Loan to Relative Abroad? No tax on Forex gains

One man said to another: "Do you know, my son-in-law (damaad), who stays abroad has asked for a loan ?"

The other man said: "That's very bad."

The first man said: "No. It's very good, because when he repays, I don't have to pay any tax on forex gains !"

Taxpayers, now, can happily avoid paying any tax on forex loans advanced to relatives abroad. Thanks to the recent *Aditya Balkrishna Shroff* v. *ITO* [2021] 127 taxmann.com 343 (Mum. - Trib.) case judgement passed by Mumbai Tribunal, an unfair practice of income tax department has been stamped out.

Aditya Balkrishna Shroff (*supra*)

The appeal raises an interesting question about tax implications of foreign exchange fluctuation gains arising upon receiving the repayment of a personal loan, which was extended by the assessee, denominated in US Dollars.

The issue lies in a very narrow compass of material facts. The assessee is an individual. During the course of scrutiny assessment proceedings, the Assessing Officer noticed that "as per the AIR information, and as per capital account of the assessee," the assessee was in receipt of Rs. 1,12,35,326".

When the Assessing Officer probed this entry further, it was explained by the assessee that on 29th March 2010 the assessee had extended a personal interest free loan of US $ 2,00,000 to his cousin one Shravan Shyam Shroff in Singapore (SSS-S, in short). The remittance so made was under LRS (Liberalized Remittance Scheme) issued by the Reserve Bank of India. As on that date, the prevailing exchange rate for purchase of one US $ was Rs. 45.14, and, therefore, the assessee had to pay Rs. 90,30,758 for this remittance of US $ 2,00,000. The borrower, namely SSS-S, paid back this amount of US $ 2,00,000 to the assessee on 24th May 2012. On that day, while converting the US $ into Indian Rupees, the exchange rate for purchase of one US $ was Rs. 56.18. Accordingly, the amount credited to the assessee's account was Rs. 1,12,35,326. The entry in question was, thus, explained by the assessee. The matter, however, did not end there.

The Assessing Officer was apparently of the view that while entry was explained, the difference, in terms of Indian Rupees, on account of this transaction was of income nature. It was explained by the assessee that the loan account was purely personal, it was not in the nature of a business transaction, and that there was no motive of economic gains in this transaction. It was explained that the loan transaction was in terms of the Liberalized Remittance Scheme of the Reserve Bank of India inasmuch as it was a permitted transaction, and specifically on capital account. It was further explained that the transaction was in capital field and that, therefore, "the gain is in the nature of capital receipt and hence not offered for taxation". None of these submissions, however, impressed the Assessing Officer. The Assessing Officer observed that "no infirmity is observed on the advancement of loan to Shri Shyam Sunder Shroff, (but).. the dispute is with respect to gains on foreign exchange fluctuation". He was of the view that "the gain on realization of loan would partake character of an income under the head income from other sources". When the Assessing Officer persisted with this analysis and, as he puts it, 'confronted' the assessee with the same, the assessee paid tax on this amount.

In view of the above, the gain on loan arising out of foreign exchange fluctuation amounting to Rs. 22,04,568/- was held as taxable under the Head 'Income from Other sources'. Penalty proceedings u/s. 271(1)© of the 1.T. Act, 1961 were thereby initiated for furnishing inaccurate particulars of income to conceal income chargeable to tax.

The assessee unsuccessfully carried the matter in appeal before the CIT(A). The Learned CIT(A) was not swayed by the submissions and simply brushed them aside.

"As per provision of the Income-tax Act if giving and taking loan is not the business of the assessee then income arising out of the loan is treated as interest of the income or income from other sources. In view of these facts, I have no reason to interfere with the findings given by the Ld. AO, therefore I confirm the addition of Rs. 22,04,568/- rate by the AO under the head income from other sources."

The assessee, not satisfied went up in appeal to Tribunal, which began by saying that it was a neatly identified legal issue in a very narrow compass of material facts. The learned judge asked the Departmental Representative whether he disputes the fact that it is a receipt on capital account as it is not in the course of business, and, if he does not dispute so, on what basis does he justify its taxation as an income. The DR emphasized that an appreciation in rupee value is clearly of income nature as it results in a gain to the assessee, and the said gain is not specifically exempted under the Income-tax Act, 1961.

To the judge's mind, so far as the fundamental legal position was concerned, it was very simple and easy to understand. When a receipt is in the capital field, even if that be a gain, it is in the nature of a capital gain, but then, as the definition of income, under section 2(24)(*vi*), stands, only such capital gains can be brought to tax as are permissible to be taxed under section 45. In other words, a capital gain, which is not taxable under the specific provisions of Section 45 or which is not specifically included in the definition of income, by way of a specific deeming fiction, is outside the ambit of taxable income.

The question then arises as to whether an accretion of value in respect of an asset held in capital account, *i.e.* foreign exchange denominated loan advanced, can be subjected to tax in the hands of the assessee.

The learned judge was reminded of a decision that he had authored, over twenty years ago, in the case of *Shaw Wallace & Co. Ltd.* v. *Dy. CIT* [2001] 117 Taxman 192 (Mag.)/[2002] 80 ITD 156 (Cal.). He had observed as follows:

"Hon'ble Supreme Court has, in the case of *Padmaraje R. Kadambande* v. *CIT* [1992] 62 Taxman 456/195 ITR 877, observed that, "...we hold that the amounts received by the assessee during the financial years in question have to be regarded as capital receipts and, therefore, are not income within meaning of section 2(24) of the Income-tax Act." [Emphasis supplied]. This clearly implies, as is the settled law, that a capital receipt, in principle, is outside the scope of 'income' chargeable to tax and a receipt cannot be taxed as income unless it is in the nature of a revenue receipt or is specifically brought within ambit of 'income' by way of specific provisions of the Income-tax Act.

.... As observed by Hon'ble Supreme Court, in the case of *CIT* v. *Kamal Behari Lal Singha* [1971] 82 ITR 460, "it is now well settled that, in order to find out whether a receipt is capital receipt or revenue receipt, one has to see what it is in the hands of the receiver and not what it is in the hands of the payer". In other words, the ... source from which the payment is made has no bearing on that question. ....

The next thing to be examined by us is revenue's reliance on Hon'ble Supreme Court's judgment in *Emil Webber* v. *CIT* [1993] 67 Taxman 532/200 ITR 83. There can hardly be any doubt about the proposition that anything which can be properly described as income is taxable under the Income-tax Act unless, of course, it is exempted under one or the other provisions of the Act. However, it cannot be overlooked that any receipt being described as income cannot be at the unfettered discretion of the revenue authorities; such a receipt has to meet well-settled criterion such as, for example, criterion of nature of receipt being revenue receipt in nature.

In the case before us, however, facts are altogether different and there is no nexus, direct or indirect, between receipt impugned in this appeal and any revenue receipts of the assessee. On the contrary, there is a clear nexus between receipt impugned in appeal before us, on one hand, and capital assets of the assessee-company. Therefore, there is little support that revenue can derive from *Emil Webber's* case (*supra*).

As regards Hon'ble Supreme Court's judgment in the case of *CIT* v. *G.R. Karthikeyan* [1993] 68 Taxman 145/201 ITR 866, this also deals with the connotations of the expression 'income' which Their Lordships have construed as of widest amplitude so as this expression may be given its natural and grammatical meaning.

There is no warrant for inference that even the most liberal interpretation of 'income' can nullify or blur the all-important distinction between capital receipt or revenue receipt.

We find that, as observed by Hon'ble Supreme Court in the case of *CIT* v. *Dr. K. George Thomas* [1999] 235 ITR 59 (Ker.) "the burden is on the revenue to establish that the receipt is of a revenue nature" though "once the a receipt is found to be of revenue character, whether it comes under exemption or not, it is for the assessee to establish".

The revenue has at best made efforts to demonstrate that the receipt in question is not taxable as a capital gain and, therefore, it can only be in nature of revenue receipt.

There is a glaring fallacy in this argument, since merely the fact that a receipt is not taxable as a capital gain would not imply, or even suggest, that such a receipt is revenue receipt.

In the case of *Ashoka Mktg. Ltd.* (*supra*), the assessee had entered into an agreement with a vendor for purchase of certain property belonging to the vendor. The vendor, having failed to complete the transaction because title of the property was not marketable as there was a prior mortgage of the property with the Government, paid liquidated damages of Rs. 1 lakh to the assessee. Hon'ble jurisdictional High Court observed that such liquidated damages are neither in the nature of capital gain nor in the nature of a revenue receipt, and, therefore, outside the ambit of taxable income.

We now come to Hon'ble Madras High Court's judgment in the case of *CIT* v. *Seshasayee Bros. (P.) Ltd.* [1996] 89 Taxman 13/222 ITR 818. Their Lordships concluded:

"... when a receipt is referable to fixed capital, it is not taxable, and it is taxable as a revenue item when it is referable to circulating capital or stock in trade."

In the present case, it is not even in dispute, and rightly so, that the receipt is in question is in the capital field but the Assessing Officer has taxed it on the basis that "the gain on realization of loan would partake character of an income under the head income from other sources", and the CIT(A) has justified such a taxation on the basis, which was altogether different *vis-à-vis* the reasoning adopted by the Assessing Officer, that the accretion in rupee terms is to be considered as interest, and is to be taxed as such by observing that "as per provision of the Income-tax Act if giving and taking loan is not the business of the assessee then income arising out of the loan is treated as interest of the income or income from other sources".

"None of these reasonings meet our approval," the court held. The Assessing Officer has proceeded to proceed on the basis that gains on realization of loan partakes the character of an income under the head income from other sources. He proceeded to put cart before the horse by deciding the head under which the income is to be taxed, even before deciding whether it is of income nature, and mixes up the concept of 'income' with the concept of 'gains'. What he "misses out" is the critical fact that, in terms of the provisions of the Income-tax Act, all 'gains' are not covered by the scope of 'income'. Take, for example, capital gains. Section 2(24)(*vi*) provides that "income, includes......any capital gains chargeable under section 45". Once the statutory provision itself lays down the principle that only such capital gains are included in the scope of 'income' as are chargeable under section 45, it is only elementary that a capital gain, which is not chargeable to tax under section 45, cannot be included in income. It is not even the case of the authorities below that the capital gains in question are taxable under section 45. As noted by Hon'ble Supreme Court in the case of *CIT* v. *D P Sandu& Bros Chembur (P.) Ltd.* [2005] 273 ITR 1/142 Taxman 713, "it would be illogical and against the language of section 56 to hold that everything that is exempted from capital gains by statute could be taxed as a casual or non-recurring receipt under section 10(3) read with section 56.

...the reasoning adopted by the Assessing Officer 'was incorrect and it does not meet our approval.' Learned CIT(A)'s line of reasoning was no better. While he accepts that the transaction in question was in the capital field, he proceeds to hold that 'income' arising out of the loan transaction is required to be treated as 'interest' or 'income from other sources'.

Under section 2(28A), interest is defined as "interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized". Essentially, therefore, interest is the amount "payable" in any manner in respect of "moneys borrowed or debts incurred" but in the present case nothing more than principal debt has been paid by the borrower, and unless borrower pays an amount in respect of moneys borrowed or debts incurred, the definition of interest does not come into play.

The learned judge concluded: "I am of the considered view that the impugned addition of Rs. 22,04,568 is not sustainable in law. The Assessing Officer is, accordingly, directed to delete the same. The assessee gets the relief accordingly. In the result, the appeal is allowed in the terms indicated above."

A SENSIBLE JUDGEMENT

Once, a court jester invited the king's treasury minister for dinner at home. Now, the minister was quite jealous of the jester. As the number of utensils at dinner went on increasing, he decided to teach a lesson. He reported to king that the jester had accumulated lots of utensils because he was not paying taxes. On questioning, the jester replied: "O king, my utensils give birth to more utensils. So, their number has increased." Puzzled, the king asked him to explain. The jester said: "If silly matters like number of utensils are considered to nab tax evaders, then my utensils giving birth is also not at all silly."

In Aditya Balkrishna Shroff case, the Mumbai Tribunal has pronounced a greatly significant decision, which removes a silly taxing stance. It has saved the assessees from ignominy of being taxed for no fault of theirs.

After all, foreign exchange gains occur owing to external factors and are not in control of assesses. So, why tax them ?

The judicial decision is expected to be very useful for all assesses. Many taxpayers would profit from the verdict. It can yield a lot of foreign exchange, for every assessee.

A SMILE FOR THE TAXPAYER

WHERE IS THE INCOME

The first, most important question in the Aditya Balkrishan case is whether income arose at all, to be taxed under Income-tax Act.

In *Cadell WVG. Mill Co. (P.) Ltd.* v. *CIT* [2001] 116 Taxman 77/249 ITR 265 the Bombay High Court said it is well-settled that all receipts are not taxable under the Act.

Section 2(24) defines "income". It is no doubt an inclusive definition. However, a capital receipt is not income under section 2(24) unless it is chargeable to tax as capital gains under section 45.

In fact, the Income-tax Act does not provide that whatever is received by a person must be regarded as income liable to tax.

The general rule under the Income-tax Act is that, all revenue receipt are taxable unless a receipt is specifically exempted and all capital receipts are exempt from taxation unless there is a provision to tax it.

The circular issued by the Department, bearing No. 158, dated December 27, 1974 says that receipts which are of a casual and non-recurring nature are liable to tax only if such receipts could properly be characterised as income either in general connotation or within the extended meaning given to the term by the Income-tax Act.

THE OPPOSITE VIEW

In the case of *CIT* v. *Gulab Chand* [1992] 60 Taxman 7/[1991] 192 ITR 495 (All.) the diametrically opposite view was held that all receipts are income, and nothing else. The assessee received Rs. 15,000 as surrender value for surrendering the tenancy of a godown occupied by the assessee as a tenant. In the return filed by him, the amount was shown as capital gains. The assessee claimed that the amount was non-taxable. The Income-tax Officer held that the amount was taxable as a casual and non-recurring receipt under section 10(3) of the Act. The Tribunal held that the amount received was a capital gain. On a reference, it was held by the High Court that Section 10(3) applied to capital receipts. That, if the amount received for surrender of the tenancy right was a capital gain but was not chargeable under section 45 then the receipt would fall under section 10(3). Section 10 deals with exemption of particular types of income from being included in the total income of an assessee. Clause (3), in particular, uses the expression "any receipts". The word "receipt" must be understood as synonymous with "income".

The second most important fact is that in *Shaw Wallace* (*supra*) it was held that income can be likened to fruit of a tree or crop of a field, but the assessee had done nothing to make the foreign exchange grow, in this case. All characteristics of income are missing. There is no frequency of receipt [lump sum or periodic sum] - *P.H. Divecha* v. *CIT* [1963] 48 ITR 222 (SC) & *CIT* v. *Panberi Tea* [1965] 57 ITR 422 (SC), neither does accounting treatment including nomenclature given in books of account - *National Cement Mines Industries Ltd.* v. *CIT* [1961] 42 ITR 69 (SC) & *Chemicals & Fertilizers Ltd.* v. *CIT* [1997] 93 Taxman 502/227 ITR 172 (SC).

The nature of a payment also does not indicate income in the hands of a payer - *CIT* v. *Presidency Co-op. Housing Society Ltd.* [1993] 69 Taxman 189/[1995] 216 ITR 321 (Bom.) and income is not indicated as frequency of transaction, like multiple transactions - *CIT* v. *Best and Co. (P.) Ltd.* [1966] 60 ITR 11 (SC) is not seen.

The third most important thing is that loans are not taxable, just like gifts.

The fourth most important thing is that whatever amount was advanced as loan was exactly the same as amount received back by the assessee. The accretion of money, in rupee terms, was on account of increase in the value of the US Dollars advanced per se.

The fifth most important matter is that howsoever, liberal or narrow be the interpretation of expression 'income', it cannot alter character of a receipt *i.e.* convert a capital receipt into a revenue receipt or vice versa.

The sixth important thing is accretion in forex was in capital account. Where income is attributed to, or linked with, a capital asset, the same will be capital receipt in nature. Where is the question of a capital receipt being taxed as income unless there is a specific provision of bringing such a capital receipt to tax. ?

The seventh most important matter is that the benefit or the gain was not on account of interest payment. In any case, where the loan is foreign currency denominated and the amount advanced as loan, as also received back as repayment, is exactly the same, there is no question of interest component at all.

In all, benefit or gain was on account of foreign exchange fluctuation but since the foreign exchange fluctuation was with respect to a transaction in capital field, on the facts of this case, the foreign exchange fluctuation receipt itself turns out to be a capital receipt.

CART BEFORE HORSE

The AO proceeded to put cart before the horse, as rightly observed by the judge. He was deciding the head under which the income is to be taxed, even before deciding whether it is of income nature. The AO, according to judge, also mixed up the concept of 'income' with the concept of 'gains'.

It was a little premature because he proceeded to decide as to what is the nature of income or under which head is to be taxed, without heeding that income cannot cover capital gains. The ambit of taxable income was not understood.

The assessing officer must observe that primary thing to be decided was whether the receipt was income or not. The choice of head under which it is to be taxed is a subsequent requirement. For taxing the income, it has to be actually seen whether income has been earned in reality.

It gave an impression as if anything, which is received by the assessee and which, in assessing officers unquestioned wisdom, can be treated as income, falls within the definition of income.

In this case, the cart was affixed, without bothering to see where the horse was.

SQUABBLE OVER HEADS

The AO wanted to tax the supposed income under one head, while the CIT thought of another. In such a condition, there was no unanimity. In *United Commercial Bank Ltd.* v. *CIT* [1957] 32 ITR 688 (SC), the court held that the heads of income are mutually exclusive and where any item of income falls specifically under one head, it has to be charged under that head and no other.

It has been further held in *East India Housing & Land Development Trust Ltd.* v. *CIT* [1961] 42 ITR 49 (SC) that if the income from a source falls within a specific head, the fact that it may indirectly be covered by an another head will not make the income taxable under the latter head. If the income cannot be taxed under s. 45, it cannot be taxed at all. [*S.G. Mercantile Corp. (P.) Ltd.* v. *CIT* [1972] 83 ITR 700 (SC)].

Furthermore, it would be illogical and against the language of Sec. 56 to hold that everything that is exempted from capital gains by statute could be taxed as a casual or non-recurring receipt under s. 10(3) r/w s. 56. The *Nalinikant Ambalal Mody* v. *S.A.L. Narayan Row, CIT* [1966] 61 ITR 428 (SC)] fortifies this view.

IN BUSINESS, TOO…

Regarding forex accretion or gains, in business arena it was decided in *Homi Mehta & Sons Pvt. Ltd.* v. *CIT* [1995] 83 Taxman 186/222 ITR 528 (Bom.) :"Held that the profit had accrued to the assessee not in the course of any trading activity or on money held for the purpose of trade but on account of appreciation in the value of the amount which was held for the purpose of investment. Hence, this accretion was capital in nature."

YOU CAN PROFIT…

Any assessee who extends Loans to Non-resident Indians (NRIs) or persons of Indian Origin (PIO) who are relatives as defined in Companies Act, 2013 can grab a chance of saving forex gains, on repayment.

Relatives as per the Act include parents, spouses, children and their spouses. They also embrace Step Father, Step Mother, Step son, Step Brother, Step Sister, in fold.

At an exchange rate of Rs. 76 to a dollar, the amount of money that can be loaned is about Rs. 1,90,00,000 or Rs. 1.90 crore. If dollar goes up, at repayment time, it will be literally raining dollars, for loan giver.

There is no restriction on the frequency of transactions in a year.

Without any prior approval of RBI , any Indian Resident is allowed to remit prescribed amount of 250,000 (Per Financial Year) of forex outside India to anyone for all permissible capital account transactions. They just need to contact an Authorised Person/Dealer for this (*i.e.* Full Fledged Money Changer, Banks).

The notable thing is that LRS is available for all Resident individuals, including minors. Of course, the deal has to authenticated by guardian.

Giving a loan to a relative is just like other permissible capital account transactions, like (*i*) opening a Foreign Bank Account (*ii*) Property Purchase Outside India (*iii*) Investments in Shares, Mutual Funds etc (*iv*) Setting up of Wholly Owned Subsidiary/Joint Venture.

SUMMING UP REMARKS

Amitabh Bachchan, once said that he was a most happy person because he neither borrowed from anyone nor lent to anyone. But, here lending forex to a relative abroad can well turn into a bonanza.

The strong point in favour of such loans is that individuals can make some monetary gains that are not specified under income tax laws. As yet, there is no provision under the Income Tax Act for such gains. These are rare and unique situations, which can be utilized by the assessee. To conclude, here's a story which shows how accretions must not be taxed.

In a kingdom, a man, once, lent his horse to a relative. After some time, the horse gave birth to a young foal. The king's minister caught the lender and asked him to pay a tax on money got from lending both horse and foal. The man protested that he wouldn't pay for foal. At the king's court, the mother horse, seeing her owner in chains, gave one kick to the minister. The young colt also administered one kick. The king ruled: "At time of lending, only horse was lent. The foal, by giving a kick has demonstrated that it is part of horse; hence, there's no separate need to tax the foal."

(Source: Taxmann.com)