Controversies

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Whether amount paid for compounding of offence is hit by explanation to section 37(1) of the Income Tax Act, 1961 and hence cannot be allowed as deduction while computing business income?

Issue :

The assessee M/s. XYZ Construction Co. Pvt. Ltd. paid compounding fees for regularizing construction of building which was made in violation of Building Regulations. The AO is of the opinion that compounding fees paid cannot be allowed as deduction since it is covered by the explanation to section 37(1) of the Income Tax Act, 1961.

Proposition :

It is submitted the compounding fees is paid only for violation of administrative regulations which gets relaxed on payment of compounding fees. It is also submitted that such payment is not against violation of law. The fact that the matter is compounded does not mean that there is admission of violation. It is further submitted that such payment is at the most for the breach of regulation under the relevant laws and not laws themselves. In these circumstances, compounding fees paid in my opinion is not hit by explanation to section 37(1) of the I.T. Act, 1961 hence the same has to be allowed as deduction.

View against the Proposition :

Let me refer to explanation to section 37(1) of the I.T. Act, 1961.

1] Prior to insertion of Explanation to section 37(1) by Finance (No.2) Act, 1998, the Courts including the Hon'ble Apex Court have on various occasions been called upon to answer the question, as to whether fines and penalties paid by the assessee could be allowed as a deduction while computing the income of the assessee and the Courts have consistently held that any expense which is paid by way of penalty for breach of law cannot be said to be an amount expended wholly and exclusively for the purposes of business – Haji Aziz & Abdul Shakoor Brothers vs. CIT [(1961) 41 ITR 350 (SC)]. However, in Pranav Construction Co. vs. ACIT [(1988) 61 TTJ (Mum.) 145] the Hon'ble Mumbai Tribunal held that payment of extortion monies and hafta by the assessee, a builder to anti social elements was an allowable business expenditure as strong circumstantial evidences were available to prove the genuineness of the payments made by the assesseee.

In order to put the matter beyond reasonable doubt and to disallow any expenditure incurred by the asessee for any purpose which is an offence or which is prohibited by law Explanation to sub-section (1) of 37 of the Act was inserted by the Finance (No. 2) Act, 1998, with retrospective effect form 1-4-1962 which read as under :

37(1)……

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."

The intention and the reason for the insertion of the Explanation was explained by the Central Board of Direct Taxes in Circular No.772, dated 23.12.1998 [(1999) 235 ITR (St.) 35] in the following words :

"20 Disallowance of illegal expenses.—

20.1 Section 37 of the Income-tax Act is amended to provide 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 purposes of business or profession and no deduction or allowance

shall be made in respect of such expenditure. This amendment will result in disallowance of the claims made by certain assesses in respect of payments on account of protection money, extortion, hafta, bribes, etc., as business expenditure. It is well decided that unlawful expenditure is not an allowable deduction in computation of income."

Thus, the Explanation was inserted with the intention to curb, rather than to act as a deterrent against, any one carrying on a profession, occupation or business in any illegal or illegitimate manner. Now, after insertion of Explanation any penalty/ fine or any expenditure incurred which is prohibited by law (Extortion money, hafta, bribes, etc.) cannot be considered as an expenditure wholly and exclusively incurred for the purpose of business. It is also against public policy to allow the deduction of expenditure incurred under one statute which is in violation of provisions of another statute.

Gareden Silk Mills Ltd. v/s. Asstt. CIT (2005) 2 SOT 856 (Ahd)

Assessee company took over business of a partnership firm – Department had launched prosecution proceedings against partners of erstwhile firm who were now directors of assessee – Assessee paid compounding fees to CBDT and claimed same as expenditure under section 37(1) – Since prosecution was launched against partners of erstwhile firm, it was their personal responsibility to face such prosecution and, therefore, deduction under section 37(1) – being also hit by Explanation to section 37(1), was not allowable.

Payments made to Municipal Corporation for regularizing unauthorized construction carried out without obtaining necessary permission from the Municipal Corporation were held to be penal in nature and hit by the provisions of Explanation to section 37(1) of the Act, Millennia Developers (P) Ltd. vs. Dy. CIT (2010) 322 ITR 401 (Karn)]. Similar view is also taken by Hon'ble Mumbai Tribunal in the case of Radhavallabh Silk Mills (P) Ltd. vs. Dy. CIT [(2007) 12 SOT 423 (Mum.)]

In CIT vs. Mamta Enterprise (266 ITR 356), by invoking Explanation to section 37, compounding fees for regularizing construction of building, the Court held that compounding process cannot wash away sin of violation. The person would still be an offender of law and hence compounding charges paid still be treated as payment for infraction of law not deductible as expense in view of Explanation to section 37. The Delhi High Court decision in Loke Nath (Supra) was distinguished being decision pertaining to period prior to insertion of Explanation.

View in favour of the Proposition:

The decision of the Hon'ble Apex Court in the case of Haji Aziz & Abdul Shakoor Brothers (supra) together with the Explanation to section 37(1) of the Act cannot be read as laying down an inflexible rule of law that in all eventualities with regard to deductibility of fines and penalties, before invoking the provisions of Explanation to section 37(1) of the Act, the assessing officer is required to examine the scheme of the provision of the relevant statute providing for payment of such levies, notwithstanding the nomenclature of the levy given by the statute, in order to find out whether the payment made by the assessee is compensatory or penal in nature. Where the amount paid by the assessee is only compensatory in nature that is to compensate the Government for any delay in payment of taxes, filing of belated returns, etc. then such payments are allowable under section 37(1) of the Act as there is no infraction of law by the assessee. On the other hand where the payment made by the assessee is partly compensatory and partly penal in nature the assessing officer has to bifurcate the compensatory and penal component of the payment made and the provisions of Explanation could be invoked only with respect to the component which is penal in nature Prakash Cotton Mills (P) Ltd. vs. CIT [(1993) 201 ITR 684 (SC)] and CIT vs. Ahmedabad Cotton Mfg. Co. Ltd [(1994) 205 ITR 163 (SC)].

Following the decision of Prakash Cotton Mills (P) Ltd. (supra), recently, the Hon'ble Himachal Pradesh High Court in the case of , CIT vs. H.P. State Forest Corporation [(2010) 320 ITR 170 (H.P.)] held that interest paid by the assessee under section 17A of the H.P. Sales Tax Act though called as penalty was not payable as and by way of penalty but the same

was by way of compensation to compensate the State for delay in payment as such the same was allowable under section 37(1) of the Act. The Court further in the judgement observed that taxing statutes normally have two imposts for delayed payments made by the assessee. One is the imposition of interest, which is automatic, the second is the imposition of penalty for which not only notice is required and thereupon if the assessee gives valid reasons for not depositing the tax in time penalty need not be imposed, such payments are penal in nature and not allowable in terms of Explanation to section 37(1) of the Act. On the other hand where the payment of interest is automatic for the delayed period, the imposition is compensatory in nature and allowable under the Act.

The Hon'ble Mumbai Tribunal in the case of, Goldcrest Capital Market Ltd. vs. ITO (2010) 2 ITR (Tib.) 355 (Mum.)] While allowing the amount paid by the member of the National Stock Exchange ("NSE") to the Stock Exchange for violation of regulations of the Exchange, held that members of NSE are bound to abide by the rules, regulations and bye-laws of the NSE However, such rules, regulations and bye-laws can be considered as regulations for controlling the internal, inter se, obligations and rights of the members of the NSE which every member of NSE would be obliged to follow. A violation thereof cannot be treated as violation of a statutory law or rule.

Summation :

In many statutes, law itself provides for compounding of offence and on payment of compounding fees, person is discharged from offence committed. Issue may arise on coverage or otherwise of amount paid for compounding of offence within the scope of Explanation.

Now, in pre-amendment era, the preponderant view of the Courts was that the moment compounding of offence is accomplished, the effect is that the person is placed in the position of an innocent person as if he had never committed crime. For instance, in the case of CIT v/s. Loke Nath & Co. 147 ITR 624 the Delhi High Court allowed deduction of compounding fees paid for regularizing construction of building which was made in violation of building regulations. In Nanhmool Jyoti Prasad (123 ITR 269), the Allahabad High Court allowed deduction of fine paid by the assessee to avoid confiscation of goods imported without proper licence. According to the Court, effect of payment of fine is that import got regularized.

Compounding fees paid to municipal corporation became an issue in CIT v. Mamta Enterprises [2004] 266 356 (Karn.). One would have thought that the description of the amount as compounding fee and the fact that the fee was paid only for violation of administrative regulations, which themselves were relaxed on payment of compounding fees, should not have militated against the deduction on the basis of guidelines laid down by the Supreme Court in Prakash Cotton Mills P. Ltd. v. CIT [1993] 201 ITR 684 (SC). The Supreme Court in the light of the earlier precedent in Mahalakshmi Sugar Mills Co. v. CIT [1980] 123 ITR 429 (SC), required consideration, whether the impost is compensatory in nature, so as to be deductible. Where it has composite nature, both compensatory as well as penal, the authorities are obliged to bifurcate the two components and allow what is compensatory. Compounding fees are ordinarily understood as being totally compensatory. It is essentially a nature of civil liability. The High Court, however, was led by precedents relating to penalties and fines following the decision in Haji Aziz and Abdul Shakoor Brothers v. CIT [1961] 229 ITR 534 (SC). The word "compound" even in a legal sense indicates settlement by mutual concessions and is understood to abate a liability. Compounding is also understood as condonation subject to a pecuniary payment. Payment by way of compounding fees should ordinarily be treated as allowable, if it is in the course of a business, because any offence capable of being settled in money terms cannot be treated on par with violation of law. In view of the multiplicity of laws, it is becoming more and more difficult for a citizen not to tread on some rule or regulation of which he may not be aware. It is for this reason that minor offences are made subject matter of compounding fees. Finally it is submitted that the compounding fees paid is allowable as deduction while computing business income not withstanding explanation to sec. 37(1).

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