Forward contracts to hedge against forex losses from import or export of diamonds by jeweller aren't speculative

Summary – The Mumbai ITAT in a recent case of Jaimin Jewellery Exports (P.) Ltd., (the Assessee) held that forward contracts which are integral part or incidental to core business of import/export of diamonds, in principle, constitute hedging transactions, and not speculative contracts

Facts

- The assessee was engaged in the business of import of rough diamond and export of polished diamonds. The assessee entered into forward contract with banks to safeguard against exchange fluctuation and booked a loss on account of loss on foreign currency fluctuations.
- The Assessing Officer treated it as a speculative loss. He stated that the said speculative transaction did not fall within the exclusive clauses of section 43(5) and loss on such speculative transaction could not be set off against profit and gains of business, but from that of speculative transaction only. Thus, made addition on that amount.
- On appeal, the Commissioner upheld the order of the Assessing Officer.
- On appeal, to the High Court:

Held

- The definition of "commodity derivative" as was provided in the Finance Bill, 2013 with that as provided under section 43, is wide enough not only to include forward contracts in derivatives relating to goods, services and rights such as warehousing and freight but also with reference to weather and similar events and activities having a bearing on the commodity sector. The co-ordinate bench of the Tribunal in the case of *London Star Diamond Company (I) (P.) Ltd.* v. *Dy. CIT* ' [2013] 38 taxmann.com 338 (Mum. - Trib.) has held that even such the forward contracts fall in the definition of "commodities".
- It may be further observed that 'foreign exchange forward contracts' entered into for the purpose of hedging the loss in import- export transactions, have been duly recognized and allowed by the Reserve Bank of India.
- From the guidelines issued by the Reserve Bank of India relating to general principles to be observed for forward foreign exchange contracts that the banks have been permitted to enter into such contracts after thorough verification of documentary evidences, etc. about the genuineness of the underlying foreign currency exposure and the need of hedging of the loss. Further the maturity of the hedge should not exceed the maturity of the underlying transaction.

- So in view of the underlying risk in import export business due to currency rate fluctuations, the Reserve Bank of India has not only defined but has also allowed the forward contracts relating to foreign exchange derivatives for hedging of such anticipated losses. Even in case of contracts covering export transactions, there is no restriction of rebooking and such contracts may be cancelled, rebooked or rolled over at ongoing rates.
- In case of import/export business, where the transactions are demonetarized in the foreign currencies and for the purpose of hedging of the anticipated loss resulting from such import-export business and not otherwise, if the assessee enters into a forward contract in foreign exchange, then such forward contracts are to be treated as integral part or incidental to the business of export/import and cannot be said to be the speculative contracts attracting the provisions of section 43(5). The loss from such hedging transactions would be treated as business loss eligible to be set off against the profits and gains of business and profession.
- The foreign exchange loss incurred by the assessee on account of entering into forward contracts with the banks for the purpose of hedging the loss in connection with his import/export business of diamonds cannot be held to be a speculative loss rather a business loss which can be set off against profit and gains of business subject to the condition that the assessee will have to satisfactorily prove that the maturity of the hedge did not exceed the maturity of the underlying transaction and further to explain the requirement/necessity for premature cancellation of such forward contracts or that such cancellations or re-bookings were done to minimize the anticipated future losses from such transactions. The findings of the CIT(A) given *vide* impugned order are, therefore, set aside and the issue is restored back to the file of the Assessing Officer to decide the same accordingly after giving proper opportunity to the assessee to represent its case.