

**BEFORE THE AUTHORITY FOR ADVANCE RULINGS
(INCOME TAX) NEW DELHI**

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P R E S E N T

**Hon'ble Mr. Justice Syed Shah Mohammed Quadri (Chairman)
Mr. K.D. Singh (Member)
Mr. K.D. Gupta (Member)**

Monday, the Thirty First May Two Thousand Four

A.A.R. NO. 508 OF 2000

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| Name & address of the applicant | M/s. Sopropa S.A., C/o Me Rene Merkt. 15, rue General Dufour, 1204 Geneva, Switzerland. |
| Commissioner concerned | Director of IncomeTax(Int. Taxn.), Delhi. |
| Present for the Department | Mr. S.M.J. Abidi, Addl. Director of Income-tax, Range-2, New Delhi. |
| Present for the Applicant | Mr. Satyen Sethi, Advocate Mr. M.S. Syali, Sr. Advocate & Mr. Manu K. Giri |

**R U L I N G
(By Mr. K.D. GUPTA)**

The applicant 'Sopropa S.A.' is a company incorporated in Switzerland and is assessed to income-tax in that country. It proposes to open a branch office in India for dealing in 'Green Coffee'.

2. The modus operandi of the proposed business plan relevant for purpose of advance ruling is as follows :-

- a) The applicant's Branch office shall buy the "green coffee" in India and sell the same either to 'processors' in India or export them to parties outside India. 'Processors' are the persons who make processed coffee out of "Green Coffee".
- b) The "green coffee" is essentially a seasonal crop which arrive in market once a year in second quarter of the year for very limited period.
- c) The sale of "green coffee" to 'processors' in India or to parties outside India shall take place throughout the year and the sale price of "green coffee" is largely determined by the then prevailing price in the international market.
- d) The applicant to carry on its business of sale of green coffee throughout the year will have to stock huge inventory of green coffee for most part of the year though it will have to buy its entire requirement during the short period of its availability in second quarter of the year
- e) Since the sale price of "green coffee" is linked to its price in the international market, the applicant will be exposed to risk of price fluctuations between the time of purchase of "green coffee" and its subsequent sale during the year.

3. It is stated that the applicant to safeguard itself against price fluctuations in respect of stock of "green coffee" will have to enter into hedging transactions on the International Commodity Exchange (hereinafter referred to as ICE in short) in which it would initially sell the "green coffee" (not necessarily of the same variety as held in stock) and thereafter settle said transaction by entering into a purchase transaction without taking actual delivery. The contract for sale of

“green coffee” will follow the hedging transaction at ICE because the contract of sale of green coffee necessarily as per business practice is entered into at the time of actual delivery.

4. Based on the above facts, the applicant has sought rulings on the following questions :-

“1. Whether on facts and circumstances stated in Annexure II, hedging in respect of stock in which the applicant deals in will be covered by clause (a) of proviso to section 43(5) of the Income-tax Act, 1961?

2. Whether the existence of contract of sale of stock in trade is a condition precedent to attract clause (a) of proviso to section 43(5) of the Act?

3. Whether on true and correct interpretation of clause (a) of proviso to section 43(5), the words “a contract in respect of merchandise” cover not only the forward purchase transaction but also forward sale transaction?

4. Whether on true and correct interpretation of clause (a) of proviso to section 43(5), the hedging transaction should also be of the same quality/quantity of goods as are held in stock?”

5. The applicant’s learned counsel explained that section 43(5) of the Income Tax Act, 1961 (the Act) and Central Board of Revenue (the Board) Circular No.23D (F.No.412/(4)60/TPL dated 12.9.1960) are relevant for understanding the applicant’s interpretation of law in respect of the questions on which advance ruling is sought. The counsel stated that section 43(5) of the Act defines a ‘speculative transaction’ to mean a transaction in which a contract for purchase or sale of any commodity, including stock and shares, is periodically or ultimately

settled otherwise than by the actual delivery or transfer of commodity or scrips. The section by way of proviso thereto provides for three exceptions. The first exception provided by clause (a) to the proviso is relevant to the applicant's case. The said proviso reads as under :-

“(a) a contract in respect of raw material or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through price fluctuations in respect of his contract for actual delivery of goods manufactured by him or merchandise sold by him”

6. The said exception is known as a hedging contract. The basic condition of exception created by this clause is that hedging in respect of merchandise should be intended to guard against price fluctuations in respect of contract of sale of actual delivery of merchandise. The counsel claimed that there is no warrant to read proviso (a) to section 43(5) so as to justify an inference that legislature intended to exclude from speculative transactions only the contract of sale of merchandise entered into by a person in the course of his merchandising business to guard against loss through price fluctuations. In the commercial world, in order to effectively hedge against adverse price fluctuations of merchandise, a merchant has necessarily to enter into forward transaction of both sale and purchase because without these contracts for sale and purchase constituting hedging transactions, there would be no effective insurance against the risk of loss in the price fluctuations of merchandise sold.

7. The counsel explained that his understanding of the scope of hedging transactions is in conformity with the opinion expressed by Central Board of Revenue (now Central Board of Direct Taxes) in Circular No.23D dated September 12, 1960 rendered in the context of parimateria clause (a) of the proviso to explanation 2 of section 24(1) of the Indian Income-tax Act, 1922. It was opined that the intention has always been that where bonafide forward sale transactions are entered into with a view to guarding against the risk of raw

materials or merchandise in stock falling in value, the loss arising as a result of such forward sales should not be treated as speculative losses.

8. According to counsel, even in commercial parlance, the hedging transaction need not be subsequent in point of time to contracts for sale and actual delivery of merchandise, but the later may be subsequently entered into. The conditions which must be satisfied are that trader must have entered into such a contract to guard against loss through price fluctuations of merchandise, the total of such hedging transaction should not exceed the total stock of merchandise, which include existing stock as well as stock acquired under firm contracts of purchase, and such hedging transactions are within reasonable time not exceeding generally the assessment year. This view has been upheld by Gujarat High Court in the case of Pankaj Oil Mills Vs. CIT (1978) 115 ITR 824.

9. Director of International Taxation, New Delhi is the jurisdictional Commissioner in this case. He is of the view that interpretation of section 43(5) made by the applicant is not correct. According to him, the applicants' hedging contract will not be covered by clause (a) of proviso to section 43(5) of the Act. Clause (a) of proviso to section 43(5) of the I.T.Act contemplates that the contract for sale should precede the hedging transaction. The Allahabad High Court has in the case of Raghunath Dass Prahlad Das v. CIT (1976) 104 ITR 95 taken the view that 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 forward contracts, he cannot claim the benefit of a hedging contract. The Madras High Court has also in the case of Gomraj Fatehchand v. CIT(1976) 102 ITR 131, taken the view that unless the assessee shows that the forward contracts of purchase entered into by him, which were ultimately settled by payment of the difference in price were to guard against loss through future price fluctuations in respect of specified contracts of sale for actual delivery, the transactions could not be treated as hedging transactions. Same view was taken by the Calcutta

High Court also in the case of Becker Gray & Co. v. CIT (1983) 139 ITR 203. Further, in para 4 of Annexure-II, the applicant has mentioned that hedging transaction would be in the form of a sale. The Madras High Court in CIT v. S.K.AR.K.AR. Somasunderam Chettiar & Co. (1975) 101 ITR 832 has held that only contracts of purchases could be covered under hedging transactions. This decision was later on affirmed by the Supreme Court also (1992) 194 ITR 1 (SC).

10. In relation to question No.4, the Director has commented that the hedging transaction can be in connected commodity also (and not necessarily in the same commodity) so long it is a genuine hedging transaction (Board's decision on point (ii) in Circular No.23D of 12.9.60). However, as far as quantity is concerned, the Andhra Pradesh High Court held in the case of M.G.Bros. v. CIT (1985) 154 ITR 695 that it was not a hedging contract because there was no evidence that the assessee had adequate stock of raw materials to the extent of the forward transaction.

11. In his rejoinder, the counsel stated that there is difference of opinion on the point raised by Jt. Director of Income Tax in as much as Gujarat High Court in Pankaj Oil Mills Vs. CIT 115 ITR 924 dissenting from the decisions of Raghunath Das Prahlad Das (supra) and Somasundaram Chettiar & Co. (supra) has held that there is no warrant or justification for restricting the width of the words "a contract in respect of raw-material or merchandise entered into" to mean the contract for purchase only. It was further observed that had that been the intention, the Parliament would have worded the section differently. Overruling its earlier decision in Chimanlal Chhotalal vs. CIT 69 ITR 129 (Guj), the Hon'ble Court held that "in the ultimate analysis, by hedging transactions a trader by a corresponding contract of sale and purchase in the forward market tries to offset the likely loss which may arise in the ready market due to adverse price fluctuations." Having so interpreted proviso (a) to section 43(5) the Hon'ble Court observed that "the only condition, in our opinion, which should be satisfied before an assessee can claim a contract entered into in respect of raw-

materials or merchandise should not be considered as a speculative transaction is that he must have entered into such a contract to guard against the loss through price fluctuations or manufactured goods or merchandise sold in respect of which he might have entered into contracts of sale for actual delivery". In other words, in order to be genuine and valid, the total of such transactions of hedging contracts of sales should not exceed the total stocks of raw material or the merchandise on hand. Further, the Board in Circular No.23D dated 12th September, 1960(F.No.4(124)/60-TPL) in response to the query whether clause (a) of proviso to Explanation 2 to section 24(1) of 1922 Act (which corresponded to section 43(5) exclude from the category to speculative transactions only a "hedging purchase" and not a "hedging sale" transaction, replied that where bonafide forward sales are entered into with a view to guarding against the risk of raw-material or merchandise falling in value, the losses arising as a result of such forward sales should not be treated as speculation losses.

12. It is further stated that as far the decision of Somasundaram Chettiar & Co. (supra) which has been affirmed by the Supreme Court in 194 ITR 1 (SC), is considered, it is stated that the view of the Central Board of Direct Taxes in Circular No.23 dated 12.9.60 was overlooked. Thus, the aforesaid view is against the benevolent circular, which is binding on the authorities. Reference in this regard is made to the decision of UCO Bank vs. CIT 237 ITR 889 (SC), wherein, the Hon'ble Apex-Court did not follow its earlier decision in the case of State Bank of Travancore vs. CIT 158 ITR 102 because in the earlier case benevolent circular was not pointed out to the court. Therefore, the decision of Supreme Court in Somasundaram Chettiar & Co. (supra) is to be examined/understood with reference to the ratio laid down by Supreme Court in UCO Bank's case (supra).

13. The counsel pointed out that without prejudice, the facts of Somasundaram Chettiar & Co.'s case (supra) were peculiar. In the aforesaid case assessee had initially entered into contracts for purchase of certain goods

from the mills. He then entered into a contract of sale of the same goods to a party. Later, he entered into a contract to repurchase the same goods from the same party. Subsequently, he took delivery of the goods from the mills and sold them to other parties. So far as contracts of purchase and sale with the first mentioned party are concerned, he settled them by paying the difference resulting in loss. In these circumstances, it has been held that the said clause (a) was not attracted in respect of such loss as to take the same out of the purview of the main section 43(5).

14. As regards Director's comments on Question No.4, the counsel claimed that the Director agrees with his interpretation of Board's Circular. However, reference has been made to M.G. Bros. Vs. CIT 154 ITR 695(AP), wherein it was held that the Circular of the CBDT No.23(XXXIV-4) D of 1960 would not be applicable where the forward contracts are not in the same line of business. In the aforesaid case, assessee was in the business of manufacture and sale of "groundnut oil and its by products" but alleged hedging transactions were entered into in "cotton seed oil and neem oil". The ratio of aforesaid decision is not applicable because applicant would enter into hedging transaction in respect of "green coffee" i.e., the business which applicant would carry on.

15. During the course of hearing the counsel for the appellant took us through the provisions of section 43(5) of the Act and the Board's Circular No,23 D. He placed reliance on the decision of the Gujarat High Court in the case of Pankaj Oil Mills Vs. CIT (1978) 115 ITR 824. He pleaded that a hedging contract can be either for purchase or sale as has been explained in the Circular of the Board and the said Circular is binding on the Assessing Officers.

16. Shri S.M.J. Abidi, Jt. Director of Income-tax, International Taxation, who appeared on behalf of the Department placed reliance on the decision of Allahabad High Court in the case of Raghunath Das Prahlad Das Vs. CIT (1976) 104 ITR 95. The court had held that unless 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 such loss that he entered into forward contracts, he cannot claim the benefit of hedging contracts. He pleaded that in the case S.K.AR. Somasundaram Chettiar & Co. (1992) 1994 ITR 1, the Supreme Court has confirmed the Madras High Court order that only contracts of purchases could be covered under hedging contracts. The judgment of the Supreme Court being of a date subsequent to the date of the Board's Circular, was binding on all the authorities.

17. Before we deal with the merits of the arguments put forth by the learned counsel of the applicant and the departmental representative, it would be appropriate to extract the relevant provisions of the Act and the relevant paragraphs of the Board's Circular.

18. Section 43(5) and proviso (a) thereto reads as under :-

“(5) “speculative transaction” means a transaction in which a contract for the 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:

Provided that for the purposes of this clause –

(a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting business to guard against loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him;”

19. The preamble and point Nos.1 & 2 of the Board's Circular No.23 D of 12.9.1960 are extracted below :-

“A number of representations and suggestions have been received by the Board from associations and Chambers of Commerce regarding the manner in which the provisions of section 24, particularly those of Explanation 2 to sub-section(1) thereof, are being interpreted and applied

by the ITOs. The Direct Taxes Administration Enquiry Committee have also made a few suggestions on this subject in Chapter III of their Report. The Board have carefully considered the points involved and their decisions thereon are given below :

Point 1 – Under clause (a) of the proviso to Explanation 2 to section 24(1), the Income-tax Officers exclude from the category of speculative transaction only a “hedging purchase” transaction entered into with reference to specified contracts for sale of goods but does not so exclude a “hedging sale” transaction made against stocks in hand or against contracts for purchase of ready goods. The latter type of transactions are also genuine transactions and should be excluded from the category of speculative transactions so that any losses sustained therein will be allowed to be set off against other income.

Board’s decision – The intention has always been that where bonafide forward sales are entered into with a view to guarding against the risk of raw materials or merchandise in stock falling in value, the losses arising as a result of such forward sales should not be treated as speculation losses. Accordingly, ITOs should not treat such transactions as speculative transactions within the meaning of Explanation 2 of section 24(1). It is to be noted in this connection that hedging sales can be taken to be genuine only to the extent the total of such transactions does not exceed the total stocks of raw materials or merchandise in hand. If the forward sales exceed the ready stock, the losses arising from the excess transactions should be treated as loss arising from speculative transactions and not from genuine hedging transactions.

Point 2 – Hedging transactions in connected, though not the same, commodities should not be treated as speculative transactions.

Board’s decision – The Board accept this point. Attention is invited to Board’s Letter No.13(102)IT/53, dated 8.9.1854 in which it was stated that as regards hedging in raw materials, the Income-tax Officers should not be too particular about the quantities and timing so long as the transactions constitute genuine hedging. Similarly, Income-tax Officers should not treat genuine hedging transactions in connected commodities as speculative transactions though the transactions may not be incidentally the same commodity. Thus, hedging transactions in one type of cotton against another type of cotton, one variety of oil seed against another, one type of grain against another, should not be treated as speculative transactions provided the other conditions of Explanation 2 to section 24 are satisfied. The condition mentioned in the last two sentences of the decision on point 1 above will apply here also.”

20. We do not agree with the contention of the departmental representative that since the Supreme Court's judgment in the case of Somasundarm Chettiar & Co. does not refer to the Board Circular, it is not applicable to this case. The Circular did not apply to the facts of that case. Even if it had been referred to before the Court, it would not have made any difference.

21. Now the scope of the provisions of the Act and the Circular of the Board have to be examined in the light of material placed before us. Before the issue of Circular of the Board, the Income-tax authorities gave a restrictive meaning to the hedging transactions. The said view was also confirmed by various High Courts including Madras High Court and Allahabad High Court in the cases relied on before us. It was however, brought to our notice that in the case of Raghunath Das Prahlad Das (supra), Allahabad High Court followed Gujarat High Court's decision in the case of Chimanlal Chhotalal (1968) 69 ITR 129. However, a larger Bench of Gujarat High Court overruled the decision in Chimanlal Chhotalal's case in the case of Pankaj Oil Mills (supra). There is no doubt that within the meaning of proviso (a) to section 43(5) the transaction proposed to be undertaken by the applicant cannot be termed as 'hedging contracts' at all. It is, therefore, necessary to examine whether the case of the applicant is covered by the concession allowed by the Board through its beneficial circular No.23 D which is binding on the officers of the Department.

22. For proper appreciation of the scope of the Board's Circular, it will be useful to refer to the observations in the Report of the Direct Taxes Administration Enquiry Committee in paragraphs 3.55, 3.56 and 3.58 of Chapter III, which read as under :-

"3.55 Definition of speculative transaction – An important criticism made by a large number of witnesses who appeared before us, had been that the assurance given by Shri C.D. Deshmukh, with regard to the treatment of bonafide hedging transactions as ordinary business, was not being duly

implemented. It was stated that the spirit of the amendments had been lost sight of by the department in the course of administration of the proviso and that sometimes even genuine hedging losses were being treated as speculative losses. In this connection, the distinction in the phraseology of clauses (a) and (b) of Explanation 2 to section 24(1) of the Income-tax Act, 1922, was brought to our notice. It was pointed out that while one clause made a reference to stocks held, the other did not and that some officers were taking a restrictive view and disallowing the deduction of hedging losses in commodities other than stocks and shares, if they were not against stocks held but against purchases.

3.56 We have examined the same at some length. We find that even the Central Board of Revenue had put too rigid and restrictive an interpretation on this provision, which is not in accord with the spirit of the assurances given by the Finance Minister. It does not, therefore, surprise us that the assessing officers have also taken an unduly narrow view in the matter and the genuine businessmen have been put to considerable hardship. We certainly appreciate, as we have done earlier, the principle under-lying the proviso, but we equally disapprove of its wrong application for denying genuine hedging losses. We feel that the solution to the various problems which have been brought to our notice in relation to this subject can be found by expanding Explanation 2 to section 24(1) so as to classify and exclude such transactions which should not come under the mischief of this section. The assessing officer should first examine whether a hedging transaction is genuine or not. If it is a genuine one, and it is by way of future sale of a commodity against stock of the same commodity, the loss arising out of this transaction should be excluded from the purview of speculation.....

3.58 The hardship caused by a too literal interpretation of Explanation 2 to section 24(1) of the Income-tax Act was illustrated to us by a case where a dealer having ready cloth business entered into a contract for the purchase of 1000 bales of cloth from a mill on a forward delivery basis. Ultimately, it was found that the mill could supply only 980 bales, the remaining twenty bales being rejected on account of some defect and the settlement was made between the dealer and the mill regarding these twenty bales by payment of difference in price. It was stated even such a transaction was taken by the assessing officers to fall within the mischief of the Explanation 2 to section 24(1) of the Income –tax Act on the ground that there was no actual delivery of the twenty bales. We are certain that this extreme view could never have been the intention of the legislature while inserting the Explanation. Since instances of this type have been brought to our notice, we recommend that the intentions of the Government in the matter should be clarified by suitable administrative instructions. “

23. There can be no doubt, the Circular of the Board has expanded the scope of 'hedging transactions', but it would be wrong to conclude that all the speculative transactions can be termed as 'hedging' simply because they are in the commodities dealt with by an assessee. The basic premise of the Circular is that a hedging transaction is genuine. The Act originally provide that where an assessee has entered into a contract of sale for actual delivery on a future date and he then enters into a forward contract of purchase to minimize his loss due to price fluctuations, such a contract of purchase shall not be regarded as 'speculative transaction'. It was brought to the notice of the Board that a trader who has merchandise in stock may enter into a transaction of 'hedging sales' with a view to guard against the risk to merchandise in stocks falling in value and thereafter the Board issued the said Circular and expanded the scope of hedging transactions.

24. Keeping in view the Circular No.23 D, and the decision of the Gujarat High Court in the case of Pankaj Oil Mills, in the case of a trader, the following position emerges in regard to scope of hedging contracts:-

- (1) Hedging contracts can be both for purchase and sale;
- (2) In order to be genuine and valid hedging contract of sales, the total of such transactions should not exceed the total stock of the raw material or merchandise on hand;
- (3) In order to be genuine and valid hedging contract of purchase, there should be an existing forward contract of sale by actual delivery'
- (4) The hedging contracts need not necessarily be in the same variety of the commodity. They could be in connected commodities e.g. one type of cotton against another type of cotton.

25. The applicant is a trader in 'Green Coffee'. It has to purchase and stock substantial quantity of green coffee during the limited period since coffee is a seasonal crop. The sales of green coffee will be spread over the whole year at

the price prevailing in the International market. The applicant to safeguard itself against price fluctuations will enter into hedging contracts in which it would initially sell green coffee in International Commodity exchange and thereafter settle said transaction by entering into purchase transaction. Such forward contract of sale of green coffee to the extent of stock will be covered within the meaning of 'hedging contract' as explained in the Board Circular No.23 D of 12.9.1960.

26. We accordingly rule as under :-

Q.No.1 – In view of the meaning assigned to it in the Board's Circular No.23 D of 12.9.1960, on facts and in circumstances of the case, forward transactions in respect of stock in which the applicant deals will be in the nature of hedging contracts.

Q.No.2 - Though the existence of contract of sale is a condition precedent to attract clause (a) of proviso to section 43(5) of the Act, it stands relaxed to the extent allowed by Circular No. 23D of 12.9.1960.

Q.No.3 - Forward sale transactions, though not covered within the meaning of hedging contracts as per proviso (a) to section 43(5), they are covered within the extended meaning given in Board's Circular No.23D of 12.9.1960.

Q.No.4 - In view of extended meaning assigned to hedging transactions in the Board in Circular No. 23D of 12.9.1960, the hedging contracts need not be of the identical quality/quantity of the goods held in stock.

Pronounced by the Authority on this 31st.day of May, 2004

**Sd/-
(JUSTICE S.S.M. QUADRI)
CHAIRMAN**

**Sd/-
(K.D. SINGH)
MEMBER**

**Sd/-
(K.D.GUPTA)
MEMBER**

F.No. AAR/508/2000

Dated

(A) This copy is certified to be a true copy of the advance ruling and is sent to:

1. The applicant.
2. The Director of Income-tax(International Taxation), New Delhi.
3. The Joint Secretary (FT&TR.), M/Finance, CBDT, North Block, New Delhi.
4. Guard file.

(B) In view of the provisions contained in Section 245S of the Act, this order should not be given for publication without obtaining prior permission of the Authority.

**(Pramila Shrivastav)
Secretary,**