Commissioner of Income-Tax, Gujarat

Vs

S. C. Kothari.

Civil Appeals Nos. 1993 of 1968 and 1173 of 1971

(K. S. Hegde, A. N. Grover JJ)

05.10.1971

JUDGMENT

GROVER J. -

This is an appeal from a judgment of the Gujarat High Court. Originally an appeal (C. A. No. 1993/68) had been brought by certificate but that certificate was found to be defective as no reasons were stated therein for granting it. A petition for special leave was, therefore, filed and the same has been granted. Both the appeals shall stand disposed of by this judgment. The assessee is a registered firm and carried on the business of commission agency and general merchants. It also does forward business. It is a member of the Saurashtra Oil and Oilseeds Association Ltd., Rajkot. During the assessment year 1958-59 the corresponding accounting period being the Samvat year 2013, the assessee claimed to have incurred a loss of Rs. 3,40,443 in certain transactions entered into with different people for the supply of groundnut oil. The transactions, according to the assessee, were non-transferable ready delivery contracts entered into with non-members of the Association. It was expected that these contracts could be performed but owing to certain reasons some of the contracts could not be performed and the differences had to be paid. According to the assessee it had acted as a pucca artia. The assessee claimed that the aforesaid loss was allowable under section 10(1) of the Income-tax Act, 1922, as a deduction against its other business income. The Income-tax Officer came to the conclusion that the transactions in question were hit by the provisions of the Forward Contracts Regulation Act, 1952, hereinafter called the "Act", and the Rules and Regulation of the Saurashtra Oil and Oilseeds Association Ltd. In particular the transactions were hit by the provisions of sub- sections (1) and (4) of section 15 of the Act and were not saved by section 18. The losses were held to have been incurred in illegal transactions. He rejected the contention of the assessee that even on the assumption that the losses were incurred in illegal transactions they could be allowed in the computation of the income The Income-tax Officer further held that the losses incurred in illegal business could not be deducted from the speculative profits under section 24 of the Indian Income-tax Act, 1922, hereinafter called "the Act of 1922". The Appellate Assistant Commissioner confirmed the order of the Income-tax Officer. In the appeal before the Tribunal it was held that the transactions in question were not illegal contracts but were contracts which had been validly entered into under the Act and the bye-laws etc. The Tribunal, thereafter, proceeded to examine the question whether the losses incurred could be allowed on the assumption that the transactions were illegal. It was of the view that the assessee would be entitled to a set off under section 24 even if the losses were incurred in illegal transactions. The Tribunal remanded the matter for a report from the Appellate Assistant Commissioner as to the applicability of the proviso to section 24(1) (read with the Explanation) of the Act of 1922. After the remand report was received the Tribunal gave the following two findings : (1) that the contracts under consideration were all non-transferable specific delivery contracts where the intention ab initio was either to give or take

delivery, (2) the contracts were entered into either for the purchase or sale, and (3) later on the same quantity was either sold or purchased back by the assessee on behalf of the same constituents at the market rates prevailing at the material time, i.e., they were squared up by corresponding sales or purchases as the case might be. After referring to certain decisions of High Court the tribunal held that the loss of Rs. 3,40,443 had been incurred in speculative transactions. The Tribunal next proceeded to consider whether, notwithstanding that the losses had been incurred in speculative transactions the assessee could set off those against the other income under section 10(1) of the Act of 1922. Purporting to follow the view of the majority of the High Courts, the Tribunal held that such a loss could not be set off against the other income. But, according to the Tribunal, the assessee was certainly entitled to set off the loss against the profits in speculative transactions and to that extent the contention of the assessee was accepted. Both the assessee and the Commissioner of Income-tax moved the Tribunal for submitting a case and referring certain questions of law to the high Court. Thus in all the following four questions were referred by the Tribunal :

> "(1) Whether, on the facts and in the circumstances of the case, the contracts in respect of which the loss of Rs. 3,40,443 was claimed were illegal contracts and were not validly entered into under the Forward Contracts (Regulation) Act, 1952 ?
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> (2) Whether even assuming that the transactions in which the loss of Rs. 3,40,443 was incurred were illegal transactions, the assessee would be entitled to the set off of the said loss ?
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> (3) Whether, on the facts and in the circumstances of the case, the transactions resulting in a loss of Rs. 3,40,443 were speculative transactions for the purpose of section 24 of the Indian Income-tax Act, 1922, merely on the ground that the assessee had not performed the contracts by giving delivery and had paid damages in settlement of the obligations contracted for ?
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> (4) Whether, on the facts and in the circumstances of the case, the assessee is entitled to set off the balance of the loss of Rs. 1,21,397 against the assessee's other income ?"

The High Court did not consider that it was necessary to answer the first question. The answer to the second question was that even though the disputed contracts were not validly entered into in accordance with the provisions of section 15(4) of the Act the loss of Rs. 3,40,443 was liable to be taken into account in computing the business income of the assessee under section 10 of the Act of 1922 and the assessee was entitled to set it off against the profits from other speculative transactions. The third question was answered in the affirmative with the result that the transactions resulting in the loss of Rs. 3,40,443 were held to be speculative for the purpose of section 24 of the Act of 1922. The fourth question was answered in the negative and against the assessee. It is the Commissioner of Income- tax alone who has appealed.

So far as the first question is concerned we are unable to comprehend why the High Court did not decide it. A lot of debate took place before us on the question whether the contravention of section 15(4) of the Act would render the contracts illegal. According to that provision no member of a recognised association shall, in respect of any goods specified in the notification under sub-section (1) enter into any contract on his own account with any person other than a member of the recognised Association unless he has secured the consent or authority of such person and disclosed in the note, memorandum or agreement of sale or purchase that he has bought or sold the goods as

the case may be on his own account. It is not necessary to refer to the proviso. It is common ground and has been admitted before us that there was a clear contravention of the provisions of section 15(4) so far as the transactions in question were concerned. According to section 20(a) any person who enters into any contract in contravention of the provisions of section 15(4) among other sections shall, on conviction, be punishable for the first offence with imprisonment which may extend to one year or with fine of not less than Rs. 1,000 or with both. It is wholly incomprehensible how such a contract would not fall directly within the ambit of the first part of section 23 of the Indian contract Act which deals with consideration or object of an agreement which is forbidden by law. Such consideration or object would be unlawful according to the provisions of that section and the agreement would consequently be void. The High Court did not decide the point whether the contracts which contravened the provisions of section 15(4) of the Act were illegal. It did not consider it material to decide whether the impugned contracts were illegal. In its opinion what was material was that the impugned contracts had been entered into unlawfully and the question was whether the loss sustained in the unlawful business could be taken into account in computing the business income of the assessee. We consider that the first question which was referred to the High Court stands concluded by the law laid down by this court in Sunder Lal & Son v. Bharat Handicrafts P. Ltd. It was laid down that the prohibition imposed by section 15(4) of the Act was not imposed in the interest of revenue. That provision was conceived in the larger interest of the public to protect them against the malpractices indulged in by members of recognised associations in respect of transactions in which their duties as agents came into conflict with their personal interest. Parliament had made a writing, evidencing or confirming the consent or authority of a non-member, as a condition of the contract if the member had entered into a contract on his own account. So long as there was no writing as was contemplated by section 15(4) or its proviso there was no enforceable contract.

It is well settled that contracts which are prohibited by statute, the prohibition being either express or implied, would be illegal and unenforceable if they are entered into in contravention of the statute. Under the provisions of the Act there is not only an express prohibition [section 15(4)] but punishment is also provided for contravention of that prohibition, (section 20). Such contracts could not possibly be regarded as having been validly entered into under the Act. The answer to the first question, therefore, should have been in the affirmative and against the assessee.

Coming to the second question, the language thereof is somewhat ambiguous and the question was not framed properly. It appears that there were two aspects which had come up for consideration before the departmental authorities, the Tribunal and the High Court. The first aspect related to the deduction of the loss of Rs. 3,40,443 incurred in the aforesaid illegal transactions while computing the profits of the assessee's speculative business under section 10(1). The other was the set off which can be allowed within the relevant parts of section 24 of the Act of 1922. The High Court referred to various English decisions as also to Wheatcroft's Law of Income Tax and Simon's Income Tax for supporting the view that even where a trade is illegal it would still be a trade within the meaning of the income-tax law and if any profits are derived from such trade they would be assessable to tax. The High Court did not accept the contention urged on behalf of the revenue that although profits from an illegal trade of business would be exigible to tax the losses from such business could not be taken into account while computing the profits. This is what the High Court observed :

> "There is in principle no distinction between profits and losses of a business and if the profits of an illegal business are assessable to tax equally the losses arising from illegal business must be held to be liable to be taken into account in computing the income of the assessee."

The High Court was not inclined to accede to the submission on behalf of the revenue that the same principle would be applicable as has been applied in certain cases in which the question which came up for determination was whether an expenditure incurred on an illegal activity would be deductible under section 10(2) (xv) of the Act of 1922. One of such cases is a decision of the Punjab High Court in Raj Woollen Industries v. Commissioner of Income-tax. In that case the real question was whether a certain amount which was paid to achiever what was prohibited by law, viz., the export of wool without having the requisite export licence, was an amount which the assessee was entitled to deduct under section 10(2) (xv) of the Act of 1922. It was held that according to principle and authority such deduction could not be claimed. It was also observed that such a deduction could not be permissible even under section 10(1). The following observations may be referred to :

> "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 of expended for carrying on the business in contravention of the law, then such an outgoing though otherwise properly admissible, as set of against the gross receipts on the principles of commercial accountancy could not be taken into consideration in computing the profits."

On the other hand according to the decision of a Full Bench of the Allahabad High Court in Chandrika Prasad Ram Swarup v. Commissioner of Income-tax income assessable to tax is the actual income of an individual or a firm irrespective of the manner in which the income was derived Legality or illegality of the transaction culminating in profits or losses was therefore, foreign to the scope of an inquiry into the income of an individual or a firm for the purpose of income- tax.

Now while section 10(1) of the Act of 1922 impose a charge on the profits or gains of a business it does not provide how these profits are to be computed. Section 10(2) enumerates various items which are admissible as deductions. They are, however, not exhaustive of all allowances which can be made in ascertaining the profits of a business taxable under section 10(1). It is undoubtedly true that profits and gains which are liable to be taxed under section 10(1) are what are understood to be such under ordinary commercial principles. The loss for which the deduction is claimed must be one that springs directly from the carrying on of the business and is incidental to it. If this is established the deduction must be allowed provided that there is no provision against the express or implied, in the Act (See Badridas Daga v. Commissioner of Income-tax). In that case loss sustained by the business by reason of embezzlement by an employee was held to be and admissible deduction under section 10(1) although it did not fall within section 10(2) (xi) of the Act of 1922. Indeed profits cannot be computed without deducting the loss and permissible expenses incurred for the purpose of the business.

The approach of the High Court in the present case, has been that in order to arrive at the figure of profits even of an illegal business the loss must be deducted if it has actually been incurred in the carrying on of that business. It is the net profit after deducing the out goings that can be brought to tax. It certainly seems to have been held and that view has not been shown to be incorrect that so far as the admissible deductions under section 10(2) are concerned they cannot be claimed by the assessee if such expenses have been incurred in either payment of a penalty for infraction of law or the execution of some illegal activity. This, however, is based on the principle that an expenditure is not deductible unless it is a commercial loss in trade and a penalty imposed for breach of the law during the course of the trade cannot be described as such. Penalties which are incurred for infraction of the law are no a normal incident of business and they fall on the assessee in some character other than that of a trader; (See Haji Aziz & Abdul Shakoor Bros. v. Commissioner of

Income-tax). In that case this court said quite clearly that a disbursement is deductible only if it falls within section 10(2) (xv) of the Act of 1922, and a penalty cannot be regarded as an expenditure wholly and exclusively laid for the purpose of the business. Moreover, disbursement or expenses of a trader is something "which comes out of his pocket. A loss is something different. That is not a thing which he expends or disperses. That is a thing which comes upon him ab extra" (Finlay J. in Allen v. Farquharson Brothers & Co.). If the business is illegal neither the profits earned nor the losses incurred would be enforceable in law. But, that does not take the profits out of the taxing statute. Similarly, the taint of illegality of the business cannot detract from the losses being taken into account for computation of the amount which can be subjected to tax as "profits" under section 10(1) of the Act of 1922. The tax collector cannot be heard to say that he will bring the gross receipts to tax. He can only tax profits of a trade or business. That cannot be done without deducting the losses and the legitimate expenses of the business. We concur in the view of the High Court that for the purpose of section 10(1) the losses which have actually been incurred in carrying on a particular illegal business must be deducted before the true figure relating to profits which have to be brought to tax can be computed or determined. This will, however, not conclude the answer to question No. 2 because it seems to have been framed with the other aspect relating to "set-off" under section 24 of the Act.

The High Court found that the transactions were of a speculative nature. It was thus held that the loss of Rs. 3,40,443 sustained in the impugned contracts was liable to be set off against the profit of Rs. 2,19,046 which was admittedly a profit from speculative transactions. The concluding portion of the judgment of the High Court may be reproduced because, to our mind, it creates a certain amount of difficulty :

> "The loss of Rs. 3,40,443 sustained in the impugned contracts was, therefore, liable to be set off only against the profit of Rs. 2,19,046 which was admittedly profit from speculative transactions and the balance of Rs. 1,21,397 after such set off was not liable to be set off against the other income of the assessee in view of the first proviso to section 24(1). We may make it clear that in taking this view we have proceeded upon the basis that the impugned contracts which resulted in the loss of Rs. 3,40,443 constituted a separate business distinct from the business of forward contracts resulting in the profit of Rs. 2,19,046. The result would, however, be the same even if the impugned contracts which resulted in the loss of Rs. 3,40,443 did not constitute a separate business but were part of the same business of forward contract which resulted in the profit of Rs. 2,19,046 for in that event the loss of Rs. 3,40,443 would be liable to be taken into account in determining the profits from such business under section 10."

Section 24, to the extent it is material for our purposes, is set out below :

> "Set off of loss in computing aggregate income. - (1) Where any assessee sustains a loss of profits or gains in any year under any of the heads mentioned in section 6, he shall be entitled to have the amount of the loss set off against his income, profits or gains under any other head in that year :

Provided that in computing the profits and gains chargeable under the head 'profits and gains of business, profession or vocation', any loss sustained in speculative transactions which are in the nature of a business shall not be taken into account except to the extent of the amount of profits and gains, if any, in any other business consisting of speculative transactions.

> Explanation 1. - Where the speculative transactions carried on are of such a nature as to constitute a business, the business shall be deemed to be distinct and separate from any other business.
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> Explanation 2. - A speculative transaction means a transaction in which a contract for purchase and sale of any commodity including stocks and shares is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips."

In order to claim the set-off, the meaning of speculative transaction has to be first looked at. Under Explanation 2 such a transaction means a transaction in which a contract for the purchase and sale of any commodity is periodically or ultimately settled otherwise than by actual delivery, etc. Now the contract has to be an enforceable contract and not an enforceable one by reason of any taking of illegality resulting in its invalidity. It has already been found by us that the contracts in question were illegal and unenforceable on account of contravention of section 15(4) of the Act. The high Court was in error in considering that any set-off could be allowed in the present case under the first proviso to section 24(1) which must be read with Explanation 2.

There would have been no difficulty in disposing of the matter finally after the above discussion. But enough attention was not devoted to the business which the assessee was doing and in which the profit of Rs. 2,19,046 was made and the loss of Rs. 3,40,443 was sustained. It has been found to be of a speculative nature but the High Court has not clearly found that it was the same business in which the amount of the profit and the loss mentioned above was earned and sustained in which case alone a deduction will be possible of the loss under section 10(1). The High Court proceeded on the basis that if the business in which the profit was made and the business in which the loss was incurred were separate a set off could be claimed by the assessee under section 24(1). If, however, the business was the same then the loss would be liable to be taken into account while computing the profits under section 10(1). As we have come to the conclusion that no set-off could be allowed under section 24(1) of the Act of 1922, it will have to be determined whether the profits and losses were incurred in the same business even though that business involved the entering into contracts some of which were, in the eye of the law, illegal. If the trade or the business, for instance, the business of commission agency or forward business, was the same in which the profits were made and the loss was incurred, then in order to arrive at the figure which can be subjected to tax, the loss will have to be deducted from the profit. For this purpose we shall have to remit the matter to the high Court to decide this point and if necessary after calling for a supplementary statement of the case.

In the result our answer to the first question is that the contracts were illegal; on the third and the fourth questions there is not dispute nor has any appeal been preferred by the assessee relating to them that the answers returned by the high Court in the affirmative and in the negative, respectively, were not correctly answered. As regards question No. 2, the High Court will have to answer the same in the light of our judgment. The appeal by special leave (i.e. C. A. No. 1773 of 1971) shall stand disposed of accordingly and the other appeal by certificate (i.e. C. A. No. 1993 of 1968) is hereby dismissed. There will be no order as to costs.

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