

# EY Tax Alert

## Supreme Court disallows confiscation loss incurred while carrying on legal business

### Executive summary

This tax alert summarizes a recent two-judge bench Supreme Court (SC) decision in the case of *Prakash Chand Lunia (D) Thr.Lrs. & Anr*<sup>1</sup> (Taxpayer) wherein the issue before the SC was whether loss incurred on account of confiscation of silver bars, owned by the Taxpayer who was engaged in legitimate jewelry business, is allowable as deduction.

The SC set aside the underlying Rajasthan High Court ruling which allowed such loss by placing reliance on the SC decision of *CIT v Piara Singh*<sup>2</sup> (three-judge bench). Both judges held that the confiscation loss incurred by the Taxpayer while carrying on legal business is not allowable. However, both judges passed separate judgements providing separate reasons for arriving at such conclusion.

The first judge held that the present case is distinguishable from ratio of *Piara Singh* ruling since the Taxpayer, in the present case, incurred confiscation loss while carrying on legal business whereas in *Piara Singh* ruling the taxpayer incurred confiscation loss while carrying on illegal business of smuggling. Hence, the loss is not allowable in the present case.

However, the second judge charted a different path of reasoning to disallow the loss. He held that insertion of an Explanation in 1998 with retrospective effect from inception of the current income tax law and amendment in 2016 to deny set off of loss against undisclosed incomes are significant developments. The Explanation denies deduction in respect of any expenditure incurred by a taxpayer for any purpose which is an offence or prohibited by law. This reflects the position that loss incurred by confiscation or penalties/fines for infraction of law is not allowable whether incurred while carrying on legal business or illegal business. To that extent, the three-Judge Bench SC ruling in *Piara Singh*'s case and two-judge bench SC ruling in *Dr. T. A. Quereshi v. CIT*<sup>3</sup> (rendered after noticing the Explanation) which allowed such loss where taxpayers were carrying on illegal business are per incuriam and not binding precedents.

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<sup>1</sup> [TS-206-SC-2023]

<sup>2</sup> [1980]124 ITR 40 (SC)

<sup>3</sup> [2006] 287 ITR 547 (SC)

## Background

- ▶ Section (S.) 37(1) of the Income Tax Law (ITL) is a residual provision which allows deduction for any revenue expenditure, not covered by any other provision, laid out or expended wholly or exclusively for the purpose of business or profession.
- ▶ In the case of Hazi Aziz and Abdul Shakoor Bros v CIT<sup>4</sup> (three-judge bench) (Hazi Aziz ruling), in the context of predecessor income tax law, the SC held that loss incurred by taxpayer by way of fine paid to customs authorities while importing goods for infraction of law is not allowable as deduction. In this case, the taxpayer was carrying on legal business of importing dates and selling them in India. The SC held that sum paid by taxpayer for infraction of law while conducting a business cannot be claimed as deductible expense. It is not a commercial loss falling on the taxpayer in capacity as a trader. Infraction of the law is not a normal incident of business and hence, expenditure like penalties and fines falling on the taxpayer in some character other than that of a trader are not deductible.
- ▶ On the other hand, in the case of CIT v Piara Singh<sup>5</sup> (three-judge bench) (Piara Singh ruling) in the context of predecessor income tax law, the taxpayer was engaged in business of smuggling by taking currency notes out of India, buying gold outside India with such currency notes and smuggling the gold back to India for sale. The taxpayer incurred loss on confiscation of currency notes by the customs authorities. The taxpayer claimed deduction of such loss while computing his undisclosed income. The SC held that since the profits of illegal smuggling business are taxable as business income, the confiscation loss was a necessary incident involved in such business within the contemplation of taxpayer. It was an incidental loss which sprung directly from carrying on illegal business and incidental to it. Hence, such loss was allowable as deduction.
- ▶ In Piara Singh ruling, the SC distinguished its earlier Hazi Aziz ruling by holding that there is a significant distinction between the infraction of the law committed in the carrying on of a lawful business (like in Hazi Aziz's case) and an infraction of the law committed in a business inherently unlawful and constitute a normal incident of such unlawful business (like in Piara Singh's case). The loss by way of penalties or fines or confiscation is not allowable in the former since it does not fall on the taxpayer in the character of a trader. But it is allowable in the latter since it is a normal feature of the illegal business.
- ▶ In the case of CIT v. S. C. Kothari<sup>6</sup> (two-judge Bench) (S. C. Kothari ruling), the SC held in the context of predecessor income tax law, that 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". What can be taxed is only the "profits" and not the "gross receipts". That cannot be done without deducting the losses and the legitimate expenses of the business.
- ▶ Finance (No. 2) Act 1998 inserted Explanation 1 to S.37(1) (Explanation) with retrospective effect from 1 April 1962 (i.e., inception of the current ITL) to clarify that any expenditure incurred by a taxpayer for any purpose, which is an offence or prohibited by law, shall not be deemed to be incurred for the purposes of business or profession and no deduction shall be made in respect of such expenditure.
- ▶ Central Board of Direct Taxes (CBDT) vide its Circular 772 dated 23 December 1998 explained that the insertion of aforesaid Explanation will result in disallowance of the claims made by certain taxpayers in respect of payments on account of protection money, extortion, hafta, bribes etc. as business expenditure. The Circular further stated that it is well decided that unlawful expenditure is not an allowable deduction in computation of income.
- ▶ In the case of Dr. T. A. Quereshi v. CIT<sup>7</sup> (two-Judge Bench) rendered in the context of the current ITL and after insertion of the Explanation, the taxpayer was found to be engaged in illegal business of manufacture and sale of heroin. The taxpayer claimed loss incurred on confiscation of heroin as deductible business loss. The SC allowed such loss by relying upon ratio of Piara Singh ruling. Significantly, the SC held that the Explanation was not applicable in the present case since S.37(1) relates to business expenditure whereas in the present case, the SC was concerned with business loss.
- ▶ Prior to amendment by Finance Act 2016 w.e.f. tax year 2016-17, there was ambiguity whether a loss can be set off against undisclosed income by way of unexplained cash credit or unexplained bullion, jewelry, etc. Post such amendment, it is

<sup>4</sup> [1961]41 ITR 350 (SC)

<sup>5</sup> [1980]124 ITR 40 (SC)

<sup>6</sup> [1971]82 ITR 794 (SC)

<sup>7</sup> [2006] 287 ITR 547 (SC)

clarified in the ITL that no such set off is allowable.

## Facts of the case

- ▶ The Taxpayer was carrying on legal business of jewelry. During tax year 1988-89, the Customs authorities found undisclosed quantities of silver at Taxpayer's business premises worth INR 30M which was confiscated by them.
- ▶ In the income tax proceedings, the Tax Authority added the value of confiscated silver as Taxpayer's undisclosed income. The Taxpayer claimed set off of equivalent loss by way of confiscation of the silver as an incidental business loss. The Tax Authority rejected the claim of set off which was upheld by First Appellate Authority and Tribunal. However, on further appeal by the Taxpayer, the Rajasthan HC allowed the set off of loss by placing reliance on Piara Singh and T. A. Quereshi rulings.
- ▶ Being aggrieved, the Tax Authority appealed further to the SC.

## SC ruling

The two judge SC bench overruled the Rajasthan HC ruling and held that the Taxpayer was not entitled to deduction of confiscation loss. However, the two judges passed separate judgements providing separate reasoning for the disallowance of loss.

### Judgement of first judge (Justice M. R. Shah, J)

- ▶ The HC erred in placing reliance on Piara Singh ruling while allowing deduction of confiscation loss.
- ▶ In the present case, the main business of Taxpayer is dealing in silver and not smuggling of silver. Thus, the Taxpayer was carrying on legitimate business and incurred confiscation loss on infraction of law. Hence, ratio of Piara Singh ruling is not applicable since it was rendered in context of taxpayer incurring confiscation loss while carrying on illegal business of smuggling.
- ▶ The Tax Authority, First Appellate Authority and Tribunal were right in denying set off of loss by applying ratio of Haji Aziz ruling.

### Judgement of second judge (Justice M.M. Sundresh, J.)

- ▶ It is well settled that although S.37(1) refers to "expenditure" and not a "loss", a commercial loss in trade arising out of a business being carried on and incidental to it is a deductible loss<sup>8</sup>. Such loss should spring directly from carrying on of business and should be incurred in the character of trader. Hence, "expenditure" referred in S.37(1) takes in its sweep loss occasioned in the course of business.
- ▶ There is interplay between "expenditure" referred in S.37(1) and amendment made by FA 2016 for denial of set off of loss from

undisclosed income. The object of both provisions is to deny deduction for loss incurred in pursuance of offence or prohibited business. The amendment made by FA 2016 explains the true nature of Explanation 1 to S.37(1).

- ▶ It is true that a commercial loss is allowable as deduction so long as it emanates directly from carrying on of business being incidental to it. The ratio of Haji Aziz ruling is that penalty for infraction of law cannot be considered as commercial loss falling on the taxpayer in the capacity as trader. Similarly, loss by confiscation of goods does not fall on the taxpayer in the capacity as trader since the confiscation is a proceeding *in rem* (i.e. against the goods regardless of owner thereof) and not a personal liability.
- ▶ It is true that in S. C. Kothari ruling, the SC held that what can be taxed is only the "profit" and "gross receipts" of illegal business but it is not an authority for allowance of deduction of penalties/fines or confiscation loss. The S. C. Kothari ruling was rendered under predecessor income tax law which did not contain the Explanation as in current law.
- ▶ In Piara Singh ruling, the true ratio of Haji Aziz was not taken note by inadvertence, particularly the nature of proceedings involved in the imposition of confiscation or penalty, being proceedings *in rem*. The SC in Piara Singh's case did not have benefit of Explanation under the current income tax law as compared to predecessor income tax law. The ratio of Piara Singh ruling may not have application to case of deduction of expenditure/loss incurred on account of penalty/confiscation coming under Explanation.
- ▶ In Dr. T. A. Quereshi ruling, the SC made a casual observation on the Explanation that it applies only to "expenditure" and not to "losses". It has to be remembered that for a precedent to be binding there has to be a conscious consideration of an issue involved. The two-judge bench of SC in Dr. T. A. Quereshi ruling did not consider ratio of three-judge bench of Haji Aziz. Hence, Dr. T. A. Quereshi ruling is *per incuriam* and not a binding precedent. Also, the question of confiscation proceeding being *in rem* was not brought to the notice in Dr. T. A. Quereshi ruling. Therefore, there cannot be situation where a taxpayer carrying on an illegal business can claim deduction of expenses or losses incurred in the course of that business, while another taxpayer carrying on legitimate business cannot seek deduction for loss incurred on confiscation or penalty. The ratio of Dr. T. A. Quereshi ruling leads to a situation where the expenditure incurred in manufacturing something illegal may not be allowable as deduction in view of the Explanation but upon confiscation of such goods, deduction will be allowable on commercial principles. This classification, being artificial not borne out of statute, which mischief is sought to

<sup>8</sup> Badridas Daga v. CIT [1958] 34 ITR 10 (SC)

be clarified by the Explanation, has no legal basis.

- Hence, it may be concluded as follows:
- The word “any expenditure” mentioned in S.37(1) takes in its sweep loss occasioned in the course of business, being incidental to it.
  - Consequently, any loss incurred by an expenditure by a taxpayer for any purpose which is an offence or which is prohibited by law is not deductible in terms of the Explanation
  - Such expenditure/loss incurred for any purpose which is an offence shall not be deemed to have been incurred for the purpose of business or profession or incidental to it and hence not deductible.
  - A penalty or confiscation is a proceeding *in rem*, and therefore, a loss in pursuance thereof is not available for deduction regardless of the nature of business, as a penalty or confiscation cannot be said to be incidental to any business
  - The SC rulings in Piara Singh and Dr. T. A. Quereshi do not lay down correct law in light of Haji Aziz ruling and insertion of the Explanation.

## Comments

The present two-judge bench SC ruling appears to be significant. While both judges agreed that confiscation loss incurred by Taxpayer carrying on legal business is not allowable, they differed on the reasoning for such conclusion.

The first judge followed the ratio of Piara Singh ruling without questioning the binding nature of such ruling. However, the second judge held that three-judge bench Piara Singh and two-judge bench Dr. T. A. Quereshi rulings do not lay down correct law in the light of Haji Aziz ruling and insertion of the Explanation. The second judge held that Dr. T. A. Quereshi ruling is not binding precedent despite being rendered after noticing the Explanation. Thus, according to the second judge, loss by way of confiscation or penalties/fines for infraction of law are not allowable regardless of whether taxpayer is carrying on legal or illegal business.

The observations of second judge may reignite the debate on the true scope of “expenditure” as referred in S.37(1) and whether it includes “loss”. It may be recollected that in context of allowing deduction for foreign exchange fluctuation loss of revenue nature, the SC in its earlier ruling in the case of CIT v. Woodward Governor (I) Pvt. Ltd <sup>[9]</sup> held that the expression “expenditure” as used in S. 37(1) may, in the circumstances of a particular case, cover an amount which is really a “loss”, even though said amount has not gone out from the taxpayer’s pocket. Also, there could be legal debate about the approach subsequent benches of the Court may adopt should there be divergence of opinion as compared to the earlier decisions particularly of the larger bench.

<sup>9</sup> [2009] 312 ITR 254 (SC)

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