$~
* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

RESERVED ON: 19.03.2015
% **PRONOUNCED ON: 15.05.2015**

+ **ITA 37/2000**

IRCON INTERNATIONAL LTD. ..... Appellant
Through: Mr. V.Giri, Sr. Advocate with
Mr. Tanmay Mehta, Advocate.

versus

DEPUTY COMMISSIONER OF INCOME TAX
..... Respondent
Through: Mr. Kamal Sawhney, Sr. Standing
Counsel with Mr. Basabraj Chakraborty and
Mr. Shikhar Garg, Advocates.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE R.K. GAUBA

JUSTICE S.RAVINDRA BHAT

%

1. The question of law which arises in this appeal, under Section 260A of the Income Tax Act, 1961 (hereafter "the Act") is: **-**

> *"Whether the assessee's claim that there was a loss and/or it was a capital loss is legally tenable"*

2. The order impugned in this case was made by the Income Tax Appellate Tribunal ("ITAT") on 19.04.1999, dismissing ITA

4486/Del/1998. The impugned order upheld the concurrent findings of the AO and the CIT (A) with respect to the amounts accruing, during the assessment year, to the assessee from bonds issued to it, by the Central Government, *in lieu* of the debt amounts payable to it for services under contract to the Iraqi Government.

3. The brief facts are that in the year 1983-84, the Government of Iraq expressed inability to pay the US Dollar Component to the assessee and other project exporters who had provided services under contract to it, under those contracts due to its involvement in war with Iran. Protocol Agreements were signed between the Union (Indian) Government and Government of Iraq. Banking arrangements were also worked out between Exim Bank of India and Central Bank of Iraq. In consideration of the appellant assigning debt receivables for the work done in US$ entered in the books of Central Bank of Iraq by executing Deed of Assignment dated 10.3.1995, the Central Government of India, pursuant to its notification dated 24.3.1995 issued Compensation Bonds-2001 governed by the provisions of the Public Debts Act, 1944 and the Public Debt Rules, 1945.

4. By computing the value of such bonds, on indexed cost of acquisition the assessee claimed loss in its return for Assessment Year 1995-96. The loss under the head 'Capital Gains" was stated at ₹1,48,22,66,649/-. By Assessment Order dated 6.3.1998 under Section 143(3) of the Income Tax Act, the Assessing Officer (AO) was of the view that the head of 'Capital Gains' was not attracted to the deduction claimed by the assessee in its return for Assessment Year (AY) 1995-96. The AO held the amount to be taxable under the head

"Income from business and profession". In the appeal against said order, the learned CIT (A) by order dated 1.7.1998 was of the view that since the Government of India issued compensation bonds to the assessee *in lieu* of debts due from Government of Iraq, this receipt was nothing but "Profit & Gain of business" taxable under Section 28 of the Income Tax Act. The assessee's appeal to ITAT was unsuccessful. It consequently appeals to this Court.

5. For the assessee, learned senior counsel Mr. V. Giri urged that the terms and stipulations contained in the Deed of Assignment executed in favour of the Central Government entitled the assessee to receive the value in the form of Compensation Bonds in 2001 and was not considered properly. It was argued that the Iraqi Government's debts, recoverable by the assessee, were in the nature of blocked/sterilized debts or money. In terms of the Government to Government protocol agreements, the banking arrangements between the Exim Bank of India and the Central Bank of Iraq and the relative developments vis-a-vis the debts detailed in the Deed of Assignment, had to be determined under the Act. The assessee was not entitled to and was in fact barred from using the receivables from the Iraqi Government in any manner, much less in the course of, or in carrying on its business activities. This was due to the supervening impossibility caused by entirely extraneous circumstances. The effect, however, was that the amounts could never be said to have been the main part of its entitlement. The acceptance of compensation bonds under these circumstances upon assigning of the Iraqi debts (to the Central Government) was not a part of the appellant's business or

trading activities. Counsel, therefore, faulted the ITAT's findings on this aspect.

6. Mr. V. Giri, learned senior counsel relied upon the judgment of the Supreme Court in *Sutlej Cotton Mills v. CIT, West Bengal*, 116 ITR 1 (SC) and highlighted the distinction between fixed capital and circulating capital. The former is what the owner turns into profit by keeping it in his possession and the latter is what makes profit by parting with and letting it change masters. Circulating capital consequently means amounts employed in trading operations of the business and dealings with it comprise "trading receipts" and "trading disbursements". It was also submitted that *Sutlej* is an authority for the further propositions that it can never be stated with certainty that a trader's assets be placed in two compartments only, and that the character of the deposits is to be determined to see if it is employed in trading operations.

7. Learned senior counsel also relied upon the judgment of the Supreme Court in *Commissioner of Income Tax, Mysore v. Canara Bank Ltd.*, AIR 1967 SC 417. In that case, the question that the Supreme Court had to deal with related to the foreign exchange fluctuation difference which had accrued to the assessee on account of an embargo placed due to difficulties in remittances from the foreign branch of an Indian Bank. The devaluation of the foreign currency led to an increase in the value of the Indian Rupee and enhanced the amounts lying in the assessee's account at its overseas branch. The Court upheld the High Court's decision that the increment which arises in such eventuality was not due to trading operations in the

carrying on of banking business and that the assessee's amount was a blocked or sterilized balance for the period or duration it could not be utilized until it was finally remitted to India. The Court then went on to state: -

> *"in our opinion, the money changed its character "of stock-in-trade" when it was "blocked" and "sterilized" and the increment in its value owing to the exchange fluctuation must be treated as a capital receipt".*

Learned senior counsel also relied upon the subsequent judgment in *Universal Radiators v. Commissioner of Income Tax* 1993 (2) SCC 629 to say that the casual and non-recurring income arising to the account of or derived by the assessee cannot be treated as income. In that case too, the change in valuation of surplus due to settlement of a claim by the insurance company was not treated as income and the Court had then noticed and followed its previous rulings in *Canara Bank* (supra).

8. Learned senior counsel argued that the amount received upon debt assignment could not be treated as income under Section 2(24) but was receipt in value, in consideration of assignment, in the form of compensation bond. The receipt was the consideration in transfer of a capital asset under Section 2(47) of the Income Tax Act. Learned counsel relied upon the decision of the Supreme Court in *Karanpura Development Co. v. Commissioner of Income Tax* (1962) 44 ITR 362 to say that income is derived through a periodical monetary receipt not in the nature of a windfall but coming in with some sort of regularity or expected regularity. Such amount, however, would not include

fixed capital or realization of fixed capital but earning into other form of capital or money. So stating learned counsel submitted that the assessee's contentions were well founded and could not have been rejected by the ITAT.

9. Learned counsel for the Revenue argued that ITAT's impugned order should not be disturbed. He submitted that the assessee claimed capital loss of ₹1,48,22,66,649/- in its revised return on account of assignment of right to receive its debt (amounting to US$ 59,967,085) from the Iraqi government. The assignment was to the Central Government. The assessee received equivalent value bonds and has urged that the transfer of right to realize its debt from the Iraqi Government to the Central Government amounted to transfer of capital asset. The computation of capital loss was furnished in the revised return; Note 6 of the said return stated that ₹12,61,252 lakhs was not credited to the profit and loss account as it pertained to debts realized till 31.3.1995 and that the correct amount finally worked-out on this account was ₹1,23,42,79,007. The assessee had contended that income, if any, due on account of FEFR on discharge of Iraqi debts would accrue in the year in which the bonds were to be paid by the Central Government. The bonds were received by the company during AY 1996-97.

10. Learned counsel for the Revenue submitted that the amount shown as receivable from the Iraqi Government was under the head of "sundry debtors" and could by no stretch of imagination be termed as a "capital asset". It was highlighted that the assessee was like any

other project exporter to Iraq who had suffered a blockage of its debt receipts, (due to extraneous factors such as US sanctions), and was the recipient of the hardship mitigation measures by the Central Government, which took over such debts and issued equivalent rupee bonds. It was argued that there was no profit element due to the taking-over of the debts by the Central Government and issuing bonds in return. In fact, no profit accrued to the assessee from the Central Government. On the other hand, profit was an intrinsic element of the debts which would have accrued in the event the Iraqi Government was capable and permitted to discharge its debt obligations. That the assessee was able to realize its debts through a third agency, i.e. the Central Government did not mean that the character of the amount transformed and the transaction became one of transfer of capital asset.

11. Learned counsel for the Revenue relied upon the AO's order who had drawn an analogy with Section 36(1)(vii), where assessees are allowed deduction in respect of bad debts or part thereof written off as irrecoverable. The AO observed that bad debts are treated as revenue expenditure, and the business income to the extent of those debts is reduced. Conversely, if debts are recovered above the book value, such amount would have to be taxed as income. Analogically, exchange gain in respect of debts would fall in the same category, and would be liable to be taxed as business income. It was argued by learned counsel for the Revenue that the intervening development of the Central Government taking over the debt and issuing bonds for a

particular value did not in any way disturb the character of the amounts received or receivable from the Iraqi Government which would have also shown exchange gain. Learned counsel further submitted that debts were not the assessee's investment as understood in common parlance in the sense that a profit was intended to be earned on their sale or transfer.

12. Learned counsel lastly highlighted that the debt in the present case due from the Iraqi Government was an incident of the assessee's business and its settlement by the Central Government, (which allotted compensation bonds) could not on the date of such transfer, result in transfer of capital asset. Consequently, the assessee's claim for entitlement to the benefit of indexation on the compensation bonds received (for which the value of the bonds at US$ 59,967,085/- was shown to be – after indexing at US$ 107,173,029/-) and a corresponding rupee equivalent loss upon conversion claimed at ₹1,48,22,66,649/- was unacceptable either in the commercial sense of the term or based upon application of any legal principle. Learned counsel highlighted that the accounting treatment given by the assessee established that the gain on account of exchange fluctuation was a business receipt.

Analysis and conclusions

13. The appellant in its return for AY 1995-96 claimed a capital loss of ₹1,48,22,66,649/-. It was a project exporter entitled to receive amounts as part of its consideration from the Iraqi Government for a

number of years. The unpaid dues were on account of the Iraqi Government's inability to repatriate any amounts due to economic blockage and the consequent sanctions imposed upon it. When the assessee had entered into the contracts, for a short duration, the Iraqi Government paid part-consideration in Iraqi Dinars and the rest in US$. The payments receivable in respect of executed work up to accounting year 1991-92, but not paid aggregated to US$ 59,967,085/. Whilst entering into the contracts with the Iraqi Government, the assessee had procured a policy from Export Credit Guarantee Corporation (hereinafter "ECGC"), which covered risk to the extent of 80% of the contracted amount. The inability of the Iraqi Government to pay the consideration agreed for the execution of the work resulted in the Central Government stepping in, and after negotiations, executing those protocols spread over a period of time with the Iraqi Government. The latter was granted deferred payment in respect of the US$ portion of the contractors' dues. In terms of the arrangements under the protocols, the Iraqi Government through its Central Bank granted credit in respect of the settled bills to the project exporters, including the assessee and corresponding debt was raised by the commercial bank against the Central Bank of Iraq. Since the Iraqi Government failed to pay the amounts due within the stipulated period, and the amount payable by ECGC was beyond its means, the Central Government constituted a Task Force comprising of various experts. This resulted in an execution of MoU between ECGC and exporters and countersigned by the other banks. In terms of this MoU, ECGC started settlement of claims due to the assessee and other

contractors. As a result, the assessee received some cash payment which was adjusted by the Exim Bank against rupee loan availed to the Exim Bank. The amounts ultimately paid were in the form of bonds issued and guaranteed by the Central Government, maturing in 2001 and carrying 12.08% interest per annum (they were entitled "the 12.08 Government of India Compensation (Project Exports to Iraq) Bonds, 2001"). The value of the bonds so issued to the assessee included a foreign exchange fluctuation gain of ₹ 1,234,279,007/-. The assessee treated the currency fluctuation gain in its books of account for AY 1996-97. The assessee accepted the year of accrual of income or loss as AY 1995-96 based on a board circular and claimed capital loss by refusing its return of income and sought to carry forward loss which according to it was unabsorbed. The income or gain on assignment of the debt – to the Central Government – in view of the bonds, was computed under the head "capital gain". The assessee contended that the Iraqi debt was a capital asset which was transferred and that the full value of such consideration on account of transfer fell short of indexed cost of acquisition. The computation of indexed cost of acquisition and the computation of loss claimed by the assessee was as follows:

Financial Year	*Amount receivable from Iraq in US$*	*Cost Inflation Index*	*Indexed Cost of acquisition in US$*
1984-85	*24,384,541*	*259/125*	*50,524,769*
1985-86	*2,520,294*	*259/133*	*4,907,941*
1986-87	*2,463,774*	*259/140*	*4,557,982*
1987-88	*1,820,390*	*259/150*	*3,143,207*
1988-89	*10,209,575*	*259/161*	*16,424,099*

1989-90	*15,319,151*	*259/172*	*23,067,791*
1990-91	*2,617,221*	*259/182*	*3,724,507*
1991-92	*632,139*	*259/199*	*822,733*
	59,967,085		*107,173,029*

(ii)	*<u>Computation of capital loss:</u>*	
	Full value of consideration of Iraqi Debts being the amount of debt converted into bonds.	*US $ 5,99,67,085*
	<u>Less</u> : Indexed cost of acquisition of Iraqi Debts as per (i) above	*US $ 10,71,73,029*
	Loss under the head Capital Gains	*US $ 4,72,05,944*
	Loss in Rs. (converted @ 1 US $ = Rs.31.40	*Rs.148,22,66,649*

14. As is evident, all the revenue authorities and the ITAT negatived the assessee's contentions. Its submission is that whatever be the initial character of the amounts of dues owed by the Iraqi Government, on account of the intervening developments of their impossibility of repatriation or payment, they were "blocked" or rendered "sterile." Strong reliance is placed upon the decision of the Supreme Court in *Canara Bank (supra)* and *Universal Radiators (supra).* The ITAT in its impugned order relied on *Sutlej Cotton (supra)* to hold that appreciation or depreciation in foreign currency value upon its conversion would ordinarily be trading profit or loss if currency is held in revenue account or in a trading account or part of circulating account. However, the exception is that if such currency is held as capital account, such profit or loss would be of capital nature. The ITAT then held as follows:

“....................The amounts receivable were as a result of project so executed. The amount has arisen directly from carrying on the aforesaid business. But for the UN sanction as imposed, the amount would have been repatriated to India as was the case before UN sanction and employed in the trading operation of the business. In such a situation it would constitute a circulating capital as it is intended to be utilized in the course of business or for trading purpose or for effecting a transaction on revenue account. The amount retained abroad was on account of factor beyond the assessee’s power. The latter is however, not material for determining the character of the receipt. The amount as retained was not for utilising it for purchase of any capital asset.

XXXXXX XXXXXX XXXXXX

6. This finding of ours is also supported by the accounting entries made by the assessee in its books of accounts. It is true that the way in which entries are made by the assessee in its books of accounts is not determinative of the character of the income which has to be determined on the facts and circumstances of each case. Nevertheless the conduct of the assessee cannot be completely ignored. The accounting entries as made have relevance while deciding the issue. At this juncture it would be relevant to mention that even before the Board of Direct Taxes this has never been the stand of the assessee. We would also like to mention that under Section 36 of the Act deduction in respect of any bad debt has been specifically allowed under clause (vii) of sub-sec. (1) of Sec. 36 of the Act. Under the aforesaid section the deductions have been provided for items which are of revenue nature. Deductions in respect of the items of capital nature have been specified as such as is the case in sec. 35(A). 35 AAB in distinction to sec. 35AB of the Act. In the circumstances, the arguments of the learned AR in this regard are relevant only in case the project receivables are held to be on capital account. This would

also include the arguments relating to the computation of capital gain.

7. Having come to the conclusion that the gain as received constitutes a revenue receipt, now we would like to revert to the arguments of the learned counsel. Shri Desai has started with the proposition that as the debt assigned falls under the expression 'capital asset' as defined in sec.2(14) of the Act, any gain or loss arising on account of fluctuation in foreign exchange would constitute a capital asset. It is something like first assuming the nature of receipt and then trying to prove as to how it is so. Starting with the definition of capital asset under sec.2(14) of the Act and assignment of debt under the provisions of Transfer of Property Act with the help of the judicial pronouncement he has gone to show that the project receivables were on capital account. In this process he has lost sight of the fact that the first step is to determine the nature of the amount receivable. The real question is not whether the later stage of the operation, i.e. assignment of debt is in the course of trading transaction but whether the first step towards the transaction is in the course of business. This cannot be delinked with the first stage. It is the nature of debt assigned which is relevant. Since the debt as assigned is on account of trading transaction, the same is of revenue nature. This is also evident from the treatment given to it under the Act."

15. In the present case, the assessee's submissions hinge almost entirely on the two decisions of the Supreme Court in *Canara Bank (supra)* and *Universal Radiators (supra)*. In the first case, the issue was the inability of a foreign branch of an Indian bank to repatriate amounts to India due to difficulties faced on account of delayed valuation of currency. The subsequent currency valuation and the bank's ultimate successes in repatriating the amount to its headquarters, was with an exchange gain. This exchange gain was

held to not be income. Unlike in the present case, the amount always belonged to the bank – its foreign branch was not a separate incorporated entity but was in fact integral to its operation. Also, the amount was not profit, but part of its general stock in trade. The event which intervened and injected temporary blockage of the funds was the partition of India. It was in these circumstances that the amounts lying in the foreign branch – which were part of its stock in trade, were treated as such; they never lost their character. Likewise, in the case of *Universal Radiators (supra)*, the amount sought to be taxed by the Revenue was an insurance claim settled by the American insurer due to loss of goods at high seas, when hostilities broke out between India and Pakistan. The Rupee devaluation resulted in an increment in the ultimate payment made by the insurer as against equivalent foreign exchange value originally claimed. The Revenue had contended that this amount was "income". It was in this context that the Supreme Court held that since the assessee did not carry on business of selling of ingots but manufacturing of iron and steel products, the compensation received by it was not for any trading or business activity but just equivalent in money of the goods lost by it which otherwise it would have used. The excess which accrued to the assessee was not due to any business but entirely due to fortuitous circumstance, i.e. the valuation of currency.

16. This Court is of the opinion that both the cases are of no assistance to the assessee. The Iraqi debts were appropriately part of the profits which arose or accrued to the assessee. Concededly, the

assessee follows a mercantile method. The fact that it could not realise those amounts for a considerable period which resulted in the Indian Government intervening and negotiating protocols and eventually taking over the debts and issuing bonds instead, did not in any manner transform or alter the nature or character of the amount receivable. The analogy drawn on the basis of the two decisions is neither sound nor appropriate. In neither case did the Supreme Court hold that the increase in value of the Indian Rupee, amounts to a gain as is being urged here. All that was said was that the isolated transactions in both cases, i.e *Canara Bank (supra)*, the exchange fluctuation resulting in gain on account of devaluation of Pakistani Rupee –was an intrinsic part of the bank's operation; and in *Universal Radiators (supra)*, the settlement of the insurance claim as compensation, the receipts were in the true sense not "real income" but capital and unintended accruals. Here, however, the debts payable were not on account of any advances given to the Iraqi Government by the assessee but rather as consideration for the services provided. In fact, for some of the years, part consideration was paid through Iraqi Dinars. It was the balance – payable in hard currency which could not be repatriated due to external factors and economic sanctions.

17. A fact which did not go unnoticed by the Revenue is that the assessee's statutory auditors in note 6 of their debt report dated 28.06.1995 commented adversely that the credit balance appearing in the Foreign Exchange Fluctuation Reserve Account (FEFR A/c) relating to the debts released till 31.03.1995 - a sum of ₹ 1,261,252/-

was not credited to the P&L account thereby understating the profit to the said extent. This was sought to be explained by the assessee that income, if any, due on account of FEFR on discharge of the Iraqi debts would accrue only in the year in which the bonds would be paid by the Central Government. The assessee further sought to elaborate by stating that the deed of assignment dated 10.03.1995 resulted in the Central Government purchasing its right to realize the amount in hard currency from the Iraqi Government. The bond amount was to mature in 2001. Consequently, the assessee contended that the income would be shown when the bonds mature. However, the lower authorities rejected that explanation. During the pendency of the assessment proceedings, on 7.5.1996, the CBDT had issued a circular that income, if any, arising out of the receipts of the bonds would be taxable in AY 1995-96.

18. In this Court's opinion, the holding of amounts in foreign currency for diverse reasons by itself cannot be determinative of its character. As held in *Sutlej Cotton (supra)*, appreciation or depreciation in foreign currency value upon conversion would be either trading profit or trading loss. However, the exception to this is that if foreign exchange currency is kept as capital asset or fixed capital – in such event, the gain or loss would be of capital nature. In the present instance, the amounts as indicated earlier were payable for services provided by way of projects executed by the assessee in Iraq. The Iraqi Government's inability to pay due to sanctions imposed by it and the subsequent Central Government's negotiating an arrangement

for its payment through bonds that were to mature in future – with interest did not in any way alter their character or convert them into capital assets as the assessee argues. Rather, this Court is also of the opinion that the analogy of bad debts and their reduction from the revenue receipts in a given year and its converse treatment – by virtue of Section 36(1)(vii) is apt to the circumstance of the case. The assessee's claim of capital loss, based on indexed treatment of capital gain is therefore insubstantial and unfounded on any principle.

19. For the above reasons, the Court is of the opinion that the impugned order does not suffer from any infirmity. The question of law is answered against the assessee and in favour of the Revenue. For these reasons, the appeal has to fail and is, therefore, dismissed.

S. RAVINDRA BHAT
(JUDGE)

R.K.GAUBA
(JUDGE)

MAY 15, 2015