

ALLAHABAD HIGH COURT

Saraya Sugar Mills Gorakhpur

Vs.

I.-T. Commr.

Income-tax Reference No. 309 of 1974

(Satish Chandra C.J., K.C. Agrawal and R.M. Sahai, JJ.)

11.05.1978

JUDGEMENT

Satish Chandra, C.J.

1. One of the questions which arose in this reference was whether interest paid on arrears of sugarcane purchase tax was an allowable deduction. At the hearing of this reference learned counsel for the assessee placed reliance on *M/s. Kamlapat Moti Lal v. Commr. of Income-tax*,¹ in support of his submission that interest so paid was a deductible expenditure.

2. The Bench hearing this reference felt that *M/s. Kamlapat Moti Lal*'s case (1975 Tax LR 1036) (All) requires reconsideration. It hence referred the case to a Full Bench. That is how the matter has come up before us.

3. In *Kamlapat*'s case (1975 Tax LR 1036) this Court laid down two main propositions.-

(1) The U. P. Sugarcane Purchase Tax Act did not call interest as penalty. It made provision for interest as well as penalty separately, and it also made independent provisions for their recovery. Interest was not penalty. In carrying on a business an assessee may not be able to discharge his financial commitments in time, and as a result may become liable to pay damages or interest. Such a situation is a normal incident of business, and any loss incurred by an assessee under such circumstances is deductible under Section 37 (1).

(2) Payment of purchase tax was a statutory exaction and so was interest payable thereon. If the principal (i. e., purchase tax) is a permissible

deduction, the interest payable thereon would also be equally permissible, because principal and interest together constitute the assessee's liability, and so interest like the principal, represented a loss incidental to the carrying on the business and deductible while computing the assessable profits under Section 28 (1).

4. The first question which requires consideration is as to the true nature and character of interest and penalty chargeable under the U. P. Sugarcane (Purchase Tax) Act, 1961.

5. Section 3 of the U. P. Sugarcane (Purchase Tax) Act, 1961, imposes on every sugar factory a tax on the purchase of sugarcane at the prescribed rates. Under sub section (2) of Section 3 the tax is payable on such dates and at such place and in such installments as may be prescribed. Sub-section (3) provides –

"(3) Any tax payable under this Act, if not paid by the date prescribed for payment thereof, shall carry interest at the rate of six per cent from such date till the date of payment".

6. U. P. Act No. 1 of 1971, which came into force on 11-8-1970 raised the rate of interest to twelve per cent. Sub-section (4) provides for levy of penalty, if the tax or the interest payable under the Act remains unpaid for a period exceeding fifteen days beyond the prescribed date, at prescribed rates.

7. Section 8 provides for imprisonment up to one year or with fine which may extend to five thousand rupees or with both on conviction of a person for, inter alia, contravening any provision of the Act or the rules.

8. Under Section 9 a court of Magistrate of first class alone is competent to try an offence punishable under that Act. To these proceedings the Criminal P. C., 1898 has been made applicable - vide Section 9 (3).

9. Under Rule 8 (1) of the rules framed under this Act interest is payable on the first day of the month next following the month in respect of which such interest is due. Rule 8 (2) provides that where any tax or interest payable under the Act remains unpaid for period exceeding fifteen days beyond the date mentioned in Rule 4 or sub rule (1), as the case may be, for the payment thereof, the owner of

the factory shall, in addition to the amount due as tax and interest thereon, pay a penalty, which, for the first two months, shall be calculated at the rate of one per cent, for the next two months at the rate of four per cent, and for the further two months at the rate of six per cent on the total sums payable. Thereafter penalty at a higher rate, not exceeding ten per cent, as may be fixed by the assessing officer, shall be payable by the owner of the factory in addition to the arrears of tax and interest. The Act and the rules make identical provisions for recovery of interest as well as penalty. Both are recoverable as arrears of land revenue.

10. It will be seen that accrual of interest as well as penalty is automatic, depending on the extent of the delay. If the delay is of more than six months, the assessing officer has to pass an order levying further penalty.

11. Section 3 (2) provides for payment of the purchase tax on prescribed dates. Interest as well as penalty is charged for breach thereof, by delaying payment. The charge for delay for the first fifteen days is called interest, while for the subsequent periods it is described as penalty. Interest as well as penalty for delay up to six months is chargeable automatically.

12. It is true that the Legislature calls the payment for delay up to 15 days as interest, while for the subsequent period as penalty. It is also true that different sub-sections provide for recovery of interest and penalty, though in the same manner, namely, as arrears of land revenue. But would that make the true nature and character of the two imposts different?

13. The Supreme Court in *Commr. of Income-tax v. Bhikaji Dadabhai and Co.*,² held –

"This Court regarded penalty as an additional tax imposed upon a person in view of his dishonest or contumacious conduct. It is true that under the Hyderabad Income-tax Act, distinct provisions are made for recovery of tax due and penalty, but that in our judgment does not alter the true character of penalty imposed under the two Acts."

The description or label put on an impost is not decisive of its true character. The correct test appears to be to find its object and impact.

14. In *Kamlapat Moti Lal* (1975 Tax LR 1036) (All), the Bench proceeded on the view that penalty is penal in nature. while interest is not. Penalty may not be a deductible expense, but the same is not true of interest.

15. The question then arises whether penalty imposed under such circumstances has any penal element. This aspect came up for consideration before a Full Bench of this Court in *Ragunandan Prasad Mohan Lal v. Income-tax Appellate Tribunal* ³

16. Gulati, J. (T. P. Mukherjee, J., concurring) held that Article 20 affords protection against conviction and punishment for an offence by a court of law. Penalties are imposed by the income-tax authorities and cannot be regarded as punishment awarded on conviction for an offence.

17. I elaborated the matter a little more, and observed (at p. 635 of AIR All) -

"It is well known that the legislature can impose both a criminal as well as a civil sanction for the same act or omission. In *Helvering v. Mitchell* ⁴ it was held that civil sanctions are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from tax-payer's fraud. Similarly, Jackson, J. said in *Spies v. United States* ⁵ that the civil sanction consists of additions to the tax upon determination of facts made by an administrative agency and with no burden on the Government to prove its case beyond a reasonable doubt whereas criminal sanction consists of penal offences enforced by the criminal process in the familiar manner. Invocation of one does not exclude resort to the other. Relying upon these decisions, the Kerala High Court in *P. Ummali Umma's* case ((1967) 64 ITR 669) held that the object of the penalty proceedings was to render evasion unprofitable and to secure to the State compensation for damages caused by attempted evasion.

Chapter XXI of the 1961 Act deals with penalty. A separate Chapter No. XXII provides for offences and prosecutions, Penalty is imposed by the revenue authorities. Prosecution for the offences has to be launched, in view of Section 292, in the regular criminal court, which alone can convict and sentence. The authorities impose penalty if they are satisfied

that a default has been committed. The revenue does not have to prove its case beyond all reasonable doubt. In prosecution Chapter XXII the revenue will have to prove its case beyond all reasonable doubt, because that is a fundamental principle prevailing in the criminal courts. All these features indicate that prosecutions under Chapter XXII are criminal proceedings, but penalty proceedings constitute a civil sanction. They are revenue in nature, to which Article 20 of the Constitution does not apply."

18. Penalty is a civil sanction. So is interest. The object of both is to render evasion or infraction of the law unprofitable, and to secure to the State compensation for damages caused by attempted evasion. Prosecution resulting in fine and/or imprisonment is a criminal sanction.

19. The Sugarcane (Purchase Tax) Act makes provision for interest, penalty as well as prosecution. In the premises, it is evident that both interest and penalty are civil sanctions of the same nature and character, provided to deter delay in payment of tax in violation or infraction of the law, and to compensate the Government for damages so caused.

20. In *Haji Aziz and Abdul Shakoor Bros. v. Commr. of Income-tax*,⁶ the Supreme Court held that fine paid for contravention of the Sea Customs Act was paid by way of penalty for breach of law and such an expense could not be said to be an amount wholly and exclusively laid out for the purpose of the business of the assessee within meaning of Section 10 (2) (xv) of the Income-tax Act, 1922. The Supreme Court observed (at P. 668 of AIR SC) –

"Infraction of the law is not a normal incident of business and, therefore, only such disbursements can be deducted as are really incidental to the business itself. They cannot be deducted if they fall on the assessee in some character other than a trader. Therefore, where a penalty is incurred for the contravention of any specific statutory provision, it cannot be said to be a commercial loss falling on the assessee as a trader....."

21. The position would, in my opinion, be no different in the case of interest which is also a civil sanction payable for breach of the law. As a trader it was the duty of the assessee to pay the statutory demands on time. If he does not do

so, the payment of interest as well as penalty is in a character other than that of a trader.

22. In *Commr. of Income-tax v. Mahalaxmi Sugar Mills Ltd.*,⁷ (Delhi) the Delhi High Court held that interest paid on arrears of sugarcane cess was not a permissible deduction, as there was no distinction between interest and penalty.

23. In *Mahabir Sugar Mills (P.) Ltd. v. Commr. of Income-tax*,⁸ a Bench of this Court held that penalty under the U. P. Sugarcane Cess Act was imposed for failure to pay cess within the time prescribed by sub section (2) of Section 3 of the Cess Act. It was payable for breach of law.

24. In *J. K. Cotton Spinning and Weaving Co. Ltd. v. Commr. of Income-tax*⁹ and In *Gabdulal Tulsiram, In re 21 ITR 330 : (1952 All LJ 167)* this Court held that the amounts paid for compounding criminal proceedings were not allowable deductions under Section 10 (2) (xv). It will be seen that in these cases penalty was not levied. The assessee incurred the expenditure for compounding the offence. The ratio of this decision is that an expenditure caused because of violation or infraction of the law is not allowable.

25. Expenditure incurred for paying damages for breach of contract has been disallowed on the finding that the assessee had acted with palpable dishonesty and the award of damages was not incidental to the trade carried on by it. See *Mask and Co. v. Commr. of Income-tax*,¹⁰

26. *Senthikumara Nadar and Sons v. Commr. of Income-tax*¹¹ is a case where, though the amount paid was described as liquidated damages, it was held that the payment was really akin to a penalty for committing an act opposed to public policy, an act which was found not to have been done in the course of the normal trading activities of the assessee.

27. Let us now turn to a different set of authorities, where payment of penalty or liquidated damages or even compounding fee have been held an allowable expense.

28. In *Central Trading Agency v. Commr. of Income-tax*¹² the assessee entered into a contract with the Government for supply of 100 tons of dehydrated

Onions by December 31, 1943. The contract contained a clause stipulating that, in the event of the assessee failing to deliver supplies in accordance with the terms of the contract, it would be liable to a penalty of two annas per pound on the quantity which it failed to deliver by the due date. As the assessee defaulted, the Government cancelled the contract and imposed a penalty at the rate of one anna per pound on the undelivered quantity. On the application of the assessee the Government extended the date of delivery of the supplies to August 31, 1944, upon condition that the assessee paid liquidated damages at two per cent. The assessee accepted the terms and paid damages totalling Rs. 17,240/-. A Bench of this Court held that the amount was paid by the assessee for the purpose of keeping the contract alive and was, inter alia, a payment made for the purpose of enabling the assessee to completely execute the contract. It was not a payment made as damages for breach of contract. Had the Government maintained its original order cancelling the contract and imposing penalty, it may have been possible to contend that the payment was made on account of breach of contract. But, in reality, the payment was in fulfilment of the condition agreed to between the parties, enabling the assessee to fulfil the contract and earn profits therefrom. The payment was made by the assessee as a trader for the purpose of enabling him to carry on and earn profits in the trade. The Bench observed that there could be little doubt that the payment was made by the assessee on the ground of commercial expediency.

29. The distinguishing feature of this case is that it was held that the expense was incurred as a trader in order to carry on the business and earn profits, and not for breach of contract.

30. The decision of the Bombay High Court in *Commr. of Income-tax v. Parmalal Narottamdas and Co.*,¹³ is another case in this category. There in the course of its business the assessee purchased bills of lading and other shipping documents from certain parties in respect of some consignment of goods imported by them from a foreign country. When the goods arrived in India and were sought to be cleared through customs by the assessee on the basis of the documents purchased by it, it was found that the imports were unauthorised and the goods were liable to be confiscated and a penalty was liable to be imposed under the Sea Customs Act. The assessee paid an amount of Rs. 31,302/- as and by way of penalty for saving the goods from being confiscated. The Trifunal

found that the assessee had purchased the documents of title in good faith and for consideration and it had to pay the penalties in order not to lose the goods which had become its property, and so the penalty amount became part of the costs of the goods imported by it.

The High Court held that on the findings the actual cost of the goods was not only what the assessee had paid to the importers but, in addition thereto what it had to pay by way of penalty in order to save the goods from being confiscated and lost to it. The penalty paid could, therefore, be regarded as part of the costs of the goods to it. It could also be regarded as an amount expended by it wholly and exclusively for purposes of business because unless the said amount was expended the goods could not have been saved from confiscation. It was observed that this was not a case where a penalty had to be incurred because of the fault of the assessee himself, or, for instance, for the reason of his having carried on the business in an unlawful manner or in contravention of certain rules and regulations.

31. In *Govind Choudhury and Sons v. Commr. of Income-tax*¹³ the facts were that the assessee carried on business, inter alia, in paddy. It entered into a contract with the Government for supplying paddy of particular specification. In the course of the execution of the contract the assessee supplied paddy which was slightly inferior in quality. The authorities levied penalty which was deducted from the amount payable to the assessee. The Orissa High Court held that this loss arising out of the imposition of penalty was integrally connected with the carrying on of the business of paddy supply. The action of the assessee was not one contrary to law, but was in violation of the terms of agreement under which the business was carried on. It was held that the amount of penalty was deductible as a business loss under Section 10 (1) of the Income-tax Act, 1922.

32. In substance the basis of this decision appears to be that the assessee did not consciously violate any law. He acted in good faith and incurred loss while carrying on his business in order to earn profits. The expenditure was incurred in his character as a trader.

33. This question has been discussed, by the Patna High Court in *Lakshmi Narayan Gouri Shankar v. Commr. of Income-tax*¹⁴ In that case the assessee

obtained a provisional licence to import artificial silk yarn. The provisional license was, however, not confirmed. One Sri Kalyanam, claiming himself to have influence in the Ministry of Finance, got the licence of the assessee duly confirmed. On its basis the assessee imported the goods. Subsequently the Customs authorities found that the licence was invalid, being a forged one. Sri Kalyanam was prosecuted and sentenced to imprisonment. The assessee was, however, let off only with penalty. The Customs authorities confiscated the goods, the assessee being given an option under Section 183 of the Sea Customs Act to pay the penalty. The assessee paid a sum of Rs. 11,02,500/- as penalty for the release of the confiscated goods and also a personal penalty of Rs. 84,200/-. The assessee claimed these two amounts as deduction. The Tribunal held on an appraisal of all the materials on the record that the cumulative effect of all the circumstances led to the irresistible conclusion that the imports made by the assessee were not so made in good faith. The Patna High Court held that these amounts were not allowable deductions. In the course of the Judgment, S. K. Jha, J. (N. L. Untwalia, C. J., concurring) illustrated the distinction –

"Suppose a dealer in mustard oil agrees to supply pure mustard oil to an institution Y at the rate of, say Rs. 10/- per kilogram. He purchased mustard oil in the market thinking it to be pure mustard oil at Rs. 9/- per kilogram. The mustard oil supplied to Y is found to be adulterated. For breach of warranty of the quality, the dealer gets Rs. 8/- per kilogram. Then the loss of Re. 1/- per kilogram is a business loss. But if for selling adulterated mustard oil he is prosecuted and a penalty is imposed in respect of the very same transaction or his goods are seized and later on released on compounding then the loss resulting therefrom is not a business loss but arises as a result of the infraction of law by the dealer. In the same transaction is involved breach of warranty as well as breach of law; but different results follow from the different types of loss."

34. Shortly put, the allowable business expense or loss is one which is incurred in carrying on the trade with a view to earn profits, *bona fide* and in good faith. Carrying on business in an unlawful manner, involving breach or infraction of the law is not carrying it on in good faith or *bona fide*. Any expenditure due to infraction of law by the assessee is not a deductible item.

35. Learned counsel for the assessee placed reliance on *Addl. Commr. of Income-tax v. Arvind Mills Ltd.*¹⁵ In that case the assessee paid a sum of money to cover the short fall in the export of agreed quantity of cloth. It was held by the Gujarat High Court that the payment was to cover the short fall which was contemplated by the parties. It was not in the nature of penalty for infraction of law or violation of public policy. It was a loss connected with and arising out of the trade and was deductible. The case is clearly distinguishable.

36. In *Commr. of Income-tax v. Shri Vijayakuverba Saheb of Morvi*¹⁶ and *Additional Commr. of Income-tax v. Rustam Jehangir Vakil Mills Ltd.*¹⁷ the finding was that the assessee was not guilty of any infraction or breach of law. The first proposition in Kamalapat' s case 1975 Tax LR 1036 (All) is in my view incorrect.

37. The other proposition formulated in Kamalapat Moti Lal' s case (1975 Tax LR 1036) (All) that if the principal amount, namely, the purchase tax, is allowable deduction, interest payable on it will also be allowable, because principal and interest together constitute the business liability of the assessee, seems to proceed on the view that purchase tax as well as interest are similar in origin and impact Purchase tax is payable on the quantity of sugarcane purchased by the assessee for carrying on its business of manufacture of sugar. It is, in a sense, part of the price. But interest is not a compulsory exaction in that sense. It is not imposable on purchase of sugarcane. It is levied because of the contumacious conduct in not paying the purchase tax by the prescribed time. It is payable for breach of law. If a businessman pays the tax in due time, no liability for interest accrues. Interest is no doubt an addition to the tax, but as interest.

38. In *Bhor Industries Ltd. v. Commr. of Income-tax*¹⁸ the Supreme Court considered whether Section 23-A of the Indian Incometax Act, 1922, which required the assessable income to be reduced by the amount of income-tax and super tax, included interest also. The Court held that there was nothing to show that interest was to be treated as tax. It retained its character of interest, though it was recoverable along with the tax.

39. In *P. S. Subramanyam v. Simplex Mills Ltd.* ¹⁹ the Supreme Court held that penal interest chargeable under the Income-tax Act was not a tax payable by the assessee.

40. It is, therefore, not quite correct to say that for the purposes of deductibility, purchase tax as well as interest together constitute the business liability of the assessee. Purchase tax payable by the assessee is no doubt its business liability, but payment of interest is a liability which accrues on infraction of the law, and is hence not incurred in its character as a trader. It is not a loss incidental to business so as to be deductible while computing the assessable profits of the business under Section 28 of the Act. In my opinion the law laid down in *Kamlapat's* case is not sound.

41. On fact the position is that the assessee in the present case paid an amount of Rs. 37,783/- as interest on arrears of cane purchase tax in the assessment year 1964-65 and an amount of Rs. 1,47,524/- in the year 1966-67. It claimed it as a business expenditure. The Income-tax Officer disallowed the claim. He relied upon *Aruna Mills Ltd. v. Commissioner of Income-tax* ²⁰ where interest payable for failure to pay advance tax was held not to be a deductible expense.

42. The appellate Assistant Commissioner as well as the Tribunal affirmed this view point. They held that violation or infringement of a statutory obligation cannot be said to be a direct incident of business being carried on.

43. At the instance of the assessee the Tribunal has referred the following questions of law for our opinion :-

"(1) Where on the facts and in the circumstances of the case, the Tribunal was justified in holding that the interest on arrears of cane purchase tax amounting to Rs. 37,783/- and Rs. 1,47,524/- for the years 1964-65 and 1966-67 respectively are not allowable as business expenditure holding that the payments are penal in nature and accordingly not laid out wholly and exclusively for purposes of the business?

(2) Whether on the facts and in the circumstances of the case, the loss on sale of securities amounting to Rupees 16,181/- and Rs. 3,071/- for the assessment years 1965-66 and 1966-67 were capital loss and hence not allowable as a revenue deduction.

(3) Whether in the facts and circumstances of the case, the Tribunal was justified in holding that the sum of Rs. 3,224/- paid to the Provident Fund Commissioner as interest during 1965-66 is not an admissible deduction under Section 37 (1)."

Only the first and the third questions have been referred to this Full Bench.

44. In my opinion the first question is to be answered in the affirmative, in favor of the Department and against the assessee.

45. In respect of the third question, Section 14-B of the Employees' Provident Funds Act provides –

"Where an employer makes default in the payment of any contribution to the Fund or in the transfer of accumulations required to be transferred by him under sub section (2) of Section 15 or in the payment of any charges payable under any other provision of this Act or of any scheme or under any of the conditions specified under Section 17, the appropriate Government may recover from the employer such damages, not exceeding twenty-five per cent of the amount of arrears, as it may think fit to impose."

The Act goes on to make provision for imposition of penalty for continued delay as well as for prosecution resulting in fine and/or imprisonment. Section 14-B calls the imposition "damages". It stands on the same footing as interest under the Sugarcane (Purchase Tax) Act *qua* penalty. Under Section 14-B the appropriate Government is entitled to recover damages. The Provident Fund Commissioner demanded payment of damages on behalf of the Government. The damages as well as penalty are civil sanctions, as opposed to prosecution resulting in fine or imprisonment, which is a criminal sanction. Damages as well as penalty are intrinsically of the same nature and character.

46. In view of the legal position discussed above, payments made as damages for delay in paying the contribution to the provident fund stands on the same footing as interest payable for non-payment of purchase tax.

The third question is answered in the affirmative, in favour of the Department

and against the assessee.

47-48. Let the papers be laid before the Division Bench with these answers to the two questions referred to the Full Bench.

K.c. Agrawal And R.m. Sahai, JJ. :- We agree.

BY THE COURT

49. At the instance of the assessee the Tribunal referred the following three questions of law for the opinion of this Court :-

(1) Whether on the facts and in the circumstances of the case the Tribunal was justified in holding that the interest on arrears of cane purchase tax amounting to Rs. 37,783/- and Rs. 1,47,524/- for the years 1964-65 and 1966-67 respectively are not allowable as business expenditure holding that the payments are penal in nature and accordingly not laid out wholly and exclusively for purposes of the business ?

(2) Whether on the facts and in the circumstances of the case, the loss on sale of securities amounting to Rs. 16,181/- and Rs. 3,017/- for the assessment years 1965-66 and 1966-67 were capital loss and hence not allowable as a revenue deduction ?

(3) Whether in the facts and circumstances of the case the Tribunal was justified in holding that the sum of Rs. 3,224/- paid to the Provident Fund Commissioner as interest during 1965-66 is not an admissible deduction under Section 37 (1)?

50. Only the first and the third questions were referred to this Full Bench.

51. Our answer to both the questions is in the affirmative, in favour of the Department and against the assessee.

52. Let the papers be laid before the Division Bench with these answers to the two questions referred to the Full Bench.

References answered in the affirmative.

Cases Referred.

1. 1975 UPTC 408: (1975 Tax LR 1036)
2. (42 ITR 123 at p. 128): (AIR 1961 SC 1265 at p. 1267)
3. 75 ITR 741: (AIR 1970 All 620)
4. (1938) 303 US 391
5. ((1943) 317 US 492)
6. 41 ITR 350: (AIR 1961 SC 663)
7. 85 ITR 320: (1972 Tax LR 1145)
8. ((1969) 71 ITR 87) (All)
9. ((1955) 28 ITR 78) (All)
10. 11 ITR 454: (AIR 1943 Mad 670)
11. ((1957) 32 ITR 138) (Mad)
12. ((1965) 56 ITR 561) (All)
13. (1971) 79 ITR 493 (Ori)
14. (1978) 100 ITR 143
15. 109 ITR 212: (1977 Tax LR 478) (Guj)
16. ((1975) 100 ITR 67) (Bom)
17. ((1976) 103 ITR 298) (Guj)
18. (42 ITR 57): (AIR 1961 SC 1100)
19. ((1963) 48 ITR 182)
20. (31 ITR 153): (AIR 1956 Bom 756)