

PRAKASH COTTON MILLS PVT. LTD.

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COMMISSIONER OF INCOME TAX (CENTRAL) BOMBAY

APRIL 6, 1993

[B.P. JEEVEN REDDY AND N. VENKATACHALA, JJ.]

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Income Tax Act, 1961—A.Y. 1966-67—Allowance under section 37(1) of interest paid by assessee for delayed payment of Sales Tax under Bombay Sales Tax Act and damages paid for delayed payment of contribution under Employees State Insurance Act, 1947.

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Allowance under section 37 (2) of entertainment expenditure.

The appellant paid Rs.19635 in the accounting year for A.Y. 1966-67, on account of interest, under Bombay Sales Tax Act, 1951, for delay in payment of sales tax, and for damages for delayed payment of contribution under Employees State Insurance Act, 1947. The assessee-appellant in the return of income, claimed the amount as allowance under section 37(1) of I.T. Act. The appellant, also claimed the entire entertainment expenses, amounting to Rs.3865 as allowance under section 37(2) of the I.T. Act. The Income-tax Officer treated the payment of Rs.19635 as penal interest and disallowed it as allowance under section 37(1) of I.T. Act. Out of the entertainment, expenses, amounting to Rs.3865 incurred by the Directors of the assessee company, for entertainment at the Diners club and C.C.I, the I.T.O. regarded Rs.1365 only as permissible deduction under section 37(2) of I.T. Act, taking the view that the remaining sum of Rs.2500 was attributable to personal expenses of the Directors of the assessee company and therefore impermissible deduction under section 37(2) of the I.T. Act. The Assessee - appellant did not succeed in appeals before the A.A.C. and in the Income Tax Tribunal. Applications under section 256 (1) of the I.T. Act before the Tribunal and under section 256 (2) in Bombay High Court were rejected.

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The assessee filed appeal by special leave in Supreme Court. This Court allowed the appeal partly and,

HELD: That the authority concerned has to allow deduction under section 37(1) of the I.T. Act, wherever the concerned impost is purely

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A compensatory in nature. Wherever such impost is found to be of a composite nature, that is partly compensatory and partly penal, the authorities are obligated to bifurcate the two components of the impost and given deduction to the component, which is compensatory in nature and refuse the deduction for the component which is penal in nature.

B Therefore, whenever any statutory impost paid by assessee by way of damages or penalty or interest is claimed, 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. This Court agreed with the view taken in earlier

C decisions by this Court and by the Andhra Pradesh High Court, which settle the law as to when any amount paid as interest damages or penalty could be regarded as compensatory (reparatory) as would entitle the assessee to claim allowance under section 37 (1) of I.T. Act. This Court concluded that the question whether the impost is in essence compensatory or is by way of penalty, has to be decided having regard to the

D relevant provisions of the law under which it is imposed, the reasons given in the order imposing and quantifying the damages or penalty. The imposition though called a penalty may be composite in nature comprising penalty as well as compensation for delayed payment. The nomenclature of the levy as interest, damages or penalty is not conclusive.

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[1991-B, 990-H, 991-A]

Mahalakshmi Sugar Mills Co. v. Commissioner of Income Tax Delhi, [1980] 123 I.T.R. 429 S.C.; *Commissioner of Income Tax v. Hyderabad Allwyn Metal Works Ltd.*, (1988) 172 ITR 113 (H.C.A.P.) and *Organo Chemical Industries v. Union of India*, A.I.R. 1979 S.C. 1803.

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This Court, remitted the matter of the Tribunal concerned, so far as it related to deduction under section 37(1) of I.T. Act, regarding impost of interest for delayed payment of sales tax and impost of damages for delayed contribution under Employees State Insurance Act, as the I.T.O.

G and the appellate authority had refused the allowance without any examination of the schemes of the provisions of the Bombay Sales Tax Act and the Provident Fund Act. [1991-D]

H This Court further held that the question as to what portion of expenses claimed, is deductible entertainment expenditure, has to be

decided by the fact finding authorities, while assessing the relevant materials placed before them. No question of law arises, particularly when the fact finding authorities had recorded concurrent findings on consideration of relevant material. Hence the question was decided against the assessee - appellant. [992-B] A

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1279 (NT)/1977. B

From the Judgment and Order dated 17.6.1976 of the Bombay High Court in I.T. Application No.63 of 1976.

Mrs. A.K. Verma, Mrs. S.V. Pathak (For J.B. Dadachanji & Co.) for the Appellant. C

P.S. Poti, Ms. A Subhashini (NP) and R. Satish for the Respondent.

The Judgment of the Court was delivered by D

VENKATACHALA, J. Two questions are raised for our decision in this appeal. First, whether the appellant was entitled to claim as allowance under Section 37(1) of the Income-tax Act, 1961 (the I.T. Act) the interest paid by it for delayed payment of sales tax under the Bombay Sales Tax Act, 1951 (the BST Act) and the damages paid by it for delayed payment of contribution under Employees' State Insurance Act, 1947 (the ESI Act.) Second, whether the appellant was entitled to claim as allowance under Section 37(2) of the I.T. Act the entire expenses incurred by it as entertainment expenses. E

The appellant is a company carrying on the business in the manufacture of textile goods. It is the assessee. In the income-tax return of the assessee for the Assessment Year 1966-67 (the previous accounting year being from 1st July, 1964 to 30th June, 1965), the interest and the damages of Rs.19,635 paid by it for delayed payment of sales tax under the BST Act and for delayed payment of contribution under the ESI Act, was claimed as revenue expenditure, allowable under Section 37(1) of the I.T. Act. So also the sum of Rs.3,865 paid by it for entertainment expenses was claimed as revenue expenditure, allowable under Section 37(2) of the I.T. Act. The I.T.O., in his assessment order made on that return, treated the said item of expenditure of Rs.19,635 as penal interest and disallowed it. As to the item of expenditure of Rs.3,865, he disallowed Rs.2,500 treating it as exclusive expenditure incurred on its Directors. Appeals preferred before H

A the A.A.C. and the Income-tax Appellate Tribunal (Tribunal) questioning the disallowance of claims of the appellant by the I.T.O., did not succeed. Application made by the assessee under Section 256(1) of the I.T. Act before the Tribunal to raise the questions covering the said matters and get them referred for decision by the High Court, also did not meet with success. Again, the application made thereafter by the assessee under **B** Section 256(2) of the I.T. Act before the Bombay High Court to obtain a reference on the questions relating to the said matters for its decision, was rejected. Hence, the assessee has filed this appeal by special leave, questioning the aforesaid orders made by the authorities and the High Court. Reference sought to be obtained from the Tribunal for decision by the **C** High Court, was on the following questions:-

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1. Whether the sum of Rs.19,635 debited in the interest account paid by way of interest for delayed payment of sales tax and Employees' State Insurance contribution could be said to have not been incurred, wholly and exclusively for the purpose of business?
 2. Whether on the facts and in the circumstances of the case, the sum of Rs.19,635 claimed by the assessee was an allowable expenditure under the Income-tax Act, 1961?
 3. Whether on the facts and in the circumstances, the Tribunal was justified in holding that the disallowance of Rs.2,500 out of expenditure incurred by the assessee at Diners Club and C.C.I. could be disallowed even though the said expenditure was less than the expenditure allowable under Section 37(2) of the I.T. Act?
 4. Whether there was any evidence or material before the Tribunal to hold that the expenditure to the extent of Rs.2,500 at Diners Club and C.C.I. was not laid wholly and exclusively for the purposes of business of the assessee-company?
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Questions 1 & 2 are covered by First Question indicated at the outset. So also, questions 3 & 4 are covered by Second Question indicated at the outset. Indeed, after hearing counsel for the parties we were inclined **H** to think that the said questions ought to be remitted to the High Court for

its opinion under Section 256 of the I.T. Act. In the normal course, we would have done so and left the questions to be answered by the High Court. But, regard being given to the fact that the questions relate to a 25 year old case of the Assessment Year 1966-67 and the fact that they could be considered by us on the facts found in the order of the Tribunal, we consider it most appropriate to deal with the questions ourselves and answer them. Such course is resorted to by us not merely because of the said peculiar facts and circumstances of this case, but also because of our inclination to remit the First Question with our answer thereon for a final decision by the Tribunal.

First Question:

Section 37(1) of the I.T. Act corresponds to Section 10(2)(XV) of Predecessor Indian Income-Tax Act of 1922 (the I.T. Act of 1922), is undisputed.

In *Mahalakshmi Sugar Mills Co. v. Commissioner of Income-tax, Delhi*, (1980) 123 ITR 429, this Court had to decide the question whether the interest paid by the appellant-assessee therein under Section 3(3) of the U.P. Sugarcane Cess Act, 1956 for delayed payment of cess payable thereunder was an allowable expenditure under Section 10(2)(XV) of the I.T. Act of 1922. For deciding that question, this Court examined the provisions of Sugarcane Cess Act, 1956 which provided for taking of several kinds of action against a person who defaulted in payment of the cess imposed under that Act. Section 4 was found to make the defaulter liable to imprisonment or fine or both. Section 3(5) was found to make the defaulter liable for payment of penalty, an amount which far exceeded the amount of cess. Then, Section 3(3) was found to make the defaulter liable for payment of interest at 6 per cent per annum from the date of default till the date of payment. On an analytical examination of the said provisions, this Court took the view that interest paid under Section 3(3) by the defaulter for delayed payment of the cess could not be described as a penalty imposed upon him for infringement of the law but ought to be regarded as an amount of compensation paid by him to the Government for delayed payment of the cess levied against him under the Act. In that view of the matter, this Court held that the interest paid by the appellant-assessee on delayed payment of cess was an allowable expenditure under Section 10(2)(XV) of the I.T. Act of 1922.

A In *Commissioner of Income Tax v. Hyderabad Allwyn Metal Works Limited*, (1988) 172 ITR 113, a Division Bench of the Andhra Pradesh High Court had to decide two questions; (i) whether the damages paid by the respondent-assessee under Section 14B of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952, was an allowable deduction under Section 37(1) of I.T. Act and (ii) whether the interest paid under the BST Act, for delayed payment of sales tax thereunder, was an allowable deduction under Section 37(1) of the I.T. Act. For deciding question (i), the Division Bench, referred to the view of A.P. Sen, J. of this Court found in a passage of his concurring judgment in *Organo Chemical Industries v. Union of India*, AIR 1979 SC 1803, on the expression 'damages' occurring in Section 14B of Central Act of 1952, which read thus:-

"The expression 'damages' occurring in section 14B is, in substance, a penalty imposed on the employer for the breach of the statutory obligation. The object of imposition of penalty under s. 14B is not merely 'to provide compensation for the employees'. We are clearly of the opinion that the imposition of damages under s.14B serves both the purposes. It is meant to penalise defaulting employers as also to provide reparation for the amount of loss suffered by the employees. It is not only a warning to employers in general not to commit a breach of the statutory requirements of section 6, but at the same time it is meant to provide compensation or redress to the beneficiaries, i.e., to recompense the employees for the loss sustained by them. There is nothing in the section to show that the damages must bear relationship to the loss which is caused to the beneficiaries under the Scheme. The word 'damages' in section 14B is related to the word 'default'. The words used in section 14B are 'default in the payment of contribution' and, therefore, the word 'default' must be construed in the light of para.38 of the Scheme which provides that the payment of contribution has got to be made by the 15th of the following month and, therefore, the word 'default' in section 14B must mean 'failure in performance' or 'failure to act'. At the same time, the imposition of damages under section 14B is to provide reparation for the amount of loss suffered

by the employees." A

The Division Bench, having regard to the said view of the expression 'damages' occurring in section 14B of Provident Fund Act, found that such damages paid by the concerned assessee-respondent could not have been treated by the Tribunal as purely compensatory. While recording such finding, the real distinction that exists between an impost which is compensatory and an impost which is a penalty, is pointed out, thus:- B

"The question whether any such impost is in essence compensatory or is by way of penalty will have to be decided having regard to the relevant provisions of the law under which it is imposed and the circumstances under which it has been imposed. The mere nomenclature as interest, penalty or damages in the Act may not be conclusive for the purpose of allowing it as a deduction under the Income-tax Act. Similarly, the circumstance that a fixed rate of interest has to be paid also may not be conclusive. Section 14B of the Act provides for levy of damages for delayed payment as a percentage of the amount due up to a prescribed maximum. Such a determination is to be done by the appropriate authority after giving an opportunity to the employer. Thus, the levy will be by a speaking order of the authority fixing quantum of damages. As held by the Supreme Court, the said amount comprises both an element of penal levy as well as compensatory payment. It will be for the authority under the Income-tax Act to decide with reference to the provisions of the Employees' Provident Funds Act and the reasons given in the order imposing and quantifying the damages to determine what proportion should be treated as penal and what proportion as compensatory. The entire sum can neither be considered as mere penalty nor as mere interest." C D E F G

Then, dealing with question (ii) relating to interest paid by the concerned respondent-assessee under the BST Act which the Tribunal had treated as an allowable deduction under Section 37(1) of the I.T. Act, the Division Bench considered the relevant provisions of the BST Act bearing H

A on the question and held, thus:-

B "From a reading of the aforesaid provision and in the
C background of the various sections mentioned above, it
D cannot be said that the levy under section 36(3), though
E called a penalty, is merely compensatory or in the shape
of interest for delayed payment or penal in character. The
Act does not provide for automatic payment of interest
due to delay in payment. The levy under sub-section (3)
of section 36 is to be made after giving notice to the dealer
and after recording reasons for it where the tax has not
been paid within the time contemplated for payment by
the Act. The Commissioner has also the power to remit
the whole or any part of the interest calculated in the
manner mentioned in it which can be only on relevant
grounds. Sub-section (5) of Section 36, which is extracted
above, indicates that after the levy of this amount under
sub-section (3), immunity is granted from prosecution on
the same facts. These indicate that the imposition, though
called a penalty, is a composite one comprising both a
penalty and a compensation for delayed payment. The
Tribunal, therefore, was not right in treating the entire
payment as merely interest for delayed payment. As al-
ready indicated while discussing question No.(1), the
nomenclature of the levy as interest, damages or penalty
may not be conclusive."

F The decision of this Court, in *Mahalakshmi Sugar Mills Company*
(supra) and the decision of the Division Bench of the Andhra Pradesh
High Court in *Hyderabad Allwyn Metal Works Ltd.* (supra) with the views
of which we are in complete agreement, are, in our opinion, decisions
which settle the law on the question as to when an amount paid by an
G assessee as interest or damages or penalty could regarded as compensatory
(reparatory) in character as would entitle such assessee to claim it as an
allowable expenditure under Section 37(1) of the I.T. Act. 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 I.T. Act, the assessing authority is required to examine the
H 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 I.T. 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.

The facts of the case under our consideration disclose that the I.T.O. and the Appellate authorities have refused to allow the claims made by the assessee under Section 37(1) of the I.T. Act, without any examination of the Scheme of the provisions of the BST Act, to find whether impost of the interest paid by the assessee for delayed payment of sales tax was compensatory in nature as would entitle it for deduction under Section 37(1) of the I.T. Act. The same is the position as regards the impost of damages paid by the assessee under the Provident Fund Act for delayed payment of contribution thereunder. Hence, we consider it necessary to remit the question to the concerned Tribunal for deciding the assessee's claims for deduction of interest and damages under Section 37(1) of the I.T. Act. First Question is answered accordingly.

Second Question:

Miscellaneous expenses claimed by the assessee as deductible expenditure allowable under Section 37(2) of the I.T. Act related to a sum of Rs.3,865 incurred by the Directors of the assessee-company for entertainment at the Diners Club and C.C.I. The I.T.O. regarded a sum of Rs.1,365 out of the said sum of Rs.3,865 as permissible deduction under Section 37(2) of the I.T. Act, while he regarded the remaining sum of Rs.2,500 as impermissible deduction under Section 37(2) of the I.T. Act taking the view that the same was attributable to personal expenses of the Directors of the assessee-company. The A.A.C. in dealing with the said claim for deduction in the appeal of the assessee filed before him, held the entire expenses claimed as deductible expenditure under Section 37(2) of the I.T. Act could not be regarded as having been laid out or expended wholly and exclusively for the purpose of the business of the assessee. He, therefore,

A refused to interfere with the order of the I.T.O. made in that regard. The Tribunal, which considered the matter in the appeal of the assessee before it, affirmed the view of the A.A.C. in the matter. As to what portion of the miscellaneous expenses claimed, is a deductible entertainment expenses of the assessee being a matter to be decided by the fact finding authorities while assessing the relevant materials placed before them, no question of law could arise in that regard, particularly, when the fact finding authorities have recorded their concurrent finding on consideration of the relevant material. Hence, the question under consideration is devoid of merit and is answered against the assessee.

C In the result, we allow that appeal partly and remit the case relating to appellant-assessee's claim for deduction under Section 37(1) of the Income-tax Act, 1961 to Income-tax Appellate Tribunal, Bombay for being decided in the light of our answer to the First Question and decide the appeal of the assessee, accordingly. No costs.

I.S.G.

Appeal allowed partly.