

ANDHRA PRADESH HIGH COURT

Soni Hinduji Kushalji & Co

Vs

Commissioner of Income-Tax

(Obul Reddi and V Rao, JJ .)

08.04.1971

JUDGMENT

Obul Reddi, J.

1. Two questions have been referred to this court under Section 256(1) of the Income-tax Act, 1961 (hereinafter referred to as "the Act ") and they are :

" 1. Whether the Tribunal is justified in law in disallowing the sum of Rs. 56,978 claimed as a business loss for the assessment year 1963-64 ?

2. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was justified in holding that the loss of Rs. 56,978 should have been claimed in the year in which the Collector has passed the order, but not when the Supreme Court has passed the order ?

2. If our answer to the first question is in the affirmative then the second question will not arise for consideration.

3. The facts necessary for determination of the questions are these : The petitioner is a firm doing business under the name and style of M/s. Soni Hinduji Kushalji & Company at Adoni. It is registered both under the Partnership Act as well as under Section 26A of the Act and carries on business in gold, silver and jewellery. The customs authorities had information that the petitioner-firm was smuggling gold from Goa to Adoni and then despatching the same to Bombay to the shop of one Bhimaji Punamchand for disposal. They, therefore, kept watch on a suspect by name Rukmanna Lam-bade going to the said shop in Bombay. On October 28, 1955, the customs officials followed the said Rukmanna Lambade to the National Refinery Ltd., and after he had taken over some gold from the refinery, searched him and seized from him gold bullion and " rawa " weighing 251 tolas and 133 grams. He disclosed that he was a servant of the petitioner-firm and had brought the gold belonging to the firm. On the same day the customs officials intercepted an uninsured railway parcel sent by the assessee-firm which was opened at the shop of Bhimaji Punamchand and it was found to contain some more pieces of gold, 600 old rupee coins and silver scrap weighing 35 lbs. and 3 tolas. After seizing the gold from Rukmanna Lambade and the other items from the shop of Bhimaji Punamchand, a notice was issued on December 31, 1955, to the assessee-firm to show cause why the gold seized of the value of Rs.

56,978 should not be confiscated. The assessee-firm filed a detailed reply in answer to the notice. The Collector of Customs, after considering the reply, ordered the confiscation of the smuggled gold. The firm then unsuccessfully preferred an appeal to the competent authority and a further appeal to the Central Government. Thereafter the assessee moved the Supreme Court under Article 32 of the Constitution, contending, inter alia, that Section 178 of the Sea Customs Act is ultra vires of the Constitution and thus inoperative and that petition was also dismissed.

4. As the sum of Rs. 56,978 represented the value of the gold seized by the customs officials on October 28, 1955, the firm in the assessment proceedings claimed this amount towards loss in vattay account. The Income-tax Officer rejected the claim of the assessee that this amount represented loss in the business of the firm to claim deduction, on the ground that it did not relate to the business carried on by it, but it is due to the confiscation of the gold under the Sea Customs Act. The subsequent appeals preferred by the assessee-firm to the Appellate Assistant Commissioner and to the Appellate Tribunal were also dismissed. It is after that that the assessee-firm moved the Tribunal under Section 256(1) for reference to this court.

5. Mr. Swamy appearing for the assessee-firm strongly contended that when the profits earned from an illegal business are not exempt from tax, the loss sustained in such business should be allowed to be deducted from the profits or gains for purposes of computing the tax payable by the assessee.

6. What are chargeable to tax in respect of a business carried on by the assessee are the profits or gains of a particular assessment year. While assessing the profits, necessarily loss incurred in the business during the year should be taken into account, as otherwise it is not possible to arrive at the true profits earned by the assessee. It is well-settled that the taint of illegality associated with profits or income is immaterial for the purpose of taxation. As observed by Lord Haldane in *Minister of Finance v. Smith*, [1927] A.C 193, 98 Income-tax Acts are not necessarily restricted in their application to lawful business only. One who contravenes a statute and trades in business prohibited by law while being liable for prosecution for the offence committed by him will, at the same time, be liable to pay tax out of the income or profits earned from the illegal trade or business. We are now concerned with the loss representing the value of gold on account of the confiscation of the gold for contravention of the provisions of the Customs Act. Can that loss be regarded as a commercial loss pertaining to the business or incidental to the business the assessee was carrying on, is the real question.

7. Mr. Swamy sought to place strong reliance upon a decision of the Gujarat High Court in *Commissioner of Income-tax v. S. C. Kothari*¹, to contend that the assessee is entitled to claim deduction of the value of the contraband gold confiscated by the customs authorities, as it represented the loss sustained by the firm in the illegal business carried on by it. The learned judges in that case were of the view that, when illegal business is business within the meaning of the Income-tax Act and if profits from illegal business are assessable to tax, there is no reason either in principle or on authority for refusing to take into account losses from illegal business. According to these, the losses so incurred must necessarily be taken into account in order to arrive at the true profits of the business and such profits may be either positive in the sense that they are actual profits or they may be negative in the sense that they are losses and there is in principle no distinction between profits and losses of a business. The learned Chief Justice, who spoke for the Bench, drew support for the view expressed on behalf of the Bench from a Full

Bench decision of the Allahabad High Court in *Chandrika Prasad Ram Swamp v. Commissioner of Income-tax*², as covering the point involved. What Iqbal Ahmed J. said in the Full Bench case, which was also quoted by the learned Chief Justice, is this :

" The question of the legality or illegality of transactions entered into by a firm is totally irrelevant in calculating the net profits or the loss incurred by the firm in a particular year. For example, if the assessee-firm had entered into a wagering contract which resulted in huge loss, it would not have been open to the income-tax department to decline to take that loss into account simply because the contract by way of wager was void in law. The income assessable to tax is the actual income of an individual or of a firm irrespective of the manner in which the income was derived. Legality or illegality of transaction culminating in profit or loss is, therefore, foreign to the scope of an enquiry into the income of an individual or of a firm for the purpose of taxing the same."

8. Allsop J., who agreed with his brother Iqbal Ahmed J., also observed that losses actually incurred must be set off against profits even if they are incurred in pursuance of activities which are illegal. That was a case where the assessee, a firm, entered into a contract of partnership with another firm and in the assessment of its profits sought to deduct its share of the loss which the bigger firm, of which it was a partner, had incurred. The claim was disallowed by the income-tax authorities on the ground that a firm cannot legally be a partner in another firm. The learned judges of the Allahabad High Court were, therefore, of the view that though a firm as such cannot enter into a partnership, with another firm, not being a legal entity, yet where two firms enter into a larger partnership, the larger partnership is in law a partnership between the members of the two firms and is not invalid and that the loss claimed was loss suffered in the course of business by the assessee-firm and was, therefore, allowable. It was further observed that even assuming that the larger partnership was illegal, the assessee-firm was entitled to have the loss in question taken into account in computing its income inasmuch as the mere illegality of the agreement cannot entitle the income-tax authorities to ignore the loss incurred.

9. It is thus seen that the view expressed by the Full Bench of the Allahabad High Court has absolutely no application to the present case, as the question to be answered here is whether confiscation of the contraband gold can be treated as loss in business so as to be allowed as a permissible deduction.

10. Kothari's case, [1968] 69 I.T.R. 1 (Guj.) as may be noticed from the facts stated therein, was not a case where a claim for deduction was made by the assessee, as he did not say that a particular expenditure incurred by him should be allowed as a permissible deduction. It is on that ground that the learned judges ruled that the decision in *Commissioner of Income-tax v. Haji Aziz & Abdul Shakoor Bros.*, [1953] 28 I.T.R. 266 (Bom.) relied upon by the revenue, where the claim for deduction under Section 10(2)(xv) of the 1922 Act was negatived, was not applicable to the case before them. Therefore, the answers given by the learned judges in Kothari's case render no assistance at all to the assessee's contention.

11. Here is a specific claim made by the assessee for deduction of the value of the gold confiscated by the Central Government on the ground that it is a trading or commercial loss, though the trade was an illegal one. It should not be lost sight of, when a claim for deduction is made, that the loss must be one that springs directly from the business or trade which the assessee carries on or is incidental to the business that he carries on and not every sort or kind of

loss, which has absolutely no nexus or connection with his trade or business.

12. It is well to remember that confiscation of contraband gold is an action in rem and not a proceeding in personam. As observed by Bhagwati J. in Maqbool Hussain v. State of Bombay, confiscation is no doubt one of the penalties which the customs authorities can impose but that is more in the nature of proceedings in rem than proceedings in personam, the object being to confiscate the offending goods which have been dealt with contrary to the provisions of the law. To the same effect is the view expressed by S. K. Das J. in Shewpujanrai Indrasanrai Ltd. v. Collector of Customs, that, so far as the confiscation of the goods is concerned, it is a proceeding in rem and the penalties are enforced against the goods whether the offender is known or not known and the order of confiscation under Section 182 of the Sea Customs Act operates directly upon the status of the property and under Section 184 transfers an absolute title to the Government. Subba Rao J. (as he then was) in Thomas Dana v. State of Punjab, in his dissenting judgment (the dissent being on other points) observed that if the authority concerned makes an order of confiscation it is only a proceeding in rem and the penalty is enforced against the goods.

13. A proceeding in rem, therefore, in the strict sense of the term is an action taken directly against the property (in this case the smuggled gold) and even if the offender is not known, the customs authorities have the power to confiscate the contraband gold. Therefore, by no process of reasoning can the confiscation of the contraband gold by the customs authorities be said to be a trading or commercial loss connected with or incidental to the assessee's business.

14. In *Commissioners of Inland Revenue v. Alexander Von Glehn & Co. Ltd.*³, Lord Slerndale M.R. observed :

" During the course of the trading this Company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong in the sense that they were willingly and knowingly sending these goods to an enemy destination, but they committed a breach of the law, and for that breach of the law, they were fined. That, as it seems to me, was not a loss connected with the business, but was a 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. "

15. The principle stated by Lord Sterndale M.R. holds good here too, as it is impossible to hold that the loss incurred by reason of the confiscation of the contraband gold is an expenditure incurred in connection with the trade or business of the assessee-firm or incidental to the carrying on of its business.

16. The Madras High Court in *Senthikumara Nadar & Sons (M. S. P.) v. Commissioner of Income-tax*⁴, held that payments of penalty for an infraction of the law fell outside the scope of permissible deductions under Section 10(2)(xv) of the 1922 Act.

17. Their Lordships of the Supreme Court in Haji Aziz and Abdul Shakoob Bros. V. Commissioner of Income-tax, after reviewing several Indian and English cases, observed at page

359:

" As was pointed out in Von Glehn's case, [1920] 2 K.B. 553 (C.A.) an expenditure is not deductible unless it is a commercial loss in trade and penalty imposed for breach of the law during the course of trade cannot be described as such. If a sum is paid by an assessee conducting his business, because in conducting it he has acted in a manner which has rendered him liable to penalty, it cannot be claimed as a deductible expense. It must be a commercial loss and in its nature must be contemplable as such. Such penalties which are incurred by an assessee in proceedings launched against him for an infraction of the law cannot be called commercial losses incurred by an assessee la carrying on his business. 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 that of 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, the test being that the expenses which are for the purpose of enabling a person to carry on trade for making profits in the business are permitted but not if they are merely connected with the business.... Anything done which is an infraction of the law and is visited with a penalty cannot on grounds of public policy be said to be a commercial expense for the purpose of a business or a disbursement made for the purposes of earning the profits of such business. "

18. Similar views have been expressed by the Punjab and Allahabad High Courts in *Raj Woollen Industries v. Commissioner of Income-tax⁵*, *Commissioner of Income-tax v. Mathura Prasad Hardwar Prasad Deoria⁶*, and *Mahabir Sugar Mills (P.) Ltd. v. Commissioner of Income-tax⁷*,

19. The Supreme Court in *Badridas v. Commissioner of Income-tax*, considered what would amount to a trading loss. Venkatarama Aiyar J. observed :

" When a claim is made for a deduction for which there is no specific pro vision in Section 10(2), whether it is admissible or not will depend on whether, having regard to accepted commercial pratice and trading principles, it can be said to arise out of the carrying on of the business and to be incidental to it. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied, in the Act. The loss for which a deduction could be made under Section 10(1) must be one that springs directly from the carrying on of the business and is incidental to it, and not any loss sustained by the assessee, even if it has some connection with his business."

20. Judged from the test laid down by their Lordships, it is impossible to hold that the confiscation of contraband gold, which is in the nature of a proceeding in rem, is a loss that springs directly from the business or trade carried on by the assessee-firm and is incidental to its business. Following the view expressed by their Lordships, the Punjab High Court in *Ram Gopal Ram Sarup v. Commissioner of Income-tax⁸*, held that the mere fact that there is some remote connection between a loss and the business would not bring the loss within the expression " loss incidental to the business ".

21. It is not even a case where it could be said that there is any sort of remote connection between the business carried on by the assessee-firm and the confiscation made by the customs authorities under the provisions of the Sea Customs Act.

22. A Full Bench of the Madras High Court in *Ramaswami v. Commissioner of Income-tax*, A.I.R. 1930 Mad. 808 held per majority that loss incurred by theft of money used in the money-lending business and (from the stronghold), in the business premises (none of the thieves being then servant of the assessee), is not incidental to the business of the assessee and not allowed for in computing income-tax.

23. As pointed out by Lord Loreburn L. C. in *Strong & Co. Lid. v. Woodi-field*,⁹ " They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trader. The nature of the trade is to be considered."

24. This court in *Commissioner of Income-tax v. Chakka Narayana*¹⁰, in a case of loss sustained by an assessee on account of theft at a railway station, held that the loss resulting thereof was not incidental to the assessee's business and was not an allowable deduction and that the mere fact that there was some remote connection between the loss and the business would not bring the loss within the expression " loss incidental to the business ".

25. The loss sustained by confiscation of the smuggled gold is absolutely foreign to the vocation or business of the assessee-firm. It is a loss incurred in some character other than that of a trader. The confiscation of the gold, being the result of a proceeding in rem. falls completely outside the trade or business which the assessee was carrying on. Confiscation of contraband goods is one of the penalties provided under the Sea Customs Act and the penalty is enforced against the goods irrespective of the fact whether the offender is known or not traced. Infraction or violation of the law is not a normal incident of a trade or business and, therefore, the penalty by way of confiscation of the contraband gold is not a commercial loss so as to be allowed as a permissible deduction.

26. For the aforesaid reasons the first question is answered in the affirmative and in favour of the revenue. In this view, the second question does not arise. The reference is answered accordingly with costs of the revenue. Advocate's fee Rs. 250.

Cases Referred.

- 1[1968] 69 I.T.R. 1 (Guj)
- 2[1939] 7 I.T.R. 269, 279, 281 (All.) [F.B.]
- 3[1920] 2 K.B. 553, 566 (C.A.)
- 4(1957) 32 I.T.R. 138 (Mad.)
- 5[1961] 43 I.T.R. 36
- 6[1965] 55 I.T.R. 476 (All.)
- 7[1969] 71 I.T.R. 87 (All)
- 8[1963] 47 I.T.R. 611 (Punj)
- 9[1906] A.C. 446, 458 (H.L)
- 10[1961] 43 I.T.R. 249 (A.P)

