

CBDT instruction to its staff regarding allowing losses on account of forex derivatives

Foreign Exchange derivative transactions entered into by the corporate sector in India have witnessed a substantial growth in recent years. This combined with extreme volatility in the foreign exchange market in the last financial year is reported to have resulted in substantial losses to an assessee on account of trading in forex-derivatives. A large number of assesses are said to be reporting such losses on 'marked to market' basis either suo motu or in compliance of the Accounting Standard or advisory circular issued by the Institute of Chartered Accountants. The issue whether such losses on account of forex-derivatives can be allowed against the taxable income of an assessee has been considered by the Board. In this connection, I am directed to say that the Assessing Officers may follow the guidelines given below:

'Marked to Market Losses':

2. "Marked to Market" is in substance a methodology of assigning value to a position held in a financial instrument based on its market price on the closing day of the accounting or reporting record. Essentially, 'Marked to Market' is a concept under which financial instruments are valued at market rate so as to report their actual value on the reporting date. This is required from the point of view of transparent accounting practices for the benefit of the shareholders of the company and its other stakeholders. Where companies make such an adjustment through their Trading or Profit/Loss Account, they book a corresponding loss (i.e the difference between the purchase price and the value as on the valuation date) in their accounts. This loss is a notional loss as no sale/conclusion/settlement of contract has taken place and the asset continues to be owned by the company.

A 'Marked to Market' loss may be given different accounting treatment by different assesses. Some may reflect such loss as a balance sheet item without making any corresponding adjustment in the Profit and Loss Account. Other may book the loss in the Profit and Loss Account which may result in the reduction of book profit. In cases where no sale or settlement has actually taken place and the loss on Marked to Market basis has resulted in reduction of book profits, such a notional loss would be contingent in nature and cannot be allowed to be set off against the taxable income. The same should therefore be added back for the purpose of computing the taxable income of an assessee.

3. Treatment of loss from actual transactions in forex-derivatives

In a case where a loss on a forex-derivative transaction arises on actual settlement / conclusion of contract and is not a notional or marked to market book entry, a further question will arise as to whether such a loss is on account of a speculative transaction as contemplated in Section 43(5) of the Income tax Act. For determining whether loss from a transaction in respect of a forex-derivative is a speculation loss or not, the Assessing Officers may refer to Proviso (d) below sub-section (5) of Section 43 inserted by the Finance Act, 2005, with effect from 1.4.2006. It lays down that any 'eligible transaction' in respect of trading in derivatives referred to in clause (ac) of section 2 of the Securities Contracts (Regulation) Act, 1956, that has been carried out in a recognized stockexchange shall not be treated as a speculative transaction. Further, an 'eligible transaction' for this purpose would be one that fulfils the conditions laid down in Explanation to Section 43(5)(d). Any loss in a speculative transaction can be set off only against profit from speculative transactions.

As the revenue implications of such transaction are large, the Assessing Officers need to examine the statements of accounts and the notes to accounts with a view to find out any reference to any loss on account of forex-derivatives. In

some cases, these losses may be camouflaged under the 'financial charges' 'foreign exchange loss' or some similar head which may make it difficult to detect them. In such cases, the Assessing Officers should make a specific query asking the assessee to give a break up of any 'Marked to Market' loss on a forex-derivatives included in the Profit and Loss Account and examine whether such transactions are 'eligible transaction' in terms of Sec.43(5)(d). An adjustment to the taxable income may therefore be made, if necessary, keeping in view the provisions of law referred to above.