



Taxation and Compliance Challenges Arising from Exchange Rate Fluctuations in Indian Import-Export Businesses

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Abstract - The fluctuating exchange rates create multiple layers of taxes and regulations for Indian exporters and importers. Fluctuations between the INR and USD, EUR, and GBP lead to cascading impacts on GST, Customs, FEMA, Income Tax, and Ind AS 21. The research covers 2017-2024, during which time periods include the COVID-19 outbreak, Russia-Ukraine war, and the US Federal Reserve's monetary tightening cycle. Five different compliance areas have been studied: assessment of value in computing the customs duty, GST considerations on foreign currency transactions, income tax provisions on foreign exchange gains/losses, FEMA considerations on remittance and hedging, and Ind AS 21 considerations on tax-accounting differences. The study concludes that SMEs face significant compliance costs, hedging contracts add further complications in terms of taxes, and regulatory inconsistencies between CBIC, CBDT, and RBI create litigation risks. Five recommended policies have been made.

Keywords: Exchange Rate Fluctuations, GST, Customs Duty Valuation, FEMA, Ind AS 21, Foreign Exchange Gains and Losses, Import-Export Compliance, Indian Taxation, Hedging, SME Trade Finance

1. Introduction

India's merchandise trade touched a value exceeding USD 1.4 trillion in fiscal year 2022-23, increasing its dependence on international logistics networks. This growth exposes the country to international foreign currency transactions, which come with their own complications of foreign currency taxation and exchange rate risk. Given its heavy import of raw materials like crude oil, electronics and capital goods and exports of pharmaceutical products, IT services, textiles, and engineering items, India has become inherently vulnerable to multi-currency risk in all trade routes.

The Indian Rupee depreciated by around 28-30 percent against the US Dollar from 2017 to 2024, dropping from INR 64-65 to the USD 1 to INR 83-84. The journey was not linear; events such as the 2018 emerging market sell-off, the March 2020 coronavirus shock, the Russia-Ukraine 2022 energy war, and

the US Federal Reserve interest rate rise cycle have created distinct episodes of volatility. The implications are not only for the treasury but for the whole compliance system. An importer who signs an import contract for USD 100,000 at INR 80 faces a very different compliance structure once the exchange rate jumps up to INR 83 at the time of import.

2. Literature Review and Theoretical Framework

The fundamental research work by Hooper and Kohlhagen (1978) and Cushman (1983) had highlighted the transaction risk associated with exchange rate uncertainties, and the possibility of trade volume reduction due to such risks. In the Indian context, Rao (2012) reported that the majority of SME exporters employ natural hedges over formal mechanisms; Dash and Vasudevan (2018) noted structural impediments for SMEs accessing foreign currency hedging markets. Jain and Agarwal (2018) and Mehta (2019) reported interpretative problems with respect to GST Rule 32(2)(b). Bose (2014) and Patel and Rajagopalan (2017) examined the taxation of exchange differences and their judicial evolution. Gupta and Narayanan (2020) have addressed deferred tax accounting complexities arising from discrepancies between Ind AS 21 and ICDS IV. There is no prior research paper addressing all the compliance areas together as done in this paper.

The research draws on Transaction Cost Theory (Williamson, 1985), according to which, compliance complexity is likely to impose higher transaction costs on smaller organizations; Agency Theory (Jensen & Meckling, 1976) provides insights into information asymmetries between companies and regulatory authorities; Institutional Theory (North, 1990) explains how fragmentation of the multiple regulatory system creates coordination failures; and Optimal Tax Theory (Mirrlees, 1971) poses ethical issues regarding the choice of an optimal tax base for exchange gains/losses.

3. Research Methodology

This research uses systematic secondary research methodology for the period of 2017-2024 spanning GST implementation to the occurrence of significant changes in exchange rates. The primary regulatory sources consist of CBIC Notifications,

CBDT Circulars, Master Directives of RBI, DGFT Policies, and ICAI Implementation Guidelines. The judicial sources include Supreme Court judgments, High Court judgments,

ITAT Orders, CESTAT Decisions, and AAR/AAAR opinions. Statistical sources include RBI Database on Indian Economy, Ministry of Commerce Trade Statistics, and IMF/World Bank Databases. A total of five hypotheses are tested using evidence triangulation:

H1: Exchange rate fluctuations significantly complicate customs duty compliance due to divergence between CBIC-notified and actual transaction rates.

H2: The GST framework for foreign currency transactions contains significant interpretive ambiguities creating compliance risk.

H3: Income tax treatment of exchange differences is a source of significant litigation and uncertainty.

H4: FEMA compliance creates a disproportionate burden on SME exporters relative to large corporations.

H5: Implementation of Ind AS 21 generates material mismatches with tax treatment, increasing compliance complexity.

4. Data Analysis and Interpretation

4.1 Exchange Rate Trends: INR vs. Major Currencies (2017–2024)

The INR depreciated approximately 28 percent against the USD — from INR 65.12 in 2017 to INR 83.45 in 2024 — with pronounced volatility in 2018 (9.2%) and 2022 (8.0%) driven by external shocks. The EUR/INR rate rose from approximately INR 74 to INR 90, and GBP/INR crossed INR 105 by 2024. These multi-currency shifts compound valuation uncertainties across all regulatory domains simultaneously.

Year	Avg INR/USD	Annual High	Annual Low	Volatility (%)	Key Driver
2017	65.12	65.75	63.37	2.3	Stable macro conditions
2018	68.39	74.39	63.67	9.2	Current account deficit; EM capital outflows
2019	70.42	72.40	68.31	3.9	Moderate volatility; global slowdown
2020	74.18	76.67	70.62	6.5	COVID-19 pandemic selloff; RBI intervention
2021	73.93	75.50	72.35	2.5	Recovery; subdued volatility
2022	78.60	83.20	74.49	8.0	Russia-Ukraine conflict; US Fed rate hikes
2023	82.67	83.42	81.59	1.8	<u>Stabilisation</u> ; RBI managed float
2024*	83.45	84.10	82.80	1.3	Continued depreciation trend (*Jan-Sep)

*Table 1: INR/USD Exchange Rate Statistics 2017–2024 (*Jan–Sep 2024) | Source: RBI DBIE*

4.2 Customs Duty Valuation under Exchange Rate Volatility

Under Section 14 of the Customs Act, 1962, CBIC notifies exchange rates fortnightly — based on RBI data from two days prior. During rapid depreciation, this creates material divergence between the notified customs rate and the actual bank transaction rate. For a USD 10 million annual import program, periodic divergences can accumulate to hundreds of thousands of rupees in duty differential. Related-party import valuation compounds the issue: when transfer prices are set at one rate and customs assessment uses another, disputes with customs authorities and Assessing Officers arise concurrently.

Period	CBIC USD Rate	RBI Ref Rate	Divergence (INR)	Duty Impact (INR Cr, 15% BCD on USD 10L)
H1-Oct 2022	82.15	82.95	+0.80	~0.12
H2-Oct 2022	82.95	83.40	+0.45	~0.07
H1-Nov 2022	82.30	80.75	-1.55	~-0.23
H1-Jun 2023	82.50	82.80	+0.30	~0.05
H1-Jan 2024	83.00	82.85	-0.15	~-0.02

Table 2: CBIC Notified Rate vs. RBI Reference Rate — Illustrative Divergence | Source: CBIC Notifications, RBI DBIE

4.3 GST Implications on Foreign Currency Transactions

IGST on imports is levied on the assessable value (CIF + BCD) converted at the CBIC-notified rate, forming the basis of the importer's ITC claim. Actual payments occur at bank transaction rates, creating a base difference requiring tracking. For exported services — a USD 250 billion sector — GST applies the exchange rate at the time of supply, creating valuation discrepancy when advance foreign currency receipts

precede invoicing. CBIC Circular No. 92/11/2019-GST provided partial guidance but left open material questions on multi-currency advance receipts. Rule 32(2)(b) of the CGST Rules governs currency exchange services through a spread-based formula that generates volatile taxable values during rapid INR movements.

4.4 Income Tax Treatment of Foreign Exchange Differences

This is the most litigated domain in the study. Section 43A governs capital asset cost adjustments for foreign currency borrowings; Section 43AA mandates ICDS IV compliance; and Sections 28-44 govern business income computation. ICDS IV operates independently of Ind AS 21, creating persistent accounting-tax mismatches. The Supreme Court's ruling in CIT v. Woodward Governor India Pvt. Ltd. (2009) confirmed deductibility of unrealised exchange losses on working capital loans, though ICDS IV subsequently altered parts of this position. The primary litigation battleground is mark-to-market losses on forward contracts: the distinction between hedging instruments (deductible as business loss) and speculative transactions (subject to set-off restrictions) remains fact-intensive and context-dependent.

4.5 FEMA Compliance Challenges

FEMA, 1999 imposes export realization obligations — typically nine months from the export date. Exchange rate volatility creates rational incentives to delay repatriation when INR depreciation is expected (maximizing INR proceeds) or to accelerate during anticipated appreciation — both of which conflict with FEMA's prescriptive timelines and invite compounding proceedings under Section 15. The RBI's 2019 Task Force Report explicitly acknowledged the barriers facing SME exporters in accessing formal hedging instruments, citing minimum contract sizes, margin requirements, and documentation burdens. Natural hedging through EEFC accounts provides partial mitigation but carries opportunity costs when domestic rates exceed offshore rates.

4.6 Ind AS 21 — Accounting-Tax Interface Complexity

Ind AS 21 requires exchange differences on all monetary items to flow through profit or loss at each reporting date. Where a foreign currency borrowing or forward contract is designated as a cash flow hedge under Ind AS 109, the effective hedge gain or loss accumulates in Other Comprehensive Income (OCI), bypassing the income statement. ICDS IV does not recognize hedge accounting, requiring immediate tax accrual on OCI-recognized exchange differences and generating temporary differences requiring deferred tax recognition under Ind AS 12. Minimum Alternate Tax under Section 115JB further complicates the interaction: OCI items excluded from book profit are recognized for tax only upon reclassification to profit or loss, creating inter-period tax volatility. The taxability of Foreign Currency Translation Reserve upon disposal of foreign subsidiaries remains one of the highest-uncertainty areas in the study — no comprehensive statutory guidance exists.

5. Hypotheses Testing and Key Findings

All five hypotheses are supported by the secondary data evidence, as summarized below.

	Evidence Summary	Outcome
H1	Fortnightly CBIC rate creates measurable divergence from transaction rates; duty differentials material at scale; related-party valuation disputes amplified by FX movements.	Supported
H2	Rule 32(2)(b) spread formula generates volatile tax bases; time-of-supply disputes for advance receipts unresolved; multiple AAR rulings confirm practitioner uncertainty.	Supported
H3	ICDS IV vs. Ind AS 21 mismatch; MTM deductibility disputes; Section 43A complexity; multiple SC/HC decisions; forward contract speculative-classification risk.	Strongly Supported
H4	Minimum lot sizes for hedging; EEFC utilisation norms; compounding procedures; AD Bank reporting complexity; RBI Task Force 2019 explicit acknowledgement of SME barriers.	Supported
H5	OCI treatment unrecognised by ICDS IV; FCTR disposal taxability unaddressed; MAT book-profit computation gaps; hedge accounting absent from ICDS IV.	Strongly Supported

Table 3: Summary of Hypotheses Testing Outcomes

The overarching macro-level finding is systemic regulatory fragmentation: the same economic event — an exchange rate movement affecting a foreign currency trade transaction — is governed by four distinct legal regimes (CBIC for customs, CBIC/GST Council for GST, CBDT/ICDS IV for income tax, and RBI for FEMA), each applying different rates, methodologies, and timelines. This fragmentation imposes

cumulative compliance costs that far exceed the sum of individual domain complexities.

SME compliance vulnerability is the second principal finding. Singh and Kumar (2019) found that 78 percent of MSME exporters identified exchange rate fluctuation as a top-three risk, yet fewer than 23 percent used any hedging instrument. Without the treasury teams, ERP systems, and tax specialists available to large corporations, SMEs are structurally unable to simultaneously manage multiple exchange rate bases, maintain FEMA documentation, access hedging markets, and perform ICDS IV vs. Ind AS 21 reconciliations — leaving them exposed to penalties, export incentive losses, and GST refund complications.

6. Policy Recommendations

Five priority reforms emerge from the findings:

First, an Inter-Regulatory Foreign Currency Tax Coordination Mechanism should be established, jointly convened by CBIC, CBDT, and RBI, to identify and resolve exchange rate inconsistencies across regulatory domains — addressing the root cause of documented fragmentation.

Second, ICDS IV must be amended to align with Ind AS 21 in three critical areas: recognition of OCI-routed exchange differences for tax purposes; hedge accounting treatment of designated financial instruments; and taxability of FCTR upon disposal of foreign operations.

Third, CBIC should increase the frequency of customs exchange rate notifications from fortnightly to weekly during periods of elevated INR volatility, reducing the material divergence between notified and actual transaction rates.

Fourth, simplified FEMA compliance frameworks should be introduced for MSME exporters: reduced minimum contract sizes for foreign currency derivatives, streamlined AD Bank documentation, and RBI/ECGC-subsidized hedging access programmers.

Fifth, CBDT should issue comprehensive guidance addressing FCTR taxation upon disposal of foreign operations, the

interaction between FCTR and capital gains on equity sales, and the tax treatment of OCI reclassifications.

Recommendation	Authority	Priority	Expected Impact
Inter-Regulatory FX Tax Coordination Mechanism	CBIC + CBDT + RBI	High	Reduced cross-domain inconsistency; lower litigation
Amend ICDS IV to align with Ind AS 21	CBDT	High	Reduced accounting-tax mismatch; fewer deferred tax disputes
Weekly CBIC exchange rate notifications during high-volatility periods	CBIC	Medium	Reduced customs valuation divergence; fewer demand disputes
Simplified FEMA compliance for MSMEs	RBI	High	Reduced SME burden; improved export participation
CBDT guidance on FCTR and foreign operation disposal	CBDT	Medium-High	Reduced litigation on foreign subsidiary disposals

Table 4: Policy Recommendations — Priority Matrix

7. Conclusion

This study presents a comprehensive cross-domain analysis of taxation and compliance challenges arising from exchange rate fluctuations in Indian import-export businesses during 2017–2024. Across five regulatory domains — customs duty valuation, GST, income tax, FEMA, and Ind AS 21 — the research demonstrates that while each framework is individually sophisticated, they collectively generate significant compliance friction through inter-domain inconsistency, interpretive ambiguity, and institutional fragmentation.

The income tax treatment of foreign exchange differences — particularly the ICDS IV versus Ind AS 21 mismatches — is the most litigated and highest-uncertainty domain, with implications cascading from business income computation through MAT book profits to deferred tax positions. GST interpretive gaps around Rule 32(2)(b) and advance foreign currency receipts drive practitioner uncertainty. Customs duty divergences, while individually moderate, accumulate materially across high-volume import programmes. FEMA compliance imposes structurally higher costs on SMEs than large corporations, undermining the competitiveness of India's MSME export base.

The INR's 28–30 percent depreciation against the USD during the study period, punctuated by episodes of acute volatility, ensured these challenges manifested in real demand notices,



refund denials, compounding proceedings, and litigation. As India pursues the ambitious target of USD 2 trillion in exports by 2030, reducing the regulatory compliance burden on import-export businesses — particularly SMEs — is both an administrative priority and a strategic economic imperative. The five policy reforms proposed in this study provide a structured pathway toward a more coherent, equitable, and business-enabling foreign currency compliance architecture.

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