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female, and that property in her constructive possession through a licensee or a lessee or a mortgagee would also be in her possession. The mere fact, therefore, that the suit property was in the physical possession of the mortgagee, can be of no consequence, and as I have already mentioned, Chopra, J., was himself of the opinion that Mehr Devi was possessed of the property when the Hindu Succession Act came into force and she became its full owner. It follows, in my opinion, that no reversionary interest remained in that property once Mehr Devi became its full owner, and there is no point in the suit of Tota Ram seeking to protect his reversionary right in such property.

For these reasons I would allow this appeal and set aside the decree granted to the plaintiff in this case and, instead, dismiss the plaintiff's suit but, in all the circumstances, leave the parties to their own costs throughout.

Khosla, C.J. G. D. KHOSLA, C. J.—I agree.

B.R.T.

CIVIL MISCELLANEOUS

Before Mehar Singh and A. N. Grover, JJ.

MESSRS. RAJ WOOLLEN INDUSTRIES,—*Petitioner.*

versus

THE COMMISSIONER OF INCOME-TAX, SIMLA,—

Respondent.

Income Tax Reference No. 15 of 1958.

Income-tax Act (XI of 1922)—Section 10(1) and 10(2)(XV)—Expenses incurred in connection with the business carried on in contravention of law—Whether admissible deductions.

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Held, that although gains and profits of a business which is carried on in contravention of law are taxable, the expenses incurred in connection with the carrying on of that business cannot be claimed as legitimate deductions under the Income-tax law. However, so far as section 10(2) (XV) of the Indian Income-tax Act, 1922, is concerned, the assessee, in order to claim the benefit of that provision, must establish that the expenditure incurred was laid out or expended wholly and exclusively for the purpose of such business. Where the expenses which are claimed as deductions have a direct and proximate connection with an act which is an infringement of law or is a contravention of it, they cannot be allowed or regarded as deductions which can be granted under the Income-tax law. If an assessee spends money in order to carry out the business unlawfully, he cannot be held entitled to deduction under section 10(2) (XV) of the Indian Income-tax Act, 1922. Nor can such expenses be allowed as deductions under section 10(1) of the Act. Even if the profits are to be computed in accordance with the accepted principles of Commercial Accountancy, the amounts which can be considered as proper outgoings and which can be set off against gross receipts must be of the same nature as the expenditure falling under section 10(2) (XV) of the Act.

Reference made under Section 66(1) of the Indian Income-tax Act, 1922 (XI of 1922) by the Income-tax Appellate Tribunal Delhi Bench for decision of the follow-question of law which arose from the judgment of the Tribunal, dated 10th October, 1957:—

> *"Whether on the facts and in the circumstances of this case the sum of Rs. 6,800 is an admissible expense either under the provisions of section 10(2) (XV) of the Indian Income-tax Act or otherwise on accepted principles of commercial accountancy under section 10(1) of the Indian Income-tax Act ?"*

H. L. SARIN, AND K. C. SOOD, ADVOCATES, for the Appellant.

D. N. AWASTHY, ADVOCATE AND M. R. MAHAJN, ADVOCATE, for the Respondents.

ORDER

Grover, J. GROVER, J.—The assessee firm dealt in raw wool and yarn apart from carrying on other business. In the account year ending 31st March, 1955, relevant for the assessment year 1955-56, the export of wool to foreign countries could be done only under a licence to be issued by the Government. During the account year in question the assessee was granted a licence to export, which is popularly known as "Export Quota", to the extent of 22,000 lbs. of wool. Similarly Messrs. Sri Kant-Banwari Lal and Company (hereinafter to be referred to as S. B. and Company) had secured some quota to export wool. The assessee entered into a contract with Messrs. J. C. Gilbert, Limited, London, in April, 1954, agreeing to sell 37 bales of Indian wool at 53d. per lb. The delivery was to be c.i.f. Liverpool. The assessee having exhausted its own export quota entered into an arrangement with S.B. and Company by virtue of which it was the latter Company which exported the bales from time to time which had previously been sold to that Company by the assessee in India and were repurchased by the assessee while they were in the course of transit on board the ship and which was ultimately delivered to Messrs. J.C. Gilbert, Limited, London, in fulfilment of the agreement between them and the assessee. The sale to S.B. and Company by the assessee in India was at the rate of Rs. 2 per lb. and the purchase from S.B. and Company in its turn was at the rate of Rs. 2-3-6 per lb. What the assessee did was that when it sold the goods to S.B. and Company at the rate of Rs. 2 per lb. it credited its trading account with the sale proceeds at that rate. When S.B. and Company sold the goods to the assessee at the rate of Rs. 2-3-6 per lb., the assessee debited its trading account with the cost of the said goods at the rate. Now it is the difference between these two figures

which led to the final figure of Rs. 6,800 which was claimed by the assessee as a deduction while computing its business profits under section 10 of the Indian Income-tax Act, 1922.

The Income-tax Officer regarded the transactions of sale and purchase entered into between the assessee and S.B., and Company as "pseudo transactions" i.e. transactions which were not genuine. According to him, the ownership in the goods never passed from the assessee to S.B. and Company and the difference between the aforesaid two figures merely represented "the cost of acquisition of shipping rights which is not an expense for carrying on the business and which is not admissible under section 10(2) (xv)". He further considered that it was of no consequence in so far as the computation of income under section 10 of the Income-tax was concerned as to what shape was given by the assessee to it in his books. Before the Appellate Assistant Commissioner, the position adopted by the assessee was somewhat different and it was sought to deduct a sum of Rs. 6,800 under section 10(1) of the Act. The appellate Assistant Commissioner agreed with the Income-tax Officer that there were no genuine sale and repurchase transactions and he further came to the conclusion that the real nature of the transactions was merely to acquire the quota rights which belonged to S.B. and Company and such an acquisition was not permissible under the law. He rejected the assessee's contention that the sum of Rs. 6,800 was not in the nature of capital expenditure if at all it was to be considered as a deduction falling under section 10(2)(xv). Before the Income-tax Appellate Tribunal the case was finally presented on behalf of the assessee was that the amount in question had been paid to the quotaholder, namely, S.B. and Company for the use of

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its quota and the amount was an admissible deduction under scetion 10(2) (xv) inasmuch as it was not in the nature of capital expenditure. This contention did not find favour with the Tribunal, although the Tribunal considered that there was no substance in the contention raised on behalf of the Department that the sum of Rs. 6,800 was in the nature of capital expenditure if that item was to be considered under section 10(2) (xv). It is clear from the order of the Tribunal dated 10th October, 1957, that the whole argument was advanced on the footing that the sales made by the assessee to S.B. and Company and the transactions of repurchase made between the Company and the assessee when the goods were on board the ship were not real and genuine transactions. The Tribunal further repelled the contention that the deduction claimed fell under section 10(1). Thus the question of law referred to us is as follows :—

> "Whether on the facts and in the circumstances of this case the sum of Rs. 6,800 is an admissible expense either under the provisions of section 10(2) (xv) of Indian Income-tax Act or otherwise on accepted principles of commercial accountancy under section 10(1) of the Indian Income-tax Act ?"

The learned counsel for the assessee has placed a good deal of reliance on a decision of the Madras High Court in *M/s. Kandappa Mudaliar* v. *Commissioner of Income-tax* (1). There, A, B, C and D had entered into a partnership for trading in cotton, etc., and when the trade was subjected to control, the firm had obtained the prescribed quotas to carry on its export trade. D retired from

(1) 32 I.T.R. 313.

the firm on 5th February, 1944, with the result that the firm was reconstituted under the same trade name with A, B and C as partners. The new firm entered into an agreement with D that until D could obtain a separate quota, the firm was to buy the entire quota goods and use it for its business and by way of compensation, D was to be paid certain sums in accordance with the prevailing conditions. The firm paid two amounts of Rs. 13,500 and Rs. 10,000 during the accounting years in question and claimed those amounts as deduction from the taxable profits of the firm. The High Court held that the payments made were not of a capital nature and what the assessee agreed to pay to D was for the use of the quota with which the assessee could acquire its stock-trade for export till D was allotted his separate quota. Then certain observations were made which were more in the nature of obiter, but on which a great deal of emphasis was laid by the learned counsel for the assessee in the present case. It was observed by the Madras Bench that a certain practice had been referred to by the Appellate Assistant Commissioner with reference to what he called the usual procedure adopted by exporters, who were purchasing export quota from others. It was considered that the aforesaid practice had legal sanction behind it and the Madras Bench proceeded to make the following observations :—

> "The quota itself, it should be remembered, is not a marketable commodity, though we have earlier referred to the transaction as a purchase of quota rights. It was really a case of payment made for the use of the quota issued to another. The export itself has to be in the name of the trader, who holds the quota. The quota all through stands in the name of the person in whose name it was issued.

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Even had Sabapathy been allotted special quotas, and the assessee paid him money for the use of these quotas, the payment would still have been of monies laid out by way of addition to the price of the goods purchased by the assessee for export."

The aspect, however, which was examined by the Tribunal in the present case does not appear to have been either advanced or discussed before the Madras Bench. At this stage reference may be made with advantage to the provisions contained in paragraphs 3 and 5 of the Exports (Control) Order, 1954, which was promulgated under the Imports and Exports (Control) Act, 1947. According to paragraph 3, "Save as otherwise provided in this order, no person shall export any goods of the description specified in Schedule I, except under and in accordance with a licence granted by the Central Government * * *". Paragraph 5(2) of the Order provides that it shall be deemed to be a condition of every licence that the licensee shall not transfer the licence except with prior permission and that "the goods for the export of which the licence is granted shall be the property of the licensee at the time of the export". The Tribunal proceeded on to the conclusion from the provisions of the Exports (Control) Order that the manner in which 37 bales were exported by the assessee constituted a contravention of the terms of the licence and of the order. If that be so, it was considered that the expenses would not fall within the ambit of section 10(2) (xv) and for this purpose the Tribunal relied on *Commissioner of Income-tax* v. *Haji Aziz and Abdul Sakoor Bros.* (1). In that case the assessee had imported certain dates by steamers in breach of a notification by

(1) 28 I.T.R. 266.

which import of dates were permissible only by country crafts. The custom authorities under section 167(8) of the Sea Customs Act confiscated the goods and gave the assessee an option to pay a fine in lieu of confiscation. The assessee paid the fine and got the goods released from the custom authorities and claimed the amount thus paid as a permissible deduction under section 10(2) (xv). Chagla C.J., who delivered the judgment of the Court, observed that under section 10(2) (xv) a permissible deduction was an expenditure which was laid out or expended wholly and exclusively for the purpose of the assessee's business, profession or vocation. Although the legislature has not stated it in express terms, it must be read into section 10(2) (xv) by necessary intendment that the expenditure contemplated by that sub-section was an expenditure which was laid out or expended for the purpose of carrying out the business of the assessee lawfully. The learned Chief Justice was quite emphatic about repelling the suggestion that if an assessee spent money in order to carry out the business unlawfully, he would be entitled to deduction under section 10(2) (xv). The following observations at page 272 are noteworthy :—

> "In our opinion no distinction can be drawn between a case where an assessee makes an unlawful expenditure and claims it as a deduction under section 10(2)(xv) and a case where an assessee commits a breach of the law, incurs an expenditure as a result of that breach of the law, and then claims that expenditure under section 10(2)(xv). The two cases are identical and no distinction can be drawn between them."

The learned counsel for the assessee has sought to distinguish the Bombay case, referred to

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above, on the ground that it fell in a different category of cases decided by Courts in this country as also in England in which it had been laid down that a fine or a penalty paid for infringement of some law could not be validly claimed as a deduction while computing the business profits. It is pointed out that no such question is involved in the present case where all that has been done is that certain expenses have been incurred in the matter of exporting goods to a foreign country by taking advantage of the quota for which S.B. and Company held a licence. The argument, as presented, would cover not only the claim made by the assessee under section 10(2) (xv), but also under section 10(1). The basis of submission is that either the whole transaction of export of 37 bales of wool by making use of the quota of S.B. and Company was illegal or it was not. If it was illegal, then it had been consistently held that profits from an illegal business were taxable. If they were taxable, then the expenses which had been laid out in respect of that venture, transaction or business must be allowed to be deducted either under section 10(2) (xv) or section 10(1). In *The Commissioners of Inland Revenue* v. *Alexander Von Glehn and Co., Ltd.*, the Court of Appeal had to deal with a case, where goods had been exported to Russia and Scandinavia and the assessee Company had been sued for penalties under the Customs (War Powers) Act, 1915, on informations by the Attorney-General in respect of alleged infringements of that Act. Those actions were settled by consent on the Company agreeing to pay a compromise penalty of £ 3,000 without costs. The Company incurred legal costs amounting to £ 1,074 12s. 7d.

(1) 12 T.C. 232.

in respect of the proceedings. The question was whether that amount was an admissible deduction while arriving at the profits of the Company's trade for the purposes of Excess Profits Duty. While holding against the assessees Lord Sterndale, M. R., noticed the argument that you have got to look at what is, in fact, the actual sum that the assessees put into their pocket and that it does not matter in the least that the sum which the assessees seek to deduct is the sum which had to be paid for a penalty imposed on account of an infraction of the law. The Master of the Rolls observed at page 238—

> "This business could perfectly well be carried on without any infraction of the law at all. 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 the case of *Strong* v. *Woodifield* (1), appeared to Lord Davey to be, a disbursement or expense which was laid out or expended for the purpose of such trade, manufacture, adventure or concern; nor does it seem to me, though this is rather more questionable, to be a sum paid on account of a loss connected with or arising out of such trade, manufacture, adventure or concern."

Indeed, the case was decided largely on the basis that a breach of law was committed and for that breach the Company was fined and that did not seem to be a loss connected with the business nor could it be regarded to be money wholly and exclusively laid out or expended for the purposes of the trade.

(1) 5 T.C. 215.

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Scrutton, L.J., was inclined to think, though he did not wish to finally decide it, that the Income-tax Act should be confined to lawful businesses and to business carried out in a lawful way. This observation of the learned Lord Justice was not accepted by the Privy Council in *Minister of Finance* v. *Smith* (1), where it was held that profit arising within Ontario from illicit traffic in liquor there carried on contrary to legislative provision of the Province was "income" as defined by section 3, sub-section (1) of the (Dominion) Income War Tax Act, 1917, and was liable to taxation under that Act. The present question, however, did not arise in that case. In the Principles of Income Taxation by Hannan and Farnsworth (1952 Edition), after referring to various English cases including *Von Glehn's case*, the learned authors have expressed the following views :—

> "The *ratio decidendi* in the above cases seems to indicate a distinction between the nature of the penalties considered by the Courts and of penalties paid by persons whose businesses are wholly illegal, e.g., unlicensed book-making. In the latter the acts which constitute the carrying on of the business, and by which the income of the business is gained, are the very acts which are punishable under the law. The risk of the penalties is inseverable from the gaining of the income. Save perhaps in the anomalous case of a bookmaker, it seems doubtful whether fines, imposed as a result of an infraction of the law would ever be regarded as proper deductions no matter what the nature of the business."

(1) 1927 A.C. 193.

The result of this discussion is that although gains and profits of a business which is carried on in contravention of law are taxable, it has not been settled by any authoritative decision so far as to what extent the expenses incurred in connection with the carrying on of that business can be claimed as legitimate deductions under the Income-tax law. However, so far as section 10(2) (xv) is concerned, the assessee in order to claim the benefit of that provision must establish that the expenditure incurred was laid out or expended wholly and exclusively for the purpose of such business. The preponderance of authority is—although the questions involved were of fines and penalties paid or amounts paid in lieu of confiscation or by way of composition in actions brought for infringement of law—that these amounts could not be allowed as deductions on the ground of expenses laid out for the purposes of the business. The true position appears to be that where the expenses which are claimed as deductions have a direct and proximate connection with an act which is an infringement of law or is a contravention of it, they have not been allowed or regarded as deductions which can be granted under the Income-tax law. With respect, the opinion expressed by Chagla C.J., in *Commissioner of Income-tax* v. *Haji Aziz and Abdul Sakoor Bros.* (1), that if an assessee spends money in order to carry out the business unlawfully, he cannot be held entitled to deduction under section 10(2) (xv), represents the correct statement of law on the point. There is force in the contention of the learned counsel for the Commissioner that the amount of Rs. 6,800 which is claimed as a deduction under section 10(2) (xv) was paid clearly to achieve what was prohibited by law, namely, to export wool without having the

(1) 28 I.T.R. 266.

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requisite quota in contravention of paragraph 3 of the Exports (Control) Order.

The learned counsel for the assessee has sought to reopen the question whether the sales to S.B. and Company in India and the transactions of repurchase from that Company were genuine or not. That cannot be allowed because the position taken up before the Tribunal by the assessee was based on the footing that the finding given by the Income-tax Officer and the Appellate Assistant Commissioner was not open to challenge.

As regards the claim of the assessee that the amount in question should have been allowed as a deduction under section 10(1), the view of the Tribunal appears to be correct. The Tribunal observed that even if the profits were to be computed in accordance with the accepted principles of Commercial Accountancy still if the law as laid down in the Bombay case, referred to before, was correct, then it followed that amounts which could be considered as proper outgoings and which could be set off against gross receipts must be of the same nature as the expenditure falling under section 10(2)(xv). If that were not so, a strange position would arise in that what was not admissible under section 10(2)(xv) would be an admissible outgoing in arriving at the profits within the meaning of section 10(1). Profits had to be ascertained according to the accepted principles of Commercial Accountancy and if section 10(2)(xv) did not permit deduction of an item of expenditure which was laid out or expended for carrying on the business in contravention of the law, then such an outgoing, though otherwise properly admissible as set off against the gross receipts on the principles of Commercial Accountancy, could not be taken into consideration in computing the

profits. The learned counsel for the assessee has not been able to assail this view either on principle or authority.

In the result, we would answer the question referred to us in the negative.

In view of the nature of the points involved, the parties will be left to bear their own costs in this Court.

MEHAR SINGH, J.—I agree.

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CIVIL MISCELLANEOUS

Before G. D. Khosla, C.J., and S. S. Dulat, J.

P. C. WADHWA,—*Petitioner*

versus

UNION OF INDIA AND ANOTHER,—*Respondents.*

Civil Writ No. 752 of 1959.

Indian Police Service (Recruitment) Rules, 1954—Rule 4—Indian Police Service (Cadre) Rules, 1954 and Indian Police Service (Fixation of Cadre Strength) Regulations, 1955—Effect of—Constitution of India (1950)—Article 311—All India Services (Discipline and Appeal) Rules, 1955—Rule 3—Reversion from a higher officiating post to substantive junior post—Whether amounts to reduction in rank.

Held, that what follows from the Indian Police Service (Recruitment) Rules, 1954, Indian Police Service (Cadre) Rules, 1954 and Indian Police Service (Fixation of Cadre Strength) Regulations, 1955, is that only a cadre officer can be posted to a cadre post which means that a member of the Indian Police Service only is eligible for appointment to a post in the senior scale. It does not, however, follow that every officer of the Indian Police Service is entitled, as of right, to be appointed to a cadre post. Persons recruited to the Indian Police Service are given, in the original instance, a post in the junior scale.

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