

FORM NO.(J2)

IN THE HIGH COURT AT CALCUTTA
SPECIAL JURISDICTION (INCOME TAX)
ORIGINAL SIDE

Present:

Hon'ble Justice Girish Chandra Gupta

And

Hon'ble Justice Asha Arora

ITA No.337 OF 2005

MUNDIAL EXPORT IMPORT FINANCE (P) LTD.
Versus
COMMISSIONER OF INCOME TAX KOLKATA - IV CIRCLE

Advocate for the Appellant: Mr. Arnab Chakraborty, Adv.

Advocate for the Respondent: Md. Nizamuddin, Adv.

Heard on: 05.01.2016

Judgment delivered on: 02.02.2016.

GIRISH CHANDRA GUPTA J. The assessee has come up in appeal under Section 260A of the Income Tax Act, 1961 against a judgement and order dated 23rd March, 2005 of the ITAT 'C' Bench, Kolkata in ITA No. 2129/KOL/ 2004 pertaining to the assessment year 2001-2002. The Tribunal by the impugned order has upheld the order of the CIT (A) confirming disallowance of Rs.6,67,266/- paid by the assessee to the Calcutta Port Trust (hereinafter referred to as CPT for brevity) by way of compensation for encroachment of land by the assessee from June 1994 to May 2000 and then June 2000 to October 2000. The questions of law which arise for determination in the instant appeal are as follows:-

(i) Whether the damages of Rs.6,67,266/- paid by the Appellant to the Calcutta Port Trust as per Clause 22 of the Lease Agreement dated October

21, 1982 by and between the appellant and Calcutta Port Trust is an expenditure covered by the Explanation to Section 37(1) of the Income Tax Act, 1961?

(ii) Whether in the facts and circumstances of the case the payment of Rs.6,67,266/- to the Calcutta Port Trust by the Appellant was an expenditure incurred wholly and exclusively for the purposes of the Appellant's business and therefore allowable as deduction under Section 37(1) of the Income Tax Act, 1961, in determining the Appellant's income for the assessment year 2001-02?

(iii) Whether the expenditure of Rs.6,67,266/- incurred by the Appellant as and by way of payment of damages to the Calcutta Port Trust for contravention of contractual obligation by way of encroachment of land adjacent to the demised land, belonging to the Calcutta Port Trust, is an expenditure capital in nature and thus not an allowable expenditure under Section 37 (1) of the Income Tax Act, 1961?

(iv) Whether in coming to the conclusion that the payment of Rs.6,67,266/- by the Appellant to the Calcutta Port Trust was an expenditure covered by the Explanation to Section 37 (1) of the Act and/ or that such expenditure was capital in nature and, therefore, on both counts was not an allowable deduction under Section 37(1) of the Income Tax Act, 1961, the Tribunal has misdirected itself in law, has acted by an outright refusal to consider relevant matters and has taken into consideration irrelevant materials and whether the said findings of the Tribunal are perverse?

The facts and circumstances in brief are as follows:-

The assessee had acquired a plot of land by way of lease from CPT under a lease agreement dated October 21st, 1982. CPT by a letter dated 28.06.2000 informed the assessee that about 855.7 sq. metres of land belonging to the trust adjacent to the demised plot at Budge Budge had been encroached by the assessee in violation of the terms and conditions of the lease agreement. The assessee was therefore asked to pay damages by a

letter dated 28.09.2000 before proposal of the assessee for grant of a long-term lease in respect of the encroached land could be placed before the Board of Trustees for examination. Such payment was duly made.

The assessee claimed that such payment amounting to Rs.6,67,266/- was a revenue expenditure. The assessing officer was not inclined to allow the same. He issued a notice to show cause why such expenditure should not be disallowed on the grounds that:-

- (a) It was capital in nature;
- (b) It was an expenditure in connection with an infraction of law.

The assessee in response contended that the payment was in the nature of arrears of rent and cannot be treated as a capital expenditure as the land belonged to CPT and not to the assessee. The assessing officer took the view that the assessee had not taken the land on rent or hire and that payment was made to obtain a long-term lease and therefore was a capital expenditure. He also held that the encroachment amount to an infraction of law. The assessing officer relied on the explanation to Section 37(1) of the Act and disallowed the expenditure. The CIT(A) affirmed the AO's order for similar reasons. The Tribunal also upheld the order of the CIT(A).

Mr. Nizamuddin learned Advocate appearing for the Revenue relied on the explanation to Section 37(1) which is as follows:-

"37. (1) Any expenditure not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee, laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".

Explanation -For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure."

He contended that the explanation disallows any expenditure incurred by the assessee for any purpose which is an offence or which is prohibited by law. He further contends that the amount in question was paid to CPT because the assessee encroached a piece of land belonging to CPT. This act of the assessee, he submits, amounted to an act which is prohibited by law and hence such expenditure cannot be allowed as a deduction.

Mr. Chakraborty learned Advocate for the appellant contended that payment of damages is for breach of contract and not on account of any infraction of law and, therefore the same is admissible as expenses having been spent fully and exclusively for the purpose of business. He further contended that breach of contract in this case was user of the adjacent land for the purpose of business for which the assessee had to pay damages in the nature of occupation charges which cannot amount to an offence. Therefore the explanation to Section 37(1) is not applicable to the instant case. He further contended that the nature of the impost needs to be examined in each case. If it is found that the impost is composite in nature being partly compensatory and partly penal then the proportion between the two requires to be determined and accordingly apportionment is to be made. The portion which is penal in nature cannot be allowed as a deduction. However, the remaining portion which is compensatory in character can be allowed as a deduction. He in support of his submission relied upon a judgement of the Apex Court in *Standard Batteries Ltd. -Vs- Commissioner of Income Tax* reported in (1995) 211 ITR 444.

We have heard the submissions advanced by the learned Advocates for the parties. The amount in question was paid by the assessee to compensate the loss suffered by CPT due to occupation of land in excess of what was demised to him. Question is whether the aforesaid expenditure is an amount expended fully and exclusively for business purposes within the meaning of Section 37(1) of the Act quoted above.

In Jamna Auto Industries, Yamunanagar -Vs- The CIT Haryana, Rohtak reported in (2008) 299 ITR 92 a full bench of Punjab and Haryana High Court elaborately dealt with the question of whether damages paid for breach of contract can be allowed as expenditure under Section 37(1) of the Act. In the aforesaid case the assessee had entered into an agreement with a German Firm for supply of certain goods. The said contract did not fructify, as the assessee did not have the requisite import license for the material intended to be imported. On a dispute being referred to an arbitrator, the assessee had to pay Rs.50,000/- to the said German firm in terms of the arbitral award. It was this amount which he claimed as deduction. The Court interpreted Section 37(1) as follows:-

"10. The legal position may first be analyzed. Section 37(1) of the Act contains the general provisions for allowance as an expenditure. According to Section 37(1), for a particular item of expenditure to be an allowable deduction under this section:-

(a) it should not be an expenditure of the nature described in Sections 30 to 36;

(b) it should not be in the nature of capital expenditure; or personal expenses of the assessee; and

(c) it should have been laid out or expended wholly and exclusively for the purpose of the business or profession of the assessee;

11. The phraseology-laid out or expended wholly and exclusively for the purposes of business or profession-embraces within it 'wholly' which refers to the quantum of expenditure and the word 'exclusively' refers to the motive, objective and purposes of the expenditure. The expression 'wholly and exclusively' does not mean 'necessarily'. If an amount is incurred for promoting the business and to earn profits, the assessee can claim deduction therefor even though there was no compelling necessity to incur such expenditure. The test for allowability of an expenditure as a deduction is to judge, whether the expense has been incurred with the sole object of furthering the trade or business interest of the assessee unalloyed or unmixed with any other consideration and that

expenditure was necessitated or justified by commercial expediency.

12. Whenever certain damages are to be paid by an assessee for the breach of a contract, such damages are treated to be normal incidences of business. For allowability as a deduction, a claim for damages is to be tested on the touchstone of the provisions of Section 37(1) of the Act. Where an assessee has to pay damages to the other party for the failure to fulfill the contract entered into by him in the ordinary course of his business, the amount of damages so paid is an allowable deduction if it is in the ordinary course of the business, and is not opposed to the public policy.

13. A penalty imposed for breach of any law during the course of trade etc. cannot be described as a commercial loss. If an assessee while conducting his business, has acted in an unlawful manner which has rendered him liable to penalty, the sum so paid cannot be claimed as a deductible expense. Infraction of the law is not a normal incident of business and, therefore, no expense which is paid by way of penalty for a breach of law is admissible deduction. In cases where a penalty has to be incurred, for the reason of the assessee having carried on business in an unlawful manner or in contravention of certain rules and regulations, such penalty could not be regarded as 'wholly and exclusively' laid out for the purposes of business as the expense has not been necessitated by the business but by the conduct of the assessee in trying to carry out the business in an unlawful manner. Under Section 37(1), only that portion of such payment having composite nature which is attributable to its compensatory character for payment as damages is to be allowed as a deduction. The other portion which is attributable to its penalty nature cannot be allowed as a deduction under Section 37(1) because such payment is for infraction of law."

In CIT -Vs- S.A. Builders Pvt. Ltd. reported in (2008) 299 ITR 88, the assessee was a contractor executing various works. The assessee claimed a deduction on account of compensation paid to the contractee for delaying the execution of works. The issue was whether the compensation paid can be allowed as a deduction. It was held that the compensation paid by the assessee was on account of breach of contract which does not fall within the category of payment of penalty for breach of any law but would be a

compensation for breach of contractual obligation, accordingly, will fall in the category of allowable deduction.

The above issue was also dealt with by the Supreme Court in the *Swedeshi Cotton Mills Co. Ltd. -Vs- CIT* reported in (1998) 233 ITR 199. The issue before the Supreme Court was regarding deductibility of liability incurred by the assessee for delayed payment of employee's contribution under Section 14B of the Employee's Provident Fund Act, 1952 and the penalty levied on the assessee under the Central Sales Tax Act. The Supreme Court followed its earlier judgement in *Prakash Cotton Mills Pvt. Ltd. -Vs- CIT* reported in (1993) 201 ITR 684 and held that wherever an amount has been paid by way of damages, the compensatory payment made by the assessee entitles him to claim deduction from the income earned by him and where an element of penal levy is concerned, any such payment made for contravention of law is inadmissible.

The Supreme Court in *Standard Batteries* (supra) reiterated the view taken in *Prakash Cotton Mills Pvt. Ltd. -Vs- CIT* reported in (1993) 201 ITR 684. Their Lordships in *Prakash Cotton Mills* (supra) had held as follows:-

".....Therefore, whenever any statutory impost paid by an assessee by way of damages or penalty or interest is claimed as an allowable expenditure under Section 37(1) of the Income Tax Act, the assessing authority is required to examine the scheme of the provisions of the relevant statute providing for payment of such impost notwithstanding the nomenclature of the impost as given by the statute, to find whether it is compensatory or penal in nature. The authority has to allow deduction under Section 37(1) of the Income Tax Act, wherever such examination reveals the concerned impost to be purely compensatory in nature. Wherever such impost is found to be of a composite nature, that is, partly of compensatory nature and partly of penal nature, the authorities are obligated to bifurcate the two components of the impost and give deduction to that component which is compensatory in nature and refuse to give deduction to that component which is penal in nature."

We have already indicated that the payment was made to compensate the loss suffered by CPT due to occupation of land in excess of what was demised to the assessee. Therefore, the payment did not partake the character of penalty. The payment could not partake the character of a capital expenditure because contention of the CPT was that the prayer for lease of the land unauthorisedly occupied could not be examined before payment of the compensation. Therefore, the payment was altogether compensatory for the benefit already received by the assessee by user of the land which had or could have nothing to do with a grant of lease in future.

For the aforesaid reasons the question No. 2 is answered in the affirmative and in favour of the assessee. No separate answer to question No.1 is necessary.

The question No.3 is answered in the negative and the question No. 4 is answered in the affirmative.

The appeal is allowed.

Parties shall bear their own costs.

(GIRISH CHANDRA GUPTA, J.)

I agree.

(ASHA ARORA, J.)