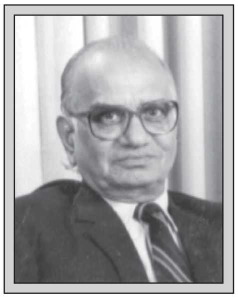
Articles



Disallowance of expenses concerning legally prohibited acts/offences in Income tax assessments – Similar provision necessary for expenses opposed to public policy

T. N. Pandey*, Advocate, Noida (UP).

An explanation inserted to section 37(1) of the Income Tax Act, 1961 by Finance (No. 2) Act 1998 disallows expenses concerning legally prohibited acts. The author advocates amendment of the Act to provide for similar disallowances in respect of expenses opposed to public policy of India.

The Bombay High Court recently by its decision in the case of *CIT* v. *Samrath Sahakari Sakhar Karkhana Ltd.* (2007) 213 CTR (Bom) 8 has ruled that bakshish (reward) payments ranging from @ Rs. 200 to Rs. 250 paid by an assessee – a sugar manufacturer – to labourers employed by the harvesting and transport contractors with a view to induce them to continue with work during the summer months as per local practice is allowable as legitimate business expenditure more so where there is no doubt regarding the genuineness of the payments.

BAKSHISH ñ WHAT DOES IT IMPLY ?

The word 'bakshish' implies gratuitous payment generally in lieu of some services rendered voluntarily or on payment basis. It could be in the normal course purely voluntary or in accordance with the local practices generally not in contravention of any law or could also be in the form of compensation for doing something wrong or illegal. In the former situation as in the case before the Bombay High Court, the payments made could be considered as business expenditure and admissible as deduction under section 37(1) of the Income tax Act, 1961 (Act). The later category of payments may come within the purview of Explanation to section 37(1) (*infra*) and hence can be disallowed. However, certain expenses may come ' in between' in two situations i.e. not illegal but contrary to public policy or norms. Whether such expenses which are not in contravention of law or for committing an offence but socially and morally undesirable should also be disallowed in computing the taxable incomes is being examined in the later discussion.

FINES AND PENALTIES FOR INFRACTION OF LAW

Explanation to section 37(1) was inserted in the Act by the Finance (No. 2) Act of 1998 with retrospective effect from 1.4.1962 – the date from which the Act came into force. Even prior to the insertion of the Explanation, payments made for contravention of law have been held to be not allowable by the courts. It has been held that commission of an offence cannot ordinarily be said to be incidental to business and infraction of law is not a normal incident of business activities. Fines and penalties imposed for infraction of law etc. have been held to be not admissible in income tax assessments. The examples of such disallowances have been fines and penalties for infraction of excise or customs laws (*Hazi Aziz & Abdul Shakoor Bros* v. *CIT* (1961) 41, ITR 350 SC), Sales tax laws (*CIT* v. *Ratan Chand Bholanath* (SS) (1986) 160, TR 500 (MP), delay in payment of provident fund contributions (*Suneeta Laboratories Ltd.* v. *CIT* (1986) 162 ITR 883(MP) and violation of FERA (*Maddi Venkala ramon & Co.* (*P*) *Ltd.* v. *CIT* (1998) 229 ITR 524 (SC) and have been held to be not allowable.

In some decisions fines, penalties and payments even for defaults not very serious in nature have been considered disallowable. Under these categories have been included penalty paid

e-mail :
tn.pandey@yahoo.co.in

Former Chairman, CBDT and Special Secretary, Ministry of Finance, Govt. of India.

for non-payment of government dues (*Deoria Sugar Mills Ltd.* v. *CIT* (1970) 771 ITR 834 (Cal), penalty for default in payment of municipal taxes which is not related to the length of the default (*CIT* v. *Dhauraj Mills Pvt. Ltd.* (1994) 209 ITR 851 (Bom), penalty for payment of arrears of sugarcane cess (*Cawnpore Sugar Works Ltd.* v. *CIT* (1992) 1961 ITR 274 (All), amount paid for compounding of criminal prosecution (*GK Cotton Spg. & Wvg. Mills Co. Ltd.* v. *CIT* (1955) 281 ITR 78 (All) etc. In such cases, the decisions have been that such payments cannot be said to be connected with or arising out of trade or business or of a commercial nature and hence cannot be allowed as deduction. The view taken has been that the very nature of such expenses removes them from the category of expenses relating to trade or business. In the case of *Amrit Bazar Patrika Ltd. Re.* 1937 5 ITR 648 (Cal), the amount of fine imposed for contempt of the judiciary has been held to be disallowable on the ground that it is not a part of the ordinary business of a newspaper to commit contempt of courts. A view here could be that if some correspondent of the paper commits contempt of court unwittingly, the fine imposed for this should be considered as an admissible deduction.

MILDER VIEWS

In later decisions milder views regarding fines and penalties have been expressed by drawing distinction *vis-a-vis* earlier decisions. In these decisions, the views expressed are that where payment is made as a fine, compensation or penalty not for any proved offence but merely to arrive at settlements as compounding payments for saving the reputation of the business or with some other similar objective, the same could be said to be business expenses (see *Golder* v. *Great Boulder Gold Mines Ltd.* 33 TC 75). In the matters of payments for breaches of contracts it has been held that such payments are not for any infraction of law but only in the nature of (civil) damages.

In *Malwa Vanaspathi & Chemicals Co.* v. *CIT* (1997) 225 ITR 383 (SC), there were two penalties, one for a wrong declaration so as to avail of a concessional rate of tax, while the other related to penalty for late filing of the sales tax return. As regards the former penalty, the Supreme Court held that the amount is partly compensatory and partly penal. The part for infringement of law setting out a time limit for compliance with law could not be allowed. In *CIT* v. *Chemical Constructions* (2000) 243 ITR 858 (Mad), where the assessee had obtained concessional rate of tax by filing C forms not being eligible to file them, penalty equal to the concession wrongly availed of is leviable. Such levy, though styled as penalty, is compensatory in character. The High Court, therefore, directed deduction, following the above decision of Malwa Vanaspathi and Chemicals Co.. In some cases the decisions have been that payment of fines and penalties for innocent infringement of laws of a regulatory nature in 'good faith' and 'bona fide beliefs' need not be considered as inadmissible.

In *Prakash Cotton Mills P. Ltd.* v. *CIT* (1993) 201 ITR 684 (SC) and *Standard Batteries Ltd.* v. *CIT* (1995) 211 ITR 444(SC), the view expressed is that a statutory impost though described as penalty under the Sales Tax Act or where the payments is for breach of contract may be allowed as deduction to the extent the same is compensatory and not punitive. Similarly in *Mahalakshmi Sugar Mills Co.* v. *CIT* (1980) 123, ITR 429 (again reiterated in *CIT* v. *Lakshmi Devi Sugar Mills Pvt. Ltd.* 1991, 188 ITR 41 (SC) the apex court has said that interest paid for non-payment of cess in time is allowable as deduction.

PAYMENTS IN VIOLATION OF LAW

A new Explanation was added to section 37(1) to disallow payments of an illegal nature – in violation of law. This explanation was inserted by the Finance (No.2) Act, 1998 with retrospective effect from 1-4-1962. Since the law did disallow expenses related to violation of law the need for Explanation was to target payments, which by themselves constitute violation of laws, like payment of extortion money, which itself constitutes an offence. This is evident from the speech of the Finance Minister in his budget speech in following words :

> "111. A controversy has arisen recently regarding the deductibility of payments by way of extortion money. To set the controversy at rest, I propose to explicitly provide retrospectively since the inception of Income-tax Act, 1961 that any money paid by way of extortion will not qualify for deduction as a business income".

The ambit of this explanation seems to have been considerably enlarged in this explanatory memorandum to the Finance (No.2) Bill 1998, where it has been said :

> "20. Disallowance of illegal expenses – 20.1 section 37 of the Income-tax Act is amended to provide that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purposes of business or profession and no deduction or allowance shall be made in respect of such expenditure. This amendment will result in disallowance of the claims made by certain assesses in respect of payments on account of protection money, extortion, hafta, bribes, etc., as business expenditure. It is well decided that unlawful expenditure is not an allowable deduction in computation of income.
>
> 20.2. This amendment will take effect retrospectively from 1st April, 1962, and will, accordingly, apply in relation to the assessment year 1962-63 and subsequent years."

The law thus, at present is that expenses which are in the nature of payments for offences or which is prohibited by law are now clearly inadmissible.

ILLEGAL EXPENSES OF ILLEGAL BUSINESSES

The issues that arises in the context of the new law is whether while taxing the income of illegal businesses, illegal expenses incurred in earning such incomes would be deductible. In this context, a decision under the English law in the case of *Minister of Finance* v. *Smith* (1927) AC 193 (PC) can provide guidance. It has been pointed out in the decision that in allowing an expenditure, what is illegal as expenditure admissible as a business expenditure, the court "does not condone or take part in the illegal enterprise". When the Revenue finds that it is entitled to tax profits from an illegal business, even those businesses in trafficking in drugs, gun running, smuggling, running gambling house, brothels, etc. it is odd that there should be hesitancy in allowing penalties or fines in the course of carrying on business. Some of these contraventions may not be willful and may have occurred because of the complexities in the laws, especially those relating to imports, customs, excise, company law or foreign exchange. There is some relaxation from the stricter view in some Supreme Court decisions. Interest paid for non-payment of cess in time was held allowable by the Supreme Court. A statutory impost though described as penalty under the Sales Tax Act, or where the payment is for breach of contract, may be allowable to the extent it is compensatory and not punitive as held in *Prakash Cotton Mills P. Ltd.* v. *CIT*.

The view that illegal expenses concerning an illegal business are allowable has been accepted by the Supreme Court in the case of *CIT* v. *Piara Singh* (1980) 124 ITR 40 (SC). In this decision referring to an earlier decision in *CIT* v. *S.C. Kothari* (1971) 82 ITR 794 (SC), the Supreme Court held that for the purpose of section 10(1) of the IT Act 1922, (equivalent section in the IT Act, 1961 being section 37(1)), a loss incurred in carrying on an illegal business must be deducted before the true figure of profits brought to tax can be computed. The Court observed : -

> "If the business is illegal, neither the profits earned nor the losses incurred would be enforceable in law. But, that does not take the profits out of the taxing statute. Similarly, the taint of illegality of the business cannot detract from the losses being taken into account for computation of the amount, which can be subjected to tax as 'profits' under section 10(1) of the Act of 1922. The tax collector cannot be heard to say that he will bring the gross receipts to tax. He can only tax profits of a trade or business. That cannot be done without deducting the loss and the legitimate expenses of the business. We find that similar view has been taken by the Andhra Pradesh High Court in *Soni Hinduji Kushalji & Co.* v. *CIT* (1973) 89 ITR 112 (AP)."

The Rajasthan High Court in the case of *CIT* v. *Hiranand* (2004) 187 CTR (Raj) 32 pronounced after the insertions of the Explanation in section 37(1) with retrospective effect did not consider the impact of the explanation in deciding the case in favour of the assessee.

In *CIT* v. *Maddi Venkatramnam & Co. P. Ltd.* (1983) 144 ITR 373 (AP), the HC has held that if the whole business itself is illegal then the illegal payments, penalties and other fines incurred in connection with such business are deductible. This view of the A P High Court has been affirmed by the SC in (1998) 229 ITR 534 (at 539-540).

Hence a logical view seems to be that in the context of taxing of illegal incomes illegal expenses will have to be allowed despite the insertion of explanation to section 37(1) with effect from 1.4.1962. In such situations the Revenue will be unfair if it taxes the income from illegal business but disallows expenses by applying explanation to section 37(1).

ALLOWANCE OF EXPENSES WHICH COULD BE CONSIDERED AS OPPOSED TO PUBLIC POLICY/ETHICS

The issue that then arises for consideration is whether the expenses which may not be illegal in violation of law but have pernicious impact on society being opposed to public policy even though they may be prompted by commercial expediency need to be allowed in computing taxable incomes. The nature of such expenses can be seen from the following court decisions : –

(i) *CIT* v. *Coimbatore Salem Transport Pvt. Ltd.* (1966) 61 ITR 480 (Mad.)

In this case expenditure incurred by a transport operator by way of mamools (customary payments) including to some public servants were considered as allowable as not being prohibited by law. It was remarked that such payments provided ' grease' to run the wheels of business.

(ii) *CIT* v. *Armugham Chettier* (1980) 125 ITR 753 (Mad), payments by way of bribe by a stevedoring contractor to crew of a ship for obtaining a non-damage certificate and to the captain of a ship for obtaining payment for bills was not held illegal and, therefore, allowable.

(iii) In *Sri Venkata Satyanarayana Rice Mills Contractors Co.* v. *CIT* (1997) 223 ITR 101 (SC) the assessee had claimed payment to the Andhra Pradesh Welfare Fund under a scheme evolved as between Rice Millers Association and the Collector, Visakhapatnam, at a specified rate with reference to the quantity for which permits were granted by the Collector for exporting boiled rice to Kerala. The favourable finding of the Tribunal was reversed by the High Court as " subversive of public interest" irrespective of the fact as to how the funds were ultimately utilized and for what purpose they were collected. The High Court had felt, that though it cannot impose it own moral values, it cannot also acquiesce in a public wrong as it would otherwise tantamount to becoming a party to it.

The Supreme Court in the above mentioned decision took a liberal view when it approved the decision of the Full Bench of the Madhya Pradesh High Court in *CIT* (*Addl*) v. *Kuber Singh Bhagwandas* (1979) 118 ITR 379 (MP) where donations given to the Chief Minister's Drought Relief Fund in the expectation of permit for export of gulabi chana was held deductible on the ground of commercial expediency. It relied upon the decision in *Patnaik and Co. Ltd.* v. *CIT* (1997) 223 ITR 101 where the loss incurred in subscribing to the government securities merely with a view to sell trucks was held allowable. After adverting to similar other decisions, it reversed the view of the Andhra Pradesh High Court and in the decision of *Sri Venkata Satyanarayana Rice Mill's* case (*supra*) and held that contributions made to a public welfare fund solely for promotion of assessee's business, whether at the instance of the authorities or otherwise cannot be treated as opposed to public policy.

(iv) The Bombay High Court in two cases has considered the payment of secret commission as admissible expenditure despite the fact that the proof of payment was not furnished by the assessee. The law on this issue has been analysed in the two decision of the Bombay HC in the cases of *CIT* v. *Goodlas Nerolac Paints Ltd*. (1991) 188 ITR 1 (Bom) & *CIT* v. *Sigma Paints Ltd*. (1991) 54 Taxman 133 where such payments have been allowed. Earlier, the same High Court in Goodlas Nerolao Paints decision itself reported in (1982) 137 ITR 58 (Bom) had come to a decision which is contrary to the decision taken in the later decision in 1991. The HC has tried to reconcile the two different approaches in the later decision.

In the earlier decision dated 22nd January, 1982, the facts show that the assessee carried on the business of manufacturing and selling paints. For the 6 years before the court, it claimed deductions of certain amounts as selling expenses by way of secret commission paid by it to the employees of its purchasers, ostensibly to promote its sales. It, however, did not furnish the names and addresses of recipients of such commission even when particulars regarding these were called for by the ITO. The ITO disallowed the claims in *toto* for all the years.

The High Court upheld the disallowance observing :…. "We may also refer to section 133(4) of the said Act which clearly requires that the names and addresses of the persons to whom commission are alleged to be paid, must be disclosed to the ITO on demand. Where such disclosure is not made and the ITO or the Tribunal disbelieves the cases that such commissions were paid as claimed by the assessee, we fail to see how it can be said that the Tribunal had gone wrong".

In the last decision in Nerolac's case, such commission has been allowed by the HC saying, *inter alia*, that the Tribunal had found that the assessee was carrying on business in the line in which payments were made to the employees of the customers to keep them on the right side and to ensure the flow of orders, quick payments and smooth running of business in all respects.

SUMMING UP

At a time when public opinion has been considerably aroused against corruption and corrupt practices and there is stress on clean functioning, the issue relating to deduction of claim pertaining to payments which are contrary to public policy and are ethically and morally unsound and of commission purported to have been paid secretly for soliciting business or for other connected matters, which have been held by courts to be admissible expenditure wholly and exclusively incurred for business purposes, needs to be reviewed.

The phrase ' public policy' has not been defined precisely in any enactment. It has, however, been explained in courts decisions. The phrase 'public policy of India' as used in section 34(2)(b) of Arbitration and Conciliation Act (26 of 1996) in a wider sense has been held to mean ' some matter which concerns public good or public concern (*ONGC Ltd.* v. *Saw Pipes Ltd*. (2003) 5 SCC 705 para 31).

'Public policy' was held by House of Lords as that principle of law which holds that no subject lawfully do that which has a tendency to be injurious to the public or against public good. *Egertion* v. *Brownlow*, (1853) 4 HLCI as cited in *Govt. of Kerala* v. *Som Dutt Builders Ltd.*, AIR 2003 Ker 61, 72, para 18.

The Apex Court held that public policy is incapable of precise definition. It connotes some matter which concerns the public good and the public interest. *Central Inland Water Corpn*. v. *Brojonath Ganguly*, AIR 1986 SC 1571. Also see *J.P. Ravidan* v. *Navyuvak,* AIR 1996 SC 2151 and *Government of Kerala* v. *Som Datt Builders Ltd.* AIR 2003 Ker 61, 72, para 19.

Broadly speaking the term 'public policy' is equivalent to the "policy of the law". It is applicable to the spirit as well as the letter. Whatever tends to injustice of operation, restraint of liberty, commerce, and natural or legal right; whatever tends to the obstruction of justice or to the violation of a statute and whatever is against good morals, - when made the object of a contract, is against public policy, and therefore void and not susceptible of enforcement.

In this background the decisions mentioned at (i) to (iv) under the preceding para heading need to be considered. Certainly payment of facilitation charges (mamools) to public servant for getting transport vehicles passed in many cases overloaded and against the norms prescribed is against the public policy though there may be no law to declare these as payments for offences or in violation of law. On the same ground, the allowability of payments a stevedoring contractor to the crew of a shop for obtaining a no damage certificate and to the captain of a ship for obtaining payment for bills would certainly be against public policy and ethics though may be considered justified on commercial grounds. Like wise, payments of secret commission to employees of the purchasers of the products of the selling companies can certainly be not considered as an ethical or fair business practice though not an offence and prohibited by any law. In such situations, passing of sub-standard products cannot be ruled out which may ultimately affect health, safety and well being of the public using the products.

Regarding decision in Sri Venkata Satyanarayana Rice Mill Contractor Co.'s case it needs to be said with utmost respect that a policy which is against public interest does not cease to be so if it is practiced by a government agency or body. Same view applies to the decision of the MP High Court in Kuber Singh

Bhagwand Dass's decision (approved in *Venkata Satyanarayana's* decision (*supra*) by the apex court). Also the end result cannot justify a measure which initially is against public policy encouraging discrimination and favourtism from the side of the government. In Kuber Singh's case, the traders who could be permitted to export gulabi channa and pulses outside the state were required to pay Rs. 30 per quintal for the export of Gulabi Channa and Rs. 5 per quintal for the export of pulses to the Chief Minister's Drought Relief Fund. Those who did not pay were not permitted to export.

In *Rice Mills* case, a District Welfare Fund was established by the District Collector (DC). Each member of the association was to deposit an amount of fifty paise per quintal of rice if he proposed to export the same from Andhra Pradesh. This deposit was to be made in the Andhra Bank. The application for the export permit was required to be made in a form wherein the applicant had to state the amount of contribution deposited by him, giving the particulars of the bank, the challans number and the date. On enquiry by the AO, the DC confirmed the position saying:

> "I am to inform you that welfare fund at Rs. 0.50 paise per quintal is being collected in respect of all rice and broken rice permits issued on trade to trade accounts".

Such payments may be justified by assesses on the ground of business needs, but certainly not cease to be against public policy. The basic question is as to why the state should be a party to such practices ?

The correct approach in this regard could be said to be of the AP High Court in *the Rice Mill's* case (*supra*) when it said that such practices are "subversive of public interest" irrespective of the fact as to how the funds are ultimately utilized and for what purpose they were collected. The High Court felt handicapped in imposing its own moral values but it found itself unable to acquiesce in a public wrong.

The MP High Court, in a similar way took a pragmatic view concerning such practices. In *Gwalior Road Lines* v. *CIT* (1998) 234 ITR 230 (MP) it refused even reference under section 256(2) in the matter of claim for deduction of payments to RTO staff and policemen on the ground that these were payments for which there was no proof and that even if they were proved, they would still be illegal gratification and, therefore, opposed to public policy.

The way to correct such situations and provide a legal basis to disallow the payments which are against public policy and interest can be to incorporate the concept of public policy also in the explanation to section 37(1) and define the phrase 'public policy' broadly in an inclusive way. ❑