TR 203

Facts

K holds a global business licence. K is engaged in the activity of financing green energy projects in India. It therefore acts as a pure funding vehicle. K raises funds from overseas lenders in USD which are then on-lent in INR to companies involved in green energy projects. The funds raised in USD are used to purchase Masala bonds from green energy companies based in India. The Masala bonds are denominated in INR. K will therefore be deriving interest from the Masala bonds in INR and paying interest in USD. K is engaged in financing activities and is thus exposed to two main financial risks namely:

- Credit risk; and
- Foreign currency risk.

Since K is dealing in two different currencies and reimbursement of the loan must be made in USD, K is exposed to high foreign currency risks. In order to minimise the potential adverse effects of unfavourable exchange rates between USD and INR, K entered into currency swap agreements to hedge against foreign exchange fluctuations. The swap agreements have been concluded at arm's length and all swap counterparties are unrelated. The purpose of the hedging instrument is to prevent a business loss and K is not involved in any speculation activities. The hedge against foreign exchange fluctuations would either result in a hedging cost or hedging income.

Points at issue

1. Whether the entire hedging costs paid on foreign currency swap agreements to mitigate foreign currency risks is deductible?
2. Whether hedging income earned on foreign currency swap agreements is subject to tax?

Ruling

On the basis of the facts mentioned above, it is confirmed that:

1. The nature of the business undertaken by K necessitates hedging activities. Hedging is a tool for risk management and risk minimisation. Fluctuation in exchange rate may have adverse effect on the profitability of K. Hedging against such fluctuations is considered as a business expense and is an allowable deduction under Section 18 of the Income Tax Act.
2. Hedging, in the present case is incidental to the borrowing and lending activity. Therefore, any income derived from the hedging business is taxable under Section 10 (1) (b) of the Income Tax Act.