2023 INSC 416

REPORTABLE

IN THE SUPREME COURT OF INDIA
CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NOS.7689-90 OF 2022

The Commissioner of Income Tax Jaipur .Appellant

Versus

Prakash Chand Lunia (D)
Thr.Lrs. & Anr. ..Respondents

J U D G M E N T

M. R. Shah, J.

1. Feeling aggrieved and dissatisfied with the impugned judgment and order dated 22.11.2016 passed by the High Court of Judicature for Rajasthan at Jaipur passed in DBITA No.96/2003

and DBITR No.6/1996 by which the High Court has allowed the said appeals, the Revenue has preferred the present appeals.

2. The facts leading to the present appeals in nutshell are as under:

2.1 A search was conducted by the Directorate of Revenue Intelligence (DRI) officers at the premises situated at A-11, 12, Sector - VII, NOIDA taken on rent by the assessee, Shri Prakash Chand Lunia. The DRI recovered 144 slabs of silver from the premises and two silver ingots from the business premises of the assessee at 1397, Chandni Chowk, Delhi. The assessee was arrested under Section 104 of the Customs Act for committing offence punishable under Section 135 of the Customs Act. The Collector, Customs held that the assessee Shri Prakash Chand Lunia is the owner of silver/bullion and the transaction thereof was not recorded in the books of accounts. The Collector of Customs, New Delhi ordered confiscation of the said 146 slabs of

silver weighing 4641.962 Kilograms valued at Rs.3.06 Crores. The Collector Customs further imposed a personal penalty of Rs.25 Lakhs on Sh. Prakash Chand Lunia under Section 112 of the Customs Act. The Collector held that the silver under reference was of smuggled nature.

2.2 During the course of the assessment proceedings the Assessing Officer observed that the assessee was not able to explain the nature and source of acquisition of silver of which he is held to be the owner, therefore the deeming provisions of Section 69A of the Income Tax Act, 1961 (hereinafter referred to as 'the Act, 1961) would be applicable. The investment in this regard was not found recorded in the books of accounts of the assessee that were produced before the then Assessing Officer. Accordingly, the Assessing Officer passed an assessment Order and made an addition of Rs.3,06,36,909/- under Section 69A of the Act, 1961. In appeals preferred by the Assessee against the assessment order, the CIT(A) dismissed the

appeal of the assessee. Feeling aggrieved the assessee preferred the appeal before the ITAT. The ITAT, Jaipur also upheld the order of the CIT(A) so far as Section 69A is concerned, however, partly allowed the appeal of the assessee. As regards some other minor additions, the ITAT set aside some minor other additions and remanded the matter to the AO for fresh examination. The AO re-examined the issue and addition was made. The CIT(A) also upheld the order of the AO. The Assessee preferred the appeal against the fresh order passed by the CIT(A) before the ITAT. The ITAT, in the second round as well upheld the order of the authorities below. A reference was made by the ITAT to the High Court with the following questions of law:

(i) "Whether on the facts and in the circumstances of the case, the Tribunal after construing and interpreting the provisions contained in section 69A of the Income Tax Act, 1961 was right in law, in holding that the assessee was the owner of the 144 silver bars found at premises no A 11 & 12 , Sector - VII, Noida and two silver bars found at premises of M/s Lunia & Co Delhi and in

sustaining addition of Rs.3,06,36,909/- being unexplained investment in the hands of the assessee under Section 69A of the Act?

(ii) If the answer to the above question is in affirmative then, whether, on the facts and in the circumstances of the case, the Tribunal was right in law in distinguishing the ratio laid down by their Lordships of the Supreme Court in the case of Piara Singh v/s CIT, 124 ITR 41 and thereby not allowing the loss on account of confiscation of silver bars?"

2.3 While the reference was pending before the High Court, penalty proceedings were initiated against the assessee. An order under Section 271 (i) (c) of the Act came to be confirmed by both the CIT (A) and the ITAT. Accordingly, the assessee filed an appeal under Section 260A of the Act against the Penalty order, before the High Court. The High Court while deciding both the cases together, qua the first question, decided in favour of the Revenue and the rental premises of the assessee, the same is to be added to his income as a natural consequence. However, with regard to the second question, the High Court held that loss of

confiscation by the DRI official of Customs Department is business loss. While holding the High Court has relied upon the decision of this Court in the case of ***CIT, Patiala vs. Piara Singh reported in 124 ITR 41***. The impugned judgment and order passed by the High Court is the subject matter of the present appeal.

3. Shri Balbir Singh, learned ASG has appeared on behalf of the Revenue and Shri Arijit Prasad, learned Senior Advocate has appeared on behalf of the assessee.

3.1 Shri Balbir Singh, learned ASG appearing on behalf of the Revenue has vehemently submitted that in the facts and circumstances of the case and while dealing with the relevant provisions of the Act, 1961, the High Court has materially erred in relying upon the decision of this Court in the case of ***Piara Singh (supra).*** It is submitted that as such the AO, CIT(A) and ITAT have correctly distinguished the judgment in case of the ***Piara***

Singh (supra) as the same pertained to an assessee who was engaged in the business of smuggling of currency notes and for whom confiscation of the currency notes was a loss occasioned in pursuing his business, i.e., a loss which sprung directly from carrying on of his business and was incidental to it. It is submitted that due to this, the assessee in the aforesaid case was held entitled to deduction under Section 10(1) of Income Tax Act, 1922. It is submitted that however in para 7 of the aforesaid judgment which refers to three cases where an exception to the aforesaid rule was noted by the Court. It is submitted that in the said decision this Court noted earlier decisions of this Court as well as the Andhra Pradesh High Court and the Bombay High Court. It is submitted that in the case of ***Haji Aziz & Abdul Shakoor Bros. v. CIT, AIR 1961 SC 663***, the assessee's claim for deduction of fine paid by him for release of his dates confiscated by customs authorities, was rejected on the ground that the amount paid by way of penalty for breach

of law was not a normal course of business carried on by it. In the other two cases, customs authorities had confiscated gold from assessees otherwise engaged in legitimate businesses. It is submitted that in two relied upon cases of Andhra Pradesh High Court and the Bombay High Court the assessees claimed the value of gold seized as a trading/business loss which is identical to the Respondent-Assessee's claim in the facts of the present SLP. It is submitted that therefore the decision of this Court in ***Haji Aziz & Abdul Shakoor Bros. v. CIT, AIR 1961 SC 663***, of the Andhra Pradesh High Court in the case of ***Soni Hinduji Kushalji & Co. vs. CIT, (1973) 89 ITR 112(AP)*** and of the Bombay High Court in the case of ***JS Parkar v. VB Palekar, (1974) 94 ITR 616 (Bom)*** shall be applicable with full force to the facts of the case on hand.

3.2 It is submitted that the Andhra Pradesh High Court observed in para 10 of the judgment in case of **Soni Hinduji *Kushalji* (supra)** that when a claim for

deduction is made, the loss must be one that springs directly from or is incidental to the business which the assessee carries on and not every sort or kind of loss which has absolutely no nexus or connection with his business. In paras 11 and 12, the High Court relied on various judgments to state that confiscation of contraband gold is an action in *rem* and not a proceeding in *personam* and thus, a proceeding in rem in the strict sense of the term is an action taken directly against the property (i.e., smuggled gold) and even if the offender is not known, customs authorities have power to confiscate the contraband gold. In view of the aforesaid, the Court stated that confiscation of contraband gold by customs authorities cannot be said to be a trading or commercial loss connected with or incidental to assessee's business. The High Court further relied on ***Haji Aziz (supra)*** and various other judgments to state that such confiscation of smuggled/contraband goods which results in infraction of law and has no incidence/connection to the business of assessee,

cannot be allowed as a business loss. Thus, the aforesaid case which has been referred to and distinguished in ***Piara Singh (supra)***, squarely applies to the facts of the present case herein. Similarly, the case of ***JS Parkar (supra)*** would also be applicable to the present case as in the former case, the assessee not only claimed the value of the gold confiscated as a trading loss but also set off of the said loss against his assumed and assessed income from undisclosed sources. Furthermore, the value of gold was sought to be taxed U/s.69/69A by the tax authorities. However, in this case also the Bombay High Court rejected the contention that Section 110 of the Evidence Act (where a person found in possession of anything, the onus of proving that he was not the owner is on the person who affirmed that he was not owner) was inapplicable to taxation proceedings and agreed that tax authorities had rightly inferred assessee to be owner of seized gold based on circumstantial evidence and assessee was not

entitled to claim value of such gold as a trading loss.

3.3 Shri Balbir Singh, learned ASG has further relied upon the decisions of this Court in the case of ***Chuharmal v. CIT, (1988) 3 SCC 588*** and ***CIT v. K Chinnathamban, (2007) 7 SCC 390***, on onus of proving ownership being on the person who denies ownership and who is in possession. It is submitted that ownership of confiscated silver fell on the Respondent-Assessee in the present case which he failed to discharge and which accordingly rendered the tax authorities' concurrent findings on his ownership to be valid. It is submitted that when the assessee has been unable to deny possession and ownership and in fact admitted the same before the Settlement Commission as well as the High Court, and further claimed the value of confiscated silver as a trading loss before AO, CIT(A) and ITAT, to alternatively argue to the contrary and deny ownership in order to state that

Section 69A cannot be applied in his case may not be accepted.

3.4 It is submitted by learned ASG that assessee shall also not be permitted to claim such loss as a business expenditure in view of the express prohibition under Explanation 1 to Section 37(1) of the Act which was added w.e.f.01.04.1962. Reliance is placed on the decisions of this Court in the case of ***TA Quereshi (Dr.) v. CIT, (2007) 2 SCC 759*** as well as ***Apex Laboratories (P) Ltd. v. CIT, (2022) 7 SCC 98***. It is submitted that Explanation 1 to Section 37(1) of the Act expressly disallows any expenditure incurred by an assessee for any purpose which is an offence or is prohibited by law, which may be claimed as an expenditure incurred for the purpose of business/profession.

3.5 It is submitted that in the case of ***TA Quereshi (supra),*** this Court clarified that the facts of the said case pertained to business loss and not

business expenditure. It is submitted that in the said case, ITAT found the assessee engaged in the business of manufacturing and selling heroin and thus, this Court held that assessee's claim of business loss was allowable as he was in the business of heroin. It is submitted that the case of ***Apex Laboratories (supra)*** distinguishes the judgment in ***TA Quereshi (supra)*** and states that the case relating to the assessee bribing doctors, did not deal with business loss but business expenditure which was disallowable under Explanation 1 to Section 37(1). It is submitted that thus either way, neither can the Respondent-Assessee claim business loss due to him not being in the smuggling business nor can he claim business expenditure as the same is prohibited under Explanation 1 to Section 37(1).

3.6 Making above submissions and relying upon the above submissions, it is prayed to allow the present appeals and restore the ITAT orders.

4. Shri Arijit Prasad, learned Senior Advocate appearing on behalf of the assessee has vehemently submitted that in the present case the respondent – assessee is engaged in the business of purchase and sale of silver. Total sales of Rs.1,46,07,314/- of Silver was declared by the respondent – assessee with a gross profit of Rs.1,32,712/- for the assessment year in question. Search was conducted by the officers of DRI when unaccounted 146 slabs of silver was recovered. The Collector of Customs ordered absolute confiscation of the said 146 slabs of silver valued at Rs.3,06,036,909/- was proposed to be added as deemed income under Section 69A of the Act. The respondent – assessee disputed being the owner of the slabs. In the alternative, the respondent also requested that 146 silver slabs having been absolutely confiscated by the Customs Department, the value of such tradable silver slabs should be allowed as loss. However, the Assessing Officer made the addition of Rs.3,06,036,909/- as income under Section 69A of the Act being a value

of 146 silver bars seized from the possession of the respondent. The said order of addition came to be confirmed upto ITAT, however by the impugned judgment and order the High Court has answered the reference in favour of the assessee by holding that when the value of material is added to the income of the respondent, as a natural consequence, the loss by confiscation of the said material is required to be allowed as business loss. It is submitted that it is through that before the High Court, the assessee did not press the argument regarding the ownership of the silver slabs and therefore, the said question was not answered by the High Court.

4.1 It is submitted that therefore present case is one where set off is claimed of the value of the 146 silver slabs as loss on account of absolute confiscation rather than claim of expenditure of any penalty and/or fine imposed for infraction of law.

4.2 It is submitted that as such the issue in the present appeals is fairly covered in favour of the assessee in view of the decision of this Court in the case of ***TA Quereshi (Dr.) (supra).*** In the said decision, it is held that the judgment of the High Court applying Section 37 of the Act to the case of business loss on account of absolute confiscation of the goods was erroneous. It is submitted that the submission of the assessee therein that Section 37 of the Act related to business expenditure whereas case of absolute confiscation was one of business loss has been accepted.

4.3 It is submitted that in the present case, upon search, 146 silver slabs were found to be in possession of the assessee. The value of the said silver slabs was determined to be Rs. 3,06,036,909/- and the same was added to the computation of income of the assessee under Section 69A of the Act as undisclosed valuable article which was not recorded in the books of account of the assessee.

4.4 It is submitted that however as the respondent – assessee was engaged in the business of trading of silver and the said silver slabs were in possession of the assessee for the purpose of trading, absolute confiscation of the said silver slabs would result in loss of stock in trade and the value thereof would be available as deduction as business/trading loss. It is submitted that therefore the decision of this Court in the case of ***T.A. Quereshi (Supra)*** shall be clearly applicable.

4.5 It is submitted that in the case of ***T.A. Quereshi (Supra)*** this Court has drawn a distinction between claim of deduction as expenditure of penalty/fine as against claim of business loss on account of confiscation of goods which are unaccounted stock in trade. It is submitted that in case of claim of deduction as expenditure of any fine and/or penalty, the Courts have held that such deduction would not be available to the assessee as it would defeat the very purpose

behind such penal action. Whereas, in case of claim of set off as business loss, the unaccounted goods though added to the income of assessee but is not available to the assessee for his trade. It is submitted that while extending the benefit of such set off, this Court in the case of ***Piara Singh (supra)*** and ***T.A. Quereshi (Supra)*** have held that the assessee shall be entitled to the set off as business loss.

4.6 It is submitted that unlike a case of imposition of redemption fine where the confiscated goods are released on payment of such amount, absolute confiscation of the goods results in the said goods vesting with the Central Government. In such cases, though the value of the goods is added to the income of the assessee, but the assessee has no option of redeeming the goods for its onward trade. Thus, there is an evident distinction between a case where deduction is sought of any penalty and/or fine as allowable expenditure and a case where business loss is claimed on account of

absolute confiscation of the goods which results in loss of stock in trade. It is submitted that present one is a case where the set off is claimed as business loss on account of absolute confiscation of the silver bars and not of any penalty and/or fine. The judgments cited during the course of hearing by the Petitioner are therefore rendered on distinct and distinguishable facts and would not be applicable to the facts of the present case.

4.7 It is submitted that the said distinction has also been statutorily recognized. As highlighted by the appellant, Section 37 which deals with allowance and deduction of expenditure, was amended vide Finance Act, 1998 w.e.f. 01.04.1962 whereby Explanation 1 was added to clarify 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 purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure. In contrast thereto, consciously

no such restriction has been brought in law with regard to set off of the value of the unaccounted stock in trade which have been absolutely confiscated.

4.8 Making above submissions it is prayed to dismiss the present appeals.

5. Heard learned counsel for the respective parties at length.

6. The short question which is posed for consideration before this Court is whether the High Court has erred in law in allowing the respondent – assessee the loss of confiscation of silver bars by DRI officials as a business loss, relying upon the decision of this Court in the case of ***CIT Patiala vs. Piara Singh, 1980 Supp SCC 166***?

6.1 While considering the aforesaid question, at the outset, it is required to be noted that the provisions of Section 37(1) under the Act has been amended by Finance (No.2) Act, 1998 by introducing

Explanation 1 thereto w.e.f. 01.04.1962 wherein any expenditure incurred by the assessee for any purpose which is an offence or prohibited by law is not an allowable business expense. It is true that in the present case the respondent - assessee did not claim value of silver bars confiscation as business expenses thus claimed as business loss. However, the amendment to Section 37 might have some bearing on the issue involved.

6.2 On going through the impugned judgment and order passed by the High Court, it appears that the High Court has simply relied upon the decision of this Court in the case of ***Piara Singh (supra).*** Having gone through the decision of this Court in the case of ***Piara Singh (supra),*** we are of the opinion that the High Court has materially erred in relying upon the decision of this Court in the case of ***Piara Singh (supra).***

6.3 In the case of ***Piara Singh (supra)*** the assessee was found to be in the business of smuggling of

currency notes and to that it was found that confiscation of currency notes was a loss occasioned in pursuing his business i.e. a loss which sprung directly from carrying on of his business and was incidental to it. Due to this, the assessee in the said case held entitled to deduction under Section 10(1) of the Income Tax Act, 1922. In view of the above fact situation this Court in the case of ***Piara Singh (supra)*** distinguished the decisions of this Court in the case of ***Haji Aziz & Abdul Shakoor Bros.*** reported in ***AIR 1961 SC 663***, and the decision in the case of ***Soni Hinduji Kushalji & Co. vs. CIT, (1973) 89 ITR 112(AP)*** and not agreed with the decision of the Bombay High Court in the case of ***J.S. Parkar vs. VB Palekar, (1974 94 ITR 616 (Bom).*** It is to be noted that in all the aforesaid three cases which were relied upon by the Revenue in the case of ***Piara Singh (supra)*** were found to be involved in legitimate businesses and not smuggling business but however they were found to have smuggled goods contrary to law which resulted in an

infraction of law and resultant confiscation by customs authorities.

6.4 In the case of ***Haji Aziz (supra)*** the assessee claimed for deduction of fine paid by him for release of his dates confiscated by customs authorities was rejected on the ground that the amount paid by way of penalty for breach of law was not a normal business carried out by it. In the case of ***Soni Hinduji Kushalji (supra)*** and ***JS Parkar (supra),*** the customs authorities had confiscated gold from assessees otherwise engaged in legitimate businesses. In the aforesaid two cases the assessee claimed the value of gold seized as a trading/business loss. It was held that the assessees are not entitled to the deductions as claimed as business loss.

6.5 In the case of **Soni Hinduji (supra),** the Andhra Pradesh High Court held that when a claim for deduction is made, the loss must be one that springs directly from or is incidental to the business which the assessee carries on and not

every sort or kind of loss which has absolutely no nexus or connection with his business. It was observed that confiscation of contraband gold was an action in *rem* and not a proceeding in *personam* and thus, a proceeding in *rem* in the strict sense of the term is an action taken directly against the property (i.e. smuggled gold) and even if the offender is not known, the customs authorities have power to confiscate the contraband gold.

6.6 In the case of ***JS Parkar (supra),*** the assessee not only claimed the value of the gold confiscated as a trading loss but also set off of the said loss against his assumed and assessed income from undisclosed sources. The value of gold was sought to be taxed under Section 69/69A of the Act by the tax authorities. However, the Bombay High Court held the assessee to be the owner of the smuggled confiscated gold and the assessee was not entitled to claim value of such gold as a trading loss.

6.7 In the present case the ownership of the confiscated silver bars of the assessee now cannot be disputed and even the assessee is not disputing the same. Even on that also there are concurrent findings by all the authorities below and including the customs authorities. Therefore, the next question which is posed for consideration before this Court is whether the assessee can claim the business loss of the value of the silver bar confiscated and whether the decision of this Court in the case of ***Piara Singh (supra)*** would be applicable?

6.8 To answer to the aforesaid question, it can be seen that in the present case the main business of the assessee is dealing in silver. His business cannot be said to be smuggling of the silver bars as was the case in the case of ***Piara Singh (supra).*** As observed hereinabove in the assessee's case he was carrying on an otherwise legitimate silver business and in attempt to make larger profits, he indulged into smuggling of silver, which was an infraction of

law. In that view of the matter the decision of this Court in the case of ***Piara Singh (supra)*** which has been relied upon by the High Court while passing the impugned judgment and order and it has been relied upon by the assessee shall not be applicable to the facts of the case. On hand or the other hand the decision of this Court in the case of ***Haji Aziz (1961) 41 ITR 350 (SC)*** and the decisions of the Andhra Pradesh High Court and the Bombay High Court which were pressed into service by the Revenue in ***Piara Singh (supra)*** would be applicable with full force.

7. In view of the above and for the reason stated above and looking to the business of the assessee namely silver business and was not in the business of smuggling silver, the decision of this Court in the case of ***Piara Singh (supra)*** shall not be applicable and therefore the impugned judgment and order passed by the High Court quashing and setting aside the order passed by the Assessing Officer, CIT(A) and the ITAT rejecting the claim of the

Assessee to treat the silver bars confiscated by the customs authorities as business loss and consequently value allowing the same as business loss is unsustainable and the same deserves to be quashed and set side.

8.1 In view of the above and for the reason stated above present appeals succeed. The impugned judgment and order passed by the High Court is hereby quashed and set aside and the order passed by the assessing officer, CIT(A) and the ITAT are hereby restored.

Present appeals are accordingly allowed. No costs.

.....J.
(M. R. SHAH)

.....J.
(M.M. SUNDRESH)

New Delhi,
April 24, 2023

REPORTABLE

IN THE SUPREME COURT OF INDIA
CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NO. 7689-7690 OF 2022

THE COMMISSIONER OF INCOME TAX, JAIPUR …APPELLANT

VERSUS

PRAKASH CHAND LUNIA (D) THR LRS & ANR. …RESPONDENTS

J U D G M E N T

M. M. Sundresh, J.

1. The present appeal is filed by the Revenue, challenging the decision of the Division Bench of the Rajasthan High Court at Jaipur, drawing a distinction between a claim for deduction of a loss incurred in an illegal business, as against a claim of a loss *qua* a legitimate business, though an illegality is attached to it. The aforesaid issue is to be tested on an offence committed leading to either a penalty or confiscation.

2. Heard Mr. Balbir Singh, learned Additional Solicitor General, Mr. AK Shrivastava, learned senior counsel for the Appellant and Mr. Arjit Prasad, learned senior counsel for the Respondents.

3. I have gone through the well-merited judgment rendered by my learned brother, Justice M.R. Shah. While concurring with the ultimate conclusion arrived at in

overturning the decision of the High Court, I would like to give my own reasoning on the aforesaid aspect. The facts being narrated with utmost clarity by my learned brother, only those which are required in support of the reasoning are being recorded.

4. The Director of Revenue Intelligence set out a search at the business premises of the Respondent/assessee. The recovery yielded silver slabs/silver ingots. The assessee was in the business of making jewellery.

5. The Respondent/assessee filed his return for the Assessment Year 1989-1990 followed by a petition before the Income Tax Settlement Commission. The Collector of Customs vide order dated 18.12.1990 ordered confiscation of goods and imposed penalty. It was done on the premise that the goods were smuggled by the assessee. A claim was made by the assessee that the loss on account of confiscation would be allowable as trading loss being incidental to the business, and hence, deductible. This argument was duly rejected as he was neither doing the business of smuggling, nor he owned the silver. The plea of ownership was given up by the Respondent/assessee before the High Court, and therefore, the decision of the assessing officer in bringing the loss suffered under Section 69A of the Income Tax Act, 1961 (hereinafter referred to as "the Act"), has become final.

6. Before the Hight Court, the Respondent/assessee placing reliance upon the judgment of this Court in ***Commissioner of Income Tax v. Piara Singh*** (1980) Supp. SCC 166, inter alia contended that smuggling by itself being prohibited in law, any loss occurred thereunder is liable for deduction. The aforesaid argument made, found acceptance at the hands of the High Court, which is sought to be impugned by the Revenue before us.

RELEVANT PROVISIONS OF THE INCOME TAX ACT, 1961

> **"2**. **Definitions**.- In this Act, unless the context otherwise requires,—
>
> xxx xxx xxx
>
> (13)"business" includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture;"

7. This provision being a definition clause merely defines various activities which could be termed as a business. Section 2(13) of the Act gives a broad definition to 'business'. Section 28 of the Act comes under the heading 'Profits and Gains of Business or Profession'. Various types of income enumerated thereunder are made chargeable to income tax. The income, as referred in Section 28 of the Act, has to be computed in the manner as prescribed under Section 30 to 43D of the Act, which is accordingly provided under Section 29 of the Act.

Section 37:

> "**37 General**.- (1) Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

> [Explanation 1.]—For the removal of doubts, it is hereby declared 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 purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure."

8. Section 37 of the Act, being one of the provisions meant for computing income from profits or gains of business or profession, is a residuary and omnibus provision which intends to cover all expenditure to the exclusion of those mentioned under Section 30 to 36 of the Act, apart from being in the nature of capital expenditure or personal expenses of the assessee. Therefore, the object behind this provision is very clear as it includes 'any expenditure'. The second mandate of this provision is that the expenditure will have to be *laid out or expended wholly and exclusively for the purpose of the business or profession* to come into the fold of income chargeable to tax as profit and gains of business or profession.

9. An ambiguity arose as to whether a business, as defined under Section 2(13) of the Act, and as dealt with under Section 37 of the Act, would include a deduction when the said expenditure is incurred for any purpose which is an offence or prohibited by law.

10. Since an anomaly has been created by the interpretation of the *pari materia* provision under the Income Tax Act, 1922 (hereinafter referred to as "the Old Act"), viz. Section 10(1) and (2), therefore, Explanation-I to Section 37 of the

Act came into the statute book with retrospective effect from 01.04.1962 through the Finance (No.2) Act 1998, (Act 21 of 1998).

11. The purpose of the insertion of the aforesaid Explanation was explained by the Central Board of Direct Taxes Circular No. 772 dated 23.12.1998,

> **"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 assessees 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."

12. Explanation-I makes a declaration to remove any possible doubts to reckon a loss suffered in the form of expenditure for any purpose which is an offence or one that is prohibited by law. There is no difficulty in holding that this explanation is clarificatory in nature. Applying the principle of literal interpretation with the intendment being very clear, giving no room for further doubts, coupled with the fact that there is no challenge to it, the meaning appears to be rather very clear. It seeks to prohibit a deduction of any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law. Due regard will have to be given to the words 'any expenditure' and 'any purpose'. The reiteration being a legislative clarification

of the main provision is required to be taken note of, as such, the power of judicial review over an explanation, which has been introduced to explain and remove the doubts of the main provision, is rather limited.

13. Though the provision speaks of expenditure while not making a specific reference to loss, one has to press into service the accepted commercial practice and trading principles. If one is to treat the expenditure as a genus, a loss would become a specie. All losses would become expenditures but not *vice versa*. A commercial loss in trade arising out of a business being carried on and incidental to it would be a deductible loss as laid down by this Court in ***Badridas Daga v. CIT***, (1959) SCR 690. There is a similarity in the test *qua* a loss as laid down by this Court, and expenditure under Section 37 of the Act. Perhaps, there is a distinction when it comes to the accounting treatment of the two concepts. Thus, there is no difficulty in holding that the word 'any expenditure' mentioned in Section 37 of the Act takes in its sweep loss occasioned in the course of business, as well. Therefore, I agree with the view of my learned brother that Section 37 of the Act and Explanation 1 will have a bearing in the present case.

Section 115BBE

> **"Section 115BBE.- "Tax on income referred to in section 68 or section 69 or section 69A or section 69B or section 69C or section 69D.-** (1) Where the total income of an assessee,—

(a) includes any income referred to in section 68, section 69, section 69A, section 69B, section 69C or section 69D and reflected in the return of income furnished under section 139; or

(b) determined by the Assessing Officer includes any income referred to in section 68, section 69, section 69A, section 69B, section 69C or section 69D, if such income is not covered under clause (a),

the income-tax payable shall be the aggregate of—

(i) the amount of income-tax calculated on the income referred to in clause (a) and clause (b), at the rate of sixty per cent; and

(ii) the amount of income-tax with which the assessee would have been chargeable had his total income been reduced by the amount of income referred to in clause (i).

(2) Notwithstanding anything contained in this Act, no deduction in respect of any expenditure or allowance or set off of any loss shall be allowed to the assessee under any provision of this Act in computing his income referred to in clause (a) and clause (b) of sub-section (1).”

14. Section 115BBE of the Act deals with levy of tax on income as mentioned in Section 68, 69, and 69A to 69D of the Act. If a case comes under Section 115BBE sub-section (1) of the Act, the rate of income tax shall be at 60%.

15. The object of this provision is to fill up the loopholes and to make sure unaccounted money either generated or used, more so in the nature of Black Money, is penalized. When this provision was introduced in the year 2012, the rate of tax was fixed at the rate of 30%. The Bill also speaks about the objective behind not allowing any deduction to the assessee in computing deemed income under Section 68, 69 and 69A to 69D of the Act. That was the reason why a decision was made to impose greater tax burden. The rate of tax was increased by a subsequent amendment to 60%.

16. Sub-section (2) of Section 115BBE starts with a *non-obstante* clause. It will have precedence over any other provision contained in the Act, while dealing

with a deduction in respect of any expenditure or allowance or set off of any loss. In other words, no such deduction would be allowed under any provision of the Act in computing an assessee's income under sub-section (1). An amendment has been introduced by Finance Act, 2016 with the inclusion of 'set off of any loss' being not allowable. Sub-section (2) once again does not speak about loss but the fact that it makes a reference to 'set off of any loss' would reiterate the view taken earlier, while considering the scope and ambit of Section 37 of the Act, that such a loss has to be read into expenditure, at least while applying the test for the purpose of deduction. To make the position clear one has to understand that the amendment merely speaks about the right of the assessee to set off the loss which presupposes that the loss has to be treated as a facet of expenditure.

17. A little bit of interplay between Section 115BBE and Section 37(1) of the Act might throw more light on both the provisions. If a loss in pursuance to an offence or prohibited business cannot be brought under Section 115BBE of the Act for income assessed under 68, 69 and 69A to 69D of the Act, which deals with unexplained income, expenditure etc., it can never be said that the same would be brought under Section 37(1) of the Act, despite the fact that the objective behind both the provisions are overlapping with some connection.

Section 115BBE being a subsequent legislation, the true meaning of Section 37(1) can be understood on that basis.

18. Having understood the provisions, I shall now consider the decisions relied upon at the Bar as they deal with the interpretation of the provisions governing.

19.*Badridas Daga v. CIT , (1959) SCR 690*

19.1 This Court was dealing with a loss suffered due to an embezzlement by an employee of the assessee. While interpreting Section 10(2) of the Old Act over a claim made for deduction, for which there was no specific provision, reliance was made on the accepted commercial practices and trading principles. Resultantly, it was held that the deduction was allowable in a case where there is no prohibition either expressed or implied under the Act. Thus, the Court has made it clear that in the absence of any prohibition, as stated above, a claim for deduction of a loss is allowable so long as it emanates directly from the carrying on of the business, being incidental to it. In other words, it does not include loss of any nature even if it has some connection with the business, if the same cannot be said to be incidental to the business.

19.2 The court went on to hold that the payment of salary to an employee being paid for the purpose of business, is deductible under the general provision, therefore, logically any loss occasioned on the action of an employee would be incidental to the business.

19.3 Considering the aforesaid, it can be said that there is a similarity between the test laid down for deduction of an expense in the residuary omnibus provision under Section 10(2)(xv) of the Old Act and the test for deduction of loss based on commercial practices and trading principles. The decision is therefore supporting the above stated interpretation of Section 37 of the Act.

19.4 Relevant paragraphs:

> "The question whether monies embezzled by an agent or employee are allowable as deduction in computing the profits of a business under s. 10 of the Act has come up for consideration frequently before the Indian Courts, and the decisions have not been quite uniform. Before discussing them, it is necessary that we should examine the principles that are in law applicable to the determination of the question. Three grounds have been put forward in support of the claim for deduction: (1) that the loss sustained by reason of embezzlement is a bad debt allowable under s. 10(2)(xi) of the Act; (2) that it is a business expense falling within s. 10(2)(xv) of the Act; and (3) that it is a trading loss, which must be taken into account in computing the profits under s. 10(1) of the Act. As regards the first ground, the authorities have consistently held that the deduction is not admissible under s. 10(2)(xi) of the Act, and that, in our view, is correct. A debt arises out of a contract between the parties, express or implied, and when an agent misappropriates monies belonging to his employer in fraud of him and in breach of his obligations to him, it cannot be said that he owes those monies under any agreement. He is no doubt liable in law to make good that amount, but that is not an obligation arising out of a contract, express or implied. Nor does it make a difference that in the accounts of the business the amounts embezzled are shown as debits, the amounts realised towards them, if any, as credits, and the balance is finally written off. They are merely journal entries adjusting the accounts and do not import a contractual liability. Nor can a claim for deduction be admitted under s. 10(2)(xv), because moneys which are withdrawn by the employee out of the business till without authority and in fraud of the proprietor can in no sense be said to be "an expenditure laid out or expended wholly and exclusively" for the purpose of the business. The controversy therefore narrows itself to the question whether amounts lost through embezzlement by an employee are a trading loss which could be deducted in computing the profits of a business under s. 10(1). It is to be noted that while s, 10(1) imposes a charge on the profits or gains of a trade, it does not provide how those profits are to be computed. Section 10(2) enumerates various items which are admissible as deductions, but it is well settled that they are not exhaustive of all allowances which could be made in ascertaining profits taxable under s. 10(1). In *Income Tax Commissioner v. Chitnavis* [(1932) LR 59 IA 290, 296, 297] the point for decision was whether a bad debt could be

deducted under s. 10(1) of the Act, there having been in the Act, as it then stood, no provision corresponding to s. 10(2)(xi) for deduction of such a debt. In answering the question in the affirmative, Lord Russel observed:

> "Although the Act nowhere in terms authorizes the deduction of bad debts of business, such a deduction is necessarily allowable. What are chargeable in income tax in respect of a business are the profits and gains of a year; and in assessing the amount of the profits and gains of a year account must necessarily be taken of all losses incurred, otherwise you would not arrive at the true profits and gains."

It is likewise well settled that profits and gains which are liable to be taxed under s. 10(1) are what are understood to be such according to ordinary commercial principles. "The word 'profits' … is to be understood", observed Lord Halsbury in *Gresham Life Assurance Society v. Styles* [(1892) AC 309, 315 : 3 TC 185, 188] "in its natural and proper sense — in a sense which no commercial man would misunderstand". Referring to these observations Lord Macmillan said in *Pondicherry Railway Co. v. Income Tax Commissioner* [(1931) LR 58 IA 239, 252]:

> "English authorities can only be utilized with caution in the consideration of Indian income tax cases owing to the differences in the relevant legislation, but the principle laid down by Lord *Chancellor Halsbury in Gresham Life Assurance Society v. Styles* [(1892) AC 309, 315 : 3 TC 185, 188] , is of general application unaffected by the specialities of the English tax system."

The result is that when a claim is made for a deduction for which there is no specific provision in s. 10(2), whether it is admissible or not will depend on whether, having regard to accepted commercial practice and trading principles, it can be said to arise out of the carrying on of the business and to be incidental to it. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied, in the Act.

These being the governing principles, in deciding whether loss resulting from embezzlement by an employee in a business is admissible as a deduction under s. 10(1) what has to be considered is whether it arises out of the carrying on of the business and is incidental to it. Viewing the question as a businessman would, it seems difficult to maintain that it does not. A business especially such as is calculated to yield taxable profits has to be carried on through agents, cashiers, clerks and peons. Salary and remuneration paid to them are admissible under s. 10(2)(xv) as expenses incurred for the purpose of the business. If employment of agents is incidental to the carrying on of business, it must logically follow that losses which are incidental to such employment are also incidental to the carrying on of the business. Human nature being what it is, it is impossible to rule out the

possibility of an employee taking advantage of his position as such employee and misappropriating the funds of his employer, and the loss arising from such misappropriation must be held to arise out of the carrying on of business and to be incidental to it. And that is how it would be dealt with according to ordinary commercial principles of trading.

At the same time, it should be emphasised that the loss for which a deduction could be made under s. 10(1) must be one that springs directly from the carrying on of the business and is incidental to it and not any loss sustained by the assessee, even if it has some connection with his business. If, for example, a thief were to break overnight into the premises of a moneylender and run away with funds secured therein, that must result in the depletion of the resources available to him for lending and the loss must, in that sense, be a business loss, but it is not one incurred in the running of the business, but is one to which all owners of properties are exposed whether they do business or not. The loss in such a case may be said to fall on the assessee not as a person carrying on business but as owner of funds. This distinction, though fine, is very material as on it will depend whether deduction could be made under s. 10(1) or not."

(emphasis supplied)

20.*Haji Aziz & Abdul Shakoor Bros. v. CIT, (1961) 2 SCR 651*

20.1 The three-Judge bench of this Court in the aforesaid case was concerned with two principal issues which we are dealing with at present. In clear terms it has been held that an expenditure is not deductible unless it is a commercial loss in trade. A penalty incurred for an infraction of law could never be termed as a commercial loss in carrying on business, apart from being an abnormal incident, consequently, it cannot be deducted. It falls on the assesse in some character other than that of a trader. A mere connection between the loss and the business of the assesse *per se* can never be the sole factor. To put it simply, this Court has made the position abundantly clear that a penalty can never be understood as a commercial expenditure/loss for the purpose of the business

nor a disbursement made to earn profit. It was further noted that a confiscation is a proceeding *in rem*, and therefore, the penalty is imposed on the goods. That being the position, in any case, an assessee cannot claim deduction of loss in a case of confiscation/penalty, as arising out of carrying on of the business or incidental to it.

20.2 Relevant paragraphs:

> **"**In support of his argument counsel for the appellant firm referred to *Maqbool Hussain* v. *State* of *Bombay etc.* [(1953) SCR 730] and to the following passage at p. 742 where Bhagwati, J., said:
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> > "Confiscation is no doubt one of the penalties which the Customs Authorities can impose but that is more in the nature of proceedings in rem than proceedings in personam, the object being to confiscate the offending goods which have been dealt with contrary to the provisions of the law and in respect of the confiscation also an option is given to the owner of the goods to pay in lieu of confiscation such fine as the officer thinks fit. All this is for the enforcement of the levy of and safeguarding the recovery of the sea customs duties."
>
> Similar observations were made by S.K. Das, J., in *Shewpujanrai Indrasanrai Ltd.* v. *Collector of Customs & Ors.* [(1959) SCR 821 at p. 836] where it was said that a distinction must be drawn between an action in *rem* and proceeding in *personam* and that confiscation of the goods is a proceeding in *rem* and the penalties are enforced against the goods whether the offender is known or not. The view taken by this Court in the other two cases cited by counsel for the appellants i.e. *Leo Roy Frey* v. *Superintendent, District Jail, Amritsar* [(1958) SCR 822] and *Thomas Dana* v. *State of Punjab* [1959 Supp (1) SCR 274 at p. 298] is the same. In *Dana case* [(1959) SCR 821 at p. 836] Subba Rao, J., said at p. 298:
>
> > "If the authority concerned makes an order of confiscation it is only a proceeding in *rem* and the penalty is enforced against the goods. On the other hand, if it imposes a penalty against the person concerned, it is a proceeding against the person and he is punished for committing the offence. It follows that in the case of confiscation there is no prosecution against the person or imposition of a penalty on him."

In *Maqbool Hussain's case* [(1953) SCR 730] the question for decision was whether after proceedings had been taken under the Sea Customs Act an accused person could be prosecuted and could or could not rely upon the plea of double jeopardy, it was held that he could not. In *Shewpujanrai case* [(1959) SCR 821 at p. 836] the contention raised was that after proceedings had been taken under the Foreign Exchange Regulation Act it was not open to the Customs Authorities to take any action under the Sea Customs Act. The other two cases were similar to *Maqbool Hussain case* [(1953) SCR 730] . The contention now raised before us is quite different. What is to be decided in the present case is whether the penalty which was paid by the appellant firm was an allowable deduction within s. 10(2)(*xv*) of the Income-tax Act which provides:

> S. 10. (2)(*xv*) "any expenditure (not being in the nature of capital expenditure or personal expenses of the assessee) laid out or expended wholly and exclusively for the purpose of such business, profession or vocation."

The words "for the purpose of such business" have been construed in *Inland Revenue* v. *Anglo Brewing Co. Ltd.* [(1925) 12 TC 803, 813] to mean "for the purpose of keeping the trade going and of making it pay". The essential condition of allowance is that the expenditure should have been laid out or expended wholly and exclusively for the purpose of such business.

In deciding this case, reference to decisions in some English cases will be fruitful. In *Commissioners of Inland Revenue* v. *Warnes & Co.* [(1919) 2 KB 444] , the assessee who carried on the business of oil exporters were sued for a penalty on an information exhibited by the Attorney-General under the Sea Customs Consolidation Act for breach of orders and proclamations. The matter was settled by consent on the assessee agreeing to pay a mitigated penalty of £ 2000. All imputations on the moral culpability of the assessees were withdrawn. The provisions of the Act under which this information was lodged and penalty paid was similar to the provisions of the Indian Sea Customs Act. This amount was held not to be a proper deduction because in order to be within the provision similar to s. 10(2)(*xv*) of the Indian Act the loss had to be something within commercial contemplation and in the nature of a commercial loss. Rowlatt, J., relying on the observation of Lord Loreburn, L.C., in *Strong & Co.* v. *Woodifield* [(1906) AC 448] said at p. 452:

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

> a 'loss connected, with or arising out of' the trade within the meaning of this rule".

This statement of the law was approved in the *Commissioners of Inland Revenue* v. *Alexander Von Glehn & Co. Ltd.* [(1920) 2 KB 553] where also in similar circumstances by consent of the assessee penalty of £ 3,000 was paid and the penalty plus the costs were claimed as deduction in arriving at the profits. The Special Commissioners had found that the penalty and costs were incurred by the assessee in the course of carrying on their trade and so incidental thereto and were admissible deductions. Rowlatt, J., on a reference held it to be a non-deductible item. This judgment was affirmed on appeal by the Court of Appeal. Lord Sterndale, M.R., was of the opinion that it was immaterial whether technically the proceedings were criminal or not. The money that was paid was paid as a penalty and it did not matter if in the information it was called a forfeiture.

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

> "Now what is the position here? This business could perfectly well be carried on without any infraction of the law. This penalty was imposed because of an infraction of the law, and that does not seem to me to be, any more than the expense which had to be paid in *Strong & Co.* v. *Woodifield* [(1906) AC 448] appeared to Lord Davey to be, a disbursement or expense which was laid out or expended for the purpose of such trade…."

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

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

In *Strong & Co.* v. *Woodifield* [(1906) AC 448] a brewing company owned a licensed house in which they carried on the business of inn-keepers. They incurred a liability to pay damages on account of injuries caused to a visitor, by the falling in of a chimney. This sum was held not to be allowable as a deduction in computing the profits. Lord Loreburn, L.C., in his speech said no sum could be deducted unless it be money wholly and exclusively laid out or expended for the purpose of such trade and that only such losses could be deducted as were connected with it in the sense that they were really incidental to the trade itself and they could not be deducted if they were mainly incidental to some other

vocation or fell on the trader in some character other than that of a trader. Lord Davey observed:

> "I think the disbursements permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arise out of, or is connected with the trade or is made out of the profits of the trade. It must be made for the purpose of earning profits."

The following passage from Lord Sterndale's judgment at p. 566 in *Von Glehn case* [(1920) 2 KB 553] from which we have already quoted shows the effect of incurring a penalty as a result of a breach of the law:

> "During the course of the trading this company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong in the sense that they were willingly and knowingly sending these goods to an enemy destination; but they committed a breach of the law, and for that breach of the law, they were fined. That, as it seems to me, was not a loss connected with the business, but was a fine imposed upon the company personally, so far as a company can be considered to be a person, for a breach of the law which it had committed. It is perhaps a little difficult to put the distinction into very exact language, but there seems to me to be a difference between a commercial loss in trading and a penalty imposed upon a person or a company for a breach of the law which they have committed in that trading. For that reason I think that both the decision of Rowlatt, J., in this case, and his former decision in *Inland Revenue Commissioners* v. *Warnes & Co.* [(1919) 2 KB 444] which he followed were right, and that this appeal should be dismissed with costs."

In *Spofforth and Prince* v. *Glider* [(1945) 26 TC 310] the assessee was a firm of chartered accountants, who claimed a deduction for certain legal costs paid in connection with a successful defence of one of the partners in a Police Court. The assessee Firm also sought legal advice in regard to matters connected with some proceedings. Summons were issued against the assessee firm but were eventually dismissed. The assessee contended that the whole of the costs incurred in connection with the proceedings were "wholly and exclusively" laid out or expended for the appellant's profession and were therefore allowable deductions. The Special Commissioner had held against the assessee which was upheld by the Court. The test laid down by Lord Davey in *Strong & Co.* v. *Woodifield* [(1906) AC 448] was applied and applying that test it was held that except the expenses for obtaining legal advice the other expenses were not admissible.

In *Farrie* v. *Hall* [(1947) 28 TC 200] F, a sugar broker was sued in the High Court for libel and the Court held that F had acted maliciously and that the defence of privilege could not prevail and awarded damages against him. F sought

to claim the amount of damages as an allowable deduction contending that it was an expenditure laid out wholly and exclusively for the purposes of his trade or was a loss connected with or arising out of the trade. Relying on the cases abovementioned this amount was disallowed because it fell on the assessee in his character of a calumniator of a rival sugar broker and it was only remotely connected with his trade as a sugar broker. Therefore it was not laid out exclusively and wholly for the purpose of his business. We were also referred to the observations of Danckwerts, J. in *Newson* v. *Robertson* [(1952) 33 TC 452 at p. 459] where it was said that if the expenditure is incurred by the tax-payer for more than one purpose including the commercial purposes in the sense that it is incurred for the purposes of earning profits of the trade and also some outside purpose then the expenses cannot be claimed at all as not being wholly and exclusively laid out or expended for the purpose of the trade. In that case expenses claimed by a Barrister for travelling between his house and his chambers were disallowed because his object and purpose in travelling was mixed and not wholly and exclusively for the purpose of the profession.

Coming now to Indian cases; In *Mask & Co.* v. *Commissioner of Income-tax, Madras* [(1943) 11 ITR 454] the assessee in breach of his contract sold crackers at a lower rate and a decree was passed against him for damages for breach of contract which he claimed as an allowable deduction. It was held that as the assessee had disregarded the undertaking given and his conduct was palpably dishonest it did not constitute an allowable expenditure. Sir Lionel Leach, C.J., after referring to *Warne's case* [(1919) 2 KB 444] and *Von Glehn's case* [(1920) 2 KB 553] held that the amount did not constitute an expenditure falling within Section 10(2)(*xii*). The Madras High Court in *Senthikumara Nadar & Sons* v. *Commissioner of Income-tax* (1957) 32 ITR 138] held that payments of penalty for an infraction of the law fell outside the scope of permissible deductions under s. 10(2)(*xv*). In that case the assessee had to pay liquidated damages which was akin to penalty incurred for an act opposed to public policy a policy underlying the Coffee Market Expansion Act, 1942, and which was left to the Coffee Board to enforce.

Reference was also made during the course of arguments to *Commissioner of Income-tax* v. *Hirjee* [(1953) SCR 714]. In that case the assessee was prosecuted under the Hoarding and Profiteering Ordinance but was finally acquitted and claimed the amount spent in defending himself under s. 10(2)(*xv*) in his assessment. It was held that the distinction between the legal expenses on a successful and unsuccessful defence was not sound and that the deductibility of such expenses under s. 10(2)(*xv*) must depend on the nature and purpose of the legal proceedings in relation to the business whose profits are in computation and are unaffected by the final outcome of the proceedings.

A review of these cases shows that expenses which are permitted as deductions are such as are made for the purpose of carrying on the business i.e. to enable a person to carry on and earn profit in that business. It is not enough that

the disbursements are made in the course of or arise out of or are concerned with or made out of the profits of the business but they must also be for the purpose of earning the profits of the business. As was pointed out in *Von Glehn's case* [(1920) 2 KB 553] 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 penalties which are incurred by an assessee in proceedings launched against him for an infraction of the law cannot be called commercial losses incurred by an assessee in carrying on his business. Infraction of the law is not a normal incident of business and therefore only such disbursements can be deducted as are really incidental to the business itself. They cannot be deducted if they fall on the assessee in some character other than that of a trader. Therefore where a penalty is incurred for the contravention of any specific statutory provision, it cannot be said to be a commercial loss falling on the assessee as a trader the test being that the expenses which are for the purpose of enabling a person to carry on trade for making profits in the business are permitted but not if they are merely connected with the business.

It was argued that unless the penalty is of a nature which is personal to the assessee and if it is merely ordered against the goods imported it is an allowable deduction. That, in our opinion, is an erroneous distinction because disbursement is deductible only if it falls within s. 10(2)(xv) of the Income-tax Act and no such deduction can be made unless it falls within the test laid down in the cases discussed above and it can be said to be expenditure wholly and exclusively laid for the purpose of the business. Can it be said that a penalty paid for an infraction of the law, even though it may involve no personal liability in the sense of a fine imposed for an offence committed, is wholly and exclusively laid for the business in the sense as those words are used in the cases that have been discussed above. In our opinion, no expense which is paid by way of penalty for a breach of the law can be said to be an amount wholly and exclusively laid for the purpose of the business. The distinction sought to be drawn between a personal liability and a liability of the kind now before us is not sustainable because anything done which is an infraction of the law and is visited with a penalty cannot on grounds of public policy be said to be a commercial expense for the purpose of a business or a disbursement made for the purposes of earning the profits of such business."

21.*CIT v. S.C. Kothari, 1972 (4) SCC 402*

21.1 The decision rendered in ***Badridas Daga (supra)*** was quoted with approval.

However, it was the view expressed that if the profit is to be taken for the

taxable income, a resultant expenditure/loss cannot be avoided, notwithstanding the nature of business. We must hasten to note that the decision rendered in ***S.C. Kothari (supra)*** may not be in tune with ***Badridas Daga (supra)*** wherein this Court held that allowing a deduction depends upon the statute and commercial principles, while applying the test of 'purpose of business' and 'incidental to business' and not by way of a general principle. Hence, non-allowance of a deduction on the ground of one incurred as an expenditure for a purpose which is an offence or prohibited by law can be disallowed otherwise through a statute. This Court in ***SC Kothari (supra)*** had merely laid down the general proposition of law by taking note of the position prevailing in other countries, but in any case, it has got no application over a case of either a penalty or confiscation.

21.2 The law as laid down in ***Haji Aziz (supra)*** despite being noted, was not followed on both the counts, viz., the deduction of loss *qua* an offence and the consequence of a penalty imposed for an infraction of law.

21.3 We must further add that in ***S.C. Kothari (supra)***, this Court was concerned with Section 10(2)(xv) of the Old Act, which did not contain any explanation as introduced to Section 37(1) of the Act. This subsequent change in law will certainly have a bearing on the understanding of the said judgment.

22.Soni *Hinduji Kushalji & Co. v. CIT, (1971) SCC Online AP 223*

22.1 The Division Bench of the Andhra Pradesh High Court considered the law laid down on deduction of loss incurred by way of a confiscation and penalty. It took into consideration the decision of this Court in ***S.C. Kothari (Supra)***. It was accordingly held that a loss must be one arising directly from the business or trade, being incidental to it, as laid down by this Court in ***Badridas Daga (supra)***. The Court while noting the decision of this Court in ***Maqbool Hussain v. State of Bombay etc.*, (1953) SCR 730** *and* ***Haji Aziz (supra)***, held that a confiscation of a contraband being an action *in rem* is not available for deduction, as the same, by no process of reasoning can be said to be trading or commercial loss connected with or incidental to the assessee's business.

22.2 Relevant paragraphs:

> "4. Mr. Swamy appearing for the assessee-firm strongly contended that when the profits earned from an illegal business are not exempt from tax, the loss sustained in such business should be allowed to be deducted from the profits or gains for purposes of computing the tax payable by the assessee.
>
> 5. What are chargeable to tax in respect of a business carried on by the assessee are the profits or gains of a particular assessment year. While assessing the profits, necessarily loss incurred in the business during the year should be taken into account, as otherwise it is not possible to arrive at the true profits earned by the assessee. It is well-settled that the taint of illegality associated with profits or income is immaterial for the purpose of taxation. As observed by Lord Haldane in Minister of Finance v. Smith [[1927] A.C. 193, 198.] , Income-tax Acts are not necessarily restricted in their application to lawful business only. One who contravenes a statute and trades in business prohibited by law while being liable for prosecution for the offence committed by him will, at the same time, be liable to pay tax out of the income or profits earned from the illegal trade or business. We are now concerned with the loss representing the value of gold on account of the confiscation of the gold for contravention of the provisions of the Customs

Act. Can that loss be regarded as a commercial loss pertaining to the business or incidental to the business the assessee was carrying on, is the real question.

6. Mr. Swamy sought to place strong reliance upon a decision of the Gujarat High Court in Commissioner of Income-tax v. S.C. Kothari [[1968] 69 I.T.R. 1 (Guj.).] to contend that the assessee is entitled to claim deduction of the value of the contraband gold confiscated by the customs authorities, as it represented the loss sustained by the firm in the illegal business carried on by it. The learned judges in that case were of the view that, when illegal business is business within the meaning of the Income-tax Act and if profits from illegal business are assessable to tax, there is no reason either in principle or on authority for refusing to take into account losses from illegal business. According to these, the losses so incurred must necessarily be taken into account in order to arrive at the true profits of the business and such profits may be either positive in the sense that they are actual profits or they may be negative in the sense that they are losses and there is in principle no distinction between profits and losses of a business…

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9.Kothari's case [[1968] 69 I.T.R. 1 (Guj.).] , as may be noticed from the facts stated therein, was not a case where a claim for deduction was made by the assessee, as he did not say that a particular expenditure incurred by him should be allowed as a permissible deduction. It is on that ground that the learned judges ruled that the decision in Commissioner of Income-tax v. Haji Aziz & Abdul Shakoor Bros [[1955] 28 I.T.R. 266 (Bom.).] ., relied upon by the revenue, where the claim for deduction under section 10(2)(xv) of the 1922 Act was negatived, was not applicable to the case before them. Therefore, the answers given by the learned judges in Kothari's case [[1968] 69 I.T.R. 1 (Guj.).] render no assistance at all to the assessee's contention.

10. Here is a specific claim made by the assessee for deduction of the value of the gold confiscated by the Central Government on the ground that it is a trading or commercial loss, though the trade was an illegal one. It should not be lost sight of when a claim for deduction is made, that the loss must be one that springs directly from the business or trade which the assessee carries on or is incidental to the business that he carries on and not every sort or kind of loss, which has absolutely no nexus or connection with his trade or business.

11. It is well to remember that confiscation of contraband gold is an action in rem and not a proceeding in personam. As observed by Bhagwati J. in Maqbool Hussain v. State of Bombay [[1953] S.C.R. 730, 742 (S.C.), AIR 1953 S.C. 325.] confiscation is no doubt one of the penalties which the customs authorities can impose but that is more in the nature of proceedings in rem than proceedings in personam, the object being to confiscate the offending goods which have been dealt with contrary to the provisions of the law. To the same effect is the view expressed by S.K. Das J. in Shewpujanrai Indrasanrai Ltd. v. Collector of Customs [[1959] S.C.R. 821, 836 (S.C.), AIR 1958 S.C. 845.] that, so far as the confiscation of the goods is concerned, it is a proceeding in rem and the penalties

are enforced against the goods whether the offender is known or not known and the order of confiscation under section 182 of the Sea Customs Act operates directly upon the status of the property and under section 184 transfers an absolute title to the Government. Subba Rao J. (as he then was) in Thomas Dana v. State of Punjab [AIR 1959 S.C. 375.] , in his dissenting judgment (the dissent being on other points) observed that if the authority concerned makes an order of confiscation it is only a proceeding in rem and the penalty is enforced against the goods.

12. A proceeding in rem, therefore, in the strict sense of the term is an action taken directly against the property (in this case the smuggled gold) and even if the offender is not known, the customs authorities have the power to confiscate the contraband gold. Therefore, by no process of reasoning can the confiscation of the contraband gold by the customs authorities be said to be a trading or commercial loss connected with or incidental to the assessee's business.

13. In Commissioners of Inland Revenue v. Alexander Von Glehn & Co. Ltd. [[1920] 2 K.B. 553, 566 (C.A.).] . Lord Sterndale M.R. observed:

> "During the course of the trading this company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong in the sense that they were willingly and knowingly sending these goods to an enemy destination, but they committed a breach of the law, and for that breach of the law, they were fined. That, as it seems to me, was not a loss connected with the business, but was a fine imposed upon the company personally, so far as a company can be considered to be a person, for a breach of the law which it had committed. It is perhaps a little difficult to put the distinction into very exact language, but there seems to me to be a difference between a commercial loss in trading and a penalty imposed upon a person or a company for a breach of the law which they have committed in that trading."

14. The principle stated by Lord Sterndale M.R. holds good here too, as it is impossible to hold that the loss incurred by reason of the confiscation of the contraband gold is an expenditure incurred in connection with the trade or business of the assessee-firm or incidental to the carrying on of its business.

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16. Their Lordships of the Supreme Court in *Haji Aziz and Abdul Shakoor Bros.* v. *Commissioner of Income-tax* [[1961] 41 I.T.R. 350 (S.C.), [1961] 2 S.C.R. 651 (S.C.).] , after reviewing several Indian and English cases, observed at page 359:

> "As was pointed out in *Von Glehn's case* [[1920] 2 K.B. 553 (C.A.).] , an expenditure is not deductible unless it is a commercial loss in trade and 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

> penalties which are incurred by an assessee in proceedings launched against him for an infraction of the law cannot be called commercial losses incurred by an assessee in carrying on his business. Infraction of the law is not a normal incident of business and, therefore only such disbursements can be deducted as are really incidental to the business itself. They cannot be deducted if they fall on the assessee in some character other than that of a trader. Therefore, where a penalty is incurred for the contravention of any specific statutory provision, it cannot be said to be a commercial loss falling on the assessee as a trader, the test being that the expenses which are for the purpose of enabling a person to carry on trade for making profits in the business are permitted but not if they are merely connected with the business…. Anything done which is an infraction of the law and is visited with a penalty cannot on grounds of public policy be said to be a commercial expense for the purpose of a business or a disbursement made for the purposes of earning the profits of such business."

17. Similar views have been expressed by the Punjab and Allahabad High Courts in Raj Woollen Industries v. Commissioner of Income-tax [[1961] 43 I.T.R. 36 (Punj.).] , Commissioner of Income-tax v. Mathura Prasad Hardwar Prasad Deoria [[1965] 55 I.T.R. 476 (All.).] and Mahabir Sugar Mills (P.) Ltd. v. Commissioner of Income-tax [[1969] 71 I.T.R. 87 (All.).] .

18. The Supreme Court in Badridas v. Commissioner of Income-tax [[1958] 34 I.T.R. 10, [1959] S.C.R. 690 (S.C.).] , considered what would amount to a trading loss. Venkatarama Aiyar J. observed:

> "When a claim is made for a deduction for which there is no specific provision in section 10(2), whether it is admissible or not will depend on whether, having regard to accepted commercial pratice and trading principles, it can be said to arise out of the carrying on of the business and to be incidental to it. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied in the Act. The loss for which a deduction could be made under section 10(1) must be one that springs directly from the carrying on of the business and is incidental to it, and not any loss sustained by the assessee, even if it has some connection with his business."

19. Judged from the test laid down by their Lordships, it is impossible to hold that the confiscation of contraband gold, which is in the nature of a proceeding in rem, is a loss that springs directly from the business or trade carried on by the assessee-firm and is incidental to its business. Following the view expressed by their Lordships, the Punjab High Court in Ram Gopal Ram Sarup v. Commissioner of Income-tax [[1963] 47 I.T.R. 611 (Punj.).] , held that the mere fact that there is some remote connection between a loss and the business would not bring the loss within the expression "loss incidental to the the".

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> 22. As pointed out by Lord Loreburn L.C. in Strong & Co. Ltd. v. Woodi-field [[1906] A.C. 448, 452 (H.L.).] , “They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trader. The nature of the trade is to be considered.”
>
> 23. This court in Commissioner of Income-tax v. Chakka Narayana [[1961] 43 I.T.R. 249 (A.P.).] , in a case of loss sustained by an assessee on account of theft at a railway station, held that the loss resulting thereof was not incidental to the assessee's business and was not an allowable deduction and that the mere fact that there was some remote connection between the loss and the business would not bring the loss within the expression “loss incidental to the the”. The loss sustained by confiscation of the smuggled gold is absolutely foreign to the vocation or business of the assessee-firm. It is a loss incurred in some character other than that of a trader. The confiscation of the gold, being the result of a proceeding in rem, falls completely outside the trade or business which the assessee was carrying on. Confiscation of contraband goods is one of the penalties provided under the Sea Customs Act and the penalty is enforced against the goods irrespective of the fact whether the offender is known or not traced. Infraction or violation of the law is not a normal incident of a trade or business and, therefore, the penalty by way of confiscation of the contraband gold is not a commercial loss so as to be allowed as a permissible deduction.”

22.3 The aforesaid reasoning of the Andhra Pradesh High Court arrived at after taking note of the earlier decisions rendered by this Court in its support, deserves to be approved.

23. *J.S Parkar v. V.B Palekar and Others, (1973) SCC Online Bom 161*

23.1 Majority view of the Bombay High Court was in line with ***Soni Hinduji Kushalji & Co. (supra)***, though not referring to the said decision. It is to be noted that though Justice Mukhi dissented with the view of Justice Deshpande, the third Judge, Justice Tulzapurkar by a separate judgment, concurred with the view of Justice Deshpande. Therefore, the majority while broadly interpreting the view of this Court in ***Haji Aziz (supra)***, held that confiscation of goods incurred for an infraction of law cannot be said to be a

normal incident of business, and this loss falls on the assessee in some character other than that of a trader. The Court further noted that this principle would equally apply to a case where the business itself is prohibited by law while disagreeing with the view of the Punjab and Haryana High Court in ***Piara Singh*** (1970) SCC OnLine P&H 429, which decision did not reach this Court at that point of time. The Court held that the decision of the Punjab and Haryana High Court in ***Piara Singh*** (1970) SCC OnLine P&H 429, was not in line with the decision of this Court in ***Haji Aziz(supra)***.

23.2 Relevant paragraphs:

Justice Deshpande:

> "23. It is then contended that, admittedly, the entire gold has been confiscated by the customs department and, as such, value of this should have been treated as a trading loss and the assessee was entitled to a set-off of this loss against his assumed and assessed income from undisclosed sources. Reliance was mainly placed on section 71, though faintly section 70 was also referred to. This point was raised before the Tribunal. The Tribunal, however, declined to entertain this plea, as it was raised for the first time before it and it thought that the same cannot be adjudicated without investigation of further facts. Unfortunately, the order of the Tribunal is not explicit as to in what manner investigation of further facts was necessary. It is, therefore, not possible to know if the Tribunal was reluctant to allow set off for loss tainted with patent illegality, against the income, source of which was not shown to be illegal or it treated the loss by confiscation as capital loss and, therefore, was reluctant to deduct the same from the income from capital gains as required under section 71. Be that as it may, I have no hesitation in saying that if it were a pure question of law capable of being adjudged on the material on record, the Tribunal was under a statutory obligation to entertain and decide the same. I, however, think that, on the admitted facts, the petitioner is not entitled to claim any set-off. The loss suffered by the assessee consequent on the confiscation of the gold for infraction of law cannot be said to be a commercial loss liable to set off under any provision of the Act. It will be enough to refer to the judgment of the Supreme Court in Haji Aziz and Abdul Shakoor Bros. v. Commissioner of Income-tax. The Supreme Court upheld the view of this court in the same case. Dates were imported from abroad by the assessee in contravention of the provisions of the Sea Customs Act. The customs authorities

confiscated the goods under section 167-B of the Sea Customs Act. It, however, gave the assessee, under section 183 of the Act, an option to pay the fine in lieu of confiscation and get the goods released. The assessee exercised the option and got the goods released on payment of fine. In the course of the assessment proceedings the assessee claimed deduction of this penalty amount under section 10(2)(xv) of the Indian Income-tax Act of 1922. The Bombay High Court negatived the claim holding that the penalty for infraction of law does not amount to any expenditure laid out or expended wholly and exclusively for the purpose of such business, profession or vocation. The Supreme Court affirmed the said view of this court on slightly broader base, observing as follows:

> "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. 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."

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"29**.** Applying this test laid down by Grover J., speaking for the Supreme Court, in *S.C. Kothari's case* and the test laid down by Kapur J., speaking for the Supreme Court, in the case of *Haji Aziz and Abdul Shakoor Bros.*, it shall have to be held that confiscation of goods incurred for infraction of law cannot be said to be a normal incident of business and loss suffered therefrom falls on the assessee in some character other than that of a trader. It is not possible to see how this principle can make any difference where the business itself is found to have been prohibited by the law. It is the commercial profit that is taxable and it is the commercial loss in trade in regard to which deduction can be claimed either because it goes to lessen the amount of profits before the quantum of net profit is determined or because the expenses are required to be incurred for the purposes of running the said business or because losses are incurred under some other sources of business under the same head or they are incurred while carrying on business or vocation under some other head. Penalty and confiscation of goods even when incurred or suffered in the course of prohibited trade or business still cannot be said to be the normal incident even of such unlawful business and the loss so suffered can still be not said to be a commercial loss in the trade for the same reason as gains of theft, dacoity, misappropriation or cheating cannot be treated as taxable income from any business or commerce. The claim of Mr. Albal for deduction of value of gold confiscated by way of set-off cannot, therefore, be entertained.

30**.** It is true, as observed by the Punjab and Haryana High Court in *Piara Singh's case*, the risk of confiscation of goods and incurring of penalties is inherent in any unlawful trading or business. So is the risk of conviction and fine. It does not, however, necessarily follow that every kind of damage suffered in such trading falls under the category of commercial loss. It shall have to be held, at any rate, on the authority of the Supreme Court in *Haji Aziz and Abdul Shakoor Bros.* that

the confiscation of property or penalty incurred while indulging in prohibited trading activities does not amount to commercial loss though it happens in fact to be a loss according to the ordinary meaning of the word "loss" as understood in common parlance. Attempt to distinguish the above Supreme Court judgment on the ground that the court was dealing with the claim of the assessee for deduction of penalty under section 10(2)(xv) and not under section 10(1) of the Income-tax Act of 1922 is an exercise in futility. That, in the above case, neither the assessee claimed deduction of such penalty by way of loss under section 10(1) of the Act, nor the Supreme Court considered it worthwhile allowing the claim under that sub-section is also indicative, if not decisive, of the untenability of such contention. Though deduction was claimed under section 10(1) of the Act, rejection of the claim is based on the broader basis that penalties and confiscations are not the normal incidents of business and do not constitute commercial loss. If one examines the scheme of section 10(2), and section 24 of the 1922 Act and corresponding provisions of sections 28, 29 to 44A and sections 70 and 71 of the 1961 Act, it will be noticed that the provisions deal with the deductions or disbursement from the profits earned under various contingencies. If the losses are incurred in the same business (source of income) under the same head enumerated under section 14, the same are liable to be deducted under section 22 (section 10(1) of the old Act) of the Act. If losses are incurred under a different source falling under the same head, the losses are liable to be deducted from the income of any other source falling under the same head under section 70. When, however, net result of all sources under any one head of income is loss, the same is liable to be deducted from the income under another head under section 71. If the net result of all sources under all heads is a loss, the same can be carried forward under section 72 of the Act. Sections 29 to 44A corresponding to section 10(2), clauses (1) to (xvi), deal with deductions or disbursements by way of expenses, etc. These provisions deal with the mode of determining the net taxable profits or income of the assessee. If the true ratio of the Supreme Court judgment is that penalty incurred by infraction of law is not a commercial loss as it is not incidental to trade or business, it matters little as to under what count the deduction or set-off is claimed. That the margin between what is and what is not incidental is very thin has been noticed by the learned judges of the Supreme Court themselves. Ratio of this judgment is applicable to all contingencies where such non-commercial loss is sought to be deducted on any count whatsoever. That the assessee in that case claimed deduction of penalty under section 10(2)(xv) cannot make any difference to the ratio of the case. I do not find it possible to agree with the view of the Punjab High Court. I do not think that the Gujarat High Court's judgment in *Kothari's case* supports its view. On the contrary, the ratio of the two Supreme Court judgments run counter to the ratio of the *Punjab case.*"

Justice Tulzapurkar:

"179**.** I have already indicated above that in *Haji Aziz's case*[1] while dealing with penalty or fine imposed in lieu of confiscation of goods, the Supreme Court has observed that the penalty suffered by an assessee for an infraction of law cannot

be regarded as incidental to the business and in fact it falls upon the assessee in some character other than that of a trader. In my view, the aforesaid authorities make the position very clear that before any loss could be claimed as deductible loss under section 10(1) of the Act, it must be a trading loss or commercial loss arising out of carrying on business or it must be incidental to the business and such loss must also fall on the assessee in his character as a trader. The question in the present case is as to whether the loss consequent upon confiscation of goods for an infraction of law suffered by the assessee could be regarded as a commercial loss or could it be said to be loss incidental to the business and, what is of importance, could it be said to have been suffered by him in his character as a trader? In my view, it is certainly not a commercial loss arising from carrying on of the business nor can it be regarded as incidental to the activity of the assessee as dealer in gold; moreover, it cannot be regarded as loss falling upon the assessee in his character as a trader. It is a loss falling upon him as a person who had infracted law. The loss suffered by confiscation of goods directly sprang from an illegal act committed by the assessee, namely, having acquired gold without requisite permit or permission of the Reserve Bank of India and without having paid any duty for the import thereof into India. Surely, the loss has not fallen on the assessee as a trader or businessman, for, obviously, even a lay person who is not a businessman, if he were to import gold for his private use without requisite permission and without payment of customs duty, would subject himself to the penalty of having that gold confiscated from him and he would as a consequence suffer great loss. It is thus clear that the loss consequent upon confiscation of goods for infraction of law suffered by the assessee must be regarded as loss falling upon him in some character other than a trader. In this view of the matter, I am clearly of the view that the petitioner is not entitled to claim the loss suffered by him as a result of confiscation of the gold in question as allowable deduction while computing his business income under section 28 of the Act.

180**.** So far as the decision of the Gujarat High Court in *S.C. Kothari's case* is concerned—which decision has been confirmed by the Supreme Court— it must be observed that the judgment is an authority only for the proposition that illegality of any business is irrelevant for the purpose of computing the net income thereof under the Income-tax Act and while the revenue is entitled to levy tax on the income of the assessee earned even from unlawful business, the assessee is also entitled to insist on deduction of loss arising out of such unlawful business. There could be no quarrel with this statement of law which has been approved by the Supreme Court. But even there, the loss in respect of which deduction could be claimed while computing the profits of the unlawful business must be a trade loss or commercial loss or loss incidental thereto but suffered by the assessee in his character as a trader and not loss suffered as a result of confiscation of goods for an infraction of law which would be a loss suffered by him in some capacity other than as a trader. Besides, in *S.C. Kothari's case* neither the Gujarat High Court nor the Supreme Court had to consider the question whether the loss suffered by way of penalty or confiscation of goods amounted to commercial loss or not. In fact, while setting out the facts of the case it has been

> stated by the Supreme Court in paragraph 1 of its judgment that the loss of Rs. 3,40,000 and odd which was claimed as deductible loss had arisen out of certain transactions entered into by the assessee with different people for the supply of groundnut oil and it was expected by the assessee that those contracts would be performed but owing to certain reasons some of the contracts could not be performed and difference has to be paid. From this it appears clear that the loss of Rs. 3,40,000 which was claimed as deductible loss was clearly in the nature of commercial or trade loss for which deduction was claimed under section 10(1) of the Act. In the circumstances, it is clear that the statement of law enunciated in the case of *S.C. Kothari* is unexceptionable but, with respect, I would like to point out that the decision is no authority for the proposition that the loss suffered by way of penalty or confiscation of goods amounts to commercial loss that could be deducted while computing the net profits of a business under section 10(1) of the Act. It is true that in *Piara Singh's case*, the Punjab and Haryana High Court has taken the view that the confiscation of cash amount of Rs. 65,500 from the assessee, who was engaged in the business activity of smuggling gold, amounted to trade loss and hence was deductible under section 10(1) of the Act. But for coming to that conclusion the Punjab High Court has principally relied upon the decision of the Gujarat High Court and of the Supreme Court in *S.C. Kothari's case*, in which, as I have stated above, neither the Gujarat High Court nor the Supreme Court was required to consider the question whether the loss arising from penalty or confiscation of goods for an infraction of law amounted to trade loss or commercial loss; in fact admittedly the nature of loss suffered by the assessee was commercial since it had arisen on account of payment of differences. With great deference, I am unable to persuade myself to agree with the view of the Punjab High Court expressed in *Piara Singh's case*, especially when it runs counter to the tests laid down by the Supreme Court in *Haji Aziz's case* and in English cases to which the Supreme Court has referred while deciding *Haji Aziz's case*. The other contention that this loss should be allowed to be set off against the income from undisclosed source under section 70 or section 71 was not pressed by Mr. Albal. In view of the above discussion, on both the points on which there was difference of opinion between the two learned judges I am in agreement with the views expressed by Mr. Justice Deshpande."

23.3 The decision of the Bombay High Court certainly falls in line with the one rendered in ***Haji Aziz (supra)***. The cogent reasons given by taking penalty and confiscation out of the purview of Section 10(1) of the Old Act appears to be the correct view.

24.*Commissioner of Income Tax v. Piara Singh, (1980) Supp. SCC 166*

24.1 This Court did not differ with the view expressed by a co-ordinate bench in ***Haji Aziz (supra)***. In fact, it gave its approval to the said decision. However, reliance was placed on ***S.C. Kothari (supra)*** by drawing a distinction between an infraction of law committed in carrying out a lawful business, as against one committed in an inherently unlawful business. It was done upon a legitimate anticipation that in an illegal business there will be many pitfalls resulting in expected loss, which cannot be factored into a normal business.

24.2 Law as laid down in ***Haji Aziz (supra)*** on both the issues have not been taken note of by inadvertence, particularly the nature of proceedings involved in the imposition of confiscation or penalty, being proceedings in *rem*. This Court did not have the benefit of the explanation as available under Section 37 of the Act, while interpreting Section 10(2) of the Old Act, apart from ignoring the word of caution mentioned in ***Badridas Daga (supra)***.

24.3 We would only clarify the position that, in any case, the law as laid down in ***Piara Singh (supra)*** may not have any application to a case of deduction of expenditure/loss incurred on account of penalty/confiscation coming under Section 37(1) of the Act, particularly in light of Explanation 1.

25.*Dr. T.A. Quereshi v. Commissioner of Income Tax, Bhopal (2007) 2 SCC 759*

25.1 This Court merely followed ***Piara Singh (supra)*** while making a casual observation on Explanation 1 to Section 37 of the Act. The earlier decisions have not been taken into consideration as we could see in ***Piara Singh (supra)***, but the principle laid down was also not taken note of. In this connection, it has to be remembered that for a precedent to be binding there has to be a conscious consideration of an issue involved. The judgment in ***Dr. T.A. Quereshi (supra)*** was delivered by a two-Judge Bench while not taking note of a three-Judge Bench decision in ***Haji Aziz (supra)***, which has neither been disapproved nor distinguished. Hence, this decision is *per incuriam* and not a binding precedent. Once again, the question of a confiscation proceeding being *in rem* was not brought to the notice of the Court.

25.2 Therefore, there cannot be a situation where an assessee carrying on an illegal business can claim deduction of expenses or losses incurred in the course of that business, while another assessee carrying on a legitimate one cannot seek deduction for loss incurred on account of either a confiscation or penalty. The interpretation of Section 37 of the Act given by the Court in ***Dr. T.A. Quereshi (supra)*** leads to a situation where the expenditure incurred in manufacturing something illegal may not be allowable as a deduction in view of the Explanation 1, however, if upon seizure, the manufactured goods are confiscated, in that case deduction will be allowable on commercial

principles. This classification being artificial not borne out by statute, which mischief is sought to be clarified by the explanation, has no legal basis.

Conclusion(s)

26. On the abovesaid analysis, the following conclusions are arrived at:

I. The word 'any expenditure' mentioned in Section 37 of the Act takes in its sweep loss occasioned in the course of business, being incidental to it.

II. As a consequence, any loss incurred by way of an expenditure by an assessee for any purpose which is an offence or which is prohibited by law is not deductible in terms of Explanation 1 to Section 37 of the Act.

III. Such an expenditure/loss incurred for any purpose which is an offence shall not be deemed to have been incurred for the purpose of business or profession or incidental to it, and hence, no deduction can be made.

IV. A penalty or a confiscation is a proceeding *in rem*, and therefore, a loss in pursuance to the same is not available for deduction regardless of the nature of business, as a penalty or confiscation cannot be said to be incidental to any business.

V. The decisions of this Court in ***Piara Singh (supra)*** and ***Dr. T.A. Quereshi (supra)*** do not lay down correct law in light of the decision of this Court in ***Haji Aziz (supra)*** and the insertion of Explanation 1 to Section 37.

27. In view of the aforesaid discussion, I am inclined to hold that the appeal of the Revenue deserves to be allowed, though conscious of the fact that Section 115BBE of the Act may not have an application to the case on hand being prospective in nature. Accordingly, the judgment & order dated 22.11.2016

passed in DBITA No. 96/2003 & DBITR No. 6/1996 by the High Court of Rajasthan at Jaipur stand set aside. No costs.

……J.
(M.M. SUNDRESH)

New Delhi,
April 24, 2023