CIVIL REFERENCE

Before Falshaw and Kapur, JJ.

COMMISSIONER OF INCOME-TAX, PUNJAB,—*Applicant*

versus

1953

May, 28th

THE HIMALAYA ROSIN AND TURPENTINE MANUFACTURING COMPANY, HOSHIARPUR,—*Respondent*

Civil Reference No. 1 of 1951

Income-tax Act (XI of 1922), Section 10(2)(xv)—Fine paid under the penalty clause in a lease, whether a proper deduction within the meaning of section 10(2)(xv).

Held, that the amount paid is not an item which was expended for the purpose of enabling the assessee to earn profits in the trade but was imposed as a penalty for the breach of the rules and is not deductable under the Statute.

Civil Reference made by the Registrar, Income-tax Appellate Tribunal, Bombay,—vide *his letter No. R.A. 493 of 49/50, dated the 11th January, 1951, for orders of the High Court under section 66(1) of the Indian Income-tax Act, 1922 (Act XI of 1922) as amended by section 92 of the Income-tax (Amendment) Act, 1939 (Act VII of 1939), in the matter of the assessment of the Himalaya Rosin and Turpentine Manufacturing Co.*

S. M. SIKRI, Advocate-General, HEM RAJ MAHAJAN, and RAJINDAR SACHAR, for Petitioner.

C. L. AGGARWAL and A. C. HOSHIARPURI, for Respondent.

ORDER

Kapur, J.

KAPUR, J. This is a reference made by the Income-tax Appellate Tribunal and the two questions which have been referred to this Court are:—

"1. Whether there was material upon which the Tribunal found that the assessee attempted to extract more rosin by contravening the terms of the lease?

2. If so, whether, upon the facts found by the Tribunal, the sum of Rs. 5,000 paid by the assessee as fine under the penalty clause of the terms of the lease was a proper deduction within the meaning of section 10(2)(xv) of the Indian Income-tax Act, 1922?"

In order to answer these questions it is necessary to briefly give the facts of the case as given in the statement of the case by the Tribunal. An agreement, Exhibit 'H', was entered into between the Tehri Garhwal State and the assessee, the Himalaya Rosin Turpentine Manufacturing Company, on the 24th November, 1937, which was to take effect from the 1st of December, 1937. The clause of this agreement relevant to the present case is No. 11 which is as follows :—

> "11. That you will be responsible to extract rosin according to the specification and prescription prescribed in the standard books on the subject as is described in the schedule enclosed herewith. You will further be responsible to pay compensation for failure to observe the terms contained in the above paragraphs or for careless or intentional damage to the forest, either by fire or otherwise resulting from your action or the action of your staff or labourers."

It appears that the assessee, the Himalaya Rosin Turpentine Manufacturing Company, was accused of having transgressed the terms of the agreement and on the 31st October, 1944, the Home Secretary on behalf of the Tehri Garhwal State wrote to the present assessees calling upon them to pay Rs. 5,000 by way of fine. In this letter it was said:—

> "I am to inform you that it has been reported to the Durbar that against the rules you are making the channels as deep as 3" as broad as 5" and as long as 22" and that even small sapplings are being tapped. As such a compensation of Rs. 5,000 (five thousand rupees) is imposed on you by way of fine which please credit into the Treasury by the 30th of November, without fail, otherwise stricter steps will be taken against you."

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The assessees accepted this liability and paid up Rs. 5,000 as they were called upon to do. In the assessment year 1945-46, the assessees claimed this sum of Rs. 5,000 as deduction in order to arrive at their net profits. This claim was rejected by the Income-tax Officer as also by the Appellate Assistant Commissioner. The matter was taken on appeal to the Income-tax Appellate Tribunal which allowed this sum as a deduction. They said:—

> "Objections in this appeal are taken to the addition of cash credits in three accounts and to the disallowance of Rs. 5,000 paid by the assessee firm as compensation to Tehri Garhwal State for breach of certain conditions of the lease, which the assessee held for extraction of rosin from State forests. The assessee attempted to extract more rosin by contravening the terms of the lease and for this unlawful gain he had to pay compensation to the State. On these facts, we see no reason why the sum of Rs. 5,000 paid to the State be not allowed as a revenue expense. This compensation would, in other words, mean 'royalty' for the rosin actually extracted or for an attempt to do it. In the circumstances of the case, we feel that payment of Rs 5,000 is an allowable deduction in assessee's trading account. It is, therefore, ordered accordingly."

According to the statement of the case it is quite clear that the Home Secretary of the Tehri Garhwal State wrote to the assessees on the 31st October 1944 that it had been reported to the Durbar that they, the assessees, were making the channels 3″ deep, 5″ wide and 22″ long and were tapping even small sapplings which was against the rules made by the Durbar, which shows quite clearly that the allegation made against them was that the rules in accordance with which they had undertaken to do the tapping had been deliberately

broken by the assessees and, therefore, a fine of Rs 5,000 was imposed upon them which they paid without any objection. These facts are sufficient material in support of the finding of the Tribunal that the assessee attempted to extract more rosin by contravening the terms of the lease and the answer to the first question must, therefore, be in the affirmative. I would answer it accordingly.

The next question which arises for determination is whether the Rs 5,000, which has been paid by the assessee as fine under the penalty clause, is a proper deduction within the meaning of section 10 (2) (xv) of the Indian Income-tax Act. The question as framed to which no objection seems to have been taken shows that this Rs 5,000 was accepted by the assessee to have been paid as fine under the penalty clause of the terms of the lease. Counsel for the assessee has submitted that this was nothing more than amount expended in their usual course of business and that they had to pay more because they had extracted more rosin, but that is not what the question seems to contemplate. The question definitely puts it "as fine under the penalty clause of the terms of the lease". Apart from that the question to be determined still remains whether it falls within the words of the statute and is, therefore, properly deductable. Section 10 (1) and (2) (xv) provides as under:—

> "10. *Business.* (1) The tax shall be payable by an assessee under the head 'profits and gains of business, profession or vocation' in respect of the profit or gains of any business, profession or vocation carried on by him.
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> (2) Such profits or gains shall be computed after making the following allowances, namely:—
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> * * * * * *
> * * * * * *
>
> (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."

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This sum of Rs 5,000 would fall under section 10(2)(xv) if it is laid out or expended wholly and exclusively for the purpose of such business.

The expression 'for the purpose of business, profession or vocation' also occurs in the English Act and was construed in *Strong* v. *Woodfield* (1), I shall quote from the Law Times Reports. In that case the assessees were a brewery company who owned an inn. A customer sleeping in the inn was injured by the falling of a chimney upon him and the assessee had to pay £ 1,490 in costs and damages because fall of the chimney was due to the negligence of the assessees' servants. In the Court of Appeal Collins, M.R., at page 356 of *Strong and Co., Ltd.*, v. *Woodfield* (*Surveyor of Taxes*) (2), said :

> "It seems to me, looking at these rules, that the root of the matter is that all expenses necessary for the purpose of earning the profits may properly be deducted, but that expenses to come out of the profits after they are earned cannot be deducted, unless there can be found some express provision of the Act authorising the deductions."

Lord Davey in the House of Lords in his speech said at page 243 of 95 L.T.R. 241 :—

> "I think that the payment of these damages was not money expended 'for the purpose of the trade'. These words are used in other rules, and appear to me to mean 'for the purpose of enabling a person to carry on and earn profits in the trade', etc. I think that 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 arises 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 the profits."

(1) (1906) A.C. 448-95 L.T.R. 241
(2) (1905) 2 K.B. 350.

In *Commissioners of Inland Revenue* v. *Warnes and Company Limited* (1), the assessee was sued for a penalty in the King's Bench Division on an information exhibited by the Attorney-General under the provisions of the Customs Consolidation Act as extended by the Customs (War Powers) Act, 1915, for an offence alleged against them in breach of certain orders and proclamations relating to the requirements of the Board of Customs and Excise with respect to a consignment shipped by them to Norway. The action was settled in Court by consent and the assessee agreed to pay a mitigated penalty of £2,000, that sum to cover the costs of the Crown, and on all imputations as to assessee's moral culpability being withdrawn and on it being made clear to the public that there was no intention on the part of the assessee to trade with the enemy. The question that arose for decision in this case was whether this sum of £ 2,000 would fall under the words 'for the purpose of business, profession or vocation'. Rowlatt, J., in giving the judgment said at page 452:—

> "But the question is whether, within the meaning of the rule, it is a loss connected with or arising out of their trade. I may shelter myself behind the authority of Lord Loreburn, L.C., who in his judgment in the House of Lords, in *Strong and Co.* v. *Woodfield* (2), said that it is impossible to frame any formula which shall describe what is a loss connected with or arising out of a trade. That statement I adopt,.....

This statement of the law was approved of by Lord Sterndale M.R. in *Commissioners of Inland Revenue* v. *Alexander von Glehn and Company, Limited* (3). The Master of the Rolls said at page 566:—

> "That, as it seems to me, was not a loss connected with the business, but was a

(1) (1919) 2 K.B. 444
(2) (1906) A.C. 448
(3) (1920) 2 K.B. 553

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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 and Co.* (1), which he followed, were right, and that this appeal should be dismissed with costs."

At page 569 Warrington, L.J., said:—

"That it arises out of the trade I think may well be conceded. It does arise out of the trade because if it had not been that the company were carrying on the trade they would not have had to incur this expenditure; but, in my opinion, it is not a loss connected with or arising out of the trade. 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 Sampath Iyengar's book, the Income-tax Act, at page 518 in paragraph 513 the law is stated as follows:—

"*Penalties.* Penalties incurred by infraction of licensing laws have been already

(1) (1919) 2 K.B. 444

observed as not incidental to trade. It is matter of consideration whether compensation paid in civil proceedings for carrying on a business in a *negligent* way would stand on any different footing so as to entitle an allowance therefor. But damages sustained by carrying out the business in a *dishonest* way can never be allowed, nor can any amount paid by a director of a company to the liquidator to compound proceedings in misfeasance started against him by the latter."

The test laid down by Lord Davey was applied by Wrottesley, J., in *Spofforth and Prince* v. *Golder* (1).

In India a similar case was decided by the Madras High Court in *Messrs Mask and Co.* v. *Commissioner of Income-tax, Madras* (2). In this case the assessee was a firm carrying on business in crackers. It had entered into a contract with the other traders in the same business under which its goods were to be sold at a specified rate. In breach of that contract the assessee sold crackers at lower rates and the other parties filed a suit to recover damages by reason of the breach of contract on the part of the assessee. The Court found the assessee to be liable in damages to a sum of Rs 5,000 which the assessee claimed to be entitled to deduct as a business expenditure. This contention was rejected. Leach, C.J., said at page 462 of the Income-tax Reports:—

"In the present case, the assessee was not fined for a breach of law, but was made to pay damages for a breach of the contract entered into. The assessee's action in disregarding the undertaking given was palpably dishonest and we are of the opinion that the award of

(1) (1945) I.A.E.R. 363
(2) 11 I.T.R. 454-A.I.R. 1943 Mad. 670

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damages which followed did not constitute an expenditure falling within section 10(2)(xii). It was not incidental to the trade."

Emphasis seems to have been laid by the learned Chief Justice on the point that this was not a case where a business was conducted in a negligent manner but it was a case of conducting business in a dishonest manner.

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In the present case it is obvious that the assessee, in breach of the rules which had been made by the Durbar and which they had under the contract undertaken to observe, started to discard the rules and caused damage to the trees including sapplings, and if they had to pay Rs. 5,000 for this action of theirs it is not in my opinion covered by the words of the section for the purposes of business, profession or vocation. As I have said before the very form of the question shows that it was accepted by the assessee that Rs. 5,000 were paid by the assessee as fine under the penalty clause of the terms of the lease and such an amount certainly falls under the rule laid down by the English cases that I have quoted as also in the Madras case *Messrs. Mask and Co.* v. *Commissioner of Income-tax, Madras* (1).

I am, therefore, of the opinion that this Rs. 5,000 is not an item which was expended for the purpose of enabling the assessee to earn profits in the trade but was imposed as a penalty for the breach of the rules and is not deductable under the statute. I would, therefore, answer the second question in the negative.

In the result the answer to the first question is in the affirmative and to the second question in the negative. As the Commissioner of Income-tax succeeds in this petition, he is entitled to costs. Counsel fee Rs. 250.

FALSHAW, J.—I agree.

(1) 11 I.T.R. 454