

**(2009) 09 DEL CK 0390**

**Delhi High Court**

**Case No:** Income Tax A. No. 899 of 2006

Commissioner of Income Tax

APPELLANT

Vs

Industrial Finance Corporation of  
India Ltd.

RESPONDENT

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**Date of Decision:** Sept. 4, 2009

**Acts Referred:**

- Income Tax Act, 1922 - Section 10(1)
- Income Tax Act, 1961 - Section 260A

**Citation:** (2010) 228 CTR 132 : (2009) 8 ILR Delhi 92 Supp : (2009) 185 TAXMAN 296

**Hon'ble Judges:** Valmiki J Mehta, J; A.K. Sikri, J

**Bench:** Division Bench

Advocate: Prem Lata Bansal Paras Chaudhry and Anshul Sharma, for the Appellant; Ajay Vohra and Kavita Jha, for the Respondent

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### **Judgement**

A.K. Sikri, J.

This is an appeal preferred u/s 260A of the Income Tax Act, 1961 (hereinafter referred to as the "Act") against the order dated 31.5.2005 passed by the Income Tax Appellate Tribunal (ITAT) in the case of the respondent in ITA No. 1563/Del/1999 for the assessment year 1995-96 whereby ITAT had allowed the claim of the assessee for deduction of expenditure of Rs. 67,06,33,245/- incurred by way of forward contracts in connection with swapping of foreign currency funds for augmenting the rupee funds required by it for its business in the year under consideration.

2. The question of law which, thus, falls for consideration is as under:

Whether the assessee is entitled to claim deduction of Rs. 67.06 crores incurred in connection with swapping of foreign currency funds in the year under consideration, i.e. the assessment year 1995-96?

3. The factual backdrop under which this question of law was framed consideration may first be recapitulated.

4. The assessee is a financial institution and the main business of the assessee is that of making loans and advances to various industrial concerns. It is a public sector undertaking. For meeting its lending requirements, the assessee also raises foreign currency borrowings. The assessee swapped such foreign currency into Indian rupees in order to augment its rupee resources for meeting its lending requirements. The foreign currencies borrowed were repayable to the foreign lenders on later dates falling within the current previous year ending on 31.3.1995 and in some cases falling in the next previous year relevant to subsequent assessment year.

5. For repurchasing these currencies on their respective due date of repayment, the assessee entered into forward contracts with banks as a safeguard against foreign currency fluctuations. The assessee recognized the difference between the forward contract rate and the exchange rate on the date of the transaction. The assessee, thus, determined the exchange difference of Rs. 8,172.85 lacs arising out of realignment of foreign currency borrowings covered against forward contracts and treated the same as cost of borrowings. In its books of account, a sum of Rs. 1,466.55 lacs was charged to the Profit and Loss account during the year itself and the balance of Rs. 67,06,33,245/- was treated as deferred revenue expenditure, which was to be charged over the balance period of forward cover which spilled over into the next assessment year. However, in the computation of income, the assessee claimed the sum of Rs. 67,06,33,245/- as deductible from the total income.

6. The Assessing Officer (AO), did not allow the aforesaid claim of Rs. 67.06 crores on the ground that the expenditure claimed pertain to the future period and not to the period relevant to the assessment year under consideration, inasmuch as, the transaction in question was to safeguard against future currency fluctuations. According to the AO, such expenditure did not cover the obligation of the previous year relevant to the assessment year under consideration and was, therefore, ineligible for deduction as the expenditure was capital in nature. He, however, allowed the deduction with respect to the amount of Rs. 1,466.55 lacs, which had been charged by the assessee in its Profit and Loss account during the year itself.

7. Dissatisfied with the aforesaid approach of the AO, the assessee carried the matter in appeal before the Commissioner of Income Tax (Appeal). The CIT (A) held that while the AO was wrong in treating a portion of the expenditure, not relating to the current assessment year, as capital expenditure but, at the same time, disallowance was sustained on the ground that such expenditure did not relate to the current assessment year. Thus, the said disallowance was upheld.

8. The assessee preferred further appeal to the ITAT, and this time successfully, as this ground raised in the appeal has been accepted by the ITAT and AO's order

disallowing the aforesaid expenditure has been set aside. We may point out at this stage itself that there were other issues also, however, since in the present appeal we are concerned only with the aforesaid aspect, we have not taken note of other disallowances made by the AO in his assessment year and treatment thereof by the Tribunal.

9. Ms. Prem Lata Bansal, learned Counsel appearing for the Revenue, submitted that the issue involved in the present appeal was to determine the year of allowability. She pointed out that the assessee had adopted mercantile system of accounting and, therefore, any expenditure accrued during the year only was allowable. In the present case, the assessee has borrowed foreign currency to augment Indian currency funds. This borrowing has to be repaid on a future date. In order to secure itself, the assessee entered into forward contracts i.e. to purchase the foreign currency at a future date for which, the exchange difference is paid in the year. Thus, this exchange difference is an upfront payment, benefit of which pertained to the period during which borrowing subsisted in lieu of periodical payment for the use of fund borrowed. Therefore, matching concept would be applied.

10. She submitted that in [M/s. Madras Industrial Investment Corporation Ltd. Vs. The Commissioner of Income Tax, Tamil Nadu-I, Madras](#), the Supreme Court had referred to this matching concept. It was held that ordinarily revenue expenditure, incurred wholly or exclusively for the purpose of business, can be applied in the year in which it is incurred. However, the facts may justify spreading the expenditure and claiming it over a period of ensuing years, where allowing the entire expenditure in one year could give a very distorted picture of the profits of a particular year. One such instance was issuing debentures at discount. The Supreme Court was of the opinion that though in such cases the assessee had incurred the liability to pay the discount in the year of issue of debentures, the payment is to secure the benefit over a number of years. There was a continuing benefit to the assessee of the company over the entire period and, therefore, the liability was to be spread over the period of debentures.

She also placed strong reliance upon the judgment of the Bombay High Court in [Taparia Tools Ltd. Vs. Joint Commissioner of Income Tax](#), . In that case also the Court had applied the matching concept under the mercantile system of accounting and held that in order to determine the net income of an accounting year, the revenue and other incomes are matched with the cost of resources consumed (expenses). Such matching was required to be done on accrual basis. The High Court also was of the opinion that under the matching concept, revenue and income earned during an accounting period, irrespective of actual cash in-flow is required to be compared with expenses incurred during the same period, irrespective of actual outflow of cash. Accordingly, the Bombay High Court allowed the assessee to spread the upfront payment made by the assessee during the first year itself, instead of periodical payment of interest, over the life of the debentures. Strong reliance was

placed on the following observations from this judgment:

#### A. Matching concept:

The Mercantile System of Accounting is based on accrual. Basically, it is a Double Entry System of accounting. Under the Mercantile System of Accounting, profits arising or accruing at the date of the transaction are liable to be taxed notwithstanding the fact that they are not actually received or deemed to be received under the Act. Under the Mercantile System of Accounting, therefore, book profits are liable to be taxed. The profits earned and credited in the books of account constitute the basis of computation of income. The system postulates the existence of tax insofar as monies due and payable by the parties to whom they are debited (see [Keshav Mills Ltd. Vs. Commissioner of Income Tax, Bombay](#), . Therefore, under the Mercantile System of Accounting, in order to determine the net income of an accounting year, the revenue and other incomes are matched with the cost of resources consumed [expenses]. Under the Mercantile System of Accounting, this Matching is required to be done on accrual basis. Under this Matching concept, revenue and income earned during an Accounting Period, irrespective of actual cash in-flow, is required to be compared with expenses incurred during the same period, irrespective of actual out-flow of cash. In this case, the assessee is following Mercantile System of Accounting. This Matching concept is very relevant to compute taxable income particularly in cases involving DRE. It has been recognised by numerous judgments. In the case of [Calcutta Company Ltd. Vs. The Commissioner of Income Tax, West Bengal](#), the facts were as follows:

The assessee bought lands and sold them in plots. When the plots were sold the purchasers paid only a portion of the purchase price and undertook to pay the balance in instalments. The assessee, in turn, agreed to develop the plots within six months. In the relevant Accounting Year, the assessee actually received only Rs. 29,392 towards sale price of the lands, but, in accordance with the Mercantile System of Accounting followed by the assessee, it credited in its accounts Rs. 43,692 representing the full sale price of the lands. At the same time, it also debited Rs. 24,809 as expenditure for the development it had undertaken even though, no part of that amount was actually spent. The Department, therefore, disallowed the expenditure of Rs. 24,809 on the ground that the amount was not actually spent. The assessee ultimately succeeded in the Supreme Court. It was held by the Supreme Court that the expression "Profits or Gains" in Section 10 of the Income Tax Act, 1922 should be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure, which is necessary for the purposes of earning the receipts is deducted therefrom. Accordingly, the Supreme Court took the view, that since the assessee was following Mercantile System of Accounting and since the assessee had credited the full sale price of lands in its accounts amounting to Rs. 43,692, the assessee was entitled to estimate the expenditure because, without such estimation of expenditure, it was not possible to

compute profits and gains. This concept is also applied by the Supreme Court in the case of [M/s. Madras Industrial Investment Corporation Ltd. Vs. The Commissioner of Income Tax, Tamil Nadu-I, Madras, .](#)

Ms. Bansal also referred to the judgment of the Bombay High Court in [Commissioner of Income Tax Vs. S.M. Holding and Finance \(P\) Ltd.,](#) in support of same plea.

11. On the basis of the aforesaid judgments, her submission was that expenses were to be allowed proportionately, i.e. the expenditure pertaining to the relevant year was to be allowed in the year under consideration and the balance had to be deferred to the subsequent year, as was done by the AO in the instant case, which was wrongly upset by the ITAT.

12. Per contra, Mr. Ajay Vohra, learned Counsel appearing for the assessee, submitted that the entire approach of the department was erroneous, inasmuch as, it was not appreciating the nature of agreements entered into by the assessee for raising foreign currency borrowings and forward contracts with banks as a safeguard against foreign currency fluctuations for repayment of foreign currency borrowings on a due date. He submitted that swapping cost incurred by the assessee, by entering into forward contract, was capable of determination at the time of execution of the forward contract and such determination does not get postponed. Once it is crystallized and formalized on the date of entering into the contract, the liability arising on account of such contractual obligation is to be allowed in entirety in the year in which the same has occurred, having regard to the terms of the contract and cannot be treated as a deferred expenditure. To buttress this submission, he referred to the judgment of the Apex Court in the case of [Calcutta Company Ltd. Vs. The Commissioner of Income Tax, West Bengal,](#) . He submitted that this principle was followed and reiterated in the following judgments:

a) Jastjit Films Pvt. Ltd. v. CIT 165 Taxman 599 (Del.)

b) [Metal Box Company of India Ltd. Vs. Their Workmen,](#)

c) ACIT v. Shree Synthetics Ltd. 207 CTR 676 (MP)

13. His submission was that in the instant case too, the assessee, in terms of its contractual obligation, is obliged to take, at a later date, delivery of the foreign currency purchased in terms of a legally binding and enforceable contract entered into on an earlier date, at a predetermined price. Under the mercantile system of accounting, the liability accrues on the date of the contract itself, notwithstanding that the delivery of foreign currency is to take place at a future point of time, as explained by the Supreme Court in the case of [E.D. Sassoon and Company Ltd. Vs. The Commissioner of Income Tax, Bombay City,](#) He also referred to another judgment of the Apex Court in the case of [Bharat Earth Movers Vs. Commissioner of](#)

[Income Tax, Karnataka](#), . In that case, the Supreme Court, after referring to its earlier judgments in Metal Box Co. (supra) and Calcutta Co. Ltd. (supra), categorically held that if a business liability had arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date.

14. We deem it appropriate to first understand the principles contained in the aforesaid judgments before proceeding to answer the question posed in the instant appeal.

15. In Calcutta Co. Ltd. (supra), the appellant therein bought lands and sold them in plots fit for building purposes undertaking to develop them by laying out roads, providing a drainage system and installing lights etc. When the plots were sold, the purchaser paid only a portion of the purchase price and undertook to pay the balance in instalments. The appellant in its turn undertook to carry out the developments within six months but time was not of the essence of the contract. In the relevant accounting year, the appellant actually received in cash only a sum of Rs. 29,392/- towards sale price of lands, but in accordance with the mercantile system of accounts adopted by it, it credited in its accounts the sum of Rs. 43,692/- representing the full sale price of lands. At the same time, it also debited an estimated sum of Rs. 24,809/- as expenditure for the developments it had undertaken to carry out, even though no part of that amount was actually spent. The Department disallowed the expenditure.

The Supreme Court was of the view that the aforesaid expenditure was allowable in the year in question though no part of that amount was actually spent as it was "accrued liability" and not merely a contingent one. The Court quoted from the book "Income Tax" {2nd Edn., Vol. II (page 204)}, authored by Simon, wherein "accrued liability" is defined as under:

In cases, however, where an actual liability exists, as is the case with accrued expenses, a deduction is allowable; and this is not affected by the fact that the amount of the liability and the deduction will subsequently have to be varied. A liability, the amount of which is deductible for income tax purposes, is one which is actually existing at the time of making the deduction, and is distinct from the type of liability accruing in *Peter Merchant Ltd. v. Stedeford (Inspector of Taxes) (1948) 30 Tax Cas. 496 C.A.*, which although allowable on accountancy principles, is not deductible for the purposes of income tax.

16. In the light of the aforesaid observations, the Apex Court proceeded to determine the nature of liability which was undertaken by the appellant therein in regard to the development of the land in question. It held that though the appellant had to carry out the developments within six months from the dates of deeds of sale, the undertaking to carry out the development was unconditional and the appellant had bound itself absolutely to carry out the same. It was not depending on

any condition being fulfilled or the happening of any event. Because of this undertaking, opined the Court, liability had already accrued on the dates of the deeds of sale, though that liability was to be discharged at a future date. It was, thus, an accrued liability and the estimated expenditure to be incurred in discharging the same could very well be deducted from the profits and gains of the business. The Court observed that inasmuch as the liability which had thus accrued during the accounting year was to be discharged at a future date the amount to be expended in the discharge of that liability would have to be estimated in order that under the mercantile system of accounting the amount could be debited before it was actually disbursed.

17. Even when the aforesaid accrued liability was on the basis of "estimated expenditure" and not actual expenditure, the Court held that it was still allowable inasmuch as the difficulty in the estimation thereof again would not convert an accrued liability into a conditional one, because it is always open to the Income Tax authorities concerned to arrive at a proper estimate thereof having regard to all the circumstances of the case. That it can be so done is illustrated by *Gold Coast Selection Trust Ltd. v. Humphrey (Inspector of Taxes) (1948) AC 459, 469 : 17 ITR (Suppl) 19, 23*, where a particular asset which could not be immediately realized in a commercial sense was valued in money for Income Tax purposes in the year of its receipt.

18. In *Metal Box Co. Ltd. (supra)*, where bonus payable to the workmen and liability under a scheme of gratuity in respect of the accounting year was stated in the profit and loss account, though not actually paid, the Court allowed the same in the following words, relying upon the judgment in *Calcutta Co. Ltd. (supra)*:

In the case of an assessee maintaining his accounts on mercantile system, a liability already accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy. It is not as if such deduction is permissible only in case of amounts actually expended or paid. Just as receipts, though not actual receipts but accrued due are brought in for Income Tax assessment, so also liabilities accrued due would be taken into account while working out the profits and gains of the business.

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In the instant case, the question is not whether such estimated liability arising under the gratuity schemes amounts to a debt or not. The question that concerns us is whether, while working out the net profits, a trader can provide from his gross receipts his liability to pay a certain sum for every additional year of service which he receives from his employees. This, in our view, he can do, if such liability is properly ascertainable and it is possible to arrive at a proper discounted present value. Even if the liability is a contingent liability, provided its discounted present value is

ascertainable, it can be taken into account. Contingent liabilities discounted and valued as necessary can be taken into account as trading expenses if they are sufficiently certain to be capable of valuation and if profits cannot be properly estimated without taking them into account. Contingent rights, if capable of valuation, can similarly be taken into account as trading receipts where it is necessary to do so in order to ascertain the true profits: (see C.N. Beatti's Elements of the Law of Income and Capital Gains Taxation, 8th edition, p. 54).

19. The principle is merely summed up by the Supreme Court in *Bharat Earth Movers* (supra) in the following manner:

The law is settled: if a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If these requirements are satisfied the liability is not a contingent one. The liability is in praesenti though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be discharged is not certain.

20. When we apply the aforesaid principle to the facts of this case, the irresistible conclusion would be that the ITAT rightly held that the assessee was entitled to claim deduction of Rs. 67.06 crores incurred in connection with swapping of foreign currency funds in the year under consideration, i.e. the assessment year 1995-96. It is clear from the nature of the transaction, that the assessee had raised foreign currency borrowings and swapped such foreign currency into Indian rupees in order to augment its rupee resources for meeting its lending requirements. The foreign currencies borrowed were repayable to the foreign lenders on later dates falling within the current previous year ending on 31.3.1995 and in some cases falling in the next previous year relevant to subsequent assessment year. In order to ensure that it is able to repay the foreign lenders in the foreign currency on their respective due dates of repayments, the assessee had entered into forward contracts as a safeguard against foreign currency fluctuations. It is the difference between the forward contract rate and the exchange rate on the date of transaction which was claimed as deduction in that very year. The forward contract is an agreement between two parties, requiring the delivery at some specified future date of a specified amount of foreign currency by one of the parties, against payment in domestic currency to the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contract is called the forward exchange rate and the market for forward transactions is known as the forward market. Thus, in case of a forward contract, assessee enters into a legally binding, enforceable contract for purchase of foreign currency on a future date at the pre-determined rates. The date and the rate of purchase of the foreign currency are decided at the time of entering into contract. The difference between the forward contract and the



exchange rate on the date of entering into the contract has to be recognized as income or expenses, which is ascertained and definite, in terms of the contract and cannot be regarded as notional or contingent. It is clear that the swapping cost incurred by the assessee is capable of determination at the time of execution of the forward contract and such determination does not get postponed.

21. Therefore, the test laid down in the aforesaid judgments to treat it as business expenditure in the same year, though part of the liability occurs on a future date, is allowable as expenditure in this very year. It was a debt owed by the assessee, which accrued on the date of entering into the forward contract itself, though as per the contract, part payment was to be made in succeeding years. The expenditure under the accrual system of accounting had, thus, crystallized on the date of the contract.

22. The judgments on which reliance is placed by the learned Counsel for the Revenue would be of no avail in the instant case. The learned Counsel for the Revenue had strongly argued that matching concept is to be applied, as per which part of the expenditure had to be deferred and claimed in the subsequent years and, therefore, approach of the AO was correct. However, this argument overlooks that even in *Madras Industrial Investment Corporation (supra)*, on which the reliance was placed by Ms. Bansal, the general principle stated was that ordinarily revenue expenditure incurred wholly and exclusively for the purpose of business can be allowed in the year in which it is incurred. Some exceptional cases can justify spreading the expenditure and claiming it over a period of ensuing years. It is important to note that in that judgment, it was the assessee who wanted spreading the expenditure over a period of time as was justifying such spread. It was a case of issuing debentures at discount; whereas the assessee had actually incurred the liability to pay the discount in the year of issue of debentures itself. The Court found that the assessee could still be allowed to spread the said expenditure over the entire period of five years, at the end of which the debentures were to be redeemed. By raising the money collected under the said debentures, the assessee could utilize the said amount and secure the benefit over number of years. This is discernible from the following passage in that judgment on which reliance was placed by the learned Counsel for the Revenue herself:

The Tribunal, however, held that since the entire liability to pay the discount had been incurred in the accounting year in question, the assessee was entitled to deduct the entire amount of Rs. 3,00,000 in that accounting year. This conclusion does not appear to be justified looking to the nature of the liability. It is true that the liability has been incurred in the accounting year. But the liability is a continuing liability which stretches over a period of 12 years. It is, therefore, a liability spread over a period of 12 years. Ordinarily, revenue expenditure which is incurred wholly and exclusively for the purpose of business must be allowed in its entirety in the year in which it is incurred. It cannot be spread over a number of years even if the assessee has written it off in his books over a period of years. However, the facts

may justify an assessee who has incurred expenditure in a particular year to spread and claim it over a period of ensuing years. In fact, allowing the entire expenditure in one year might give a very distorted picture of the profits of a particular year. Thus in the case of [Hindustan Aluminium Corporation Ltd. Vs. Commissioner of Income Tax](#), the Calcutta High Court upheld the claim of the assessee to spread out a lump sum payment to secure technical assistance and training over a number of years and allowed a proportionate deduction in the accounting year in question.

16. Issuing debentures at a discount is another such instance where, although the assessee has incurred the liability to pay the discount in the year of issue of debentures, the payment is to secure a benefit over a number of years. There is a continuing benefit to the business of the company over the entire period. The liability should, therefore, be spread over the period of the debentures.

23. Thus, the first thing which is to be noticed is that though the entire expenditure was incurred in that year, it was the assessee who wanted the spread over. The Court was conscious of the principle that normally revenue expenditure is to be allowed in the same year in which it is incurred, but at the instance of the assessee, who wanted spreading over, the Court agreed to allow the assessee that benefit when it was found that there was a continuing benefit to the business of the company over the entire period.

24. What follows from the above is that normally the ordinary rule is to be applied, namely, revenue expenditure incurred in a particular year is to be allowed in that year. Thus, if the assessee claims that expenditure in that year, the Income Tax department cannot deny the same. However, in those cases where the assessee himself wants to spread the expenditure over a period of ensuing years, it can be allowed only if the principle of matching concept is satisfied, which upto now has been restricted to the cases of debentures.

25. The upshot of the aforesaid discussion is to answer the question in favour of the assessee and against the revenue. The consequence would be to dismiss this appeal, which is hereby dismissed with costs.