Detailed analysis of Explanation to S.37(1) from an aseessee's perspective

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Section 37 as it currently stands reads as under:

> ***Section 37-****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 assesse), 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".*
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> *Explanation - 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.*
>
> *(2) Notwithstanding anything contained in sub-section (1), no allowance shall be made in respect of expenditure incurred by an assessee on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party.*

The objective of Section 37 is to claim business expenditure incurred by the assessee which is not cover under section 30 to 36 as deductions. So, this section serves as a general, catch-all section for claiming deductions.

Now, to claim deduction under section 37 following ingredients should be present,

- The expenditure should not be a capital expenditure.
- The expenditure should not be covered under any heads in section 30 to 36
- The expenditure should be incurred for the purpose business or in the course of business.
- The expenditure should not be of personal expenditure.
- The expenditure should not be disallowed under sub-section 2 of section 37.
- **The expenditure should not be any illegal purpose or violative of any law of the land.**

This article deals with only the last limb above i.e., cases relating to expenditure incurred for illegal purpose or violative of any law of the land and that too from an assessee's perspective. Why was this Explanation needed at all? What are the ramifications of insertion of said Explanation? What expenditures will **escape** the clutches of Explanation to S.37? In this article, we deal with all these questions, from the viewpoint of the assessee, while going over related case laws.

Intention behind insertion of Explanation 1

Prior to Explanation 1 of S.37 there were a catena of decisions dealing with the allowability of expenditure u/s 37, whether illegal or not, treated on a case by case basis. One principle of note which seems to be present right from pre-amendment days is that if the amounts paid were compensatory in nature they were allowable, if they were penal in nature it wasn't to be allowed as enshrined by the SC in ***Mahalakshmi Sugar Mills Co. Ltd. vs CIT (123 ITR 429)*** *and* ***CIT vs Hyderabad Allwyn Metal Works Ltd (172 ITR 113 SC)*** wherein it was held that when an amount paid by assessee could be regarded as compensatory (reparatory) in character then it would be allowable u/S 37(1) and if it were penal in nature it was not allowable. In another landmark case the SC in **H*aji Aziz and Abdul Shakoor Bros. v CIT Bombay City II*** [1] held that: "*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".*

This insertion of Explanation 1 seems to have been brought out by the controversial decision, among others, of ***Pranav Constructions v CIT***[2] by the Mumbai Tribunal wherein payment of hafta, extortion charges by builders in Mumbai was upheld. The facts of the case were that a partner of the company has paid money to various persons in form of cash for the purpose of providing security to partners and for getting the "tapories" vacated earlier. Paper reports also supported the assesse's claim that builders engaged in construction activities are vulnerable to such danger as extortion, haftas, etc. and unless they oblige it would be impossible to conduct the business The

[1] (1961) 41 ITR 350
[2] 116 TTJ 445

Tribunal, controversially, held that payments made by a builder for the purpose of providing security to the partners or for getting the tapories vacated was deductible, there being circumstantial evidence supporting such payments.

The Department wanting to enshrine in law that illegal expenditure cannot be a deduction under the ambit of Income Tax. Thus Explanation 1 was inserted by the amendment by Finance Act, 1998 and was given retrospective effect from April 1 1962. The legislative intent behind the insertion of this explanation as given in memorandum of Finance Bill 1998 being as follows:

"It is proposed to insert an explanation after sub section (i) of section 37 to clarify that no allowance shall be made in respect of expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law. This proposed amendment will result in disallowance of the claim made by certain tax payers of payment on account of protection money, extortion, hafta, bribes, etc. as business expenditure."

Further, the CBDT clarified this position vide Circular 722 dated 23/12/1998 whose operative part reads as follows:

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. 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.

Given this context, we now look at a few case laws post Explanation to S.37 which have been decided in favour of the assessee. In these controversial cases, it has been held that the assessee's expenditures in question do NOT fall under the Explanation to S.37 and we analyze the same:

1. **Payment of ransom**

CIT V M/s Khemchadmotila Jain Tobacco Producers Pvt. Ltd.[3] (High Court of MP)

Assessee is a private limited company, engaged in the business of manufacturing and sale of bidis. Its Director 'S' was kidnapped and immediately an FIR was lodged but the police remained unsuccessful in getting the Director released from the dacoit and the amount demanded was paid by way of ransom. The said amount was claimed as "General Expenses" by the company! Revenue contended that amount of ransom could not have been claimed by way of expenditure as the Explanation of sub-section (1) of Section 37 of the Income-tax Act, 1961 prohibited such expenditure. The payment of any amount which was prohibited by law was not a business expenditure and it could not be allowed as an expenditure. Assessee contended that the amount was paid to the dacoits to get their Director released, who was on business tour, working as Director of the Company and thus the amount was rightly claimed as an expenditure of business. The High Court held that kidnapping for ransom is an offence under Section 364A of the I.P.C. The said section provided that kidnapping a person for ransom was an offence and any person doing so or compelling to pay, was liable for the punishment as provided in the Section, but nowhere it was provided that to save a life of the person if a ransom is paid it would amount to an offence. No provision is brought to the notice that payment of ransom is prohibited by any law. In absence of it, the Explanation of sub-section (1) Section 37 will not be applicable. The entire tour of Director 'S' was for purchase of tendu leaves of quality and for this purpose, he was on business tour and during his business tour, he was kidnapped and for his release the aforesaid amount was paid. Therefore, the amount is allowable as business expenditure.

2. **Payment of money for settlement procedure**

CIT v. Desiccant Rotors International Pvt. Ltd[4] (High Court of Delhi)

Assesse, was engaged in the business of manufacturing of environmental control systems such as rotors. During the assessment year proceeding AO noticed assesse had debited an amount paid for settlement of dispute as deduction under section 37. While exporting the products to one of its

[3] 2011-TIOL-540-HC-MP-IT

[4] 347 ITR 32 (2011) 245 CTR 572 / 201 Taxman 144 / 64 DTR 214 (Delhi)(HC)

customer “VVI”. “S” from USA had filled a suit against the “VVI” for infringement of registered patents in USA by selling the products of assessee company in US Court. Since the cost of proceeding was likely to be huge the assessee went for settlement by paying $ 6,75,000. This amount was claimed as expenditure as it was compensatory in nature to compensate the loss incurred by “VVI” as a result of selling the product covered by patent held by “S” to “VVI”. AO was of the view that amount paid by the assesse was a penalty or something akin to penalty was made only due to infringement. In the view of explanation to section 37, AO held that the payment which was not a normal incident of business and therefore, it was not allowable as business expenditure. ITAT allowed the appeal of the assessee, accepting that the payment was not in the nature of any penalty and no such violation of patent law was held to be proved and it was only in the nature of compensation due to settlement arrived at between the parties and was allowable expenditure u/s 37 of the IT act.

3. Expenditure incurred on eviction

CIT V M/s Airlines Hotel Pvt. Ltd.[5] (High Court of Mumbai)

Assessee was engaged in running a hotel. The bar and restaurant of the hotel were handed over to one Jairam N. Shetty pursuant to an agreement to be managed and conducted by him against a monthly royalty. The agreement was initially for a period of 15 years with an option of renewal for 5 years. In 1979, litigation ensued between the assessee and the conductor Mr.Jairam N. Shetty. In a suit which was instituted, consent terms were arrived at in terms whereof, a consent decree was passed. Under the consent terms, the assessee paid some amount of money to the conductor of the business which was treated as settlement charges. The assessee also incurred legal expenses. The assessee claim for deduction of these two items was disallowed by the departmental authorities but was allowed in appeal by the Tribunal.

Before the HC the Revenue's Counsel submitted that the amount paid by the assessee to the conductor of the business for securing vacant possession of the premises would constitute a benefit of enduring nature and would, therefore, be expenditure on the capital account. The Assessee Counsel submitted that the assessee could remove the hindrance and obstruction in the conduct of

[5] 2012-TIOL-242-HC-MUM-IT

the business in the premises by payment of the settlement amount. This was a matter of commercial expediency and since the obstruction in the conduct of the business was removed by payment of the settlement charges, the expenditure was of a revenue nature. The Court held that the conductor was a bare licensee and had no interest by way of tenancy or otherwise in respect of the premises. Consequently, the payment which was made by the assessee was one which in the true sense of the term was for removing the obstruction or hindrance in conducting and managing the restaurant and must be regarded as a matter of commercial expediency. The legal expenses are also clearly an allowable deduction for the same reason.

4. Payment of interest & damages

Prakash Cotton Mills Pvt. Ltd. v CIT[6] (Supreme Court)

Assessee, a textile manufacturer, pays interest for delayed sales tax payment as well as damages for delayed payment of contribution under employee's state insurance act. He treats both expenditure as revenue expenditure and claims deduction under sec 37(1). In the view of explanation to section 37 AO disallows the expenditure stating that it was penal in nature and prohibited by the law. The Court held that, whenever any statutory impost paid by an assessee by way of damages or penalty or interest, is claimed as an allowable expenditure under s. 37(1) of the IT Act, the assessing authority is required to examine the scheme of the provisions of the relevant statute providing for payment of such impost notwithstanding the nomenclature of the impost as given by the statute, to find whether it is compensatory or penal, in nature. The authority has to allow deduction under s. 37(1) of the IT Act, wherever such examination reveals the concerned impost to be purely compensatory in nature. Wherever such impost is found to be of a composite nature, that is, partly of compensatory nature and partly of penal nature, the authorities are obligated to bifurcate the two components of the impost and give deduction to that component which is compensatory in nature and refuse to give deduction to that component which is penal in nature. This followed the ratio of the *Mahalakshmi Sugar Mills (supra) and Hyderabad Allwyn Metal (supra).*

[6] (1993) 111 CTR 0389: (1993) 201 ITR 0684: (1993) 67 TAXMAN 0546

CIT V Prasad and Co[7] (High Court of Delhi)

Assessee **c**laimed expenditure for penalty paid to NSE and DSE. AO disallowed the same stating that it was a penalty which was not admissible expenditure. The amount was paid during the course of business of assessee business and there was no infraction of law. The Tribunal, on the other hand, referred to the details furnished by the assessee and has recorded as under: - "…these penalties are paid for late deposits of Margin money and other violations of timely delivery etc." and gone on to allow these amounts. The High Court upheld the view of the Tribunal stating that the Revenue was not able to show why the findings of the Tribunal are incorrect and that the payments were in fact in the nature of penalty and not in the nature of normal interest on delayed payment.

5. **<u>Expenses towards re-export of goods & redemption fines</u>**

5.a) Apeejay (Private) Ltd. Vs. Commissioner of Income Tax[8] (High Court of Kolkata)

The assessee had to re-export the goods pursuant to the direction given by the appropriate authorities to re-export the goods because the assessee had imported the goods without a valid license. Therefore, it is clear that the assessee had originally imported the goods in infraction of the law. But the assessee was allowed to re-export the goods without suffering the confiscation of the goods. The expenses that the assessee had incurred were in connection with the said re-exportation of the goods. There is no dispute that such expenses were incurred by the assessee in the capacity as a trader. The cause for such re-exportation of the goods was the importation of the goods by the assessee in infraction of the law. It is clear that the amounts were not the amounts which had been imposed upon the assessee as any penalty or any fine for the infraction of law. The expenses that were incurred by the trader qua trader in connection with his trade would be allowable even though additional expenses might have been necessitated because of the fact that the assessee had not complied with the law and the expenses could be described to be the expenses which were the liability incurred because of carrying on the business not in accordance with the laws. The Court held that, any sum paid for infraction of law is not to be deducted because such

[7] 2012-TIOL-121-HC-DEL-IT
[8] (1978) 46 CCH 0105 KolHC

infraction is not normal incident of the business. In this case because of the manner in which the assessee had carried on the business, viz., the illegal importation of the goods in question, the assessee might have incurred the expenditure but the purpose of the expenditure was for carrying on of the business and the expenditure was incurred in the capacity of a trader. The expenditure was not a liability imposed for violation of law. The liability might have arisen for carrying on the business in a manner not in accordance with law. But that does not detract from the fact that the expenditure was incurred in the capacity of a trader for carrying on the business. That being the case the expenses are allowable. Expenses incurred by a trader on re-exporting goods were incurred as a trader and were not in the nature of penalty or fine for the infraction of law and were therefore allowable.

5.b) Commissioner Of Income Tax Vs. N.M. Parthasarathy[9] (High Court of Madras)

The authority has to allow deduction under s. 37(1) whenever an examination of the scheme of the provisions of the relevant statute, providing for payment of imposts notwithstanding the nomenclature of the impost as given by the statute reveals the concerned impost to be purely compensatory in nature. Whenever such impost is found to be of composite nature, that is, partly of compensatory nature and partly of penal nature, the authorities are obliged to bifurcate the two components of the impost and give deduction to that component which is compensatory in nature and refuse to give deduction to that component which is penal in nature. The goods belonging to the assessee had been confiscated under s. 111(d) of the Customs Act, 1962 r/w s. 3 of the Imports and Exports (Control) Act, 1947. However, under s. 125 of the Customs Act, 1962, an option had been given to the owner-assessee to pay, in lieu of such confiscation, a fine and the goods had been cleared exercising the option. If the seized goods, without the exercise of option, had been confiscated once and for all, it goes without saying that the property in the goods shall vest in the Government, in the sense of the Government becoming the absolute owner thereof. The fine amount, whatever be its quantification, that is to say, whether it is equivalent to or below the value of the goods seized, cannot at all, in such a situation, be stated to be penal in nature, **notwithstanding its nomenclature**, but it is reparatory or compensatory in nature. Once it is

[9] (1995) 125 CTR 0174: (1995) 212 ITR 0105: (1995) 78 TAXMAN 0470

compensatory in nature, it goes without saying that the authority has to allow deduction under s. 37(1). Further, the expenses incurred by way of payment of fees to advocates in defending penalty proceedings must also be construed as an allowable deduction. The Court thus held that the redemption fine levied by the customs authorities is an additional duty and therefore that there was an infraction of law is erroneous and fallacious. It was therefore held that payment of redemption fine in exercise of option given under s. 125 of Customs Act, 1962, for getting release of goods imported in violation of import regulations being compensatory in nature, is an allowable business expenditure. Interestingly, the High Court has held that it was "erroneous or fallacious reasonings" that the redemption fine is an additional duty and therefore not an infraction of law and rather interpreted the fine as compensatory in substance and hence allowable.

5.c) Usha Micro Process Controls Ltd. Vs. Commissioner Of Income Tax[10] (High Court of Delhi)

Briefly, the facts are that the petitioner had imported some software during the relevant Assessment Year i.e. 1985-86. It had sought to re-export the software after making some declarations. The customs authorities were of the opinion that the appellant's action was not legal and directed it to pay differential duties. In addition, its Managing Director was made personally liable to penalty. The goods were sought to be confiscated. The matter was carried in appeal. Eventually the Customs, Excise and Gold (Control) Appellate Tribunal (CEGAT) decided the matter on 30.5.1999. The Tribunal directed the deletion of personal penalty but proceeded to uphold the order in so far as the fine in lieu of confiscation is concerned—to Rs. 4,00.000/-; the original amount was Rs. 10,00,000/-. For Assessment Year 1985-86, the assessee had claimed Rs. 4,00,000/- as deductible under Section 37(1) of the Income Tax Act.

This Court notices that originally the penalty which the appellant had been directed to pay was deleted by the CEGAT. What remained was the confiscation; the appellant was given the choice of redeeming the goods by depositing redemption fine as is evident from combined reading of

[10] (2013) 86 CCH 0007 DelHC

CEGAT order. The Tribunal went so far as to say that valuation of goods in question was on the basis of difference of opinion. Nevertheless, that being the rationale for deletion of penalty, the Tribunal felt that the order of confiscation did not require to be upset, instead redemption fine was reduced to Rs. 4,00,000/-. This Court was of the opinion that the amount of redemption fine in the present case was compensatory and therefore, fell outside the mischief of explanation of Section 37(1) of the Income Tax Act.

6. **Payment of secret commission**

Interestingly, pre-amendment, a number of cases in various High Courts have allowed the payment of "secret commissions" saying that these commissions paid to agents is for commercial expediency. Specifically, we refer to Bombay High Court in ***Goodlas Nerolac Paints Ltd. vs. CIT (1982) 137 ITR 58 (Bom), CIT vs. Goodlas Nerolac Paints Ltd. (1991) 188 ITR 1 (Bom) and CIT vs. Sigma Paints Ltd. (1991) 188 ITR 6 (Bom).***

However, an important decision in this regard, post-amendment which disallowed secret commission payments while taking cognizance of the previous judgments and the effect of the amendment is as follows:

Tarini Tarpaulin Production v Commissioner of Income Tax[11] (Orissa High Court)

The facts of the case are the assessee has paid secret commission to various persons and claimed them as expenditure stating them as commission paid to agents. Assessee refused to disclose the identities of the agents and expressed its inability to correlate the payments with the orders produced or sales effected. The assessee submitted the ITAT decision Pranav construction (supra) which allowed payment of protection money as deduction under section 37 in his favor. The Court held that, Explanation to s.37(1) has been inserted with retrospective effect to disallow any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law. Therefore, secret commission alleged to have been paid by the assessee to persons whose names it could not disclose was not allowable as deduction in view of Explanation to s. 37(1) inserted with retrospective effect.

[11] (2002) 174 CTR 0509: (2002) 254 ITR 0495: (2002) 124 TAXMAN 0876

7. **Payment towards regularization / violation of procedure**

Another vexing issue has been the allowability of payments made towards regularization / violation of procedures. The viewpoint pre-amendment has been that these payments were allowable. The main decision in this regard (in favour of the assessee) is as follows:

CIT v Loke Nath and Co.[12]

The Delhi High Court allowed payment of compensation charges as allowable deduction under 37. It has been held that, the compensation here is for the breach of a regulatory procedure in the matter of ex-post-facto sanction of a building constructed in deviation of a sanctioned plan or when the sanction has lapsed. The ex-post-facto sanction obtained shows that there is no breach of a provision against public policy. The acceptance by way of compensation of a sum cannot be for any illegal act against public policy. It is for an act done in disregard of the formalities required to be complied with. The acceptance of Rs. 4 lacs by the Committee in this case shows that there was no breach, no violation or no infringement in the nature of infraction of law on which penalty is imposable. An amount paid under s. 195 of Punjab Municipal Act is paid as compensation for disobedience and not as penalty for infraction of law, and hence, it is a permissible deduction.

However, we note that, post-amendment, the Karnataka High Court in the case of **Mamta Enterprises**[13] (and a few other cases since then) has distinguished the *Loke Nath (supra)* judgment stating that, the Delhi High Court decision was rendered prior to insertion of explanation 37(1) and given retrospective effect from 1.4.1962. when the section itself declares the 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, it is not possible to take view that the expenditure incurred for compounding of the offence should be allowed. When the law is clear and unambiguous, it is not possible for the courts to stretch the meaning attached to the provision

[12] (1984) 147 ITR 624(del)
[13] (2004) 266 ITR 356

to give benefits to the person who violates the law or regulation made by the corporation or municipal authority.

8. **Payment of penalty for violation of extra-territorial laws**

Mylan laboratories ltd v CIT[14] (ITAT Hyderabad)

The assessee company was engaged in pharmaceutical business. During the assessment proceedings u/s 143(3) of the I.T. Act 1961, the AO noticed from the Annual Report for the F.Y. 2013-14, that the Assessee company had charged Rs.141,50,90,000/- as litigation cost under the head 'other expenses'.AO disallowed that expenses under explanation 1 to section 37. The assessee submitted that what is to be disallowed under Explanation 1 to section 37(1) of the Act is a fee or fine which is penal in nature. Assessee submitted that levy by EU Commission is not penal in nature but was akin to disgorgement i.e. a monetary equitable remedy that is designed to prevent a person from unjustly enriching himself. The assessee said the same amount was received and offered to income a few years ago as part of patent settlement agreement it had reached with a foreign company to not enter the EU market for a drug and subsequently the EU Commission on anti-trust and competitive laws held that these patent settlement agreements were not legal and the amount had to be disgorged, so this amount being paid was only a 'take-back' of an earlier amount received and that too this could not attract S.37(1) explanation being laws of an extra-territorial jurisdiction outside India. The AO however was not convinced with assessee contentions and held that the levy of fine is for violation of rules and hence the expenditure claimed as litigation cost is to be disallowed under the Explanation 1 to Sec. 37(1) of the Act. He accordingly brought the same to tax. It was held, that the European Commission had required the assessee to pay 1.18 crores of GBP which is equivalent to 141,50,90,000 INR which is the exact amount received by assessee from Servier earlier. The Revenue had pleaded that it is only a penalty levied by EU, with the quantum being the same as the amount received by the assessee, and hence it is not a disgorgement simplicitor because though the receipt is from Servier, the payment by the assessee is to European Commission. The Tribunal held that these amounts will not violate Indian laws and cannot attract S.37(1) explanation and further held that the amounts alternatively can be allowed as business loss

[14] ITA No. 12/Hyd./2019

as it was offered to income in the earlier years. Peculiarly, in our view, the Tribunal has agreed that the amounts paid are not a disgorgement and not compensatory in nature while however upholding the business loss claim u/s. 28 (as well expenditure claim u/s 37).

9. **Payment of fee to advocate**

Commissioner of Income Tax vs. Birla Cotton Spg. & Wvg. Mills Ltd[15]

Assessee, which is a public limited company, spent some amount for representing its case before the Investigation Commission relating to the past asst. yrs. 1941-42 to 1947-48. These expenses which were termed as "general expenses" were claimed by the assessee as deduction under s. 10(2)(xv) or in the alternative under s. 10(1) of the IT Act, 1922 which were disallowed by the Department. The Court held that, the expression "for the purpose of the business" is essentially wider than the expression "for the purpose of earning profits". It covers not only the running of the business or its administration but also measures for the preservation of the business and protection of its assets and property. It may legitimately comprehend many other acts incidental to the carrying on of the business. It is well-settled by now that the deductibility of expenditure incurred in prosecuting the civil proceedings to resist the enforcement of a measure, legislative or executive, which means restriction on the carrying on of a business or to obtain a declaration that the measure is invalid, would, if other conditions are satisfied, be admissible as a deduction under s. 10(2)(xv). Deductibility of such expenditure does not depend on the final outcome of those proceedings. However wrong-headed, ill-advised, unduly optimistic or over-confident in his conviction the assessee might appear in the light of the ultimate decision, expenditure in prosecuting a civil proceeding cannot be denied as a permissible deduction if it is reasonably and honestly incurred to promote the interest of the business.

[15] (1971) 82 ITR 0166

Conclusion: The aim of explanation to Section 37(1) is to disallow expenditure incurred for offences or in violation of laws. This Explanation has been a constant subject matter of litigation before the Courts with the Department taking an aggressive stance on what expenses can be deemed to be illegal. Courts have time and again held that expenses penal in nature cannot be allowed while those compensatory have to be allowed and so the classification of the expenses into these two categories is a matter of never-ending dispute. In this article, we have tried to analyze some of the interesting and controversial cases, especially those where the assessee have successfully managed to escape the clutches of the Explanation.

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