Forex loss in forward contract isn't speculative as contract is made to hedge loss in export-import transaction

Summary – The Mumbai ITAT in a recent case of Perfect Circle India Ltd., (the Assessee) held that Foreign exchange loss incurred by assessee on account of entering into forward contracts with banks for purpose of hedging loss in connection with its import/export business has to be regarded as business loss subject to condition that maturity of hedge does not exceed maturity of underlying transaction

Facts

- The assessee was engaged in the business of manufacturing rings and semi-finished castings (automobile parts). It entered into forward contracts in order to hedge the risk on adverse currency fluctuation in respect of export realization to the tune of USD 6,00,000.
- Export receivable of USD 1,73,670 was hedged and the balance forward contracts of USD 4,26,330 were marked to market. The assessee incurred loss of INR 18,22,633 on mark to market.
- The Assessing Officer held that the mark to market losses were purely notional losses. The assessee had not actually suffered any loss and that it was only because that its assets were marked to market and the resultant figure was a loss figure which was a notional figure and was not deductable as business loss.
- The Commissioner (Appeals) confirmed the disallowance made by the Assessing Officer.
- On second appeal:

Held

- 'Foreign exchange forward contracts' entered into for the purpose of hedging the loss in import-export transactions, have been duly recognized and allowed by the Reserve Bank of India. *Vide* Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000, Notification No. FEMA25/RB-2000, dated 3-5-2000, Reserve Bank of India has defined the forward contract and foreign exchange
- From the guidelines issued by the Reserve Bank of India relating to general principles to be observed for forward foreign exchange contracts that the banks have been permitted to enter into such contracts after thorough verification of documentary evidences etc. about the genuineness of the underlying foreign currency exposure and the need of hedging of the loss. Further the maturity of the hedge should not exceed the maturity of the underlying transaction.
- In view of the above, it can be safely held that in case of import/export business, where the transactions are demonetarized in the foreign currencies and for the purpose of hedging of the anticipated loss resulting from such import-export business and not otherwise, if the assessee

enters into a forward contract in foreign exchange, then such forward contracts are to be treated as integral part or incidental to the business of export/import and cannot be said to be the speculative contracts attracting the provisions of section 43(5). The loss from such hedging transactions would be treated as business loss eligible to be set off against the profits and gains of business and profession.

- It is held accordingly that the foreign exchange loss incurred by the assessee on account of entering into forward contracts with the banks for the purpose of hedging the loss in connection with his import/export business cannot be held to be a speculative loss rather a business loss which can be set off against profit and gains of business subject to the condition that the assessee will have to satisfactorily prove that the maturity of the hedge did not exceed the maturity of the underlying transaction. The findings of the Commissioner (Appeals) given are therefore set aside and the issue is restored back to the file of the Assessing Officer to decide the same accordingly.