IN THE SUPREME COURT OF PAKISTAN
(APPELLATE JURISDICTION)

PRESENT: MR. JUSTICE MIAN SAQIB NISAR, CJ
MR. JUSTICE UMAR ATA BANDIAL
MR. JUSTICE FAISAL ARAB

CIVIL APPEALS NO.26 OF 2009 AND 228 OF 2010
(on appeal against the judgment dated 16.10.2008 and 27.04.2009 of the High Court of Sindh, Karachi passed in I.T.C.293/1992 and I.T.A.594/2000 respectively)

Commissioner of Income Tax Karachi (in both cases)
...Appellant(s)

VERSUS

M/s. Hassan Associates (Pvt) Ltd. (in CA 26/09)
M/s. National Refinery Ltd. Karachi (in CA 228/10)
...Respondent(s)

For the Appellant(s):
(in both cases) Muhammad Siddiq Mirza

For the Respondent(s):
(in CA 26/09) Ms. Lubna Pervez, ASC.
(in CA 228/10) Mr. Iqbal Salman Pasha, ASC.

Date of Hearing: 16.05.2017

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ORDER

MIAN SAQIB NISAR, CJ.- The key question involved in these appeals with the leave of the Court is whether the amounts claimed to be expenditures by the respondents *(in both cases)* in their income tax returns are permissible deductions falling within the purview of Section 23(1)(xviii) of the Income Tax Ordinance, 1979 *(the Ordinance)* or they fall within the ambit of fine or penalty for infraction of law to be disallowed in terms of the law laid down in the case of **Commissioner of Income Tax Vs. Premier Bank of Pakistan [1999 PTD 3005 = (1999) 79 Tax (SC) 589]**.

2. Heard. The arguments of the learned counsel in both the cases shall be reflected in the course of this opinion. Since the facts of

both the appeals are distinct, we shall first examine the relevant law and then discuss the individual cases. Section 15 of the Ordinance provides for various heads of income for the purposes of charge of income tax and computation of total income, one of which is 'income from business or profession' *[sub-part (d)]*. Section 22 of the Ordinance stipulates the different incomes chargeable under the head 'income from business or profession'. Section 23(1) of the Ordinance goes onto list the allowances and deductions to be made when computing the income under the head 'income from business or profession', part (xviii) whereof reads as under:-

> *23.* ***Deductions****.- (1) In computing the income under the head "Income from business or profession", the following allowances and deductions shall be made, namely:-*
>
> *(xviii) any expenditure (not being in the nature of capital expenditure of personal expenses of the assessee) laid out or expended wholly and exclusively for the purpose of such business or profession;*

In the judgment of **Premier Bank** *(supra)* this Court was faced with the question as to whether the liabilities incurred by Premier Bank Limited *(the respondent assessee therein)* on account of payment of penal interest under Section 36(4) of the State Bank of Pakistan Act, 1956 *(the Act, 1956)* for having failed to maintain the credit balance levels as required by Section 25 of the Banking Companies Ordinance, 1962 and Section 36(1) of the Act, 1956, can be claimed as deductions in terms of Section 10(2)(xvi) of the repealed Income Tax Act, 1922 *(the Act, 1922)*. It was held as under:-

> *9. …revenue expenses incurred by the assessee wholly and exclusively for the purpose of his business-can legitimately be claimed by him as an allowable deduction*

> *under section 10(2)(xvi) [of the repealed Income tax Act, 1922], but* ***expenditure incurred as penalty or fine paid on account of infraction of law cannot be permitted as expenditure laid out wholly or exclusively for the purpose of the business of the assessee. However, in case of expenditure which, although, has been incurred by the assessee on account of infringement of a provision of a statute, but is not in the nature of penalty, the question whether such expenditure is admissible under section 10(2)(xvi), or not, would depend upon the circumstances of each case****…*
>
> *[Emphasis supplied]*

It is pertinent to note that Section 10(2)(xvi) of the Act, 1922 is almost identically worded as Section 23(1)(xviii) of the Ordinance, the former of which read as under:-

> ***10. Business.-*** *(2) Subject to the provisions of this Act such profits or gains shall be computed after making the following allowances,, namely;-*
>
> *(xvi) any expenditure not being in the nature of capital expenditure of personal expenses of the assessee laid out or expended wholly and exclusively for the purposes of such business, profession or vocation;*

Thus, the reasoning in the **Premier Bank** case *(supra)* would very well apply to the corresponding provision of Section 23(1)(xviii) of the Ordinance. Therefore, according to Section 23(1)(xviii) of the Ordinance, any expenditure, which is not in the nature of capital expenditure of personal expenses of the assessee, is laid out or expended wholly and exclusively for the purpose of such business or profession, shall be deducted while computing the income under the head 'income from business or profession'. However, as per the law laid down by this Court

in the case of **Premier Bank** *(supra)* in which the *pari materia* provision of Section 10(2)(xvi) of the Act, 1922 was being examined, any expenditure incurred as a penalty or fine paid on account of an **infraction, breach or violation of law** would not be allowed to be an expenditure laid out wholly or exclusively for the purpose of the business of the assessee. As per the said judgment, as regards expenditure which an assessee has incurred on account of a violation of law but is not in the nature of a penalty or fine, the question whether such expenditure would be admissible under Section 23(1)(xviii) of the Ordinance or not would depend upon the facts and circumstances of each case.

It must also be noted that it was after the **Premier Bank** case *(supra)* that the legislature inserted *vide* Finance Ordinance, 2000, Section 24(j) in the Ordinance which made "*any expenditure incurred on account of payment of a fine or penalty for the violation of any law, rule or regulation for the time being in force*" inadmissible as a deduction. A very similar provision was retained in Section 21(1)(g) of the Income Tax Ordinance, 2001. Since these two provisions were referred to by the learned counsel for the appellant *(in both appeals)*, we would like to observe that they *(the provisions)* have in effect introduced in statutory form, the law that this Court had laid down in **Premier Bank**'s case *(supra)*. However since they were not in force during the assessment years in question, we shall not delve into them any further.

3. We shall now advert to the facts of each case and apply the law thereto.

Civil Appeal No.26/2009

4. A private limited company indulged in the business of construction, the respondent in this appeal was awarded a contract by

the Government of Punjab *(GoP)* for the construction of a hockey stadium subject to furnishing of a performance bond *(bank guarantee)* to the tune of Rs.2,065,000/-. The GoP encashed the bank guarantee during the assessment year 1985-86 for alleged breach of contract by the respondent. The respondent claimed the said amount as expenditure in the income tax return filed for the relevant assessment year and also filed a civil suit against such encashment. The Income Tax Officer disallowed the said amount as expenditure and added it to the respondent's income on the ground that it *(the amount)* was recoverable from the GoP. The Commissioner of Income Tax (Appeals) *[CIT(A)]* and the Income Tax Appellate Tribunal *(ITAT)* dismissed the respondent's appeals and upheld the addition. The ITAT refused the respondent's application for approval to refer the question to the learned High Court under Section 136 of the Ordinance, against which the respondent filed a reference before the learned High Court to consider the question, *"Whether on the facts and in the circumstances of the case the learned Income Tax Appellate Tribunal was justified in confirming the disallowance of the claim of enchasment (sic) of performance bond by the Government of Punjab"*. The learned High Court answered the question in the negative *vide* impugned judgment and the expenditure was allowed for the reason that the said amount was expended wholly and exclusively for the purpose of business and therefore, was allowable under section 23(1)(xviii) of the Ordinance, hence this appeal with the leave of the Court dated 2.1.2009 to consider whether *"…the view taken by the High Court is contradictory to the view taken by this Court in the case of Commissioner of Income Tax Vs. Premier Bank Ltd, Karachi [(1999) Tax 589 (SC Pak)] as the judgment of this Court was not properly appreciated."*

5. It is the appellant's case that the encashment of the bank guarantee was due to the respondent's failure to fulfill its contractual

obligation, therefore, it was a penalty and cannot be allowed as an expense. He also argued that such payment was a violation of the Contract Act, 1872 *(the Act, 1872)* and thus was a breach of the law, therefore was not permissible as an expenditure according to **Premier Bank**'s case *(supra)*. On the other hand, it is the respondent's case that the encashment of the bank guarantee was pursuant to a business transaction between the respondent and the GoP which could not be regarded as a fine or penalty and was not an infraction of law as per **Premier Bank**'s case *(supra)* which is not attracted in the instant case.

6. At this juncture, we find it appropriate to consider the instances as to what constitutes an expenditure laid out or expended wholly and exclusively for the purpose of a business or profession. As regards the cases from the Pakistani jurisdiction, in **Commissioner of Income Tax, Karachi Vs. Eastern Automobiles Ltd., Karachi [(1967) 15 TAX 233]** it was held that the damages paid for breach of contract were an allowable expenditure. In **Karachi Steam Navigation Co. Ltd. Vs. Commissioner of Income Tax [(1967) 15 TAX 73]** the learned High Court of Sindh held that damages paid in settlement of litigation for breach of contract was an expenditure wholly and exclusively made for the purposes of the business and was thus an admissible expenditure.

7. We now advert to the cases from the Indian jurisdiction. In **Hind Mercantile Corporation Ltd. Vs. Commissioner of Income-Tax, Madras [(1963) 49 ITR 23]** the Madras High Court held that the amounts paid by way of damages and legal expenses were allowable as an expenditure in computing the profits and gains of the assessee's business as such loss incurred in the course of the business was incidental to and intimately connected with the conduct of the business and for the purpose of earning profits for the business. In **Commissioner**

Of Income-Tax (Central) Vs. Inden Biselers [(1973) 91 ITR 427] again the Madras High Court held that the discharge of promissory notes was a legal obligation of the assessee incurred in the course of and incidental to the business, therefore the damages paid by the assessee was a revenue loss incurred in the course of carrying on of the business and, therefore, liable to be deducted as an expenditure. In **Addl. Commissioner Income Tax Vs. Rustam Jehangir Vakil Mills Ltd. [(1976) 103 ITR 298]** it was held by the High Court of Gujarat that the payment made to the Textile Commissioner by the assessee for contravention of the directions given by the Textile Commissioner was not in the nature of penalty and was incidental to the carrying on of the assessee's business and was thus was an allowable business expenditure. In **Commissioner Income Tax Vs. Tarun Commercial Mills Co. Ltd. [(1977) 107 ITR 172]** it was held by the Gujarat High Court that the amount paid to the Textile Commissioner for non-fulfilment of the assessee's obligation contained in the bond it executed with the Government of India was business expenditure incurred wholly and exclusively for the purposes of the assessee's business. In the case of **Commissioner Income Tax Vs. Surya Prabha Mills (P.) Ltd. [(1980) 123 ITR 654]** the High Court of Madras held that where the assessee could not import the quantity of foreign cotton allotted by the Indian Cotton Mills Federation of which the assessee was a member and had to make payment of the guarantee amount for the bales that it did not import, such payment was paid only to avoid further loss, and could only be treated as an expenditure laid out wholly and exclusively for the purpose of the business; there was no element of any penalty, no infraction of law or offence against public policy. In the case of **Commissioner Income Tax Vs. Bharat Vijay Mills Ltd. [(1981) 128 ITR 633]** the High Court of Gujarat held that where the

assessee had to pay certain amounts for failure to carry out the directions of the Textile Commissioner for production or packing of the minimum of the particular types of cloth, the compensation paid to the Textile Commissioner for the non-production of the controlled variety of cloth was an allowable business expenditure.

8. According to the above case law, an amount paid as damages or compensation is an expenditure laid out wholly or exclusively for the purpose of the business of the assessee. It is a revenue loss incurred in the course of carrying on of the business and therefore an admissible deduction under Section 23(2)(xviii) of the Ordinance. In the instant appeal, the contract was executed between the respondent and the GoP in connection with the business of respondent, who failed to perform its part of agreement, as such the GoP encashed the performance bond. It was purely a business transaction between the parties and there was no infraction or violation of any law whatsoever. When we asked the learned counsel for the appellant to show us whether there was any infraction of law by the respondent for which the penalty, if any, has been imposed on the respondent, he candidly conceded that the penalty was imposed for violation of the contract. A weak attempt was made to argue that the 'law' in this case was the Act, 1872 which to our mind is completely unfounded. There was a breach of the **contract** and not the law. To put it differently, the GoP would not be able to recover any money from the respondent if not for the existence of the performance bond. Thus, the encashment of bank guarantee can at best be considered to be damages or compensation paid to the GoP for unsatisfactory performance of a contract by the respondent which is a revenue loss incurred by the latter in the course of carrying on its business. The forfeiture of an amount under a contract cannot be

equated with a fine or penalty incurred due to infraction or violation of any law. Further, the civil suit filed by the respondent against the GoP having been dismissed, such amount is no more adjustable. Thus, we are of the view that **Premier Bank**'s case *(supra)* is not applicable in the instant appeal.

9. For the forgoing reasons, we find no illegality in the impugned judgment of the learned High Court calling for interference. This appeal is accordingly dismissed.

Civil Appeal No.228/2010

10. The respondent in this appeal is a public limited company and is in the business of refining of crude oil into various petroleum products. During the assessment year 1999-2000 it *(the respondent)* imported crude oil from Aramco, Saudi Arabia under a loan from the Islamic Development Bank, Jeddah *(IDB)* on the guarantee of the State Bank of Pakistan *(SBP)*. As per the SBP's procedure, the respondent was required to deposit the counterpart rupee fund within ten days of disbursement of funds by IDB, which it failed to do, as such in terms of Para 44 of Chapter 13 of the Foreign Exchange Manual *(the Manual)*, SBP charged an amount of Rs.4/- per day per Rs.10,000/- or part thereof for the period of delay amounting to Rs.30,500,000/-. The respondent claimed the said amount as an expenditure in its income tax returns, however, the Assessing Officer refused to allow the same on the ground that such amount was a penalty incurred on account of infraction of law in terms of the judgment of this Court in **Premier Bank**'s case *(supra)* and was thus an impermissible deduction. The CIT(A) dismissed the respondent's appeal, however, the ITAT accepted its appeal holding that the amount paid by the respondent was not in the nature of fine or

penalty in respect of any infringement of law or the SBP Regulations rather was a payment made on account of the delay in payment of the principle amount of the loan and was an expenditure laid down exclusively for the business of the respondent and was therefore an allowable deduction. On further appeal, the learned High Court upheld the order of the Tribunal *vide* impugned judgment, hence this appeal with the leave of the Court dated 1.4.2010 granted on the basis of the leave granting order dated 2.1.2009 in Civil Appeal No.26/2009.

11. It is the appellant's case that the amount paid by the respondent to SBP was a penalty for infraction of law, namely, the Manual, therefore, the case is fully covered under **Premier Bank**'s case *(supra)*. It is the respondent's case that SBP charged an 'interest' and not a fine or penalty under any law. We find that the amount was charged by SBP under Para 44 of Chapter 13 of the Manual. For convenience, the relevant paragraphs thereof are reproduced hereunder:-

> ***43. Fine on delay in deposit of Counterpart Funds.***
> *In the event of delay in depositing counterpart funds with the State Bank within the prescribed period,* ***the concerned Authorised Dealer will pay to the State Bank fine at the rate of Rs 4 per day per Rs 10,000 or part thereof for the period of delay****.*
>
> ***44. Documents received on Collection Basis due to Discrepancy/Documents drawn on usance basis.***
> *(i) In cases where the overseas negotiating bank does not make payment to the supplier but sends the documents to the bank in Pakistan on collection basis due to discrepancy in the documents, the Authorised Dealers will deposit counterpart funds with the State Bank on retirement of the documents by the importers concerned. The prescribed period for deposit of counterpart funds will be reckoned as*

> *from the date of retirement of bill by the importer.* ***If the funds are held back by the Authorised Dealers beyond the prescribed period, fine would be charged as per paragraph 43 ibid****.*
>
> *[Emphasis supplied]*

From the above provisions it is clear that it was not a mere interest or additional amount demanded by SBP, rather the word used is **fine** which to our mind in this case is akin to a penalty for a violation of Para 44 of Chapter 13 of the Manual. The learned counsel for the respondent in order to take his case out of the purview of **Premier Bank**'s case *(supra)* argued that there was an agreement between the respondent and SBP, and the additional amount was paid for violation of that contract, as such, it was not a fine or penalty. However, he failed to show any contract from record. It is not the case of the respondent even before the lower forums that there was a contract between the respondent and SBP and the additional amount was paid as damages for violation of such contract. Essentially, crude oil was to be supplied by Aramco to the respondent through a loan from IDB, whereas SBP was only a guarantor.

12. The learned counsel for the respondent also submitted that **Premier Bank**'s case *(supra)* is distinguishable as in the said case it was mandatory for the respondent-bank to maintain minimum reserves as per Section 10(1) of the Act, 1956, however, in the instant case the respondent was not required under any provision of law to deposit the counterpart rupee fund with SBP. We find that as per para 44 of Chapter 13 of the Manual, the authorised dealers are bound to deposit counterpart funds with SBP on retirement of the documents by the importers concerned. In case the funds are held back by the authorized dealers beyond the prescribed period, a fine would be charged. The rate

of fine has been mentioned in Para 43 thereof which provides that in the event of delay in depositing counterpart funds with SBP within the prescribed period, the concerned authorized dealer will pay to SBP a fine at the rate of Rs.4/- per day per Rs.10,000/- or part thereof for the period of delay. It is to be noted that the Manual contains the basic regulations issued by the Government of Pakistan and SBP under the provisions of the Foreign Exchange Regulations Act, 1947, therefore, it has the force of law and any violation thereof would entail the penal consequences provided therein. As the respondent failed to comply with the provisions of the Manual, a fine was charged at the prescribed rate. It is essentially a fine for infraction of the law, i.e. the above referred provisions of the Manual, and are not damages or compensation for breach of a contract. Thus, the law laid down in **Premier Bank**'s case *(supra)* is fully applicable to the instant appeal.

13. In the light of the above, this appeal is allowed, the impugned judgment of the learned High Court is set aside and the order of the ITAT is upheld.

CHIEF JUSTICE

JUDGE

JUDGE

ISLAMABAD.
16th May, 2017.
Approved for reporting
Mudassar/*