ASSISTANT C.I.T., VADODARA
v.
ELECON ENGINEERING CO. LTD.
(Civil Appeal No. 2057 of 2010)

FEBRUARY 26, 2010

[S.H. KAPADIA AND H.L. DATTU, JJ.]

Income Tax Act, 1961: s.43A, Explanation 3 – Assessment year 1986-87 – Roll over premium charges paid in respect of foreign exchange forward contracts – Treatment of – Held: Roll over charges represent the difference on account of change in foreign exchange rates – Under Explanation 3 to s. 43A, if liability is incurred in foreign exchange by entering into forward contract for purchase of fixed asset, gain or loss arising from such forward contract is required to be capitalised – s.43A applies to the entire liability remaining outstanding at the year-end, and it is not restricted merely to the instalments actually paid during the year.

The question which arose for consideration in these appeals was whether the roll over premium charges paid by the assessee for the assessment year 1986-87 in respect of foreign exchange forward contracts had to be capitalised in terms of Explanation 3 to Section 43A of the Income Tax Act, 1961.

Allowing the appeal, the Court

HELD: 1. Exchange differences are required to be capitalized if the liabilities are incurred for acquiring the fixed asset, like plant and machinery. It is the purpose for which the loan is raised that is of prime significance. In order to ascertain whether the purpose of the loan is to finance the fixed asset or working capital, the relevant loan agreement and the correspondence between the

parties concerned are required to be looked into. In the present case, the relevant contract and correspondence were not produced by the assessee, therefore, the Court proceeded on the basis that the purpose of the loan taken by the assessee was to finance the purchase of plant and machinery. [Para 8] [118-D-F]

CIT v. Gujarat Alkalis and Chemicals Limited **(2008) 2 SCC 475, held inapplicable.**

India Cements Ltd. v. Commissioner of Income-Tax, Madras, **(1966) 60 ITR 52, referred to.**

2. Section 43A of the Income Tax Act, 1961, before its substitution by a new Section 43A by Finance Act, 2002, was inserted by Finance Act, 1967 with effect from 1.4.1967, after the devaluation of the rupee on 6th June, 1966. It applied where as a result of change in the rate of exchange there was an increase or reduction in the liability of the assessee in terms of the Indian rupee to pay the price of any asset payable in foreign exchange or to repay moneys borrowed in foreign currency specifically for the purpose of acquiring an asset. The Section has no application unless an asset was acquired and the liability existed, before the change in the rate of exchange. When the assessee buys an asset at a price, its liability to pay the same arises simultaneously. This liability can increase on account of fluctuation in the rate of exchange. An assessee who becomes the owner of an asset (machinery) and starts using the same, it becomes entitled to depreciation allowance. To work out the amount of depreciation, one has to look to the cost of the asset in respect of which depreciation is claimed. Section 43A was introduced to mitigate hardships which were likely to be caused as a result of fluctuation in the rate of exchange. Section 43A lays down, firstly, that the increase or decrease in liability should be taken into account to modify the figure of actual cost and, secondly,

A such adjustment should be made in the year in which the increase or decrease in liability arises on account of fluctuation in the rate of exchange. It is for this reason that though Section 43A begins with a *non-obstante* clause, it makes Section 43(1) its integral part. This is because
B Section 43A requires the cost to be recomputed in terms of Section 43A for the purposes of depreciation. A perusal of Section 43A makes it clear that insofar as the depreciation is concerned, it has to be allowed on the actual cost of the asset, less depreciation that was
C actually allowed in respect of earlier years. However, where the cost of the asset subsequently increased on account of devaluation, the written down value of the asset has to be taken on the basis of the increased cost minus the depreciation earlier allowed on the basis of the
D old cost. One more aspect needs to be highlighted. Under Section 43A, as it stood at the relevant time, it was provided that where an assessee had acquired an asset from a country outside India for the purposes of his business, and in consequence of a change in the rate of exchange at any time after such acquisition, there is an
E increase or reduction in the liability of the assessee as expressed in Indian currency for making payment towards the whole or part of the cost of the asset or for repayment of the whole or part of the moneys borrowed by him for the purpose of acquiring the asset, the amount
F by which the liability stood increased or reduced during the previous year shall be added to or deducted from the actual cost of the asset as defined in Section 43(1). This analysis indicated that during the relevant assessment year adjustment to the actual cost was required to be
G done each year on the closing date, i.e., year-end. Subsequently, Section 43A underwent a drastic change by virtue of a new Section 43A inserted vide Finance Act, 2002. Under the new Section 43A such adjustment to the cost had to be done only in the year in which actual
H payment is made. Under Explanation 3 to Section 43A, if

the assessee had covered his liability in foreign exchange by entering into forward contract with an authorized dealer for the purchase of fixed assets, the gain or loss arising from such forward contract was required to be taken into account. [Para 9] [118-G-H; 119-A-H; 120-A-B] A

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3. During the relevant assessment years, Section 43A applied to the entire liability remaining outstanding at the year-end, and it was not restricted merely to the instalments actually paid during the year. Therefore, at the relevant time, the year-end liability of the assessee had to be looked into. Further, it cannot be said that roll over charge has nothing to do with the fluctuation in the rate of exchange. In the present case, the Notes to the Accounts for the year ending 31st December, 1986 (Schedule 17) indicated adverse fluctuations in the exchange rate in respect of liabilities pertaining to the assets acquired. This Note clearly established existence of adverse fluctuations in the exchange rate which made the assessee opt for forward cover and which made the assessee pays roll over charges. The word "adverse" in the Note itself presupposed increase in the liability incurred by the assessee during the year ending 31st December, 1986. Roll over charges represent the difference arising on account of change in foreign exchange rates. Roll over charges paid/ received in respect of liabilities relating to the acquisition of fixed assets should be debited/ credited to the asset in respect of which liability was incurred. However, roll over charges not relating to fixed assets should be charged to the Profit & Loss Account. [Para 10] [121-A-F] C D E F

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Case Law Reference:

(1966) 60 ITR 52	**referred to**	**Para 3**
(2008) 2 SCC 475	**held inapplicable**	**Para 6**

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CIVIL APPELLATE JURISDICTION : Civil Appeal No. 2057 of 2010.

From the Judgment & Order dated 21.7.2008 of the High Court of Gujarat at Ahmedabad in Tax Appeal No. 144 of 2001.

WITH

C.A. No. 2058, 2059, 2060, 2061, 2062, 2063, 2064, 2065 of 2010.

Parag P. Tripathi, ASG, Kunal Bahrai, H. Raghavendra Rao, Sunita Rani Singh, B.V. Balaram Das for the Appellant.

Pravin H. Parekh, Shakun Sharma, Sumit Goel, Pallavi Shrivastava, Rajat Nair (for Parekh & Co.) for the Respondent.

The Judgment of the Court was delivered by

S.H. KAPADIA, J. 1. Leave granted.

2. This batch of civil appeals concerns the nature of roll over premium charge incurred by the assessee as also the scope and applicability of Section 43A of the Income Tax Act, 1961 ("the Act" for short), in the context of such charges.

3. The lead matter in this batch of civil appeals is civil appeal arising out of S.L.P.(C) No.8363 of 2009. It concerns assessment year 1986-87. Assessee is a manufacturing company. It manufactures gears and mechanical handling equipments. It procured a foreign currency loan for expansion of existing business. Since the repayment of loan was stipulated in instalments, assessee desired to ensure that foreign currency required for repayment of the loan be obtained at a pre-determined rate and cost. Accordingly, the assessee booked forward contracts with Citibank for delivery of the required foreign currency on the stipulated dates. The contract was entered into for entire outstanding amount and the delivery of foreign currency was obtained under the contract for

instalment due from time to time. The balance value of the A
contract, after deducting the amount withdrawn towards repayment, was rolled over for a further period up to the date of the next instalment. Assessee filed its return of income for assessment year 1986-87 on 30.6.1986. A revised return was filed by it on 27.3.1989 declaring a total income of B
Rs.2,10,08,640/-. The A.O. disallowed an amount of Rs.8,86,280/-, being the roll over premium charges paid by the assessee in respect of foreign exchange forward contracts to Citibank N.A. on the ground that the said charges were incurred in connection with the purchase of a capital asset (plant and C
machinery), hence, it was not admissible for deduction under Section 36(1)(iii) or under Section 37 of the Act. On appeal, the CIT (A) held that the roll over premium charge(s) incurred by the assessee was allowable as it was incurred by the assessee to mitigate the risk involved in higher payment D
because of adverse fluctuation of rate of exchange. According to CIT (A), roll over premium charge(s) constituted an expenditure incurred for raising loans on revenue account, hence, the said expenditure was allowable under the Act. It may be noted that CIT (A) did not refer to a specific section under which assessee was entitled to such deduction. The CIT(A) did E
not examine Section 43A of the said Act. The CIT(A) relied upon the judgment of the Supreme Court in support of its findings in the case of *India Cements Ltd. v. Commissioner of Income-Tax, Madras* – (1966) 60 ITR 52.

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4. Vide order dated 21.3.2001, the Tribunal held that roll over premium charges (carry forward charges) were required to be paid to the authorized dealer as consideration for permitting the unutilized amount of the contract (balance value of the contract) to be availed of at a latter date and in the G
circumstances roll over premium charges had to be capitalized under Explanation 3 to Section 43A of the said Act. Consequently, the Tribunal upheld the order of the assessment.

5. Aggrieved by the decision of the Tribunal, the assessee H

filed an appeal(s) before the Gujarat High Court inter alia challenging the capitalization of the roll over charges paid in respect of foreign currency. The said appeal(s) was allowed by the High Court which came to the conclusion that the roll over premium charge(s) paid by the asssessee was in the nature of interest or committal charge(s), hence, the said charges were allowable under Section 36(1)(iii) of the said Act, hence this civil appeal(s).

6. According to the Department, the roll over charge was required to be capitalized in view of Section 43A of the Act. In answer to this basic argument, Mr. P.H. Parekh, learned senior counsel appearing on behalf of the assessee submitted that the roll over contract mechanism came to be devised because at the relevant time forward contracts could be entered into for a period of six months ahead of the required delivery of foreign currency for payment of instalments. However, the "term loan agreements" stipulated repayment schedule extending beyond the six months' period. Consequently, there arose a need for a mechanism whereby foreign currencies required to be remitted to meet the instalments falling due beyond six months were made available at a pre-determined exchange rates. Accordingly, the roll over contract mechanism came to be devised. Assessee accordingly entered into a contract with the foreign exchange authorized dealer (Citibank) for providing the entire amount of foreign currency outstanding at an appropriate exchange rate. The authorized dealer in turn agreed to provide, out of such contracted sum, such amount as may be necessary to meet the instalments on due dates and to carry forward the unutilized portion of the foreign currency contracted to meet the subsequent payments. Accordingly, out of the total foreign currency contracted and outstanding, as and when any instalment became due, the borrower deposited the rupee equivalent of the instalment due at the pre-determined rate and carried forward or rolled over the balance unutilized amount of the contracted foreign currency. According to the assessee, this exercise involved a cost for carrying forward the contracted

foreign currency, which was not immediately required for repayment. The said cost was called "the roll over charges". According to the assessee, such cost is akin to the interest payable on the rupee equivalent, which the authorized dealer had invested in holding the foreign currency at the borrower's account. This argument was accepted by the High Court. Thus, according to the assessee, the said roll over charges incurred by the assessee during the relevant assessment years was altogether different from increase in cost on account of exchange rate fluctuation as envisaged under Section 43A and Explanation 3 and, consequently, according to the assessee, in this case Section 43A was not applicable. According to the assessee, Section 43A, as it stood at the relevant time, applied only when there was an increase or reduction in the liability of the assessee consequent upon change in the rate of exchange of currency for payment of cost of asset or for payment of loan. According to the assessee, the roll over premium was not paid because of any fluctuation in the rate of exchange. It was paid as a premium to the dealer for the risk taken by the dealer in holding the foreign exchange at pre-determined rate on borrower's account. According to the assessee, roll over charge had nothing to do with the fluctuation in the rate of exchange and was payable even if there was no fluctuation in the liability of the assessee in Indian currency for making payment towards repayment of the money borrowed. Therefore, according to the assessee, Section 43A was not attracted. According to the assessee, the second reason why Section 43A was not applicable was because there was no increase or reduction in the liability for payment of cost of asset as a result of the change in the rate of exchange. On the contrary, according to the assessee, the said payment was made to avoid the increase or reduction in liability as a consequence of the change in the rate of exchange. According to the assessee, only certain charges were required to be added to the actual cost under Explanation 3 to Section 43A. According to the assessee, the roll over charge was not required to be added to the actual cost nor was it required to be capitalized as such roll over charge had nothing to do with the actual cost of the asset. According to the assessee, when a forward contract is entered into with an authorized dealer, then, only at the forward rate, assets can be capitalized. This is what the assessee has in fact done. The assessee has capitalized the actual rate difference and it claimed depreciation thereof. The only controversy, according to the assessee, is in respect of the roll over charges. According to the assessee, Explanation 3 does not talk of any roll over charges to be capitalized under Section 43A. Hence, according to the assessee, in the present case, the assessee had rightly debited the roll over charges in its Profit & Loss Account under the Head Administrative Expenses – Insurance / Bank Charges. According to the assessee, roll over charges are commitment charges. They are in the nature of interest. They are paid in relation to the amounts borrowed. They are akin to the interest payable on the rupee equivalent, which the authorized dealer had invested in holding the foreign currency on the borrower's account. For the afore-stated reasons, it was submitted that roll over charges were allowable as deduction under Section 36(1)(iii) of the Act. According to the assessee, roll over charges were also meant for covering a risk on account of fluctuations between the rupee and the contracted foreign currency. Such risk is built into the roll over charges, hence, such charges were allowable as deduction under Section 36(1)(iii) of the Act. In the alternative, on behalf of the assessee, it was submitted that in the event of this Court coming to the conclusion that roll over charges were not deductible under Section 36(1)(iii) then in that event such charges were deductible under Section 37 of the Act. In support of this contention, learned counsel for the assessee placed reliance on the judgment of this Court in *CIT v. Gujarat Alkalis and Chemicals Limited,* (2008) 2 SCC 475 which held that commitment and insurance charges payable by the assessee were admissible deductions under Section 37 of the Act.

7. At the outset, we quote hereinbelow Section 43A, as it

stood at the relevant assessment years, as under: A

"43A. *Special provisions consequential to changes in rate of exchange of currency*—(1) Notwithstanding anything contained in any other provision of this Act, where an assessee has acquired any asset from a country B
outside India for the purposes of his business or profession and, in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there is an increase or reduction in the liability of the assessee as expressed in Indian currency *for making* C
payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of the moneys borrowed by him from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the asset (being in either case the *liability* D
existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability aforesaid is so increased or reduced during the previous year shall be added to, or, as the case may be, deducted from, the actual cost of the asset as defined in clause (1) of section 43 or the amount of expenditure of E
a capital nature referred to in clause (iv) of sub-section (1) of section 35 or in section 35A or in clause (ix) of sub-section (1) of section 36, or, in the case of a capital asset (not being a capital asset referred to in section 50), the cost of acquisition thereof for the purposes of section 48, F
and the amount arrived at after such addition or deduction shall be taken to be the actual cost of the asset or the amount of expenditure of a capital nature or, as the case may be, the cost of acquisition of the capital asset as aforesaid. G

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Explanation 3: Where the assessee has entered into a contract with an authorised dealer as defined in section 2 of the Foreign Exchange Regulation Act, 1947 (7 of 1947), H for providing him with a specified sum in a foreign currency on or after a stipulated future date at the rate of exchange specified in the contract to enable him to meet the whole or any part of the liability aforesaid, the amount, if any, to be added to, or deducted from, the actual cost of the asset or the amount of expenditure of a capital nature or, as the case may be, the cost of acquisition of the capital asset under this sub-section shall, in respect of so much of the sum specified in the contract as is available for discharging the liability aforesaid, be computed with reference to the rate of exchange specified therein."

8. Before analysing the Section quoted above, by way of preface, we need to state that exchange differences are required to be capitalized if the liabilities are incurred for acquiring the fixed asset, like plant and machinery. It is the purpose for which the loan is raised that is of prime significance. Whether the purpose of the loan is to finance the fixed asset or working capital is the question which one needs to answer and in order to ascertain that purpose, the facts and circumstances of the case, including the relevant loan agreement and the correspondence between the parties concerned are required to be looked into. In the present case, it appears that the relevant contract and correspondence has not been produced by the assessee. We are proceeding on the basis that the purpose of the loan taken by the assessee from ICICI was to finance the purchase of plant and machinery.

9. Section 43A, before its substitution by a new Section 43A vide Finance Act, 2002, was inserted by Finance Act, 1967 with effect from 1.4.1967, after the devaluation of the rupee on 6 June, 1966. It applied where as a result of change in the rate of exchange there was an increase or reduction in the liability of the assessee in terms of the Indian rupee to pay the price of any asset payable in foreign exchange or to repay moneys borrowed in foreign currency specifically for the purpose of acquiring an asset. The Section has no application unless an

asset was acquired and the liability existed, before the change in the rate of exchange. When the assessee buys an asset at a price, its liability to pay the same arises simultaneously. This liability can increase on account of fluctuation in the rate of exchange. An assessee who becomes the owner of an asset (machinery) and starts using the same, it becomes entitled to depreciation allowance. To work out the amount of depreciation, one has to look to the cost of the asset in respect of which depreciation is claimed. Section 43A was introduced to mitigate hardships which were likely to be caused as a result of fluctuation in the rate of exchange. Section 43A lays down, firstly, that the increase or decrease in liability should be taken into account to modify the figure of actual cost and, secondly, *such adjustment should be made in the year* in which the increase or decrease in liability arises on account of fluctuation in the rate of exchange. It is for this reason that though Section 43A begins with a non-obstante clause, it makes Section 43(1) its integral part. This is because Section 43A requires the cost to be recomputed in terms of Section 43A for the purposes of depreciation (Sections 32 and 43(1)). A perusal of Section 43A makes it clear that insofar as the depreciation is concerned, it has to be allowed on the actual cost of the asset, less depreciation that was actually allowed in respect of earlier years. However, where the cost of the asset subsequently increased on account of devaluation, the written down value of the asset has to be taken on the basis of the increased cost minus the depreciation earlier allowed on the basis of the old cost. One more aspect needs to be highlighted. Under Section 43A, as it stood at the relevant time, it was inter alia provided that where an assessee had acquired an asset from a country outside India for the purposes of his business, and in consequence of a change in the rate of exchange at any time after such acquisition, there is an increase or reduction in the liability of the assessee as expressed in Indian currency for making payment towards the whole or part of the cost of the asset or for repayment of the whole or part of the moneys borrowed by him for the purpose of acquiring the asset, the amount by which the liability stood increased or reduced *during the previous year* shall be added to or deducted from the actual cost of the asset as defined in Section 43(1). This analysis indicates that during the relevant assessment year adjustment to the actual cost was required to be done each year on the closing date, i.e., year-end. Subsequently, Section 43A underwent a drastic change by virtue of a new Section 43A inserted vide Finance Act, 2002. Under the new Section 43A such adjustment to the cost had to be done only in the year in which actual payment is made. In this case, we are not concerned with the position emerging after Finance Act, 2002. Under Explanation 3 to Section 43A, if the assessee had covered his liability in foreign exchange by entering into forward contract with an authorized dealer for the purchase of fixed asseet, the gain or loss arising from such forward contract was required to be taken into account.

10. In the present case, one of the main arguments advanced on behalf of the assessee before us was that Section 43A was not applicable because roll over charge stood paid to avoid increase or reduction in liability as a consequence of the change in the rate of exchange. According to the assessee, Section 43A, as it stood at the material time, applied only to cases where there existed a fluctuation in the rate of exchange and since the roll over charge was paid to the authorized dealer by the assessee to avoid increase or reduction in liability on account of such fluctuation, Section 43A read with Explanation 3 thereto would not apply to such roll over charges. We find no merit in this argument advanced on behalf of the assessee. According to the assessee, the cost for carrying forward the contracted foreign currency, not immediately required for repayment, is called the roll over charge(s). As stated above, according to the assessee, Section 43A was not applicable in this case as there was no increase or reduction in liability because such roll over charges were paid to avoid increase or reduction in liability consequent upon change in the rate of exchange. To answer this submission, one needs to keep in

mind that during the relevant assessment years Section 43A A
applied to the entire liability remaining outstanding at the year-
end, and it was not restricted merely to the instalments actually
paid during the year. Therefore, at the relevant time, the year-
end liability of the assessee had to be looked into. Further, it
cannot be said that roll over charge has nothing to do with the B
fluctuation in the rate of exchange. In the present case, the Notes
to the Accounts for the year ending 31st December, 1986
(Schedule 17) indicates adverse fluctuations in the exchange
rate in respect of liabilities pertaining to the assets acquired.
This Note clearly establishes existence of adverse fluctuations C
in the exchange rate which made the assessee opts for forward
cover and which made the assessee pays roll over charges.
The word "adverse" in the Note itself presupposes increase in
the liability incurred by the assessee during the year ending 31st
December, 1986. In the circumstances, we find no merit in the D
contention of the assessee that roll over charges have nothing
to do with the fluctuation in the rate of exchange. Lastly, in this
case we are concerned with capitalization of exchange
difference in respect of acquisition of fixed assets acquired
from abroad. According to Indian Accounting Standards by E
Dolphy D'Souza, roll over charges are indicative of the increase
or decrease in the liability of the company in the next specified
period, generally of six months. Roll over charges represent the
difference arising on account of change in foreign exchange
rates. Roll over charges paid/ received in respect of liabilities
relating to the acquisition of fixed assets should be debited/ F
credited to the asset in respect of which liability was incurred.
However, roll over charges not relating to fixed assets should
be charged to the Profit & Loss Account. [See page 325]

11. Before concluding, we may state that this judgment is G
confined to the facts of the present case. We may also clarify
that the judgments cited on behalf of the assessee concerning
commitment charges, warranty charges, etc., do not apply to
the present case. None of these judgments deal with roll over
charges. Hence, it is not necessary to discuss those judgments. H

A 12. An alternative argument was advanced on behalf of the assessee that in the event this Court holds that roll over charges are to be capitalized in terms of Explanation 3 to Section 43A as it stood prior to assessment year 2003-04, then, in that event the Tribunal may be directed to grant depreciation allowance
B on the written down value of the asset not only for the concerned years but also for the subsequent years till the entire value of the asset is written off. According to the assessee, such a direction is required to be given because the depreciation, according to the assessee, is available even for the
C assessment years after AY 1994-95. On behalf of the assessee it was further submitted, as and by way of alternative submission, that the Department may not be allowed to charge interest or penalty as the issue involved is debatable.

13. We find no merit in the alternative submissions
D advanced on behalf of the assessee. The Tribunal while holding that roll over charges are required to be adjusted in the carrying amount of fixed asset, has allowed the assessee the benefit of depreciation on the adjusted cost of fixed asset. Hence, it is not necessary for this Court to give direction to the Tribunal,
E as sought by the assessee. On the facts and circumstances there is no question of this Court directing dispensation from payment of interest and penalty.

14. For the afore-stated reasons, we find merit in this batch
F of civil appeals filed by the Department and set aside the impugned judgment of the High Court. Accordingly, the civil appeals filed by the Department are allowed with no order as to costs.

D.G. Appeal allowed.