

3. The brief facts of this issue is that the assessee is a company engaged in the business of Investment and Finance Activity and deriving interest income. The assessee borrowed interest free loan of USD 2 Crores from its shareholder M/s Asian Tele Communication Investments (Mauritius) Ltd and gave advance of Rs. 94,58,50,000/- to its subsidiary M/s Usha Martin Telematics Ltd. This foreign currency loan was to be repaid on 13.6.2006 as per the terms of the loan agreement. The Loan agreement specifies the purpose of the loan as meant for general corporate purposes. The said foreign currency loan was restated at the exchange rate prevailing at the end of the year in order to comply with the requirements of Accounting Standard (AS 11) issued by the Institute of Chartered Accountants of India (ICAI) which is mandatorily to be followed by the assessee company. This restatement resulted in a foreign exchange gain of Rs. 6,71,12,500/- and the same was credited to the profit and loss account by the assessee in its books of accounts. The assessee however chose to reduce the same in the statement of total income as the resultant foreign exchange gain is only notional gain and not actually realized by the assessee. As only the real income should be taxable for income tax purposes, this reduction was made by the assessee. However , this contention did not hold water in the mind of the Learned AO who added the same on the following grounds:-

- a) The assessee itself had credited the exchange gain in its profit and loss account as income.
- b) The assessee had borrowed monies from its foreign shareholder and utilized the same for advancing to its subsidiary company in the ordinary course of its business as the assessee itself is engaged in the business of investment and financing activity. Hence the loan was taken only on revenue account.
- c) The main business of the assessee is financing and investment activities. Since the borrowed funds have been deployed by the assessee in its financing activities in the ordinary course of business, the borrowed funds

would be construed as the business liabilities of the assessee. The only income derived by the assessee is interest income.

- d) As per Accounting Standard (AS) 11 issued by the Institute of Chartered Accountants of India (ICAI), all foreign exchange fluctuations on restatement at the end of the year, be it gain or loss, needs to be recognized in the profit and loss account.
- e) As per AS 1 issued by ICAI under the heading 'Prudence', even the unrealized gains are to be recognized in the profit and loss account which has been rightly done by the assessee in its books. Hence the assessee trying to take a shift in the treatment of the said gain for tax purposes is not in accordance with law.

4. On first appeal, the Learned CITA deleted the addition by making the following observations :-

- a. Assessee's action of crediting the 'gain' to P&L A/c is not the decisive test to decide the true nature of the transaction. This has to be decided as per the principles of law.
- b. Even borrowed funds to be treated as business liabilities as observed by AO, there is no real accretion to the capital / loan and the liability is outstanding and not settled.
- c. Reference to Rule 115 of IT Rules read with section 145(2) of the Act and drawing inferences with reference to accrual of income is not in agreement with the legislative intent. What is to be taxed is 'real income' and not the 'notional income' as held by judicial forums.
- d. With regard to case laws (viz. **Indian Overseas Bank Ltd vs CIT 246 ITR 206 and CIT vs IOB 151 ITR 446**) relied upon by the assessee, the AO wrongly distinguished loss on unsettled contracts. In fact the referred cases are in favour of the assessee. On the other hand, the case law relied by the

- AO (viz **Coca Cola Exp. Corpn 158 ITR 446**) is in favour of the assessee.
- e. The case on which reliance placed by the AO on the principle of revenue recognition (63 ITR 328) can be distinguished on facts.
 - f. **Sutlej Cotton Mills Ltd case (116 ITR 1)** , the case on which AO placed reliance to distinguish capital account with that of revenue account, the Apex court only laid down the general principles for deciding the nature of ‘gain’ and the facts can be distinguished.
 - g. Foreign exchange gain is on account of fixed capital and not circulating capital.
 - h. The gain is only contingent and notional as held by **Uttarakhand High Court in the case of CIT vs ONGC Ltd (301 ITR 415)** and this view is further supported by **Hon’ble Kolkata ITAT (EIH Hotels Ltd)**.
 - i. Foreign exchange gain is only hypothetical in nature and not realized by the assessee.
5. Aggrieved, the revenue is in appeal before us on the following ground:-
- On the facts and in the circumstances of the case, Ld. CIT(A) has erred in deleting the addition of the Rs. 6,71,12,500/- though there has been a violation of Accounting Standard AS -11 which is mandatory for companies.*
6. The arguments of the Learned DR could be summarized as under:-
- a. The assessee had borrowed monies from its shareholder without any interest and had advanced the same to its subsidiary company without any interest in the ordinary course of its business. Moreover, the loan agreement filed by the assessee clearly stipulates that the foreign currency loan is meant for general corporate purposes. Hence the loan is utilized

- only on revenue account. Accordingly the resultant foreign exchange gain arising out of restatement of foreign currency loan at the end of the year is to be brought to tax in the light of decision rendered by the **Hon'ble Apex Court in the case of Oil & Natural Gas Corporation Ltd vs CIT reported in 322 ITR 180 (SC)** which had followed the previous decision of the apex court in the case of **Woodward Governor of India Ltd reported in 312 ITR 254 (SC)**.
- b. He further argued that the assessee is engaged in the investment and financing activity and this lending to subsidiary company had been made as part of its business activities and hence the foreign currency loan has been utilized only on revenue account. Admittedly, the foreign currency loan has not been utilized for purchase of fixed assets. Moreover, the provisions of section 43A of the Act would not be applicable to the facts of the instant case as the loan has been borrowed and utilized on revenue account.
 - c. He further argued that even under the concept of Prudence as per AS 1 issued by ICAI, the assessee is supposed to recognize the foreign exchange gains in its profit and loss account and offer the same to tax.
 - d. He further argued that the assessee itself had credited the foreign exchange gain as its income in the profit and loss account but strangely chose to withdraw the same from the ambit of taxation while filing the return treating it as notional gain. He argued that once the assessee itself had credited this gain in its profit and loss account, the concept of prudence automatically fails.
7. In response to this, the Learned AR assailed the impugned issue on several counts and the various arguments of the Learned AR could be summarized as under:-
- a. Interest free advance given to subsidiary company by the assessee. From the break up of interest income earned by the assessee, it could be seen that

- the assessee has not received any interest income on the advance made to subsidiary company out of borrowings from its shareholder. The Learned AR argued that hence even though the assessee is an investment company, this lending was not made with a view to earn interest income and accordingly cannot be construed as amounts lent in the ordinary course of business of the assessee. Hence he argued that the transaction cannot be treated as loan utilized on revenue account and has to be treated as loan utilized on capital account.
- b. The Learned AR argued that assessee during the asst year under appeal had derived notional foreign exchange gain on restatement of the foreign currency loan at the end of the year. Similarly it had incurred notional exchange loss in the subsequent assessment years , the details of which are stated in Pg 56 of the paper book. He stated that these notional exchange losses were not claimed as deduction by the assessee in line with the consistent method followed by the assessee for tax purposes. In other words, notional gain is not offered to tax and similarly notional loss is not claimed as deduction. He stated that even the decisions of **ONGC Ltd (322 ITR 180 –SC) and Woodward Governor case (312 ITR 254-SC)** relied on by the Learned DR , affirms the view of consistency and method of accounting system adopted by the assessee.
- c. He argued that Accounting standard 1 (AS 1) issued by ICAI is notified u/s 145(2) of the Act. In AS 1, the principle of Prudence states that unrealized gains should not be recognized in the books and whereas the provision should be made for known liabilities including future liabilities on the basis of principle of conservatism. He argued that the Learned AO completely erred in understanding the concept of prudence as per AS 1 and presented misleading facts in page 3 para 1 of his order with regard to income recognition. He further argued that even the decision of Woodward Governor (312 ITR 254 – SC) states that the unrealized profits in the shape

- of appreciated value of goods remaining unsold at the end of the accounting year and carried over to the following years account in a continuing business are not brought to the charge as a matter of practice, though, as stated above, loss due to fall in the price below cost is allowed even though such loss has not been realized actually.
- d. The Learned AR argued that the Learned AO proceeds to understand the recognition of foreign exchange gains on restatement at the end of the year on the mistaken premise that the loan is settled during the asst year under appeal, which is factually incorrect. The loan is due for settlement only in June 2006 as per the loan agreement and the assessee had not chosen to prepay the loan.
- e. He argued that the decision of the **Hon'ble Supreme Court in the case of Woodward Governor case reported in 312 ITR 254(SC)** is not applicable to the facts of the assessee case. He stated that the issue before the supreme court was regarding the notional exchange loss / gain due to restatement of loans at the end of the year if the loan is utilized on revenue account. **The Hon'ble SC held** that since the loan is utilized on revenue account, the resultant exchange gain / loss even though unrealized, should be recognized in the profit and loss account and considered for tax purposes. He further argued that with regard to the loan utilized on capital account, the Hon'ble SC only decided whether the provisions of section 43A of the Act introduced in the statute with effect from 1.4.2003 would have prospective or retrospective application. Admittedly, this is not the issue before us in the asst year under appeal. Hence Woodward Governor case would not cover the matter in the impugned issue.

8. We have heard the rival submissions and perused the materials available on record including the paper book filed by the assessee. We find that the short point that arises for consideration is as to whether the foreign currency loan has been utilized on

revenue account or capital account by the assessee. This is the entire crux of the issue and various arguments of the counsels of both the sides. We find that the Learned AR is trying to assail the issue before us based on certain facts which were mistakenly understood by the Learned AO such as :-

- (a) interest income has been earned by the assessee out of advances made to subsidiary company (Usha Martin Telematics Ltd) in the ordinary course of business, which is factually incorrect.
- (b) Similarly the concept of prudence as per AS -1 issued by ICAI further notified u/s 145(2) of the Act has been mistakenly stated by the Learned AO that it states that even the unrealized gains should be recognized in the profit and loss account, which is factually incorrect. In this regard, it would be relevant to get into AS -1 – ‘Disclosure of Accounting Policies’ under the heading ‘Prudence’, the revenue recognition is made on the following basis:-

Para 17 a. In view of the uncertainty attached to future events , profits are not anticipated but recognized only when realized though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

- (c) that the foreign exchange gain on restatement is out of a settled loan transaction and hence it is not notional. This finding is factually incorrect as the loan is outstanding at the end of the year and the same is repayable only in June 2006.

The Learned AR was only trying to take advantage of these mistakes by trying to sweep the basic and real facts under the carpet. We hold that the real fact is that borrowings were made from shareholder for business purposes and the same was utilized by advancing to subsidiary company Usha Martin Telematics Ltd in the ordinary course of its business by the assessee. The fact that the assessee did not

receive any interest income on this lending would not shift the business purpose for which the assessee advanced monies to Usha Martin Telematics Ltd. We find in the instant case, that since the assessee does not have any cost for its borrowed funds and that is why the assessee has tried to take this stand that the lending is not meant for business purposes of the assessee as there is no question of disallowance of interest on borrowed capital u/s 36(1)(iii) of the Act. The following facts are indisputable in the present case :-

- a) The assessee is engaged in financing and investment activities.
- b) Interest free funds borrowed by assessee from its shareholder.
- c) Interest free funds advanced by assessee to its subsidiary company Usha Martin Telematics Ltd in the ordinary course of its business. As the said advance is interest free, there is no question of charging any interest thereon.
- d) The Loan agreement clearly specifies that the borrowings are meant for general corporate purposes.
- e) The foreign exchange gain had arose due to restatement of the loan balance outstanding at the end of the year based on exchange rate prevailing at the end of the year amounting to Rs. 6,71,12,500/-.
- f) The assessee had credited the said foreign exchange gain in its profit and loss account as income. But for tax purposes, the assessee had treated the same as unrealized gains and hence not chargeable to tax as it is only notional gain.
- g) The assessee had similarly restated the loan outstanding in the subsequent years at the end of the year and had incurred foreign exchange loss as below:-

Asst Year 2005-06	72,00,000
Asst Year 2006-07	1,72,00,000
Asst Year 2007-08	4,64,00,000

The Learned AR fairly conceded that these foreign exchange losses though booked as loss in the books of accounts had not been claimed as deduction for tax purposes in the subsequent assessment years.

8.1. We agree that Woodward governor case dealt with foreign currency borrowed on capital account from the perspective of prospective applicability of section 43A w.e.f 1.4.2003 and no decision was rendered by the Hon'ble Apex Court in this case with regard to the foreign exchange fluctuations arising out of loan borrowed on capital account. But the said decision duly considered the recognition of foreign exchange gains for tax purposes if the loan is utilized on revenue account. Admittedly, the loan in the instant case has been utilized only on revenue account. Hence the resultant foreign exchange gain arising due to restatement at the end of the year needs to be brought to tax. Reliance in this regard is also placed on the decision of the **Hon'ble Apex Court in the case of Sulej Cotton Mills Ltd vs CIT reported in 116 ITR 1 (SC)** wherein it was held 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 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.

8.2. We agree with the arguments of the Learned AR that merely because the assessee had recognized the exchange gain in its profit and loss account , it would not automatically take the character of income for tax purposes. Entries in the books of accounts are not determinative of the question whether the assessee has earned any profit or suffered any loss. We are not approaching the impugned issue based on the entries made by assessee in its books of accounts.

8.3. The Loan agreement clearly mentions that the loan is meant for general corporate purposes only which means it is meant for revenue account. If it is meant for any capital investment, then the loan agreement would have been differently worded

specifying the purpose of making the investments and in which case, the loan would be categorized as a specific purpose loan. But in the instant case, it is mentioned as general corporate purposes meaning – that the loan is meant for general business purposes of the assessee. The amounts advanced to Usha Martin Telematics Ltd is meant for business purposes of the assessee and has to be construed as amounts lent in the ordinary course of business only . The business of the assessee itself is making investments in other companies. We hold that just because no interest income is derived in this transaction, the character of the transaction for business purposes (i.e the loan utilization on revenue account) would not change. Hence the argument of the Learned AR that the utilization of borrowings is made on capital account is not appreciated. Once this is lost, then the decision of **Woodward Governor case (312 ITR 254 –SC)** would automatically come into play on which point, the counsels of both the sides are agreeable. The concept of prudence has been considered in the judgement of supreme court in Woodward Governor case. Once the utilization of borrowings are held to be on revenue account, then the resultant exchange gain or loss at the end of the year due to restatement of foreign currency loan would automatically take the revenue receipt / expenditure as the case may be.

8.4. However, we find that the assessee had incurred exchange losses due to restatement of the subject mentioned foreign currency loan at the end of the year in subsequent assessment years and had not claimed as deduction as it is notional in nature in line with the consistent stand taken by the assessee. In this regard, we deem it fit and appropriate in the interest of justice and fair play, to give directions to the Learned AO to grant deduction of notional exchange loss in the subsequent assessment years to be in consonance with our findings hereinabove. Otherwise, it would only result in revenue trying to blow hot and cold simultaneously. Accordingly, the ground raised by the revenue is allowed subject to the direction contained hereinabove.

