the Act. From the above discussion it can safely stated that the said clause applies, if following conditions are fulfilled:

i)there is a contract for actual delivery of goods manufactured by the assessee /a merchandise sold by it,

ii)assessee must be a subsequent transaction intend to guard against losses through future price fluctuations in respect of such contract,

iii)transaction in question must be a contract entered into in respect of raw materials or merchandise in the course of the assessee's manufacturing business and it should have been settled otherwise than by actual delivery of goods,

iv)hedging contracts may be both with regard to sales and purchases,

v)hedging contracts need not succeed the contracts for sale and actual delivery of goods manufactured,but the latter may be subsequently entered into, provided they are within the

reasonable time not exceeding generally the assessment year,
vi)in order to be genuine and valid hedging contracts of sales, the total of such transactions should not exceed the total stocks of the raw materials or the merchandise on hand which would include existing stocks as well as the stocks acquired under the firm contracts of purchases,
vii)the hedging contract need not necessarily be in the same variety of the commodity they could be in connected commodities, e.g., one type of cotton against another type of cotton.

In other words,unless the assessee shows that there was some existing contract in respect of which he was likely to suffer a loss because of future price fluctuations and that it was to safeguard against such loss that he entered into the forward contracts of sale, he could not claim the benefit of clause (a) of the proviso to section 43(5). With regard to speculative/hedging transactions we had benefit of perusing the judgments of M.G.Brothers (154ITR695), Nuddea Mills Co.Ltd (171 ITR169),Delhi Flour Mills Co.Ltd.(95ITR151) and Pankaj Oil Mills, (115ITR824) delivered by the Hon'ble High Courts of Andhra Pradesh, Calcutta, Delhi and Gujarat respectively.

From the principles laid down by above mentioned judgments one thing becomes clear that for hedging transaction commodity dealt should be the same.If the subject matter of the transactions is different it cannot be termed a hedging transaction.In the case of M.G. Brothers(supra)assessee -firm was carrying on business of the manufacturing and sale of groundnut oil and its by-products. For the AY.1973-74,it filed return declaring an income of Rs. 2,90,807/- and claimed a loss of Rs.1,60,946/- in respect of certain transactions which it had entered into in cotton seed oil and neem oil.The assessee claimed that said transactions were hedging transactions.Matter finally travelled up to the Hon'ble High Court of AP.Deciding the issue against the assessee Hon'ble Court held as under:

> *"....the forward contracts entered into by the assessee in cotton seed oil and neem oil were not covered by cl. (a) of the proviso to s. 43(5) and were not hedging transactions. The forward transactions were speculative in character and the loss arising therefrom could not be set off against the assessee's income from the business in the manufacture and sale of groundnut oil."*

Similarly, in the case of Nuddea Mills Co.Ltd (supra)the assessee was a manufacturer of jute goods and it has entered into forward contracts of sale of standard jute goods. In view of overseas offer,it decided to manufacture special quality jute goods.Assessee entered in to forward purchases of standard jute goods and purchase back of forward contracts of sale.It incurred loss in covering its forward contracts of sale.In the appeal filed by the assessee,Hon'ble Calcutta High Court, confirming the order of the ITAT, held that losses suffered by the assessee were result of the speculative transactions.In the case of Delhi Flour Mills Co.Ltd.(supra) Hon'ble Delhi High Court held that forward transactions made by the assessee in respect of matar(a substitute of gram) could not be treated as hedging transactions and the loss sustained by the assessee in such transactions could not be set off against its profits in the business of manufacturing atta (wheat flour)and other wheat products.Hon'ble Allahabad High Court, while deciding the appeal of M.P. Sugar Mills (P.) Ltd.(148 ITR 203) has held as under:

> *"Section 43(5)(a) of the Income-tax Act, 1961, which excludes hedging contracts from the definition of speculative transactions, contemplates contracts entered into by two classes of persons, namely, (1) persons who manufacture goods from raw materials; and (2) merchants. Whereas in the case of a manufacturer it is the contract entered into by him, in respect of raw materials used in the course of his manufacturing business, to guard against any loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him, that are taken out of the ambit of speculative transactions, the contracts taken out of the scope of such transactions in the case of merchants are those which he enters into in respect of his merchandise with a view to safeguard loss through future price fluctuations in respect of contracts for actual delivery of the merchandise sold by him. …It will depend upon the facts of each case whether a particular transaction by way of forward sale, which is mutually settled otherwise than by actual delivery of the said goods, has been entered into with a view to safeguard against loss*

through price fluctuation in respect of the contract for actual delivery of the goods manufactured."
In order that forward transactions in commodities may fall within proviso (a) to section 43(5) of the Act, it is necessary that the raw materials or merchandise in respect of which the forward transactions have been made by the assessee must have a direct connection with the goods manufactured or the merchandise sold by him.In other words raw material in respect of which the assessee has entered into forward transactions must be the same raw material which is used by him in his manufacturing business. We find that in the case under consideration assessee was not dealing in Foreign Exchange, therefore transactions entered into by it in Foreign Exchange cannot be held to be hedging transactions.As the assessee is dealing in diamonds and FC entered into only for diamonds would have been covered by the proviso (a) to the section 43(5)of the Act.As held by the Hon'ble High Court of Calcutta in the matter of Gourepore Co. Ltd.(135 ITR 606) onus was on the assessee to prove that the transactions in question were not of a speculative nature.We are of the opinion that it has failed to discharge the onus cast upon him by the statute. It was also not able to contradict the finding of fact that booking and cancellation of FC of foreign exchange were not in respect of specified export or import. Besides, finding of fact given by the Revenue Authorities remained un-contravened that loss in question,shown by it pertained to those FC transctions,against which no actual delivery of foreign exchange was made.
On appreciation of the facts surrounding the transaction we have reached at the conclusion that transactions entered in to by the assessee were speculative in nature and the case of the assessee is not covered by proviso(a) of the section 43(5) of the Act.
5.5. Now we would like to discuss the cases relied upon by the AR.In the case of Intergold (I) Ltd. (supra)the matter related to sections 10A and 80HHC of the Act.In the matter of Bombay Diamond Co.Ltd.(supra),the FAA had held that loss arising out of forex contract was business loss and the Tribunal had endorsed the view of the FAA.Thus,the case was limited to the facts of that case.In the case of Friends and Friends Shipping Pvt.Ltd.the Hon'ble Gujarat High Court had specifically mentioned that FC was entered in to by the assessee with the bank was for hedging losses,whereas in the present case the transactions are not of hedging nature.Even in the case of Badridas Gauridu(supra)the Hon'ble jurisdictional High Court had held that the transaction in question were hedging transactions and not speculative transactions and only a few of the contracts were cancelled.In the case under appeal the AO and the FAA given a categorical finding of fact that the disputed transactions were speculative and not hedging transaction,that the assessee could not relate any single bill to any of the contract and it had not provided detail of any purchase order relatable to specific transaction,during the assessment or appellate proceedings. Thus,the transactions undertaken by it have to be taken as transactions relatable to Foreign Exchange.We are of the opinion that the order of the FAA does not suffer from any legal or factual infirmity.Therefore, considering the peculiar facts and circumstances of the case,we confirm his order FAA and decide effective ground against the assessee.

As a result,appeal filed by the assessee stands dismissed.
फलतः निर्धारिती द्वारा दाखिल की गई अपील अस्वीकृत की जाती है.
Order pronounced in the open court on 17th,October,2014.
आदेश की घोषणा खुले न्यायालय में दिनांक 17 अक्टुबर, 2014 को की गई ।

Sd/-	Sd/-
(डी .मन्त्रमोहन /D.Manmohan)	**(राजेन्द्र/Rajendra)**
उपाध्यक्ष /VICE PRESIDENT	**लेखा सदस्य /ACCOUNTANT MEMBER**

मुंबई/Mumbai,दिनांक/Date: 17.10.2014.
SK
<u>आदेश की प्रतिलिपि अग्रेषित</u>/Copy of the Order forwarded to :

1. Assessee /अपीलार्थी **2.** Respondent /प्रत्यर्थी

3. The concerned CIT(A)/संबद्ध अपीलीय आयकर आयुक्त,**4.**The concerned CIT /संबद्ध आयकर आयुक्त

5. DR "A" Bench, ITAT, Mumbai /विभागीय प्रतिनिधि **ए** खंडपीठ,आ.अ.न्याया.मुंबई

6. Guard File/गार्ड फाईल

सत्यापित प्रति //True Copy//

आदेशानुसार/ **BY ORDER,**

उप/सहायक पंजीकार **Dy./Asst. Registrar**

आयकर अपीलीय अधिकरण, मुंबई **/ITAT, Mumbai**