

# CTR ENCYCLOPAEDIA ON INDIAN TAX LAWS

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## **MADDI VENKATARAMAN & CO. (P) LTD. vs. COMMISSIONER OF INCOME TAX**

SUPREME COURT OF INDIA

Suhas C. Sen & S. Saghir Ahmad, JJ.

Civil Appeal No. 4205 of 1985\*

2nd December, 1997

(1997) 65 CCH 1084 ISCC

(1998) 144 CTR 0214 : (1998) 229 ITR 0534 : (1998) 96 TAXMAN 0643

### Legislation Referred to

S 28, 37(1)

### Case pertains to

1970-71

### Decision in favour of:

Revenue

***Business expenditure—Penalty, fine, etc. for infraction of law—Wholly and exclusively for business—Export of tobacco at discounted price—Assessee claiming that it had to export sub-standard tobacco at a price 20 per cent less than floor price fixed by Govt. in order to avoid loss and difference was passed on to importer through an illegal channel—Transactions were in violation of FERA—Spur of loss cannot be a justification for contravention of law—Expenditure incurred for evading the provisions of FERA cannot be allowed as deduction—Moreover, it will be against public policy to allow the benefit of deduction under one statute, of any expenditure incurred in violation of the provisions of another statute***

### Held :

*One exception to the rule i.e. payments tainted with illegality cannot be claimed as deduction which has been recognised by the Courts is where the entire business of the assessee is illegal and that income is sought to be taxed by the ITO then the expenditure incurred in the illegal activities will also have to be allowed as deduction. But if the business is otherwise lawful and the assessee resorts to unlawful means to augment his profits or reduce his loss, then the expenditure incurred for these unlawful activities cannot be allowed to be deducted. Even if the assessee had to pay fine or penalty because of an inadvertent infraction of law which did not involve any moral obliquity, the result will be the same. Even in such cases, deduction will not be permitted of the amounts paid as penalty or fine of the value of the goods confiscated by the statutory authority as expenditure wholly and exclusively incurred for the purposes of carrying on the trade. It has been consistently held by the English Courts that fines or penalties payable for violation of law cannot be permitted as deduction under the IT Act. That will be against public policy. Even though the need for making*

such payments arose out of trading operations the payments were not wholly and exclusively for the purpose of the trade. One can carry on his trade without violating the law. In fact, s. 37 presumes that the trade will be carried on lawfully.

**(Para 4)**

In the instant case the assessee had indulged in transactions in violation of the provisions of FERA. The assessee's plea is that unless it entered into such a transaction, it would have been unable to dispose of the unsold stock of inferior quality of tobacco. In other words, the assessee would have incurred a loss. Spur of loss cannot be a justification for contravention of law. The assessee was engaged in tobacco business. The assessee was expected to carry on the business in accordance with law. If the assessee contravenes the provisions of FERA to cut down its losses or to make larger profits while carrying on the business, it was only to be expected that proceedings will be taken against the assessee for violation of the Act. The expenditure incurred for evading the provisions of the Act and also the penalty levied for such evasion cannot be allowed as deduction. Moreover, it will be against public policy to allow the benefit of deduction under one statute, of any expenditure incurred in violation of the provisions of another statute or any penalty imposed under another statute. In the instant case, if the deductions claimed are allowed, the penal provisions of FERA will become meaningless. It has also to be borne in mind that evasion of law cannot be a trade pursuit. The expenditure in this case cannot, in any way, be allowed as wholly and exclusively laid out for the purpose of assessee's business.—[CIT vs. Maddi Venkataratnam & Co. \(P\) Ltd.](#) (1983) 35 CTR (AP) 87 : (1983) 144 ITR 373 (AP) : TC 14R.783 **affirmed**; IRC vs. Alexander Von Glehn & Co. Ltd. 12 Tax Cases 232 and [Haji Aziz & Abdul Shakoor Bros. vs. CIT](#) (1961) 41 ITR 350 (SC) : TC 16R.514 **applied**

**(Para 13)**

Conclusion :

*Export of substandard quality of tobacco at price below floor price fixed by Govt. and difference passed on to importer through an illegal channel was in violation of provisions of FERA and thus the discount offered by assessee as also penalty levied under FERA was not allowable either as deduction or as business loss even though the purpose of transaction was to avoid business losses.*

**Business income—Loss—Penalty, fine, etc. for infraction of law—Export of substandard quality of tobacco at price below floor price fixed by Govt. and difference passed on to importer through an illegal channel was in violation of provisions of FERA and thus the discount offered by assessee as also penalty levied under FERA was not allowable either as deduction or as business loss even though the purpose of transaction was to avoid business losses**

Conclusion :

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Counsel appeared:

Ramesh P. Bhatt with M.N. Shroff Ms. Ragini Singh, for the Appellant : Ranvir Chandra, C.V.S. Rao, S.R. Tardol, Nagpal & B.K. Prasad, for the Respondent

**SUHAS C. SEN, J.**

The Tribunal referred the following question of law to the Andhra Pradesh High Court under s. 256(1) of the IT Act, 1961.

"1. Whether, on the facts and in the circumstances of the case, a sum of Rs. 2,95,000 has to be taken into account in computing the income of the assessee from business under the provisions of s. 28 of the IT Act, 1961 ?

If the answer to the above question is in the negative—

Whether, on the facts and in the circumstances of the case, the claim of Rs. 2,95,000 is covered by sub-r. (j) of r. 6DD, framed under s. 40A(3) of the IT Act, 1961 ?

2. Whether, on the facts and in the circumstances of the case, the sum of Rs. 19,659 incurred as guest-expenses is allowable as a deduction ?"

**2.** The assessee, to start with, was a partnership consisting mostly of family members. In 1965, it was converted into a public limited company to carry on the business of export of tobacco. The first directors appointed at the time of incorporation were to hold office during their lifetime or until they resigned voluntarily.

On the basis of the information received, a search was conducted by the Enforcement Directorate in the assessee's business premises. A number of letters and other documents were seized which disclosed that the assessee had indulged in transactions in violation of the provisions of Foreign Exchange (Regulation) Act (for short 'FERA'). It was found that the assessee had remitted to a private party in Singapore in violation of law. Proceedings were taken against the assessee for infringement of ss. 4 (2) and 5(1)(e) of FERA and ultimately a penalty of Rs. 35,000 was imposed under s. 23(1)(a) r/w s. 23C of the Act [sic—FERA]. The assessee in its IT return for the asst. yr. 1970-71 claimed deduction of Rs. 2,95,000 as business expenditure/loss. According to the assessee in course of carrying on of its business by the year 1968, it had accumulated 329.2 tonnes of substandard quality tobacco which it could not export over the last three years. Since the accumulated stock of tobacco was of substandard quality, it could not be sold at the floor price fixed by the Government of India for such tobacco. According to the assessee, it had no alternative but to sell the tobacco at a discount of 20 per cent to a Singapore party. On paper, the full sale price was paid by the Singapore party but in reality 20 per cent of the price paid by the party was remitted back to him through one Shamsuddin. In pursuance of this agreement, tobacco was sold and the full floor price was received by the assessee from the Singapore party. The assessee paid a sum of Rs. 2,88,000 to Shamsuddin who remitted the equivalent amount in Singapore currency to the Singapore party. Thus, according to the assessee, it had no alternative but to enter into such a transaction with a view to dispose of the said unsold stock of inferior quality of tobacco. In these facts of the case, it was claimed by the assessee that the amount of Rs. 2,88,000 paid to Shamsuddin ought to be deducted as business expenditure or treated as business loss.

The ITO, however, disallowed the claim. According to him, payment was not genuine and it contravened the provisions of s. 40A(3) of FERA [sic—IT Act]. It was further held that the payment did not fall within any of the exceptions to r. 6DD. The AAC affirmed the order of the ITO. On further appeal, the Tribunal made the following findings :

(a) A sum of Rs. 2,95,000 was paid by the assessee-company to Shamsuddin which consisted of an amount payable to him for his services and also a sum of Rs. 2,88,000 to be remitted to the Singapore party. The amount paid to Singapore party was difference of 20 per cent of the floor price of tobacco fixed by the Government.

(b) The assessee was knowingly a party to the above transaction and it violated the provisions of FERA. The Tribunal also took the view that the assessee's income from export to the Singapore party in reality was not the full price shown to have been received from the Singapore party, i.e., Rs. 8,86,702.89. The figure had to be reduced by a sum of Rs. 2,95,000 because this was the sum which was really received by the assessee. It was of the view that it was unnecessary to go into the question whether the sum of Rs. 2,95,000 was to be treated as a deduction and if so under which section and further whether it attracted s. 40A(3) of the Act.

(c) The Tribunal held that even otherwise, the said payment did not attract s. 40A(3) since it was covered by sub-r. (j) of r. 6DD inasmuch as the said payment to Shamsuddin was made in cash due to exceptional and unavoidable circumstances.

The Department's contentions that the payment made to Shamsuddin was illegal and could not be taken into account for any purpose were unsustainable in law. The IT law did not distinguish between legal and illegal income or between legal and illegal expenditure.

**3.** The High Court was of the view that the Tribunal was in error in coming to the conclusions that it had reached. The High Court pointed out that expenses tainted with illegality could not be allowed as business expenditure under s.37 or as business loss or on any other basis. The High Court was of the further view that the assessee could not be allowed to achieve the same result by invoking s. 28. The High Court also expressed the view that the assessee's contentions that its real income from export of tobacco was not Rs. 8,86,702.89 paise which was paid to it but its real income was that amount minus Rs. 2,95,000 which he had subsequently repatriated in Singapore dollars. It was only a facade to realise the true price of the transaction which was 80 per cent of the floor price. Therefore, the invoice which showed the floor price was not the true reflection of the real transaction between the two parties. The High Court rejected this contention by holding that the very agreement to receive 80 per cent of the floor price which was the invoice value of the tobacco was illegal. The High Court pointed out that in law, there could not be an agreement to agree to take anything less than the invoice price. The argument that tobacco was of substandard quality was no answer. An exporter was not supposed to export substandard tobacco.

The High Court was of the view that the sum of Rs. 2,88,000 had not been repatriated in a straightforward manner but has been sent to Singapore through an illegal channel. It is not a case of money being diverted under an overriding legal obligation. The High Court ultimately concluded that the agreement being illegal and contrary to law, cannot be recognised by a Court of law nor can entering into such transaction be a normal incidence of carrying on business. The High Court further held that argument based on real price was of no substance. If a contractor received an amount of Rs. 10 lakhs under a contract entered into with the Government, he cannot claim that in reality, the amount was Rs. 9 lakhs, because at the time of awarding the contract, he had an understanding with the authority to pay a sum of Rs. one lakh by way of bribe.

**4.** The High Court referred to a large number of decisions where it has been held that payments tainted with illegality cannot be claimed as deduction under the IT Act. Moreover, if an assessee is penalised under one Act, he cannot claim, that amount to be set off against his income under another Act because that will be frustrating the entire object of imposition of penalty.

One exception to this rule which has been recognised by the Courts is where the entire business of the assessee is illegal and that income is sought to be taxed by the ITO then the expenditure incurred in the illegal activities will also have to be allowed as deduction. But if the business is otherwise lawful and the assessee resorts to unlawful means to augment his profits or reduce his loss, then the expenditure incurred for these unlawful activities cannot be allowed to be deducted. Even if the assessee had to pay fine or penalty because of an inadvertent infraction of law which

did not involve any moral obliquity, the result will be the same. Even in such cases, deduction will not be permitted of the amounts paid as penalty or fine of the value of the goods confiscated by the statutory authority as expenditure wholly and exclusively incurred for the purposes of carrying on the trade. It has been consistently held by the English Courts that fines or penalties payable for violation of law cannot be permitted as deduction under the IT Act. That will be against public policy. Even though the need for making such payments arose out of trading operations the payments were not wholly and exclusively for the purpose of the trade. One can carry on his trade without violating the law. In fact, s. 37 presumes that the trade will be carried on lawfully.

The English Courts have consistently held that penalty or fine or money paid to compound an offence under another statute cannot be allowed as a deduction under the IT Act for the application of these principles. Consideration of moral obliquity was quite immaterial.

**5.** In the case of IRC vs. E.C. Warnes 12 Tax Cases 227, the company had to pay a penalty under the provisions of the Customs (Consolidation) Act, 1876, in respect of a consignment of oil shipped by it to Norway. The action was settled by consent on the agreement of the company to pay a mitigated penalty of £2,000 and on all imputations as to the company's moral culpability being withdrawn. It was declared that there was no intention from the beginning to the end of the transaction that the company had, by connivance or consent been taking part in trading with the enemy, but had only been culpable of carelessness. In defending the penalty proceedings, the company had incurred legal costs amounting to £560 18s 10d. These two amounts incurred on payment of the penalty and also legal costs have been taken for the computation of excess profits duty purposes. On behalf of the company, it was contended that both the penalty and costs should be allowed as losses arising out of and incidental to trade. It was pointed out that the penalty and the costs were solely connected with and arose out of the trade carried on by them and as such were deductible in the same manner that bad debts are deductible in computation of profits. Lastly, it was argued that profits must be taken in their commercial sense. In that sense this was a loss which an ordinary prudent commercial men would and could only write off against the profits of the business. The Commissioners who heard the appeal held in favour of the company. When the matter came before the High Court Rowlatt, J. recognised that the provision of law under which the penalty was imposed is "one of very great and startling stringency but, of course, the liability it creates can only be regarded as a liability of a penal character" and held

"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 . but I do not think it is possible to say that when a fine, which is what it comes 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 decision of Rowlatt, J. was cited with approval by the Court of Appeal in the case of The IRC vs. Alexander Von Glehn & Co. Ltd. 12 Tax Cases 232. In that case Lord Sterndall noted that the assessee was a firm of high standing. A great part of its trade consisted in the exporting of goods to Russia and Scandinavia. Some goods were exported to Russia at a time when the Customs (War Powers) Act, 1915, was in force and the goods of the assessee had ultimately gone to the enemy territory. Proceedings were taken for infraction of law because the assessee was not able to prove that he had taken all reasonable steps to secure that the ultimate destination of the goods was the destination mentioned in the declaration. The assessee agreed to pay a fine of £3,000 and now the question was whether this amount paid as penalty was admissible as deduction from the income of the assessee's-company.

Lord Sterndale held that the customs proceedings were not technically criminal proceedings; but he stated :

"I do not think that matters. They certainly are proceedings in which a penalty is being sued for by the Attorney General as representing the Crown, for an infraction of the law, whether, technically criminal for the purpose of appeal seems to me to be immaterial. The money which is paid is money paid as a penalty, and it does not matter in the least that the Attorney General has selected to take treble the value of the goods, nor does it matter that it may be called in the information a forfeiture."

Lord Sterndale stated that it was a hard case and observed :

"It may be so, and it may seem hard, because it was agreed that there was no moral obliquity to use the expression which is used in all these cases, to be attributed to the appellants. But, it seems to me that those are matters which we cannot take into consideration, and in justice to both the learned counsel who argued the case for the appellants, they did not rest their case upon any such basis as that, but they rested it upon the broad principle that it does not matter whether the expense is incurred in consequence of an infraction of the law or whether it is a penalty for doing an illegal act, so long as it is something which reduces the amount which comes into the trader's pockets as the result of his trading."

Lord Sterndale has, however, held that the payments for infraction of law could not be called to be for the purpose of the trade. Relying upon the remarks of Lord Davey in the case of *Strong vs. Woodfield* 5 Tax Cases 215, it was held that the disbursements permitted as deductions must be for the purpose of the trade. It was not enough that the disbursement was made in the course of or arose out of or was connected with the trade or was made out of the profits of the trade.

Dealing with the question that the disbursements were connected with the trade, Lord Sterndale observed :

"Of course, as Mr. Justice Rowlatt said, in a sense you may say that it has been connected with the trade, because if the trade has not been carried on the penalty would not have been incurred; there would not have been an opportunity for the breach of the law which took place but in the sense in which the words are used in the Act, I do not think that this was connected with or arising out of such trade, manufacture, adventure, or concern, and still less do I think that it was a disbursement under the First Rule which applies to the first two cases, that is to say, "money wholly and exclusively laid out or expended for the purposes of such trade".. 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 Mr. Justice Rowlatt in this case and his former decision in *IRC vs. Warnes* 12 Tax Cases 227, which he followed were right, and I think this appeal should be dismissed with costs."

Warrington, L.G. who agreed with Lord Strendale observed as under :

"Now, it cannot be said that the disbursement in the present case is made in any way for the purpose of the trade or for the purpose of earning the profits of the trade. The disbursement is made, as I have already said and the same remark applies to this Rule as to the other—because the individual who is conducting the trade has not from any moral obliquity, but has unfortunately been guilty of an infraction of the law."

**6.** In the case of *Cattermole (H.M. Inspector of Taxes) vs. Borax & Chemicals Ltd.* 61 Tax Cases 202, the question was whether fines imposed in the U.S.A. upon the company and upon its managing director for infringement of anti-trust legislation of

the USA should be allowed as deductions in computing the amount of company's profits. The fine was imposed in very unusual circumstances. It was doubtful whether the company and its managing director could have been proceeded against the American Law but they decided to submit voluntarily to the jurisdiction of the California Court. It was done out of supposed business necessity because the English company was a subsidiary of an American Company. If the English company and its managing director along with the American company did not submit to the jurisdiction of the California Court the result would be that its supplies would have been stopped altogether and it would have been unable to carry on the business with the American company. The company was extremely anxious to settlement. It was argued that it was a matter of vital importance to the American company that the English company and Mr. Hatchley should appear in the suit. The matter was ultimately settled. One of the terms of the settlement was that the English company would pay a fine of 10,000 US dollars and the managing director would pay a fine of 6,000 US Dollars.

The Commissioners took the view that the amount was deductible as business expenditure because it was paid to ensure the supplies. Croom-Johnson, J., held that the amount was not paid wholly and exclusively for the purposes of carrying on the trade. It may have been one of the reasons but manifestly it was not the only reason. "One of the reasons was to get as cheaply as possible a settlement with the American authorities, paying something by way of compromise agreeing with one's adversary while one is in a way with him. That is really what happened here."

**7.** The Indian Courts have also consistently held that payments tainted with illegality cannot be treated as money spent wholly and exclusively for the purpose of business. A long line of decisions was noted in the judgment under appeal. It is not necessary to refer to all of them. We shall refer to three cases decided by this Court.

**8.** In the case of Haji Aziz & Abdul Shakoor Bros. vs. CIT (1961) 41 ITR 350 (SC) : TC 16R.514, a Bench of three judges of this Court held that the expenses which were permitted as deduction were such as were made for the purpose of carrying on the business. It was not enough that the disbursements are made in the course of, or arose out of or were connected with the trade. No deduction can be allowed if the expenditure fell on the assessee in some character other than that of a trader. If a sum has to be paid by an assessee because in conducting his business, he had acted in a manner which had rendered liable for penalty for infraction of law, it could not be claimed as a deduction because it could not be called in commercial sense as incurred in carrying on the business. It was emphasised in that judgment by Kapoor, J., that infraction of law is not a normal incidence of business.

**9.** The point that the expenditure incurred for the purpose of unlawful activity must be allowed to find out the commercial profits of the company was specifically argued and rejected in the case of IRC vs. E.C. Warnes (supra). If a penalty is imposed for contravention of any statutory provision, it cannot be said that the commercial loss had fallen on the assessee as a trader. Illegal activity cannot be treated as a trading activity at all. As Lord Sterndale held that it was not enough that the disbursement was made in the course of or arose out of or was connected with the trade or was made out of the profits of the trade. Only if it could be shown that it was spent for the purpose of the trade that the deduction can be permitted unless the entire trade was unlawful.

**10.** The case of Haji Aziz & Abdul Shakoor Bros. (supra) is important for another reason. It was categorically held in this case that no distinction can be made in this regard between a personal liability and a liability of any other kind. So long as the payment has to be made for infraction of law, it cannot be said that it was made in course of carrying out of the trade.

**11.** In the case of CIT vs. S.C. Kothari 1974 CTR (SC) 137 : (1971) 82 ITR 794 (SC) : TC 46R.223, it was held that the loss which had actually been incurred in carrying on

a legal business must be deducted before the true figure relating to profits which had to be brought to tax could be computed or determined. If a business was illegal, neither the profits earned nor the loss incurred would be enforceable in law but that did not take the profits out of the taxing statute. Similarly, that taint of illegality of the business could not detract from the loss being taken into account for computing the amounts which had to be subjected to tax. The tax collector cannot be heard to say that he will bring the gross receipts to tax, he could only tax the profits of a trade or business. That cannot be done without taking the loss and the legitimate expenses of the business.

**12.** In the case of CIT vs. H. Hirjee (1953) 23 ITR 427 (SC) : TC 17R.391, a Bench of four judges of this Court dealt with a case of an assessee who was carrying on the business as selling agent of a company. He was prosecuted under s. 18 of the Hoarding and Profiteering Ordinance, 1943, on a charge of selling the goods at prices higher than a reasonable price in contravention of the provisions of the s. 6 of the Act. A part of the stock of goods was seized and taken away. The prosecution, however, ended in acquittal. The assessee claimed deduction of a sum of money spent in defending the case. The Tribunal found that the expenditure was incurred solely for the purpose of maintaining the assessee's name as a good businessman and to save his stock from being undersold if the Court held that the prices charged by him were unreasonable. The High Court rejected the reference application on the ground that the decision of the Tribunal was based on finding of fact. On appeal, this Court held that the findings of the Tribunal were vitiated by its failure to consider the possibility of criminal proceedings terminating in the conviction and imprisonment of the assessee. It was held that the deductibility of such expenses must depend upon the purpose and nature of legal proceedings and could not be affected by the final outcome of the proceedings. It was also pointed out that the income-tax assessment had to be made for every year and could not be held up until the final result of the legal proceedings which pass through several Courts was announced.

**13.** In the instant case the assessee had indulged in transactions in violation of the provisions of FERA. The assessee's plea is that unless it entered into such a transaction, it would have been unable to dispose of the unsold stock of inferior quality of tobacco. In other words, the assessee would have incurred a loss. Spur of loss cannot be a justification for contravention of law. The assessee was engaged in tobacco business. The assessee was expected to carry on the business in accordance with law. If the assessee contravenes the provisions of FERA to cut down its losses or to make larger profits while carrying on the business, it was only to be expected that proceedings will be taken against the assessee for violation of the Act. The expenditure incurred for evading the provisions of the Act and also the penalty levied for such evasion cannot be allowed as deduction. As was laid down by Lord Sterndale in the case of Alexander Von Glehn (supra) that it was not enough that the disbursement was made in the course of trade. It must be for the purpose of the trade. The purpose must be a lawful purpose.

Moreover, it will be against public policy to allow the benefit of deduction under one statute, of any expenditure incurred in violation of the provisions of another statute or any penalty imposed under another statute. In the instant case, if the deductions claimed are allowed, the penal provisions of FERA will become meaningless. It has also to be borne in mind that evasion of law cannot be a trade pursuit. The expenditure in this case cannot, in any way, be allowed as wholly and exclusively laid out for the purpose of assessee's business.

**14.** We are in agreement with the view expressed by the High Court in this case. The appeal is dismissed. There will be no order as to costs.

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