**ADVANCE DIPLOMA IN CORPORATE TAXATION - NALSAR LAW UNIVERSITY, HYDERABAD**

# Expenditures due to Commercial Expediency & Disallowance of expenses owing to transgression of laws, offences and penalties

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# Coverage of Today's session

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| 1. | Background of expense claimed under the head Business & Profession. |
| 2. | What is 'Commercial Expediency' with help of cases |
| 3. | Instances of what can be allowed and not allowed as an expense based on commercial expediency. |
| 4. | Relevant Legal provisions and Legislative history for explanation to Section 37(1) |
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# Background:

**Section 28: is a Charging section** Specifies an inclusive list of incomes which can be chargeable to tax as income under the head "Profits and gains of business or profession“. Some examples are:

- Compensation
- Income derived by trade/profession/similar association
- Perquisites
- Any income received by partner of a firm
- Non –compete fees
- Sum received under Keyman insurance policy [including bonus] etc.

**Section 29: Computational Section:** Income from profits and gains of business or profession, how computed The income referred to in section 28 shall be computed in accordance with the provisions contained in sections 30 to 43D.

# Some specific expense sections:

- Rent, Rates, Taxes, Repairs And Insurance For Building [Section 30]
- Repairs and insurance of machinery, plant and furniture [Section 31]
- Depreciation [Section 32]
- Investment Allowance [Section 32A]
- Development Allowance [Section 33A]
- Tea/Coffee/Rubber Development Account [Section 33AB]
- Site Restoration Fund [Section 33ABA]
- Reserves for Shipping Business [Section 33AC]
- Expenditure on Scientific Research [Section 35]
- Insurance Premium [Section 36(1)(i)]
- Bonus or Commission to Employees [Section 36(1)(ii)]
- Interest on Borrowed Capital [Section 36(1)(iii)]
- General Deductions [Section 37]

# General Expenses allowable as per section 37

- Expenditures should not be covered by Section 30 to 36
- Expenditure should Not be of Capital Nature.
- The expenditure should not be of a Personal Nature
- The expenditure should have been incurred during the previous year
- **The expenditure should have been incurred wholly or exclusively for the purpose of the Business or Profession**
- Expenses should be in respect the Business carried on by the Assessee.
- **Expense should not be of any illegal purpose or violative of any law of the land.**

# Commercial expediency explained by case laws:

- ***CIT v/s. Chandulal Shah (38 ITR 601) SC:***
- In deciding whether the payment was a deductible expenditure the question of commercial expediency and the principles of ordinary commercial trading had to be taken into consideration. If the payment of expenditure was incurred for the purpose of the trade or business of the **assessee it did not matter that the payment endured to the benefit of a third party also.** Another test was whether the transaction was properly entered into as a part of the assessee's legitimate commercial undertaking in order to facilitate the carrying on of its business. But if the expense was incurred for fostering the business of another only or was made by way of distribution of profits or was **wholly gratuitous or for some improper or oblique purpose outside the course** of business then the expense was not deductible.

# Commercial expediency explained by case laws:

- ***CIT v/s. Dalmia Cement (254 ITR 377) Delhi HC:***
- The jurisdiction of AO is confined to deciding the reality of expenditure namely whether the amount was claimed as deduction was factually expended or laid down and whether it was wholly and exclusively for the purpose of the business. The reasonableness of the expenditure could be gone into only for the purpose of determining whether, in fact, the amount was spent. Once it is established that there was a nexus between the expenditure and the purpose of the business, the Revenue cannot justifiably claim to put itself in the armchair of a businessman or in the position of the board of directors and assume the said role to decide how much is a reasonable expenditure having regard to the circumstances of the case. It needs no reiteration that the settled position in law is that no businessman can be compelled to maximise his profits.

# Commercial expediency explained by case laws:

- ***Indian Molasses Co. (P.) Ltd.* v. *CIT* [1959] 37 ITR 66 SC**
- "Expenditure" is equal to "expense" and "expense" is money laid out by calculation and intention. But the idea of "spending" in the sense of "paying out or away" money is the primary meaning. "Expenditure" is thus what is "paid out or away" and is something which is gone irretrievably. To be an allowance within cl. (xv), the money paid out or away must be (a) paid out wholly and exclusively for the purpose of the business and further (b) must not be (i) capital expenditure, (ii) personal expense or (iii) an allowance of the character described in cls. (i) to(xiv). But whatever the character of the expenditure, it must be a paying out or away. **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.** It must be a commercial loss and in its nature must be contemplable as such. The mere fact that the assessee establishes the existence of an agreement between him and his agents and the fact of actual payment, the discretion of the ITO to consider whether the expenditure was made exclusively for the purpose of the business is not taken away.

# Commercial expediency explained by case laws:

- **S.A.Builders v/s. CIT(A) 288 ITR 1 SC**
- The expression 'commercial expediency' is an expression of wide import and includes such expenditure as **a prudent businessman incurs** for the purpose of business. The expenditure may not have been incurred under any legal obligation but yet it is allowable as a business expenditure if it was incurred on grounds of commercial expediency.
- **Aluminium Corporation of India Ltd. v. CIT [1972] 86 ITR 11 SC**
- It is also true that by the mere fact that the assessee establishes the existence of an agreement between him and his agents and the fact of actual payment, the discretion of the ITO to consider whether the expenditure was made exclusively for the purpose of the business is not taken away. The expenditure incurred must be for commercial expediency. In applying the test of commercial expediency for determining whether an expenditure was wholly and exclusively laid out for the purpose of the business, **reasonableness of the expenditure has to be adjudged from the point of view of the businessman and not of the Revenue**. It is, of course, open to the Tribunal to come to a conclusion either that the alleged payment is not real or that it is not incurred by the assessee in the character of a trader or it is not laid out wholly and exclusively for the purpose of the business of the assessee and to disallow it.

# Commercial expediency explained by case laws:

**CIT v/s. M/s. Airlines Hotel Pvt Ltd. (BOM HC )**

- Assessee engaged in running of hotel. The bar and restaurant was headed by one Mr. J and he was paid monthly royalty. There arose a dispute between the two, and the matter before court and the parties entered into a consent decree. As a result of decree , the assessee paid amount to Mr.J and incurred some legal expenses were incurred on the suit. These amounts were claimed as expenses from business income. It was revenues case that since the decree amount was for securing vacant possession of premises it would constitute benefit of enduring nature and therefore would be capital expenditure and not allowable. The Assessee contended that removing hindrance and obstruction in conduct of business was a matter of commercial expediency and hence it was revenue expenditure. Bom HC allowed the plea.

# Commercial expediency explained by case laws:

**Mundial Export Import Finance (P.) Ltd.** ***v. CIT*** **238 Taxman 34**

- The assessee had taken on lease a plot of land from the Calcutta Port Trust (CPT) under a lease agreement. It had encroached some of land belonging to the trust. The CPT by a letter asked the assessee to pay damages before its proposal for grant of lease in respect of the encroached land could be placed before the Board of Trustees for examination. The assessee paid a certain amount to the CPT to compensate the loss suffered by CPT due to occupation of land in excess of what was demised to it and claimed deduction of the same as a revenue expenditure. The Assessing Officer disallowed the payment in question.

- The payment was made to compensate the loss suffered by CPT due to occupation of land in excess of what was demised to the assessee. Therefore, the payment did not partake the character of penalty. The payment could not partake the character of a capital expenditure, because contention of the CPT was that the prayer for lease of the land unauthorisedly occupied could not be examined before payment of the compensation. Therefore, the payment was altogether compensatory for the benefit already received by the assessee by user of the land which had or could have nothing to do with a grant of lease in future.

- In view of the aforesaid, the payment to the CPT by the assessee was an expenditure incurred wholly and exclusively for the purposes of the business and, therefore, allowable as deduction under section 37(1).

# Commercial expediency- Instances:

- Genuine business borrowings, the AO cannot disallow part of interest on ground that rate of interest is too high.(East India Inds. 31 ITR 803)
- AO cannot disallow expenses on the ground that assessee had enough funds and there was no need to recourse to outside borrowings. (CIT v/s. Bombay Samachar 74 ITR 723)
- The burden to show commercial expediency is on the assessee. (225 ITR 560, 201 ITR 181).
- Interest on loan given to a subsidiary which is a NPA, not allowable.
- If the business are interconnected between the same group companies, then interest on loan may be allowable based on commercial expediency.
- Expenditure wholly incurred "for purpose of business" is wider than for the "purpose of earning profit". (Meenakshi Mills Ltd 63 ITR 207 SC).
- The purpose is more relevant and not the motive for which expenses incurred (Sarabhai Sons v/s. CIT 201 ITR 164)

# Commercial expediency- Instances:

- Fees paid by assessee for valuation of assets to comply with FERA in order to continue business in India. [CIT v. Malayalam Plantations (India) Ltd. 201 ITR 301]
- Expenditure incurred by a film producer on production of films which were subsequently abandoned on the ground of commercial expediency. [Nagi Reddy (B) v. CIT (1993) 199 ITR 451]
- Expenditure remotely connected with business cannot be allowed. [Orissa Cement Ltd. v. CIT (1969) 73 ITR 14]

# Relevant Law : Explanation to Section 37(1)

- Explanation 1 - Generic explanation - any expenditure incurred for purpose which is **an offence** or **prohibited by law** – no deduction can be allowed.
- Explanation 3 **(w.e.f 01-04-2022)** – meaning of expression “incurred by an assessee for any purpose which is an offence or prohibited by law.
- Explanation 3 is inclusive (uses the word shall include and deemed to be have included)
- Following expenses shall always be disallowed:

- Any expenditure for an offence;
- Any expenditure which is prohibited by any law for time being in India or outside India;
- Any expenditure to provide benefit or perquisite (in any form) which is in violation of any law, rule or regulation or guideline governing the conduct of such person;
- Any expenditure to compound an offence under any law in or outside India.

# Background to Explanation 1 of section 37(1)

- Whether illegal expenses allowed or not ?
- Does it make a difference in allowability if the expenses are penal in nature or compensatory ?
- SC decisions in case of Mahalaxmi Sugar Mills Ltd (123 ITR 429) and CIT v/s. Hyderabad Allwyn Metal Works Ltd. (172 ITR 113).
- SC decision in case of Haji Aziz Shakoor Bros (41 ITR 350) held that any expenses which is a penalty on breach of any law cannot be said to be amount used wholly and exclusively for the purpose of business and therefore cannot be allowed as expenditure.
- Trigger point was Mum ITAT decision In case of Pranav Constructions (116 TTJ 445) - Payment paid to protect the partners of business and provide security from taporis was allowed as expenditure on ground that such hafta and extortion money was deductible as was part of business operations of a construction business.
- Explanation 1 inserted by FA 1998 w.r.e.f 01st April 1962 – disallowing such expense.

# What is an offence…1

**Case Study – Amount of ransom paid whether allowable**

- Company A is in the business of manufacturing bidi. Director of company A was kidnapped and FIR was lodged but police could not find or release the director from dacoit and ransom amount was paid for release. This amount was claimed as expenditure from business by the Company A. Kidnapping any person is an offence u/s. 346A . The Assessing Officer disallowed the expenditure u/s. 37(1) of the Act.
- Director was kidnapped during an ongoing business tour.
- Kidnapping though is an offence under IPC, saving a person by paying ransom is not classified as an offence under any statute.
- CIT v/s. Khemchadmotila Jain Tobbaco Producers Pvt Ltd. (2011- TIOL- 540 HC-MP)

# What is an offence…2

**Case Study - Paying bribe which is not prohibited as per any law:**

- The assessee main income from contract receipts for civil construction from K Ltd. The assessee claimed certain commission paid to A, MD of K Ltd. For awarding the contract. The reason of such payment was cost reduction in the original estimates of the contract. It was held that it is a clear case of collusion and the tender was floated at higher price on purpose, after receving the contract, it was agreed that assessee shall reduce the contact price and pay the difference back. It was obvious kick back or bribery and just sugar coated with commission.
- J.K.Panthaki & Co. v/s. ITO (344 ITR 329)( Kar HC)

# What is an offence…3

**Case Study – Amount paid towards settlement of a suit:**

- Company B is in the business of manufacturing environmental control systems, like rotors. The company paid certain amount for settlement of disputes and claimed the same as expenditure u/s. 37(1). The dispute was that one of their export parties was sued by person in USA on basis of infringement of patents registered in USA. Instead of getting into litigation, Company B settled the case by payment of settlement fees. AO decided against the assessee, considering the same as akin to penalty towards infringement of patent law.
- CIT v/s. Desiccant Rotors International Pvt Ltd. (Delhi HC 347 ITR 32)

# What is an offence…4

**Case study – Whether amount paid is in character of interest or penalty:**

- Expenses paid towards the penalty of BSE and NSE by a assessee into business of share dealing was disallowed u/s. 37(1) of the Act. Assessee claimed amount was paid during the course of business and there was no infraction of law. It was recorded by higher courts that the amount paid were for penalty for late deposit of margin money and other violations of timely delivery etc. The HC allowed the expenses stating that the revenue has to show why the expenses or payments should be considered as penalty and not as normal interest on delayed payment.
- CIT v/s. Prasad and Co. (Delhi HC -2012 TOIL- 121- DEL)

# What is an offence...5

- The word 'offence' has not been defined under the Act. However Chapter XXII deals with offences and prosecutions. It refers to various sections under the Act and non-compliance with those provisions are punishable with punishment as prescribed therein.
- Willful attempt to evade tax is an offence under the Act. The word 'offence' has to be understood in the context of an offence generally under any Act.
- If the assessee commits an offence under any law in the course of his business and incurs expenditure for any purpose in connection with the said offence, the said amount is not deductible under s. 37 of the Act.
- 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. 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.

# Test of compensatory or penal .. 1

- 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 claims both expenditure under sec 37(1). The 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, the AO 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.
- Wherever such examination reveals that its purely compensatory in nature, it should be allowed. When partly of compensatory and partly of penal nature, the authorities need to bifurcate the two components and give deduction to compensatory expense.
- Prakash Cotton Mills Pvt Ltd. v/s. CIT (SC) (201 ITR 684 1993)

# Test of compensatory or penal .. 2

*Mannaial Khetan* v. *Kedar Nath Khetan* [1977] 2 SCC 424 has held as under:

- Where a contract, express or implied, is expressly or by implication forbidden by statute, no Court will end its assistance to give it effect. ...A distinction is sometimes made between contracts entered into with the object of committing an illegal act and contracts expressly or impliedly prohibited by statute. The distinction is that in the former class one has only to look and see what acts the statute prohibits; it does not matter whether or not it prohibits a contract; In the latter class, one has to consider not what act the statute prohibits, but what contracts it prohibits.
- Penalties are imposed by statute for two distinct purposes : (1) for the protection of the public against fraud, or for some other object of public policy; (2) for the purpose of securing certain sources of revenue either to the State or to certain public bodies. If it is clear that a penalty is imposed by statute for the purpose of preventing something from being done on some ground of public policy, the thing prohibited, if done will be treated as void, even though the penalty if imposed is not enforceable."

# Offence or violation of foreign law

- The assessee company was engaged in pharmaceutical business. The AO noticed from the Annual Report that the Assessee company had charged Rs.xxx/- as litigation cost under the head 'other expenses'.AO disallowed that expenses under explanation 1 to section 37. 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 contended amount was 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 .The Tribunal held that these amounts will not violate Indian laws and cannot attract 37(1).
- Mylan Labarotries Ltd v/s. CIT (Hyd ITA No.12/Hyd/2019) – **Pre amendment 2022**

# The infamous pharma freebies controversy:

- Regulation 6.8 of the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 disallows medical practitioners from accepting emoluments in the form of *inter alia* gifts, travel facilities, hospitality, cash or monetary grants. Acceptance of such freebies could result in a range of sanctions against the medical practitioners, from 'censure' for incentives received up to Rs. 5,000/, to removal from the Indian Medical Register or State Medical Register for periods ranging from three months to one year.
- CBDT Circular No.5 /2012 stated guidelines issued by Indian Medical Council is binding and disallowance u/s.37(1) to be made in the hands of such pharma companies or allied health sectors providing such benefits.
- Confederation of Indian Pharmaceuticals Industry – holds that interpretation of circular is in line with section 37(1) and therefore cannot be said to be incorrect.

# The infamous pharma freebies controversy:

- DCIT v/s. PHL Pharma (78 taxmann.com 36) – contrary to Live health care decision of coordinate bench itself. Held that section 37(1) not applicable on the said issue and no disallowance to be made as MCI guidelines only applicable to medical professionals and not pharma companies.
- DCIT v/s. Macleods Pharmaceuticals Ltd. Mum ITAT (131 taxmann.com 154): Suggested constituting a special bench of three or more members as not convinced with the decision of PHL Pharma.
- Does accepting freebies by doctors being illegal , make pharmaceutical companies distributing them also illegal expenses ? **Apex Labarotries Ltd v/s. DCIT (135 taxmann.com 286) 2022 SC: Prohibited activity**

# Rationale to Explanation 3 of section 37(1)

- Explanatory memorandum to Finance Bill, 2022: *It is seen that certain taxpayers are claiming deductions on expenditure incurred in offering certain benefits or perquisite to a person which are not intended to be allowed under this section, like meeting his expenditure related to travel, hospitality, conference etc. In these cases acceptance of such benefit or perquisite by such person is in violation of a law or rule or regulation or guidelines, as the case may be, governing the conduct of such person.*
- *Further, some taxpayers are seen to be claiming deduction on expenses incurred for a purpose which is an offence under foreign law or for compounding of an offence for violation of foreign law, claiming that provisions of Explanation 1 to subsection (1) of section 37 of the Act applies only to offences which are prohibited by the domestic law of the country. In some case this view has also been accepted by the tribunal. These judgments are also against the intention of the legislation as the legislation does not say that the Explanation 1 applies only to the violation of domestic law. In order to make the intention of the legislation clear and to make it free from any misinterpretation, it is proposed to insert another Explanation to sub-section (1) of section 37 to further clarify that the expression "expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law",*

# Thank You !!!

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