

# SUPREME COURT OF INDIA

Oil & Natural Gas Corp. Ltd. Tr. M.D.

Vs.

Commr.of Income Tax, Dehradun

C.A.No.7223 of 2008

(D.K.Jain and T.S.Thakur JJ.)

15.03.2010

## JUDGEMENT

### **D.K. Jain, J.:**

1. In these appeals, essentially the following two questions arise for our consideration:- (i) Whether on the facts and circumstances of the case, the additional liability arising on account of fluctuations in the rate of exchange in respect of loans taken for revenue purposes could be allowed as deduction under Section 37(1) of the Income Tax, Act, 1961 (for short "the Act") in the year of fluctuation in the rate of exchange or whether the same is allowable only in the year of repayment of such loans? (ii) Whether the Assessee is entitled to adjust the actual cost of imported capital assets acquired in foreign currency on account of fluctuation in the rate of exchange at each balance-sheet date, pending actual payment of the varied liability? (only in C.A. No.7228/2008 - Assessment Year 1991-92)

2. As, in our opinion, both the afore-noted issues are no more res integra, we deem it unnecessary to state the facts in detail and with a view to appreciate the controversy, a brief reference to the foundational facts in respect of assessment year 1991-92 would suffice. These are:

“The appellant, hereinbefore referred to as "the Assessee", is a public sector undertaking, substantially owned by the Government of India. It is engaged in capital intensive exploration and production of petroleum products for which it has to heavily depend on foreign loans to cover its expenses, both capital and revenue, on import of machinery on capital account and for payment to non-resident contractors in foreign currency for various services rendered. The Assessee had made three types of foreign exchange borrowings -- (i) in revenue account; (ii) in capital account and (iii) for general purposes, partly utilised in revenue account and partly in capital account. As per terms and conditions of foreign exchange borrowings, some of the loans became re-payable in the year under consideration but date of repayment of some loans fell after the end of the relevant accounting year. The Assessee revalued in Indian

currency all its foreign exchange loans in revenue account, capital account as also in its general purposes account, outstanding as on 31st March, 1991 and claimed the difference between their respective amounts in Indian currency as on 31st March, 1990 and on 31st March, 1991 as revenue loss under Section 37(1) of the Act in respect of loans used in revenue account, and also took into consideration the similar difference in foreign exchange on capital account loans as an increased liability under Section 43A of the Act for the purposes of depreciation. The foreign exchange loss incurred by the Assessee in the revenue account on account of repayment of these loans made in the year under consideration was allowed by the Assessing Officer as a deduction under Section 37(1) of the Act, and he also took into consideration an increased liability of foreign exchange loans taken in capital account and repaid in the accounting year, for the purposes of depreciation, under Section 43A of the Act. He, however, did not allow to the Assessee its claim for foreign exchange loss claimed on such foreign currency loans both in revenue account and in capital account which were outstanding on the last day of the accounting year under consideration and were as per terms of borrowings repayable after the end of the relevant accounting year. Similar treatment was given to the foreign exchange loans taken for general purposes, used partly in revenue account and partly in capital account. Thus, the Assessee's claim for foreign exchange loss/increased liability on revaluation of these foreign exchange loans at the end of the accounting year under consideration both in the revenue account and capital account as also on loans used partly in revenue account and partly in capital account, made on the ground that it had followed mercantile system of accounting in this regard, was disallowed by the Assessing Officer. According to the Assessing Officer, such a loss could be allowed to the Assessee on discharge of liability at the time of actual repayment of these loans.”

3. Aggrieved, the Assessee preferred appeals before the Commissioner of Income Tax (Appeals). Insofar as Assessee's claim for foreign exchange loss in revenue account was concerned, the Commissioner (Appeals) affirmed the view taken by the Assessing Officer on the ground that it was a notional liability and the same had not crystallised or accrued in the relevant assessment year. However, as regards the adjustment for increased liability made by the Assessee for the purposes of Section 43A of the Act in respect of foreign exchange loans in capital account, which were outstanding as on 31st March, 1991, the Commissioner accepted the stand of the Assessee and directed the Assessing Officer to allow the benefit of such increased liability for computation of depreciation allowance on plant and machinery purchased out of such foreign exchange loans for the assessment year under consideration.

4. Being dissatisfied, both the Assessee as well as the Revenue carried the matter in further appeals to the Income Tax Appellate Tribunal (for short "the Tribunal"). The Tribunal observed that the method of accounting adopted by the Assessee right from the assessment year 1982-83 is mercantile system; it has been consistently claiming loss suffered by it on account of fluctuation in foreign exchange rates on accrual basis; in respect of assessment years 1982-83 to 1986-87, the Assessee's claim on this account had been allowed by the Assessing Officer himself; in respect of assessment year 1997-98, the Assessee had shown a

gain of Rs.293.37 crores on account of fluctuation in foreign exchange because the Indian Rupee had appreciated as compared to the foreign currency and that the said amount was taxed as Assessee's income. Taking all these factors into consideration, the Tribunal held that the loss claimed by the Assessee on revenue account was allowable under Section 37(1) of the Act. The appeal preferred by the Revenue on the question whether the Assessee was entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange, in terms of Section 43A of the Act, was also dismissed.

5. The Revenue took the matter in further appeal to the High Court.

“By a common judgment pertaining to the assessment years 1991-92 to 1994-95 and 1997-98, the High Court has reversed the decision of the Tribunal on both the issues. Terming the order of the Tribunal as perverse, having been passed without any material on record and against the statutory provisions, the High Court has held that the foreign exchange loss claimed by the Assessee being only a contingent and notional liability, it was not allowable as deduction under Section 37(1) of the Act. Insofar as the applicability of Section 43A of the Act was concerned, the High Court observed that the said provision is confined only to those liabilities which have become due as per the terms and conditions of written agreement between the Assessee and the foreign creditors but since in the present case, no such agreement was made available by the Assessee at any stage of the proceedings, the claim of the Assessee was not justified. According to the High Court, the variation in foreign exchange was neither quantified, nor it had become due or repaid and, therefore, deductions on that account had been allowed by the Tribunal without application of mind and were, therefore, illegal.

Being aggrieved by the said decision, the Assessee is before us in these appeals.”

6. Mr. S. Ganesh, learned senior counsel appearing on behalf of the Assessee, submitted that in view of the decision of this Court in decision of the High Court cannot be sustained. Learned counsel also argued that in view of the fact that the Committee on disputes had expressly refused permission to the Revenue to pursue appeals before the High Court, in the light of the decisions of this Court Board, *Direct Taxes & Anr.*<sup>3</sup>, the High Court should not have entertained the appeals preferred by the Revenue.

7. Mr. B. Bhattacharya, learned Additional Solicitor General, appearing on behalf of the Revenue, on the other hand, while candidly admitting that both the issues raised in the present appeals, have been decided by this Court in Woodward's case (supra), submitted that in view of the finding by the High Court that no agreement between the Assessee and the foreign creditors had been placed on record, the High Court was correct in law in allowing Revenue's appeals.

8. At the outset, we may note that although in view of the orders passed by the Committee on disputes, advising the Revenue not to file appeals against Tribunal's orders, we find some

substance in the objection of learned counsel for the Assessee about the maintainability of Revenue's appeals before the High Court but as we have heard learned counsel for the parties on merits of the appeals, at this stage, we do not propose to go into this question. We also reject at the threshold the submission of learned counsel for the Revenue that the claim of the Assessee qua capital account deserved to be disallowed because no agreement between the Assessee and the foreign creditors, as observed by the High Court was placed on record, because no such objection was raised by the Revenue at any stage of the assessment proceedings nor had the Assessing Officer rejected the claim of the Assessee on that ground.

9. Thus, the questions surviving for determination are :- (i) that when the Assessee maintained their accounts on mercantile system of accounting and there was no finding by the Assessing Officer on the correctness or completeness of the account and that the Assessee had complied with the accounting standards, laid down by the Central Government, can the "loss" suffered by it on account of fluctuation in the rate of foreign exchange as on the date of balance-sheet be allowed as expenditure under Section 37(1) of the Act notwithstanding the fact that the liability had not been actually discharged in the year in which the fluctuation in the rate of foreign exchange had occurred and (ii) whether on account of fluctuation in the rate of exchange at the end of the previous year, the Assessee is entitled to adjust the actual cost of imported assets acquired in foreign currency?

10. Having carefully perused the decision of this Court in Woodward's case (supra), we are of the opinion that both the issues stand concluded by the said decision. Dealing with the said issues extensively, speaking for the Bench, S.H. Kapadia, J. summarised the following factors which should be taken into account in order to find out if an expenditure on account of fluctuation in the foreign currency rates, when the Assessee is following mercantile system of accounting, is deductible:

“(i) whether the system of accounting followed by the assessee is the mercantile system, which brings in the debits of the amount of expenditure for which a legal liability has been incurred even before it is actually disbursed and credits, what is due, immediately it becomes due even before it is actually received;

(ii) whether the same system is followed by the assessee from the very beginning and if there was a change in the system, whether the change was bona fide;

(iii) whether the assessee has given the same treatment to losses claimed to have accrued and to the gains that may accrue to it;

(iv) whether the assessee has been consistent and definite in making entries in the account books in respect of losses and gains;

(v) whether the method adopted by the assessee for making entries in the books both in respect of losses and gains is as per nationally accepted accounting standards;

(vi) whether the system adopted by the assessee is fair and reasonable or is adopted only with a view to reducing the incidence of taxation.

Applying these factors on the facts of that case, it was held that the "loss" suffered by the Assessee, maintaining accounts regularly on mercantile system and following accounting standards prescribed by the Institute of Chartered Accountants of India (ICAI), on account of fluctuation in the rate of foreign exchange as on the date of balance-sheet was an item of expenditure under Section 37(1) of the Act, notwithstanding that the liability had not been discharged in the year in which the fluctuation in the rate of foreign exchange occurred.”

11. We are of the opinion that the ratio of the said decision, with which we are in respectful agreement, squarely applies to the facts at hand and, therefore, the loss claimed by the Assessee on account of fluctuation in the rate of foreign exchange as on the date of balance-sheet is allowable as expenditure under Section 37(1) of the Act.

12. On the question whether an Assessee is entitled to adjust the actual cost of imported assets acquired in foreign currency on account of fluctuation in the rate of exchange at each balance-sheet date, pending actual payment of the varied liability with reference to unamended Section 43A of the Act, in Woodward's case (supra), the Court observed thus: "...what triggers the adjustment in the actual cost of the assets, in terms of the unamended section 43A of the 1961 Act is the change in the rate of exchange subsequent to the acquisition of asset in foreign currency. The section mandates that at any time there is change in the rate of exchange, the same may be given effect to by way of adjustment of the carrying cost of the fixed assets acquired in foreign currency. But for section 43A which corresponds to paragraph 10 of AS-II such adjustment in the carrying amount of the fixed assets was not possible, particularly in the light of section 43(1). The unamended section 43A nowhere required as condition precedent for making necessary adjustment in the carrying amount of the fixed asset that there should be actual payment of the increased/decreased liability as a consequence of the exchange variation. The words used in the unamended section 43A were "for making payment" and not "on payment" which is now brought in by amendment to section 43A, vide the Finance Act, 2002."

“Opining that the amendment of Section 43A of the Act by the Finance Act, 2002 with effect from 1st April, 2003 is amendatory and not clarificatory and would thus, apply prospectively, the Court explained that under the unamended Section 43A, adjustment to the actual cost takes place on the happening of change in the rate of exchange, whereas under the amended Section 43A, the adjustment in the actual cost is made on cash basis. In other words, under the unamended Section 43A, "actual payment" was not a condition precedent for making necessary adjustment in the carrying cost of the fixed asset acquired in foreign currency but under the amended Section 43A, with effect from 1st April, 2003, such payment of the decreased/enhanced liability on account of fluctuation in foreign exchange rate has

been made a condition precedent for making adjustment in the carrying amount of the fixed asset.”

13. We are of the opinion that the decision of this Court in Woodward's case (supra) settles the second issue as well. We respectfully concur with the same and hold that all the assessment years in question being prior to the amendment in Section 43A of the Act with effect from 1st April, 2003 the Assessee would be entitled to adjust the actual cost of the imported capital assets, acquired in foreign currency, on account of fluctuation in the rate of exchange at each of the relevant balance-sheet dates pending actual payment of the varied liability.

14. Resultantly, all the appeals are allowed; the impugned orders are set aside and both the questions formulated in para 1 (supra) are answered in favour of the Assessee, leaving the parties to bear their own costs.

<sup>1</sup>2009 (312) I.T.R. 254 (SC)

<sup>2</sup>(1992) Supp (2) SCC 432

<sup>3</sup>2004 (267) I.T.R. 647 (SC)