M/S. Haji Aziz And Abdul Shakoor Bros vs The Commissioner Of Income-Tax, Bombay ... on 24 November, 1960

Equivalent citations: 1961 AIR 663, 1961 SCR (2) 651, AIR 1961 SUPREME COURT 663

Author: J.L. Kapur

Bench: J.L. Kapur, M. Hidayatullah, J.C. Shah

PETITIONER:
M/S. HAJI AZIZ AND ABDUL SHAKOOR BROS.

Vs.

RESPONDENT:
THE COMMISSIONER OF INCOME-TAX, BOMBAY CITY II

DATE OF JUDGMENT:
24/11/1960

BENCH:
KAPUR, J.L.
BENCH:
KAPUR, J.L.
HIDAYATULLAH, M.
SHAH, J.C.

CITATION:
1961 AIR 663 1961 SCR (2) 651
CITATOR INFO :
RF 1961 SC 668 (8)
R 1964 SC1722 (9)
D 1969 SC 288 (12)
RF 1972 SC 391 (6)
RF 1980 SC1271 (7)

ACT:
Income-tax--Business deduction--Import of goods by steamer--Government notification prohibiting import by steamer--Payment of penalty in lieu of confiscation--Allowable expenditure--Commercial expense--Sea Customs Act, 1878 (8 of 1878), s. 167(8)--Indian Income-tax Act, 1922 (11 of 1922), S. 10(2)(XV).

HEADNOTE:

The appellant firm imported dates from abroad partly by steamer and partly by country craft. At the relevant time import of dates by steamers had been prohibited by Government

(1) [1945] 1 3 I.T.R. Supp. 1.

(2) [1956] S.C.R. 551.

652

notification, and the consignments which were imported by steamer were, therefore, confiscated by the customs authorities under s. 167, item 8, of the Sea Customs Act, i878, but under s. 183 of the Act the appellant was given an option to pay Rs. 82,250 as penalty in lieu of confiscation. The appellant paid the amount and got the dates released. Before the Income-tax authorities it claimed to deduct the amount paid as penalty as an allowable expenditure under S. 1O(2)(XV) of the Indian Income-tax Act, 1922, but the claim was rejected. It was contended that the order of confiscation was against the stock-in-trade and not against the person of the appellant firm and as the amount paid was expended for the release of the stock-in-trade, it was an allowable expenditure.

Held, that the amount paid by the appellant by way of penalty for a breach of the law could not be considered to be an expenditure laid out wholly and exclusively for the purpose of the business and was not an allowable deduction under S. 1O(2) (xv) of the Indian Income-tax Act, 1922.

Expenses which are permitted as deductions are such as are made in order to enable a person to carry on and earn profit in the business. It is not enough that the disbursements are made in the course of or arise out of or are concerned with or made out of the profits of the business but they must also be for the purpose of earning the profits of the business. An expenditure is not deductible unless it is a commercial loss in trade and a penalty imposed for breach of the law during the course of trade cannot on grounds of public policy be said to be a commercial expense for the purpose of a business or disbursement made for the purpose of earning the profits -of such business.

Case law reviewed.

JUDGMENT:

CIVIL APPELLATE JURISDICTION: Civil Appeal No.110 of 1957. Appeal by special leave from the judgment and order dated February 25, 1955, of the former Bombay High Court in I.T.R. No. 57/X of 1954.

N. A. Palkhivala and I. N. Shroff, for the Appellant. A. N. Kripal and D. Gupta, for the Respondent. 1960. November 24. The Judgment of the Court was delivered by KAPUR, J.-This is an appeal by special leave against the judgment and order of the High Court of Bombay answering the question

submitted to it. against the assessee firm who is the appellant before us, the respondent being the Commissioner of Income-tax. The appeal relates to the assessment year 1949-50, the accounting year ended on July 25, 1948. The appellant is a firm doing the business of importing dates from abroad and selling them in India. During the accounting year the appellant imported dates from Iraq. At the relevant time the import of dates by steamers was prohibited by two notifications dated December 12, 1946, and June 4, 1947, but they were permitted to be brought by country craft. Goods which had been ordered by the appellant were received partly by steamer and partly by country craft. Consignments, which were imported by steamer and were valued at Rs. 5 lacs were confiscated by the Customs Authorities under s. 167, item 8 of the Sea Customs Act but under s. 183 of that Act the, appellant was given an option to pay fines aggregating Rs. 1,63,950 which sum on appeal was reduced to Rs. 82,250. This sum was paid and the dates were released. On the sale of the goods certain profits accrued out of which it sought to deduct Rs. 82,250 paid as penalty on ordinary principles of commercial accounting. The Income-tax Officer disallowed this claim which was also disallowed by the Appellate Assistant Commissioner. On appeal to the Income-tax Appellate Tribunal this sum was held to be allowable by a majority of two to one. At the instance of the respondent the Tribunal referred the following question to the High Court for its opinion:-

> "Whether on the facts and in the circumstances of the case, the payment of Rs. 82,250 is an allowable expenditure under Section 10(2) (xv) of the Indian Income-tax Act?"

The High Court held that the above amount of Rs. 82,250 could not be said to have been paid for salvaging the goods but was paid as a penalty incurred in consequence of an illegal, act on the part of the appellant and was therefore not an allowable item under s. 10(2)(xv) of the Income-tax Act. Against this judgment the appellant firm has come in appeal to this Court by special leave.

any contract of hire purchase was contemplated, cannot be applied simpliciter, because such a contract has in it not only the element of bailment but also the element of sale. At common law the term 'hire -purchase' properly applies only to contracts of hire conferring an option to purchase, but it is often used to describe contracts which are in reality agreements to purchase chattels by instalments, subject to a condition that the property in them is not to pass until all instalments have been paid. The distinction between these two types of hire purchase contracts is, however, a most important one, because under the latter type of contract there is a binding obligation on the hirer to buy and the hirer can therefore pass a good title to a purchaser or pledgee dealing with him in good faith and without notice of the rights of the true owner, whereas in the case of a contract which merely confers an option to purchase there is no binding obligation on the hirer to buy, and a purchaser or pledgee can obtain no better title than the hirer had, except in the case of a sale in market overt, the contract not being an agreement to buy within the Factors Act, 1889, or the Sale of Goods Act, 1893." The observations quoted above are based mostly on two leading cases which have come to be regarded as the locus classicus upon the subject, namely Lee v. Butler (1) in which the transaction was described by Lord Esher, M.R., as "Hire and Purchase Agreements" and Helby v. Matthews (2) in which the House of Lords distinguished the former case on the ground that in that case there was a binding contract to buy and not merely an option to buy, without any obligation to buy. Both these cases were decided in terms of Factors Act of 1889 (52 & 53 Viet. c. 45, s. 9). Both

the kinds of agreements exemplified by the two leading cases aforesaid would now be included in the definition of 'hire-purchase' as contained in s. 21 of the Hire Purchase Act, 1938 (1 & 2 Geo., 6, c. 53):-

> "'Hire-purchase agreement' means an agreement for the bailment of goods under which the bailee (1) [1893] 2 Q.B. 318. (2) (1895] A.C. 471.

may buy the goods or under which the property in the goods will or may pass to the bailee, and where, by virtue of two or more agreements, none of which by itself constitutes a hire-purchase agreement, there is a bailment of goods and either the bailee may buy the goods, or the property therein will or may pass to the bailee, the agreements shall be treated for the purposes of this Act as a single agreement made at the time when the last of the agreements was made."

It is clear that under the Law, as it now stands, which has now been crystallised into the section of the Hire Purchase Act, quoted above, the transaction partakes of the nature of a contract or bailment with an element of sale, as aforesaid, added to it. 'in such an agreement, the hirer may not be bound to purchase the thing hired;. he may or may not be. But in either case, if there is an obligation to buy, or an option to buy, the goods delivered to the hirer by the owner on the terms that the hirer, on payment of a premium as also of a number of instalments, shall enjoy the use of the goods, which ultimately may become his property, the transaction amounts to one of hire-purchase, even though the title to the goods has remained with the owner and shall not pass to the hirer until a certain event has happened, namely, that all the stipulated instalments have been paid, or that the hirer has exercised his option to finalise the purchase on payment of a sum, nominal or otherwise.

But it has been contended on behalf of the petitioners that there is no binding agreement to purchase the goods and that title is retained by the owner not as a security for payment of the price but absolutely. According to third term of the agreement, on the hirer duly performing and observing the terms of the agreement, with particular reference to the payment of the monthly instalments, "the hiring shall come to an end and the vehicle shall, at the option of the hirer, become his absolute property; but until such payments as aforesaid have been made, the vehicle shall remain the property of the owners. The hirer shall also have the option of purchasing the vehicle at any belonging to him may be, the name and residence of the said person and the amount of penalty or increased rate of duty unrecovered; and such Magistrate shall thereupon proceed to enforce payment of the said amount in like manner as if such penalty or increased rate had been a fine inflicted by himself."

These sections show the punishments provided for the breach of the prohibitions in regard to importation or exportation of goods under ss. 18 and 19; the power of the Customs Authorities to give an option to pay in lieu of confiscation and how the penalties are to be imposed. Therefore when the appellants incurred the liability they did so as a penalty for an infraction of the law; but it cannot be said that the money which they had to pay was not paid as a penalty and in fact under s. 167(8) it was a penalty.

In support of his argument counsel for the appellant firm referred to Maqbool Hussain etc. v. The State of Bombay etc. (1) and to the following passage at p. 742 where Bhagwati, J., said:-

> "Confiscation is no doubt one of the penalties which the Customs Authorities can impose but that is more in the nature of proceedings in rem than proceedings in personam, the object being to confiscate the offending goods which have been dealt with contrary to the provisions of the law and in respect of the confiscation also an option is given to the owner of the goods to pay in lieu of confiscation such fine as the officer thinks fit. All this is for the enforcement of the levy of and safeguarding the recovery of the sea customs duties."

Similar observations were made by S. K. Das, J., in Shewpujanrai Indrasanrai Ltd. v. The Collector of Customs & Ors. (2) where it was said that a distinction must be drawn between an action in rem and proceeding in personam and that confiscation of the goods is a proceeding in rem and the penalties are enforced against the goods whether the offender is known or not. The view taken by this Court in the other two cases cited by counsel for the appellants, i.e., Leo Roy (1) [1953] S.C.R. 730. (2) [1959] S.C.R. 821, 836.

Frey v. The Superintendent, District Jail, Amritsar (1) and Thomas Dana v. The State of Punjab (2) is the same. In Dana case (2) Subba Rao, J., said at p. 298:-

> "If the authority concerned makes an order of confiscation it is only a proceeding in rem and the penalty is enforced against the goods. On the other hand, if it imposes a penalty against the person concerned, it is a proceeding against the person and he is punished for committing the offence. It follows that in the case of confiscation there is no prosecution against the person or imposition of a penalty on him."

In Maqbool Hussain's case (3) the question for decision was whether after proceedings had been taken under the Sea Customs Act an accused person could be prosecuted and could or could not rely upon the plea of double jeopardy, it was held that he could not. In Shewpujanrai's case (4) the contention raised was that after proceedings had been taken under the Foreign Exchange Regulation Act it was not open to the Customs Authorities to take any action under the Sea Customs Act. The other two cases were similar to Maqbool Hussain's case (3). The contention now raised before us is quite different. What is to be decided in the present case is whether the penalty which was paid by the appellant firm was an allowable deduction within s. 10(2)(xv) of the Income-tax Act which provides:

> S. 10(2)(xv) "any expenditure (not being in the nature of capital expenditure or personal expenses of the assessee) laid out or expended wholly and exclusively for the purpose of such business, profession or vocation." The words "for the purpose of such business" have been construed in Inland Revenue v. Anglo Brewing Co. Ltd. (5) to mean "for the purpose of keeping the trade going and of making it pay". The essential condition of allowance is that the expenditure should have been laid out or expended wholly and exclusively for the purpose of such business. (1) [1958] S.C.R. 822. (2)

[1959] Supp. I S.C.R. 274, 298. (3) [1953] S.C.R. 730. (4) [1959] S.C.R. 821, 836. (5) (1925) 12 T.C. 803, 813.

In deciding this case, reference to decisions in some English cases will be fruitful. In Commissioners of Inland Revenue v. Warnes & Co. (1), the assessee who carried on the business of oil exporters were sued for a penalty on an information exhibited by the Attorney-General under the Sea Customs Consolidation Act for breach of orders and proclamations. The matter was settled by consent on the assessee agreeing to pay a mitigated penalty of pound 2,000. All imputations on the moral culpability of the assessees were withdrawn. The provisions of the Act under which this information was lodged and penalty paid was similar to the provisions of the Indian Sea Customs Act. This amount was held not to be a proper deduction because in order to be within the provision similar to s. 10(2) (xv) of the Indian Act the loss had to be something within commercial contemplation and in the nature of a commercial loss. Rowlatt, J., relying on the observation of Lord Loreburn, L. C., in Strong & Co. v. Woodifield (2) said at p. 452:-

> "but it seems to me that a penal liability of this kind cannot be regarded as a loss connected with or arising out of a trade. I think that a loss connected with or arising out of a trade must, at any rate, amount to something in the nature of a loss which is contemplable and in the nature of a commercial loss. I do not intend that to be an exhaustive definition, but I do not think it is possible to say that when a fine--which is what the penalty in the present case amounted to-has been inflicted upon a trading body, it can be said that that is a "loss connected, with or arising out of" the trade within the meaning of this rule."

This statement of the law was approved in the Commissioners of Inland Revenue v. Alexander Von Glehn & Co. Ltd. (3) where also in similar circumstances by consent of the assessee penalty of pound 3,000 was paid and the penalty plus the costs were claimed as deduction in arriving at the profits. The Special Commissioners had found that the penalty and costs were incurred by the assessee in the course of carrying on (1) [1919] 2 K.B. 444. (2) [1906] A.C. 448.

(3) [1920] .2 K.B. 553.

their trade and so incidental thereto and were admissible deductions. Rowlatt, J., on a reference held it to be a non-deductible item. This judgment was affirmed on appeal by the Court of Appeal. Lord Sterndale, M. R., was of the opinion that it was immaterial whether technically the proceedings were criminal or not. The money that was paid was paid as a penalty and it did not matter if in the information it was called a forfeiture.

It was argued by the assessee in that case that no moral obliquity was attributed to them and that it did not matter whether the expense was incurred in consequence of an infraction of the law or whether it was a penalty for doing an illegal act. At p. 565 Lord Sterndale said:-

> "Now what is the position here? This business could perfectly well be carried on without any infraction of the law. This penalty was imposed because of an infraction

> of the law, and that does not seem to me to be, any more than the expense which had to be paid in Strong & Co. v. Woodifield (1) appeared to Lord Davey to be, a disbursement or expense which was laid out or expended for the purpose of such trade....."

Warrington L.J. said at p.569:-

> "It is a sum which the persons conducting the trade have had to pay because in conducting it they have so acted as to render themselves liable to this penalty. It is not a commercial loss, and I think when the Act speaks of a loss connected with or arising out of such trade it means a commercial loss, connected with or arising out of the trade."

In Strong & Co. v. Woodifield (1) a brewing company owned a licensed house in which they carried on the business of inn- keepers. They incurred a liability to pay damages on account of injuries caused to a visitor, by the falling in of a chimney. This sum was held not to be allowable as a deduction in computing the profits' Lord Loreburn, L. C., in his speech said no sum could be deducted unless it be money wholly and exclusively laid out or expended for the purpose of such (1) (1906) A.C. 448.

trade and that only such losses could be deducted as were connected with it in the sense that they were really incidental to the trade itself and they could not be deducted if they were mainly incidental to some other vocation or fell on the trader in some character other than that of a trader. Lord Davey observed:"I think the disbursements permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arise out of, or is connected with the trade or is made out of the profits of the trade. It must be made for the purpose of earning profits." The following passage from Lord Sterndale's judgment at p. 566 in Von Glehn's case (1) from which we have already quoted shows the effect of incurring a penalty as a result of a breach of the law:

> "During the course of the trading this company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong in the sense that they were willingly and knowingly sending these goods to an enemy destination; but they committed a breach of the law, and for that breach of the law, they were fined. That, as it seems to me, was not a loss connected with the business, but was a fine imposed upon the company personally, so far as a company can be considered to be a person, for a breach of the law which it had committed. It is perhaps a little difficult to put the distinction into very exact language, but there seems to me to be a difference between a commercial loss in trading and a penalty imposed upon a person or a company for a breach of the law which they have committed in that trading. For that reason I think that both the decision of Rowlatt, J., in this case, and his former decision in Inland Revenue Commissioners v. Warnes & Co. (2) which he followed were right, and that this appeal should be dismissed with costs."

In Spofforth and Prince v. Glider (3) the assessee was a firm of chartered accountants, who claimed a deduction for certain legal costs paid in connection with a (1) [1920) 2 K.B. 55.3. (2) [1919] 2 K.B. 444. (3) (1945) 26 T.C. 310.

successful defence of one of the partners in a Police Court. The assessee firm also sought legal advice in regard to matters connected with some proceedings. Summons were issued against the assessee firm but were eventually dismissed. The assessee contended that the whole of the costs incurred in connection with the proceedings were "wholly and exclusively" laid out or expended for the appellant's profession and were therefore allowable deductions. The Special Commissioner had held against the assessee which was upheld by the Court. The test laid down by Lord Davey in Strong & Co. v. Woodifield (1) was applied and applying that test it was held that except the expenses for obtaining legal advice the other expenses were not admissible.

In Farrie v. Hall (2) F, a sugar broker was sued in the High Court for libel and the Court held that F had acted maliciously and that the defence of privilege could not prevail and awarded damages against him. F sought to claim the amount of damages as an allowable deduction contending that it was an expenditure laid out wholly and exclusively for the purposes of his trade or was a loss connected with or arising out of the trade. Relying on the cases above mentioned this amount was disallowed because it fell on the assessee in his character of a calumniator of a rival sugar broker and it was only remotely connected with his trade as a sugar broker. Therefore it was not laid out exclusively and wholly for the purpose of his business. We were also referred to the observations of Danckwerts, J. in Newson v. Robertson (3) where it was said that if the expenditure is incurred by the tax-payer for more than one -purpose including the commercial purposes in the sense that it is incurred for the purposes of earning profits of the trade and also some outside purpose then the expenses cannot be claimed at all as not being wholly and exclusively laid out or expended for the purpose of the trade. In that case expenses claimed by a Barrister for (1) [1906] A.C. 448. (2) [1947] 28 T.C. 200. (3) [1952] 33 T.C. 452, 459.

travelling between his house and his chambers were disallowed because his object and purpose in travelling was mixed and not wholly and exclusively for the purpose of the profession.

Coming now to Indian cases; In Mask & Co. v. Commissioner of Income-tax, Madras (1) the assessee in breach of his contract sold crackers at a lower rate and a decree was passed against him for damages for breach of contract which he claimed as an allowable deduction. It was held that as the assessee had disregarded the undertaking given and his conduct was palpably dishonest it did not constitute an allowable expenditure. Sir Lionel Leach, C. J., after referring to Warne's case (2) and Von Glehn's case (3) held that the amount did not constitute an expenditure falling within s. 10(2)(xii). The Madras High Court in Senthikumara Nadar & Sons v. Commissioner of Income-tax, Madras (4) held that payments of penalty for an in. fraction of the law fell outside the scope of permissible deductions under s. 10(2)(xv). In that case the assessee had to pay liquidated damages which was akin to penalty incurred for an act opposed to public policy a policy underlying the Coffee Market Expansion Act, 1942, and which was left to the Coffee Board to enforce.

Reference was also made during the course of arguments to Commissioner of Income-tax v. Hirjee (1). In that case the assessee was prosecuted under the Hoarding and Profiteering Ordinance but was finally acquitted and claimed the amount spent in defending himself under s. 10(2)(xv) in his assessment. It was held that the distinction between the legal expenses on a successful and unsuccessful defence was not sound and that the deductibility of such expenses under s. 10(2)(xv) must depend on the nature and purpose of the legal proceedings in relation to the business whose profits are in computation and are unaffected by the final outcome of the proceedings.

A review of these cases shows that expenses which (1) [1943] 11 I.T.R. 454.

(3) [1920] 2 K.B. 553.

(2) [1910] 2 K.B 444.

(4) [1957] 32 I.T.R. 138 (5) [1953] S.C.R. 714.

are permitted as deductions are such as are made for the purpose of carrying on the business, i.e., to enable a person to carry on and earn profit in that business. It is not enough that the disbursements are made in the course of or arise out of or are concerned with or made out of the profits of the business but they must also be for the purpose of earning the profits of the business. As was pointed out in Von Glehn's case (1) an expenditure is not deductible unless it is a commercial loss in trade and a penalty imposed for breach of the law during the course of trade cannot be described as such. If a sum is paid by an assessee conducting his business, because in conducting it he has acted in a manner, which has rendered him liable to penalty it cannot be claimed as a deductible expense. It must be a commercial loss and in its nature must be con- templable as such. Such penalties which are incurred by an assessee in proceedings launched against him for an infraction of the law cannot be called commercial losses incurred by an assessee in carrying on his business. Infraction of the law is not a normal incident of business and therefore only such disbursements can be deducted as are really incidental to the business itself. They cannot be deducted if they fall on the assessee in some character other than that of a trader. Therefore where a penalty is incurred for the contravention of any specific statutory provision, it cannot be said to be a commercial loss falling on the assessee as a trader the test being that the expenses which are for the purpose of enabling a person to carry on trade for making profits in the business are permitted but not if they are merely connected with the business. It was argued that unless the penalty is of a nature which is personal to the assessee and if it is merely ordered against the goods imported it is an allowable deduction. That, in our opinion, is an erroneous distinction because disbursement is deductible only if it falls within s. 10(2)(xv) of the Income-tax Act and no such deduction can be made unless it falls within the test laid down in the cases discussed above and it can be said to be expenditure wholly and exclusively laid for the purpose of the business. Can it be said (1) (1920) 2 K.B. 553.

that a penalty paid for an infraction of the law, even though it may involve no personal liability in the sense of a fine imposed for an offence committed, is wholly and exclusively laid for the business in the sense as those words are used in the cases that have been discussed above. In our opinion, no expense which is paid by way of penalty for a breach of the law can be said to be an amount wholly

and exclusively laid for the purpose of the business. The distinction sought to be drawn between a personal liability and a liability of the kind now before us is not sustainable because anything done which is an infraction of the law and is visited with a penalty cannot on grounds of public policy be said to be a commercial expense for the purpose of a business or a disbursement made for the purposes of earning the profits of such business.

In our opinion the High Court rightly held that the amount claimed was not deductible and we therefore dismiss this appeal with costs.

Appeal dismissed.