

## **Forward contracts should have direct nexus with domain of assessee**

**Summary – The Mumbai ITAT in a recent case of S. Vinodkumar Diamonds (P.) Ltd., (the Assessee) held that for hedging transactions it is necessary that commodity in respect of which forward transactions have been made by assessee must have a direct connection with the goods manufactured or sold by the assessee.**

### **Facts**

- The assessee company dealing in diamonds export entered into forward contracts in respect of foreign exchange. It claimed loss on cancellation of such contracts as hedging loss.
- The Assessing Officer held that the disputed loss on account of cancellation of forward exchange contract was not allowable as business loss as the transactions entered into by assessee were of speculative nature.
- On first appeal, the Commissioner (Appeals) confirmed the order of Assessing Officer and held that the contracts were in respect of foreign exchange which could not be termed as goods manufactured by the assessee and since the transactions were settled without actual delivery, therefore, it could not be considered as hedging. Therefore, loss from such transactions was to be assessed as speculation loss.
- On second appeal, the assessee contended that it always hedged the risk of fluctuation in foreign currency rate by taking forward cover and that losses in the forward contract were purely hedging loss and could not be considered as speculative in nature.

### **Held**

- The ITAT held that a forward contract is an agreement between a buyer and seller getting the seller to deliver a specified asset of specified quality and quantity to the buyer on a specified date at a specified place and the buyer in turn is obligated to pay the seller a pre-negotiated price in exchange of the delivery.
- FC can be entered in to for exports also. In such transactions when the actual export is made, spot price may differ from the spot price on the date on which the appellant expected an export order. On the date or receipt of foreign exchange, if the spot price of rupee against foreign exchange increases/decreases then the assessee may make profits or suffer losses.
- As per the details available, the assessee had entered into such transaction during the year under consideration. It was claimed on behalf of the assessee that these transaction were hedging contracts and not speculative transactions as held by the departmental authorities. Concepts of speculative transaction /hedging transactions are not new concepts of tax laws. Distinction between the two is vital and both have consequences in determining the tax liability arising out of them.

- The definition of 'speculative transaction' in section 43(5) gives a simple test for deciding for the purpose of income-tax what a speculative transaction means. If a contract for sale or purchase is ultimately settled out and no actual delivery of the goods was affected under the settlement then it is a speculative transaction.
- Thus, the true test is delivery of commodities/goods as per the contract, including a forwarding contract. Profit/loss in respect of unperformed contracts is considered speculation profit/loss. In short, in order that a transaction may fall within the scope of the expression 'speculative transaction', it must be a transaction in which a contract for purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips.
- In order to be genuine and valid hedging contracts of sales, the total of such transactions should not exceed the total stocks of the raw materials or the merchandise on hand which would include existing stocks as well as the stocks acquired under the firm contracts of purchase. As per the accepted commercial norms object of a hedging contract is to secure oneself against loss in a future delivery contract, but such transactions cannot be regarded as inter-connected. Each one is independent of the other. So far as the profit or loss arising from a future delivery contract is concerned, it is determined on the date of actual delivery irrespective of the date on which the contract was entered into. In respect of a hedging contract, profit/loss arising therefrom can be ascertained or crystallized at fixed intervals of the term when the clearance takes place.
- In other words, unless the assessee shows that there was some existing contract in respect of which he was likely to suffer a loss because of future price fluctuations and that it was to safeguard against such loss that he entered into the forward contracts of sale, he could not claim the benefit of clause (a) of the proviso to section 43(5).
- In order that forward transactions in commodities may fall within proviso (a) to section 43(5), it is necessary that the raw materials or merchandise in respect of which the forward transactions have been made by the assessee must have a direct connection with the goods manufactured or the merchandise sold by him.
- It is found in the case under consideration assessee was not dealing in Foreign Exchange, therefore transactions entered into by it in Foreign Exchange cannot be held to be hedging transactions. On appreciation of the facts surrounding the transaction the conclusion reached is that transactions entered in to by the assessee were not hedging transaction, but same were speculative and thus the case of the assessee is not covered by proviso(a) of the section 43(5).
- The ITAT thus decided the appeal against the assessee.