BOMBAY HIGH COURT

J.B. Advani

Vs.

Commissioner of Income-tax

Income-tax Ref. No. 21 of 1949

(Chagla, C.J. and Tendolkar, J.)

17.03.1950

JUDGMENT

Chagla, C.J.

1. The first question that we have to consider on this reference is whether certain expenditure incurred by the assessee company as legal expenses are permissible deductions as falling within Section 10(2)(xv), Income-tax, Act.

2. The facts that give rise to this question are brief. The assesses company is a private limited company in which the directors have a controlling interest. There are four managing directors. They and their manager were prosecuted in Madras for offences under the Hoarding and Profiteering Prevention Ordinance, 1943, and the charge against them was that on 20th January 1944, the company sold to the Superintendent of Stationery box-boards at Re. 1.1.0 as against the landed coats of Re. 0-3 10 per pound. The Chief Presidency Magistrate at Madras discharged all the accused. The directors and the salesman were also prosecuted at Karachi under the Defence of India Rules on the ground that the salesman refused to sell paper as he should have done. The City Magistrate also discharged the accused before him. It is in connection with these two prosecutions that the assessees claim to have incurred an expenditure of Rs. 5,247 which they claim as permissible deductions under Section 10(2)(xv) of the Act.

3. Now, before we deal with the various authorities that have been cited at the bar it is necessary to notice two or three important facts in connection with the claim made by the assessee company. The charges which the managing directors and the salesman were called upon to meet both at Madras and at Karachi were incidental to the business that the company was carrying on. It was the business of the company to sell stationery and the company was charged with having sold it in one case contrary to the law and in the other case having refused to sell. Therefore, both the charges were directly in connection with the business of the company as a trader. The charges

against the accused were also in their capacity as agents for a company which was a trading company. A further fact to note is that the expenses for the litigation were not incurred by the person charged with the offences themselves but they were incurred by the company in order to eaves those persons from the consequences of the prosecution.

4. Now, it has been alleged by the Attorney-General that the primary and the paramount object in incurring these expenses was to save the directors and the salesman from being convicted and from suffering the consequences of such convictions. He says that, if at all, it was incidentally that the assessee could have thought of the good name or reputation of the business of the company. In my opinion on the facts found and which I have just stated that contention cannot be accepted. The position would have been very different if the expenditure had been incurred by the directors and the salesman themselves. Then undoubtedly it could have been urged that when a man is served with a summons from a criminal Court, he is not thinking of his business or the good name and reputation of the business, but, primarily he is thinking of himself, his liberty and of the consequences of the conviction. But when we have fact as we have here of a different entity altogether - the limited company - spending money for its managing directors and its salesman in order to resist the prosecution, in my opinion the primary and the paramount object must be for the company to have the reputation of the company as a trading company so that its business and profits should not be affected. Once this position is made clear, then it will be found that the authorities that have been cited present no difficulties whatsoever.

5. The leading case which has been cited by Sir Jamshedji and which has been referred to in most of the cases which deal with the point similar to the one that has risen for our determination is *Strong and Co. Limited v. Woodifield*[1], In that case a brewery owned an inn which was carried on by a manager as a part of their business. A customer sleeping in the inn was injured by the fall of a chimney and recovered damages and costs against the company for the injury, which was owing to the negligence of the company's servants. When a claim was made for deduction of these damages and coats in estimating the profits of the company for the purposes of income-tax, that claim was rejected. Lord Loreburn L.C. in his speech in the Houser of Lords lays down the principle in the following terms (p. 452) :

> "In my opinion, however, it does not follow that if a loss is in any sense connected with the trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade, or it may be connected with something else quite as much as or even more than with the trade. I think only such losses can be deducted as are connected with in the sense that they ate really incidental to the trade itself. They cannot be deducted if they ate mainly incidental to some other vocation or fall on the trader in some character other than that of trade." There ate two points emphasized by the Lord Chancellor, viz., that the loss must be incidental to the trade itself and it must fall on the trader in his character as a trader.

6. Now, applying these two tests to the facts of the case, in my opinion both the tests are satisfied because the loss is incidental to the trade because it was in the course of its business of selling stationery that the directors were charged with having contravened the law and it is also in its capacity as a trader that the company was called upon to defend its directors and the salesman.

7. The Attorney General has relied on two English cases where a prosecution resulted in a

[1](1906) AC 448 : (75 LJ KB 864)

conviction. Now there can be no doubt that if a trader is charged with an offence which is a breach of the law and he is convicted, he cannot claim the legal expenses incurred for defending himself against the prosecution as moneys expended wholly and exclusively for the business, because it can never be said that the breach of the law was incidental to a business. It can never be urged that a business could only be carried on for the purposes of profits by causing infraction of the law, and, therefore, these two eases, to which I shall presently refer, are clearly distinguishable from the facts of this case. The position in this case would have been clearly different if the directors and the salesman had been convicted of the offences with which they were charged. Both these cases are to be found in 12 Tax cases. The first is Commissioners of Inland Revenue E.C. Warnes and Co., Ltd. (1919) 12 Tax Cas 227. There the assessees who were oil mills were sued for a penalty for breach of certain orders and proclamations relating to the requirements of the Board of Customs and Excise and the assessees settled the action by paying mitigated penalty of 2000. Rowlatt, J. held that the mitigated penalty and coats were not a loss connected with and arising out of the company's trade, and in deciding this he relied on the passage of Loreburn L.C. in *Strong it Co. Ltd. v. Woodifield*[2]*,* to which I have just referred. To the same effect is another decision reported in Commissioners of *Inland Revenue v. Alexander von Glehn to Co., Ltd*[3]*.,* where also the assessees agreed to pay by way of compromise a penalty, having committed a breach of the Customs Act, and claimed the payment of the penalty and coats as a permissible deduction.

Lord Sterndale at p. 328 stated that the assessees commuted a breach of the law, and for that breach they were fined, and that did not seam to him to be a loss connected with the business, but it was a fine imposed upon the company personally, as far as a company can be a person, for the breach of the law which they had committed. The learned Lord Justice further went on to say that it was perhaps a little difficult to put the distinction into very exact language, but there seemed to him to be a difference between a commercial lose in trading and a penalty imposed upon a person or a company for a breach of the law which they had committed in that trading.

8. The test that Scrutton L.J. applied which is to be found at p. 244 was : were these fines made or paid for the purposes of earning profits ? As the answer to that question according to the learned Lord Justice was in the negative, he came to the conclusion that it was not a permissible deduction.

9. Certain Indian cases have been referred to at the bar and excepting one they do not really touch the question that we have to decide, but I shall briefly review these decisions. The first is the Privy Council case of *Income-tax Commissioner v. Maharajadhiraj of Darbhanga*[4], In that case a suit was filed by the assessee in respect of a loan of ten lacs of rupees made to a company and there was also a suit by the company challenging the loan on the ground that the assesses had committed a breach of the contract in not properly financing the company. The cost of the litigation to enforce the payment of the loan was allowed as a permissible deduction, but the question arose as to whether the expenses of defending the litigation filed against the assessee should be so allowed or not. The Privy Council held that the assessee's defense to the action was just as essential for the full protection of his rights as the creditor in the loan of Rs. 10,00,000

[2](1906 AC 448 : 75 LJ KB 864) [4]69 IA 15 : (AIR 1942 PC 11)

[3](1920) 12 Tax Cas 232

as was his suit for the recovery of the loan. Therefore, the principle underlying here is clear and that is that if the litigation is launched for the protection of the assets belonging to the trade, then the assessee who is carrying on the trade is certainly entitled to the costs of the litigation. Then we have a case of criminal prosecution but which ended on a conviction, viz. the case of Amrita, Bazar Patrika Ltd., In re, (1937) 5 ILR 648 : AIR 1938 Calcutta 241 SB). The Amrita Bazar Patrika published an article which was a comment on the judiciary. The printer and the publisher were prosecuted and convicted for contempt of Court in respect of that article. The costs of the contempt proceedings were sought to be deducted from the income as a permissible deduction, and with respect it was rightly pointed out by Costello Ag. C.J. and Panckridge and Edgly, JJ. that it was difficult to understand how the particular expenditure was incurred for the purpose of earning profits or gains. It cannot be said that committing contempt of the judiciary is a part of the ordinary business of a newspaper. Then we have a case from *Nagpur, Income-tax Appellate Tribunal v. Chhaganmal Mangilal*[5], which reviews most of the authorities to which I have referred. But on the facts of that case the decision arrived at by Grille C.J and Sen, J. is clearly understandable. There the assessee was carrying on a business in cloth and he was using a certain trade-mark on the cloth, and a textile mill filed a suit for injunction restraining the assesses from making use of the trade-mark. The litigation was ultimately compromised and the assessee claimed the expenses of the litigation as an expenditure falling under Section 10(2)(xi) of the Act as it then stood. The Court held that it was a permissible deduction. In view of what I have just stated about the Privy Council decision it is clear that what the assessee was doing was protecting and safeguarding the asset of the business which was the trade-mark.

10. There are really only two cases which touch the point which we are called upon to determine. One is a case from *Rangoon : Commissioner of Income Tax, Burma v. Gasper and Co*[6]., and the other is a recent English case. In the Rangoon case a partnership firm had been importing for a considerable number of years a certain brand of whisky and brandy from a company at Calcutta. Criminal charges were levelled against the partners of conspiracy of committing offences against the Excise Act and the prosecution resulted in an acquittal of all the partners and the partners claimed that the expenditure incurred was a permissible deduction. Roberts, C.J. held that the assessees were not entitled to this deduction. Now this case has been strongly relied upon by the

learned Attorney General. The one distinguishing feature between the Rangoon case and the case before us is that in the Rangoon case all the partners of the firm which was the assessee were prosecuted for an offence and the defended themselves against the charge and the Chief Justice took the view that it was clear under the circumstances that a part of their object was to save the individual partners from the possible adverse consequences of a criminal conviction. According to the Chief Justice in fighting the prosecution the main purpose was no more than securing the acquittal of each of the partners. The learned Chief Justice relied on the language used in Section 10(2)(ix) which corresponds with the present Section 10(a)(xiii) where the language used is different from the language used in the present sub-section. The language there used was that expenditure must be solely for the purpose of earning profits or gains in a business carried on by the assessee and the view of the learned Chief Justice was that in spending the money for defending the person against the prosecution money was not laid out solely for the purpose of earning profits or gains. The observation

[5](1944) 14 ITR 206 : AIR 1946 Nag 94

[6](1939) 8 ITR 100 : AIR 1940 Rang 195 (SB)

of the learned Chief Justice receives considerable emphasis from the fact that the assessees and the accused in that case were the same persons, and as I stated before, in the case before us we have a limited company spending money to defend its managing directors and the salesman against a charge which related to a transaction which took place in the ordinary course of their business. In the Nagpur case to which I have referred the learned Chief Justice referred to this case and expressed an opinion that the case was of doubtful authority and the reason why they thought that that decision would not be applicable to the Income-tax Act after it was amended with respect to Section 10(2)(xv) was that the limitation for the purpose of earning such profits had been removed from the amended section and all that is required now is that the expenditure should be for the purpose of such business. With respect to the learned Chief Justice I do not think that that case can be distinguished on this ground, because although the section has been amended and the limitation referred to have been removed, we still have the limitation that the expenditure should be wholly and exclusively for the purposes of business. The better view seems to be as I shall presently point out that substantially the amendment makes no difference to the law, and even today if an expenditure has to be incurred wholly and exclusively for the purposes of business, it must be shown to have been incurred for the purposes of earning profits of the business.

11. The English case on which the Attorney-General relied is *Spofforth and Prince v. Bolder*[7], There one Spofforth, who was a chartered accountant, was charged with having supplied a scheme to one White to avoid payment of surtax and also having supplied three clerks from his office to apply for shares in a one man company formed solely for the purpose of evading payment of sur-tax by White. In defending this charge Spofforth incurred certain expenditure which he claimed as a permissible deduction and that claim was rejected by Wrottesley, J. Now it is significant to note that the charge against Spofforth was not in his capacity as a chartered accountant but in his personal capacity and therefore he was defending himself against a personal charge. In everything that he did he acted not as a chartered accountant but he acted purely in his

personal capacity. Spofforth was a partner with one Prince in this business of chartered accountants and the assessees were the partnership firm of Spofforth and Prince and it was this partnership firm that was claiming the deduction. Wrottesley, J. expressed a grave doubt in his judgment whether the firm ever incurred the expenditure. According to the learned Judge the documents appeared to suggest that it was Spofforth himself who incurred the expenses. Therefore this case is also distinguishable from the case before us on the two grounds which I bare mentioned, viz., that the prosecution was not with regard to anything done in the course of the business of the assessee, and secondly, it was doubtful whether the assessee had incurred the expenditure which was claimed as deduction. There are important observations of the learned Judge. The test that the learned Judge applies is (p. 314) :

> "In the disbursement one made not merely in the course of, or arising out of or connected with, or made out of the profits of the profession, but also for the purpose of earning the profits of the profession ?"

Now, it is important to note that this test was applied to a provision of the English Income-tax Act which in terms corresponds to our Section 10(2)(xv). Therefore it is clear

[7](1945) 26 Tax Cas 310 : ((1945) 1 All England Reporter 363)

that the Judges in England read the expression "expended wholly and exclusively for business" as meaning "expenses incurred for the purpose of earning profits of the business."

12. The review of these authorities makes it clear that there is no difficulty in the class of cases where an asset of a business is protected or safeguarded by the assesses carrying on the business in a civil litigation. The costs of such litigation are always a permissible deduction. The difficulty only arises when you have a criminal prosecution. There again where a criminal prosecution ends in a conviction, there is no difficulty because the assessee who is guilty of a breach of the law cannot be heard to say that the costs of the litigation against him was a permissible deduction because the commission of an offence was not necessary for the purposes of his trade. The real difficulty only arises when you have a case where the prosecution terminates in acquittal. Then the two tests to be applied as I suggested would be whether the assessee was charged with regard to a transaction which took place in the ordinary course of business and the other test would be whether he was charged in his capacity as a trader. If these two tests are satisfied and the Court comes to the conclusion that the primary object of incurring the expenditure was to protect the good name of the business, then it could be said that the expenditure was wholly and exclusively for the purposes of business.

13. The second question that has been referred to us is whether a sum of Rs. 5,688 paid by the company on account of quarters provided free for residence of the directors could be considered to be remuneration within the meaning of Rule 7(1) of the rules in Schedule I, Excess Profits Tax Act. The Tribunal held that it was director's remuneration and the assessees before us contend that it is not. Prima facie I should have said that money or equivalent of money paid by an

employer to an employee must always be remuneration. Sir Jamahedji concedes that if the company had paid rent to the directors in money, that rent would have been part of their remuneration, but be contends that inasmuch as rent was not paid but free quarters were given to the directors, the position is different and the rent for the free quarters cannot be considered as part of the remuneration of the directors. I do not understand what difference there can be between an employer giving rent in cash and his securing quarters for the directors and paying rent to the landlord. Sir Jamahedji has relied on a decision (*Tenant v. Smith*[8], and he has particularly relied on the observations of Halsbury, L.C. where the Lord Chancellor observed that the occupation of a house which was given free of rent may in certain contingencies be not a benefit but a burden. Sir Jamshedji overlooks the fact that these observations are made in a case which is quite different from the case that we have before us. In that case the agent of a Bank of Scotland was stationed at Montrose and the agent was bound as a part of his duty to occupy the bank house as a custodian of the premises belonging to the bank and also for the purposes of the transactions of special nature after banking hours. It was therefore a part of the duty of the agent and part of his obligation to reside in the house given to him by the bank and therefore when the agent contended that the house rent could not be treated as his income he made that contention with considerable justification which was upheld by the House of Lords. In the case before us it is not suggested that there was any obligation upon the directors to reside in the quarters given to them by the company. If there was such an obligation and if they had to occupy them as part of their business as directors, then the case might have presented a different

[8](1892) 3 Tax Cas 158

aspect; but on the facts found by the Tribunal it is clear that the sum of Rs. 5,688 expended by the company for rent for the residence of the directors is nothing more than a part of the remuneration paid to the directors.

14. We would, therefore, answer the questions referred to us;

Question No. 1 : In the affirmative.
Question No. 3 : In the affirmative.

The Commissioner to pay three-quarters of the costs of the assessees.
Answers in the affirmative.