

Marked-to-market loss from forward contracts deductible under Section 37(1): Delhi High Court

Facts of the case - PCIT v. Simon India Ltd. – [2022] (Delhi)

The assessee was engaged in the business of providing engineering, consultancy, and related services. The assessee claimed a loss of Rs. 9.20 crores against a forward contract entered into to hedge the risk against foreign exchange fluctuations to cover the exports and imports. Out of the total loss, the loss of Rs. 7.12 crores was related to unmatured forward contracts.

The Assessing Officer (AO) held that the loss on forward contracts was speculative and to be disallowed in terms of the CBDT Instruction No. 3/2010. The said Instruction explained 'Marked to Market' as a concept where financial instruments are valued at market rate to report their actual value on the date of reporting. Such 'Marked to Market' losses represent notional losses and are required to be added back to compute taxable income.

On appeal, the CIT(A) set aside the disallowance. On further appeal, the Tribunal concurred with the decision of the CIT(A) and held that the loss on forward contracts could not be disallowed in terms of the CBDT Instruction. Aggrieved-AO filed the instant appeal before the Delhi High Court.

The main questions raised before the High Court were whether the losses on account of foreign exchange fluctuations on forward contracts are allowable under Section 37(1) and covered as hedging transactions under Section 43(5)(a) or should be disallowed as speculation losses under Section 43(5) of the Act in view of the CBDT Instruction No. 3/2010?

Decision of the case:

- i. The High Court held that there is no dispute that the forward contracts were entered into by the assessee to hedge against foreign exchange fluctuations. Thus, the transaction falls within the exceptions of proviso (a) to Section 43(5) of the Act and should not be treated as speculative. The Court held that the forward contracts, in the present case, are hedging transactions.
- ii. On the issue of the deductibility of the loss, the High Court relied on the case of the CIT v. Woodward Governor India Pvt. Ltd. [2009] (SC), wherein the Supreme Court had referred to AS-11. In terms of AS-11, the exchange difference arising on foreign currency transactions must be recognized as income or expense in the period in which they arise, except in cases of exchange differences arising on repayment of liabilities for acquiring fixed assets.
- iii. Applying the above ratio, the High Court held that as the assessee was reinstating its debtors and creditors in connection with the execution of contracts entered into with foreign entities based on the value of the foreign

exchange, the loss on account of forward contracts would require to be recognized.

- iv. The Court upheld the order of CIT(A) and the Tribunal in finding that the loss, on account of Forward Contracts, cannot be considered speculative, and the AO had erred in disallowing the same.