
(1976) 11 P&H CK 0022

In the Punjab And Haryana At Chandigarh

Case No : Income-tax Reference No. 57 of 1975

Cineramas

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 16-11-1976

Acts Referred:

Income Tax Act, 1961 — Section 37

Citation : (1977) 110 ITR 762

Hon'ble Judges : S.P. Goyal, J; O. Chinnappa Reddy, J

Bench : Division Bench

Advocate : G.C. Sharma, D.V. Sehgal and D.K. Jain, for the Appellant; D.N. Awasthy and B.K. Jhingan, for the Respondent

Judgement

Chinnappa Reddy, J.—The assessee who carries on business in exhibition of films is a member of the East Punjab Motion Pictures Association. Under the bye-laws of the association, a member is obliged to carry out the "award and directives" of the association arising out of all disputes between members or upon complaints received by the association. A member failing to carry out the directive of the association would be suspended from membership of the association and would be eligible to be reinstated on payment of a specified sum of penalty in addition to " reinstatement circulation charges ". The assessee had to pay a sum of Rs. 4,300 by way of penalty to the association during the accounting year relevant to the assessment year 1970-71. The assessee claimed that the sum of Rs. 4,300 paid by way of penalty to the association was a sum " laid out wholly and exclusively for the purposes of the assessee's business " and was, therefore, allowable expenditure u/s 37 of the Income Tax Act, 1961. The Tribunal held that breaches of contractual obligations were not incidents of business and, therefore, the amount paid by the assessee as penalty was not allowable expenditure.

2. At the instance of the assessee, the following question has been referred to us for our opinion :

"Whether, on the facts and in the circumstances of the case, the Tribunal was

justified in holding that the sum of Rs. 4,300 paid by the assessee by way of penalty to the East Punjab Motion Pictures Association was not deductible as business expenditure under the Income Tax Act, 1961 ?

The learned counsel for the assessee invited our attention to paragraph 16(a) of the rules and regulations of the East Punjab Motion Pictures Association which prohibits every distributor-member of the association from supplying films to a non-member exhibitor and vice versa, and argued that in order to survive in the business of an exhibitor of films, the assessee was bound to seek reinstatement of membership by paying the penalty. The payment of penalty was essential to enable the assessee to continue to carry on the trade and so it must be held to have been laid out wholly and exclusively for the purposes of the assessee's business. The learned counsel argues that breaches of contractual obligations were often commercially expedient and that they should not be treated on a par with "infractions of law".

3. We do not agree with the submissions of the learned counsel. We are unable to hold that damage paid for committing breaches of obligation can any more be said to be expenditure laid out wholly and exclusively for the assessee's business than a penalty paid for an infraction of the law. Infractions of law may be as commercially expedient as breaches of obligation. For a smuggler or a bootlegger, infraction of law is the very breath of his business but he cannot claim the " hush-money " that he may pay to corrupt officials as expenditure incurred wholly and exclusively for his business on the ground that it is commercially expedient to pay " hush-money ", otherwise he will be out of business. We do not think that commercial expediency is always a correct or conclusive test to determine whether expenditure is laid out wholly and exclusively for the assessee's business. We think it is impossible and inexpedient to define the expression " wholly and exclusively for the assessee's business". (This is a difficulty which was also expressed by Rowlatt J. and Lord Sterndale M.R., whose observations we will presently quote). We think it is perhaps wiser to leave the words of the statute as they are than to put a gloss upon them; All that is necessary for us to say is that the expenditure must, in some way, be connected with trade, it must be an ordinary or contemplable incident of trade. There must be a discernible nexus between the expenditure and the trade. There must be something commercial about it. We are of the view that infractions of law, including breaches of obligations, are not normal incidents of business and penalties and damages paid in connection with such infractions and breaches are not expenditure " laid out or expended wholly and exclusively for the assessee's business ".

4. In MASK AND CO. Vs. COMMISSIONER OF Income Tax, MADRAS., , the assessee committed a breach of contract and in a suit filed by the other party, he was obliged to pay a sum of Rs. 5,000 by way of damages. The amount was claimed by the assessee as expenditure " laid out or expended wholly and exclusively for purposes of the assessee's business ". Negating the assessee's

claim, Leach C.J. and Lakshmana Rao J., after referring to Inland Revenue Commissioners v. E.C. Warnes & Co. (1919) 12 TC 227 and MASK AND CO. Vs. COMMISSIONER OF Income Tax, MADRAS., :

" In the present case, the assessee was not fined for a breach of law, but was made to pay damages for a breach of the contract entered into. The assessee's action in disregarding the undertaking given was palpably dishonest and we are of the opinion that the award of damages which followed did not constitute an expenditure falling within Section 10(2)(xii). It was not incidental to the trade."

5. The decision in MASK AND CO. Vs. COMMISSIONER OF Income Tax, MADRAS., was quoted, with implicit approval by the Supreme Court in Haji Aziz and Abdul Shakoor Bros. Vs. The Commissioner of Income Tax, Bombay City II, .

6. In Inland Revenue Commissioners v. E. C. Warnes & Co. [1919] 12 TC 227, a mitigated penalty of ₹ 2,000 was levied for breaches of certain orders and proclamations under the Customs (War Powers) Act, 1915. The amount was claimed as business expenditure. Rowlatt J. said (page 231):

" But the question, really, is whether, within the meaning of this rule, it is a loss connected with or arising out of their trade. I may shelter myself behind the authority of Lord Loreburn, who, in his judgment in the House of Lords in Strong and Co. v. Woodfield [1906] 5 TC 215 said that it is impossible to frame any formula which shall describe what is a loss connected with or arising out of a trade. That statement I adopt, and I am not sure that I gain very much by going through a number of analogies ; 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 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. As I say, it is impossible to say what is such a " loss ", but I have a clear view that this is not, and I can say no more than that "

7. The decision of Rowlatt J. was approved by the Court of Appeal in Inland Revenue Commissioners v. Alexander von Glehn and Co. [1920] 12 TC 232. After referring to rule 1, in which was used the expression " money wholly and exclusively laid out or expended for the purposes of such trade ", Lord Sterndale said (page 238):

" 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 and that does not seem to me to be a loss connected with the business, but it is a fine imposed upon the company personally, as far as a

company can be a person, for a breach of the law which they 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."

8. In *Haji Aziz and Abdul Shakoor Bros. Vs. The Commissioner of Income Tax, Bombay City II*, the Supreme Court held that a fine paid by the assessee under the Customs Act as an alternative to confiscation of the goods imported by him was not "expenditure laid out or expended wholly and exclusively for the assessee's business". After referring to several decided cases including *MASK AND CO. Vs. COMMISSIONER OF Income Tax, MADRAS.*, *Inland Revenue Commissioners v. E. C, Warnes & Co.* [1919] 12 TC 227 and *Inland Revenue Commissioners v. Alexander von Glehn & Co.* [1920] 12 TC 232, the Supreme Court said--See *Haji Aziz and Abdul Shakoor Bros. Vs. The Commissioner of Income Tax, Bombay City II*, :

"A review of these cases shows that expenses which 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 *Alexander von Glehn's* case [1920] 12 TC 232 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 contemplable as such. Such penal ties 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."

9. In *Travancore Titanium Products Ltd. Vs. Commissioner of Income Tax, Kerala*, *Commissioner of Income Tax, Kerala Vs. Malayalam Plantation Ltd.*, and *Commissioner of Income Tax, West Bengal I Vs. Birla Cotton Spinning and Weaving Mills Ltd.*, the Supreme Court explained that the expression "for the purpose of the business" was wider in scope than the expression "for the

purpose of earning profits " and could take in " the rationalization of its administration and modernization of its machinery " " the preservation of the business ", " the protection of its assets and property from expropriation, coercive process or assertion of hostile title", " payment of statutory dues and taxes imposed as a pre-condition to commence or for carrying on business " and " many other acts incidental to the carrying on of a business ". The learned judges took care to say that such expenditure must be incidental to the carrying on of the business.

10. In COMMISSIONER OF Income Tax Vs. HIMALAYA ROSIN-TURPENTINE MANUFACTURING COMPANY., , the facts were that the assessee who was carrying on the business of extracting rosin and selling it, entered into an agreement with the Tehri Garhwal State for extracting rosin according to certain terms and conditions. If he failed to observe the conditions, he was to pay compensation. The assessee was obliged to pay a sum of Rs. 5,000, said to have been imposed by way of fine, to the Tehri Garhwal State for committing breach of some of the terms of the agreement. They claimed the sum as allowable expenditure u/s 10(2)(xv) of the Indian Income Tax Act, 1922. Falshaw and Kapur JJ. held that the assessee was not entitled to claim the deduction. The decision of the Madras High Court in MASK AND CO. Vs. COMMISSIONER OF Income Tax, MADRAS., was followed. Reference was also made to the observations of Rowlatt J. and Lord Sterndale M.R. which we have already extracted.

11. Learned counsel for the assessee relied upon Commissioner of Income Tax, West Bengal Vs. Royal Calcutta Turf Club, , CENTRAL TRADING AGENCY Vs. COMMISSIONER OF Income Tax, U.P., , Govind Choudhury and Sons Vs. Commissioner of Income Tax, and Additional Commissioner of Income Tax, Gujarat Vs. Rustam Jehangir Vakil Mills Ltd., .

12. In Commissioner of Income Tax, West Bengal Vs. Royal Calcutta Turf Club, , the question was whether the Royal Calcutta Turf Club whose business was to hold race-meetings on commercial basis, was entitled to claim as a deduction the expenditure incurred in connection with a school for the training of Indian boys as jockeys. It was found that there was a risk of jockeys becoming unavailable and such non-availability would seriously affect the business of the Turf Club. It was for that reason that the Turf Club opened the school. On these facts the Supreme Court found that the expenditure which was incurred for preventing extinction of the assessee's business was expenditure " wholly and exclusively laid out for the purpose of the assessee's business ". We do not see how this case is of any assistance to the present assessee.

13. In CENTRAL TRADING AGENCY Vs. COMMISSIONER OF Income Tax, U.P., , the assessee entered into a contract with the Government for the supply of 100 tonnes of dehydrated onions before a certain date; by that date the assessee was able to supply only 15 tonnes. The Government cancelled the contract, but on the application of the assessee extended the date for the delivery upon the

condition that the assessee paid liquidated damages at 2 per cent. The assessee accepted the terms and paid damages of Rs. 17,240 which he claimed as permissible deduction u/s 10(2)(xv) of the Indian Income Tax Act, 1922. The Allahabad High Court took the view that the amount paid by the assessee by way of liquidated damages was for the purpose of keeping the contract alive and was in reality an attempt made for the purpose of enabling the assessee to completely execute the contract. It was not a payment made as a penalty or as damages for breach of contract, it was merely the fulfilment of a condition of the agreement between the parties. On the finding of the learned judges that the payment was neither penalty nor damages, the payment had to be held an admissible expenditure. It was a clear case of a commercial loss in trading.

14. In *Govind Choudhury and Sons Vs. Commissioner of Income Tax*, , the assessee had to pay to the Government by way of penalty a sum of Rs. 1,233 for supply of inferior quality of paddy and rice. The Orissa High Court held that it was not admissible deduction u/s 10(2)(xv), but could be treated as a loss deductible from the income itself u/s 10(1) of the 1922 Act as it was a payment integrally connected with the carrying on of the business of supply of paddy. It was also a clear case of a loss in trading.

15. In *Additional Commissioner of Income Tax, Gujarat Vs. Rustam Jehangir Vakil Mills Ltd.*, , the assessee had the option to pack and supply a minimum quantity of cloth as directed by the Textile Commissioner or pack and supply cloth in excess of the minimum quantity specified or to pack and supply less than the minimum quantity specified. For excess supply he was entitled to dash payment by way of assistance from the Textile Commissioner. If he supplied less he would have to compensate the Textile Commissioner at prescribed rates. The assessee who packed and supplied less than the minimum specified quantity of cloth had to pay to the Textile Commissioner certain amounts which he claimed as deductible expenditure. The Gujarat High Court accepted the claim of the assessee. They held that there was no question that the amount was paid by way of penalty or that the amount paid was akin to penalty. There was no infraction of the law. In fact the very scheme of the law was that the assessee should have option to adopt one of three courses. By adopting one course, he could not be said to have committed any infraction of law. It is clear that, on the facts of the case, no other conclusion was possible.

16. In the light of the aforesaid discussion, we are clearly of the opinion that the amount of Rs. 4,300 paid by the assessee by way of penalty to the East Punjab Motion Pictures Association was not allowable as revenue expenditure. The reference is answered accordingly. No costs.