

**IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCH "B", MUMBAI**

**BEFORE SHRI G.S. PANNU, ACCOUNTANT MEMBER AND
SHRI SANDEEP GOSAIN, JUDICIAL MEMBER**

**ITA NOS. 3766/MUM/2014 : A.Ys : 2009-10 & 2010-11
& 88/MUM/2015**

M/s. Blue Star Diamonds Pvt. Ltd., Vs. Addl. CIT, Range-5(1),
CE-9010, 9th floor, Tower-C, Mumbai (Respondent)
Bharat Diamond Bourse, BKC,
Bandra-East, Mumbai 400 051
PAN : AADCB6475E (Appellant)

Appellant by : Shri Anuj Kisnadwala

Respondent by : Shri T.A. Khan

Date of Hearing : 06/03/2018

Date of Pronouncement : 01/06/2018

ORDER

PER G.S. PANNU, AM :

The captioned are two appeals by the assessee which involve common issues and, therefore, they have been clubbed and heard together and a consolidated order is being passed for the sake of convenience and brevity.

2. In order to appreciate the controversy, the appeal for Assessment Year 2009-10 is taken as the lead case. This appeal by the assessee is directed against the order of CIT(A)-9, Mumbai dated 11.03.2014 pertaining to the Assessment Year 2009-10, which in turn has arisen from the order

passed by the Assessing Officer dated 26.02.2013 under section 143(3) of the Income Tax Act, 1961 (in short 'the Act').

3. In this appeal, the assessee has raised the following Grounds of appeal:-

“1.0 Ground - 1

1.1 On the facts and in circumstances of the case, the learned Commissioner of Income-tax Appeals - 9 ["CIT(A)"] has erred in law and facts in confirming the change of income head of compensation income received from renting of property along with facilities from "Income from Other Sources" to "Income from House property" without appreciating the fact that the appellant has entered into a valid and enforceable agreement for providing business service center against which such compensation was received.

2.0 Ground - 2

2.1 On the facts and in circumstances of the case, the learned CIT(A) has erred in law and facts in confirming the disallowance of Rs. 688,272/- under section 14A of the Income Tax Act, 1961 ('the Act'), by applying Rule 8D of the Income tax Rules, 1962 ('the Rules).

3.0 Ground - 3

3.1 On the facts and in circumstances of the case, the learned CIT(A) has erred in law and facts in treating the loss on premature cancellation of forward exchange contracts of Rs. 35,595,000/- as speculation loss without appreciating the fact that forward contracts are in the nature of hedging transactions and integral /incidental to the import / export activity and premature cancellation was on account of mitigating the market risk as a matter of business prudence.”

4. Insofar as Ground of appeal no. 1 is concerned, the learned representative for the assessee explained that the issue relates to

assessability of income received by the assessee from renting of property alongwith facilities of a 'Business Service Centre'. The claim of the assessee was that the same was assessable under the head 'Income from Other Sources' whereas as per the income-tax authorities, such income is liable to be assessed under the head 'Income from House Property'. It has been pointed out that an identical controversy came-up before the Tribunal in Assessment Year 2008-09 and vide its order in ITA No. 2510/Mum/2013 dated 27.05.2016, the matter was restored back to the file of the Assessing Officer for a decision afresh and in the set-aside proceedings, the Assessing Officer vide his order u/s 143(3) r.w.s. 254 of the Act dated 27.12.2017 has assessed such income under the head 'Income from House Property', a position which has since been accepted by the assessee. In this background, the action of the income-tax authorities in the instant year to assess the rental income under the head 'Income from House Property' is sustained and accordingly, Ground of appeal no. 1 is dismissed.

5. Ground of appeal no. 2 relates to disallowance of Rs.6,88,272/- made u/s 14A of the Act by applying Rule 8D(2)(iii) of the Rules. Notably, the Assessing Officer noted on a perusal of the Balance-sheet of the assessee as on 31.03.2009 that it has made specific investment in shares. Pertinently, it was pointed out that the business, which was carried on earlier in the name of "Blue Star" as a partnership firm, was converted into a Company, which is the present assessee, w.e.f. 05.12.2008. Before the lower authorities, assessee explained that the only investment in shares was to the tune of Rs.42,94,34,878/- in Bombay Stock Exchange (BSE) share, which was made on 16.04.2007, i.e. during the erstwhile firm; that the assessee-company since taking over of the erstwhile partnership firm had not earned any

dividend during the year; and, that the dividend had been received by the erstwhile partnership firm. The assessee also pointed out that the investment in the earlier period towards the BSE share was made out of advance received from one of the overseas buyer and, therefore, no interest expenditure was incurred on such investment. It is also explained that such advance was repaid by adjustment against export of diamonds made subsequently. No disallowance was made by the Assessing Officer on account of interest expenditure, however, he computed a disallowance of Rs.21,47,174/- by applying Rule 8D(2)(iii) of the Rules on account of administrative expenditure incurred for earning of such income, but since the assessee-company was assessed for the period 05.12.2008 to 31.03.2009, he determined the disallowance on a proportionate basis, at Rs.6,88,272/-. The CIT(A) has also affirmed the said decision.

6. At the time of hearing, the learned representative for the assessee categorically made an assertion that so far as the assessment of the assessee-company is concerned, such dividend income has not been assessed as such inasmuch as the same was relatable to the period assessed in the hands of the erstwhile assessee-firm, i.e. till 05.12.2008 and, therefore, on that basis, assessee had asserted that since it has not earned any exempt income, the question of disallowing any expenditure u/s 14A of the Act would not arise. In this context, he has also referred to the decision of the Hon'ble Delhi High Court in the case of *Joint Investments Pvt. Ltd. vs CIT, ITA No. 117 of 2015 dated 25.02.2015*. For the said reason, we find no reasons to uphold the impugned disallowance which is hereby directed to be deleted.

7. The third and substantive Ground in this appeal is with regard to the action of income-tax authorities in treating the loss incurred by the assessee on premature cancellation of forward exchange contracts of Rs.3,55,95,000/- as 'speculation loss'. The relevant facts in this regard are that the appellant company, *inter-alia*, is in the business of dealing in rough and polished diamonds and its activities involve import of rough diamonds and export of polished diamonds thereof. Considering the nature of assessee's business, assessee is required to safeguard against the exchange fluctuations and, for that purpose, during the year under consideration it had entered into eight forward contracts in foreign exchange. Out of said eight contracts, six matured at their contracted dates and the other two were prematurely cancelled by the assessee. The loss incurred on such premature cancellation of forward contracts amounted to Rs.3,55,95,000/-, which was treated by the Assessing Officer as speculation in nature. The said action of the Assessing Officer, which has been affirmed by the CIT(A), though on a different basis, is the subject matter of dispute before us.

8. Notably, when the assessee was show-caused by the Assessing Officer, assessee explained that the impugned loss arising out of premature cancellation of forward contracts in foreign exchange was a 'business loss' inasmuch as the same was incurred in the course of carrying on of the business as it was relatable to the business operations of import and export of goods. Assessee also pointed out that such loss was actual and real loss and it was not a case where the loss was arising on account of 'mark-to-market' of foreign exchange derivative contracts. The Assessing Officer, however, did not accept the plea of the assessee for the reason that the loss suffered was on account of premature cancellation and that such transaction

was not carried out in any regular stock exchange; and, therefore, he treated it to be in the nature of 'speculation' and not a 'business loss'.

9. Before the CIT(A), assessee made detailed submissions, which have been reproduced by the CIT(A) in para 4.1 of his order. Apart from explaining the reasons for cancelling the forward contracts prematurely, assessee also referred to various decisions, *inter-alia*, including the decision of the Mumbai Bench of the Tribunal in the case of *London Star Diamond Co. (I) Pvt. Ltd. dated 11.10.2013 in ITA No. 6169/Mum/2012* to contend that such loss incurred on premature cancellation of forward contracts was a 'business loss'. The CIT(A) has considered the submissions put forth by the assessee and has ultimately upheld the action of the Assessing Officer in treating the same as a 'speculation loss'. However, in coming to such a decision, the CIT(A) has made the following discussion which would bring out the precise reason for his disagreement with the assessee though, in principle, he has accepted the proposition canvassed by the assessee based on the decision of the Mumbai Bench of the Tribunal in the case of *London Star Diamond Co. (I) Pvt. Ltd. (supra)* :-

"5.4it is noted that similar issue was before the Hon'ble Mumbai ITAT in the case of M/s. London Star Diamond Company (India) Pvt. Ltd. in ITA No. 6169/M/2012, where in order dated 11/10/2013, after considering various decisions of higher Courts, it is held by the ITAT that in the case of exporters/importers forward contracts of foreign exchange are in the nature of hedging transactions if they match with the export/import turnover. It is further held by the ITAT that – (i) the loss on hedging transactions of the exporters/importers are business loss if the loss arises on the maturity of forward contracts of foreign currency (ii) when the assessee claims loss on pre-mature cancellation/termination of the forward contract, then assessee needs to answer as to why it went for premature termination for claiming the loss on such premature

cancellation as business loss or damages and if the assessee does not provide specific explanation for pre-mature cancellation, then such losses will be disallowed. In the light of this recent decision of the jurisdictional ITAT, the claim of the appellant does not succeed, because in the instant case the appellant has incurred loss by premature cancellation of contracts of foreign currency which were terminated before the due date of maturity. The contracts of this category which were terminated premature are therefore, in the nature of speculation as the appellant has not been able to file any convincing evidence as to why these contracts were terminated before maturity. As regards the claim of appellant that loss on such contracts in the hands of erstwhile firm were allowed by the A.O., it is noted that those contracts were cancelled on maturity of the term of contracts whereas the appellant company has cancelled both the contracts in question before the maturity date. Accordingly in the light of aforesaid decision of ITAT Mumbai these contracts appears speculative in nature. Therefore, the A.O. has correctly treated this loss as speculative loss.”

10. The aforesaid discussion by the CIT(A) clearly brings out that he has accepted the position that in the case of exporters and importers, forward contracts in foreign exchange are in the nature of hedging transactions so far as they are relatable to the export or import turnover. However, with regard to the premature cancellation of such forward contracts, as per the CIT(A), the onus is on the assessee to show the reasons for premature cancellation and, according to him, only if the reasons are convincing, such a loss can be treated as a ‘business loss’. In this background, the assessee is in further appeal before us.

11. The learned representative for the assessee vehemently pointed out that the CIT(A) has erred in not appreciating the reasons canvassed by the assessee for premature cancellation of the forward contracts in two cases, which clearly establish that it was a business decision taken by the assessee

to cancel them. In this connection, our attention has been invited to para 4.1 of the order of the CIT(A), wherein the reasons for premature cancellation canvassed by the assessee have been reproduced verbatim. On the strength of such reasons, the learned representative pointed out that looking at the prospects of business declining in future, assessee took steps to prematurely cancel the forward contracts inasmuch non-cancellation would have resulted in over-hedging of the expected imports and resulted in avoidable loss if the foreign currency had moved adversely. Nevertheless, the learned representative also referred to the decision of the Tribunal in the case of *DCIT vs Mahendra Brothers Exports (P.) Ltd.*, [2016] 161 ITD 772 as well as in the case of *D. Kishorekumar & Co. vs DCIT*, [2005] 2 SOT 769 (Mum.) to support assessee's treatment of such loss as a 'business loss' and not as a 'speculation loss'.

12. On the other hand, the Id. DR reiterated the reasoning taken by the CIT(A) to disallow the loss, which we have already noted in some detail in the earlier paras and is not being repeated for the sake of brevity.

13. We have carefully considered the rival submissions. Pertinently, the assessee is engaged in the business of import and export of diamonds and, at any given point of time, it would have outstanding on account of export receivables and import payables. It is a commonly accepted feature of assessee's business of export and import that foreign exchange forward cover is taken up with the bankers in order to hedge the future foreign exchange liabilities. In the case of assessee too, the fact-position shows that assessee had undertaken foreign exchange forward contracts on eight occasions – while on six occasions, the contracts expired at their maturity

period and nature of the resultant loss/profit has not been disturbed by the Assessing Officer. In fact, at page 30 of the Paper Book is placed the details of the foreign exchange loss incurred during the year of Rs.5,00,52,780/- which, *inter-alia*, includes the amount in dispute before us, i.e. Rs.3,55,95,000/-. The disputed loss pertains to premature cancellation of two forward contracts, details of which have also been placed at page 26 of the Paper Book. At pages 28 and 29 of the Paper Book are placed the month-wise details of outstanding import creditors and outstanding export debtors respectively, which clearly establish that the hedging done by the assessee by the means of forward contracts in foreign exchange are on a much lower level than the outstanding export receivables and import liabilities. Be that as it may, it is not the case of Revenue that such hedging was not related to business because so far as six of the contracts are concerned, the resultant loss/profit has not been treated by the Assessing Officer to be in the nature of 'business loss'. Only in relation to two of the contracts, which have been prematurely cancelled, the resultant loss has been treated as a 'speculation loss' by the Assessing Officer. The CIT(A) has retained the disallowance made by the Assessing Officer, albeit on the basis that there was no convincing explanation for premature cancellation of the forward contracts. Be that as it may, we proceed further on the premise that, but for the non-acceptance of assessee's explanation as convincing with respect to premature cancellation of forward contracts, the hedging undertaken by taking foreign exchange forward contracts is otherwise an activity in the course of business. This position is, in-principle, fortified by the various decisions of the Tribunal relied before us, viz. *Mahendra Brothers Exports (P.) Ltd. (supra)* as well as *D. Kishorekumar & Co. (supra)*.

14. Now, we may examine the efficacy of the reasons which have been explained by the assessee for premature cancellation of the two forward contracts. Before the CIT(A), assessee explained that earlier the business was carried under the name and style of 'Blue Star' as a partnership firm, which got converted into the assessee-company w.e.f. 05.12.2008. The two forward contracts in question were entered into during the existence of the erstwhile firm on 20.11.2008 and were cancelled on 10.12.2008. Assessee explained that the two forward contracts were entered to hedge imports of diamonds considering the future volume of exports estimated on the basis of the past performance. It was explained that during the period April, 2008 to November, 2008, the average volume of imports per month was approximately Rs.60 crores (approx. USD 12 million based on exchange rate prevailing at that time) and based on such volume, assessee entered into forward contracts of USD 20 million, which was approx. 1.67 months of purchase/imports. Assessee contended that post conversion to company, business fell drastically and the average imports during the period December, 2008 to March, 2009 came down to Rs.8.16 crores, i.e. a fall of almost 86% in the volume of business. In this scenario, the forward contracts already entered into would have reflected almost 6-month purchase volumes. Assessee had also explained that post conversion into company, due to market recession and also due to the changed status, it took time for the business of the assessee to stabilise and, therefore, it affected the level of export realisations which, in turn, affected the volume of imports during the period relatable to the forward contracts in question. Once assessee understood this decline, assessee took steps to minimise the loss and the forward contracts had to be cancelled because otherwise continuation of the forward contracts would have resulted in over-hedging

the expected imports and assessee would have incurred loss if the Dollar was to move adversely. For all these reasons, assessee took a conscious decision to prematurely cancel two of the contracts which has resulted in the impugned loss.

15. We find that though the aforesaid reasoning canvassed by the assessee has been reproduced by the CIT(A) in his order, but he has not given any finding as to why the reasoning is not convincing. As per the discussion in the order of CIT(A), which we have extracted above, only a bland assertion has been made about the absence of *“any convincing evidence as to why these contracts were terminated before maturity”*. Even at the time of hearing before us, the Id. DR has not contested the assertions made by the assessee in this regard. Therefore, in our view, it is a case where the reasons explained by the assessee have been merely brushed aside and overlooked without establishing any infirmity in the same. At this point, we may also refer to the decision of our co-ordinate Bench in the case of *D. Kishorekumar & Co. (supra)*, wherein also our co-ordinate Bench was dealing with a situation arising from cancellation of forward contracts, though in a slightly different context. So, however, what is of essence is that as per our co-ordinate Bench, the decision as to whether hedging against cost incurred in foreign currency is warranted or not is essentially a commercial decision, which has to be left to the perception of the businessman. Our co-ordinate Bench explained that in certain situations, a businessman may perceive market trends in such a way that business expediency may justify cancellation of a contract also. The Bench thereafter explained that the fact of premature cancellation itself cannot alter the nature of the transaction. In the present case too, the entire conspectus of

facts and circumstances show that merely because assessee took a decision to prematurely cancel the forward contracts cannot be a ground to say that it is a 'speculation loss' and not a 'business loss', when otherwise entering of forward contracts in order to hedge against foreign exchange fluctuations with respect to import and export is accepted to be an activity carried out in the course of business. In fact, in the present case, assessee has sufficiently demonstrated that the action of premature cancellation of forward contracts was to contain avoidable future loss on account of adverse movement in the value of foreign exchange and the circumstances under which such a decision was taken, has also been sufficiently narrated. In the absence of any controversion of the same, we find that the assessee has discharged the onus cast on it to explain the incurrence of loss in question and, therefore, we deem it fit and proper to allow the stand of the assessee of treating the amount of Rs.3,55,95,000/- as a 'business loss'. Thus, on this aspect, assessee succeeds.

16. In the result, appeal of the assessee for Assessment Year 2009-10 is partly allowed.

17. Insofar as appeal for Assessment Year 2010-11 is concerned, one of the issues relates to the assessability of rentals from business service centre, which is similar to that considered by us in the earlier paras by way of Ground of appeal no. 1 in relation to Assessment Year 2009-10 and, therefore, our decision in Assessment Year 2009-10 will apply *mutatis mutandis* in this appeal also and accordingly, this Ground for Assessment Year 2010-11 is dismissed.

18. The only other issue in this appeal is with regard to the action of CIT(A) in sustaining the disallowance of Rs.1,13,21,041/- made by the Assessing Officer u/s 14A of the Act. In this context, the relevant facts are that the Assessing Officer computed the disallowance u/s 14A of the Act by applying the formula contained in Rule 8D(2) of the Income Tax Rules, 1962 (in short 'the Rules') whereby the interest expenditure of Rs.91,73,867/- was disallowed as per Rule 8D(2)(ii) of the Rules and administrative expenses of Rs.21,47,174/- was disallowed as per Rule 8D(2)(iii) of the Rules, thereby totalling to Rs.1,13,21,041/-. This addition has further been sustained by the CIT(A), against which assessee is in further appeal before us.

19. Before us, the learned representative for the assessee pointed out that in the instant year there was no investment made except the investment made by the erstwhile partnership firm in the shares of BSE of Rs.42,94,34,878/-, which was made on 16.04.2007. It has also been explained that the only exempt income earned by the assessee during the year is by way of dividend on the shares of BSE amounting to Rs.42,46,684/-.

20. Before us, the learned representative assailed the disallowance out of interest expenditure by pointing out that the only investment is in the shares of BSE, which is a brought forward investment and no fresh investment has been made and that, in any case, in the earlier assessment year of 2009-10, no interest disallowance was made by the Assessing Officer himself *qua* the said investment. The said assertion of the appellant is borne out of record inasmuch as in the earlier paras we have already dealt with the disallowance u/s 14A of the Act for Assessment Year 2009-10 wherein the only investment was in the shares of BSE and the Assessing Officer himself has not made any

disallowance out of interest expenditure. In our view, in such a factual background, the disallowance computed by the Assessing Officer out of interest expenditure by applying Rule 8D(2)(ii) of the Rules is misplaced and is hereby directed to be deleted.

21. So far as the disallowance out of Administrative expenses of Rs.21,47,174/- made by the Assessing Officer by applying Rule 8D(2)(iii) of the Rules is concerned, no specific arguments have been raised before us and the same is hereby affirmed. Thus, on this aspect, assessee partly succeeds.

22. In the result, appeal of the assessee for Assessment Year 2010-11 is partly allowed.

23. Resultantly, both the appeals of the assessee are partly allowed.

Order pronounced in the open court on 1st June, 2018.

Sd/-
(SANDEEP GOSAIN)
JUDICIAL MEMBER

Sd/-
(G.S. PANNU)
ACCOUNTANT MEMBER

Mumbai, Date : 1st June, 2018

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Copy to :

- 1) The Appellant
- 2) The Respondent
- 3) The CIT(A) concerned
- 4) The CIT concerned
- 5) The D.R, "B" Bench, Mumbai
- 6) Guard file

By Order

Dy./Asstt. Registrar
I.T.A.T, Mumbai