

# CTR ENCYCLOPAEDIA ON INDIAN TAX LAWS

## COMMISSIONER OF INCOME TAX vs. MAMTA ENTERPRISES

HIGH COURT OF KARNATAKA

P. Vishwanatha Shetty & Ajit J. Gunjal, JJ.

ITRC No. 24 of 1998

30th October, 2003

(2003) 71 CCH 0858 KarHC

(2004) 187 CTR 0414 : (2004) 266 ITR 0356 : (2004) 135 TAXMAN 0393

Legislation Referred to

Sections 37(1), Expln.

Case pertains to

Asst. Year 1984-85

Decision in favour of:

Revenue

***Business expenditure—Penalty, fine, etc.—Compounding fees for offence of unauthorised construction—Putting up any construction without there being a sanctioned plan is an offence under the Karnataka Municipal Corporation Act, 1976, and it is treated as an act prohibited by law—Bye-law 5.6 read with cl. (b) of s. 483 of said Act empowers the Commissioner to compound the violation or deviation from the sanctioned plan—It cannot be said that once the violation is compounded, no offence was committed or that the offence committed is wiped out—Explanation to s. 37(1) prohibits deduction of expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law—Compounding of the offence could not take away the rigour of Explanation to s. 37(1)—Therefore, deduction of compounding fees is not allowable***

Held :

*The submission of the counsel that since the provision in cl. (b) of s. 483 of Karnataka Municipal Corporation Act permits compounding of the offence, once the violation is compounded, there was no offence committed in the eye of law, and the offence committed is wiped out, cannot be accepted. Sec. 300 of the Corporation Act prohibits commencement of the construction or reconstruction of a building without there being a permission granted by the Corporation for the execution of the work. From the scheme of the several provisions in the said Act, it is clear that nobody can put up any new construction or proceed to reconstruct the existing building without there being a sanctioned plan or permission granted by the Commissioner on that behalf; the putting up any construction without there being a sanctioned plan is made as an offence under the Act and it is treated as an act prohibited by law. Bye-law 5.6, read along with cl. (b) of s. 483, empowers the Commissioner to compound the violation or deviation of the sanctioned plan done by a person who constructs a building. The order passed by the Dy. Director of Town Planning, in unmistakable terms states that*

he had permitted for compounding of the "offences of unauthorised construction" of 8th floor in two blocks of the premises belonging to the assessee. The language employed in cl. (b) of s. 483, referred to above, also says that the Commissioner is empowered to "compound the offence". Under these circumstances, there cannot be any doubt what has been done is to permit the assessee to "compound the offence" committed by it by putting up unauthorised construction of 8th floor in the building in question on payment of compounding fine. The Explanation given to s. 37(1), makes it clear that the assessee who incurs expenditure for any purpose which is an offence or which is prohibited by law is not entitled for deduction of such expenditure incurred by him. The Explanation declares that such an expenditure "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. When the Explanation to s. 37(1) defines that the expenditure incurred for any purpose which is an offence or which is prohibited by law is not entitled for deduction, it is not possible to take the view that the compounding of the offence or violation of the provisions of the Act, for the purpose of saving the offender of the law from the consequences of the commission of such an offence or violation of law should also be given the benefit of s. 37(1) by permitting the assessee to pay the compounding fee as the fine. The compounding of the offence under the Act could not take away the rigor of the Explanation given to s. 37(1). The claim for deduction made by the assessee has to be considered in the light of the Explanation given to s. 37(1) and not with reference to the provision in the Corporation or, the Municipal Law which permits the violator of the provisions of the Corporation or the Municipal Law to compound the offence either to save the unauthorised or illegal construction put up or to relieve such violator of law from the consequences provided in such Corporation or Municipal Law. When the section itself declares the 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, it is not possible to take the view that the expenditure incurred for compounding of the offence should be allowed. When the section is clear and unambiguous, it is not permissible for the Courts to stretch the meaning attached to the provision of law to extend the benefit to a person who violates the law or the Regulations/Rules made by the Corporation or the Municipal authorities with impunity. Under these circumstances, the expenditure incurred to pay the penalty cannot be treated as loss in business to get the benefit. The penalty paid has enured to the benefit of the assessee to save the additional construction put up in violation of the provisions of the Act. and the By-laws framed thereunder and also the consequences of penal provision provided under the Corporation or the Municipal Law. Therefore, deduction permitted by the CIT(A) as well as the Tribunal is totally unsustainable in law.—[Haji Aziz & Abdul Shakoor Bros. vs. CIT](#) (1961) 41 ITR 350 (SC) and [Maddi Venkataraman & Co. \(P\) Ltd. vs. CIT](#) (1998) 144 CTR (SC) 214 : (1998) 229 ITR 534 (SC) **relied on**; [CIT vs. Loke Nath & Co. \(Construction\)](#) (1984) 40 CTR (Del) 297 : (1984) 147 ITR 624 (Del) **distinguished**.

**(Paras 5 to 9)**

#### Conclusion :

Compounding fine paid by the assessee to regularise the construction of the building made in violation of the building regulations could not be allowed as deduction in view of specific prohibition in Explanation to s. 37(1) as compounding of such an offence by paying compounding fine did not wipe out the offence or infraction of law committed by the assessee under the relevant Corporation Act.

#### In favour of :

Revenue

#### Counsel appeared:

M.V. Seshachala, for the Petitioner : Ashok A. Kulkarni, for the Respondent

**P. VISHWANATHA SHETTY, J.**

**Order**

This reference is made under s. 256(2) of the Income-tax Act, 1961 (hereinafter referred to as 'the Act'), at the instance of Revenue out of the order dt. 16th July, 1996, made by the Income-tax Appellate Tribunal (hereinafter referred to as 'the Tribunal') in ITA No. 198/Bang/1989. The question of law referred to this Court reads as follows :

"Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in holding that the payment of the compounding fees is not a penalty for infraction of law and hence allowable?"

**2. Facts in brief may be stated as hereunder:**

The respondent-assessee (hereinafter referred to as 'the assessee') is a builder carrying on its business in building apartments and selling the same. In the return filed by the assessee, the assessee claimed a sum of Rs. 89,960 paid as compounding fine to the Bangalore City Corporation as an expenditure under s. 37 of the Act. However, the AO disallowed the said claim. Aggrieved by the said order, the assessee preferred an appeal before the CIT(A). The CIT(A) by means of his order dt. 10th Oct., 1988, allowed the appeal and held that the assessee is entitled for deduction of allowances claimed and granted the said claim made by the assessee under s. 37 of the Act by treating it as an expenditure incurred by the assessee during the course of its business. The Revenue took up the matter in appeal to the Tribunal. The Tribunal by means of its order dt. 16th July, 1996, confirmed the order passed by the CIT(A) relying upon the judgment of the Delhi High Court in the case of CIT vs. Loke Nath & (Construction) Co. (1984) 40 CTR (Del) 297 : (1984) 147 ITR 624 (Del), wherein the Delhi High Court took the view that the payment of compounding fine by the assessee to regularise the construction of the building made in violation of the Building Regulations must be regarded as an integral part of the profit-earning process of the assessee.

**3.** Sri Seshachala, learned counsel appearing for the Revenue, submitted that the conclusion reached by the Tribunal that the compounding fine paid by the assessee to regularise the construction of the building made in violation of the building regulations must be regarded as an integral part of the profit-earning process of the assessee is totally erroneous in law and the said conclusion has been reached by the Tribunal overlooking the Explanation provided to s. 37 of the Act. Elaborating his submission he pointed out that the construction of 8th floor in the absence of a sanctioned plan amounts to violation of the provisions of s. 300 of the Karnataka Municipal Corporations Act, 1976 (hereinafter referred to as 'the Corporation Act'), and the Building Regulations and, therefore, when it is prohibited by the bye-law and also it is made as an offence under s. 436 of the Corporation Act; in view of Explanation to s. 37 of the Act which in specific terms excludes the 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 CIT(A) as well as the Tribunal have erroneously erred in law in reversing the order made by the AO disallowing the said expenditure. The learned counsel in support of his submission, relied upon the decision of the Supreme Court in the case of Haji Aziz and Abdul Shakoor Bors. vs. CIT (1961) 41 ITR 350 (SC) and referred to us the observations made at pp. 359 and 360 of the judgment and also the decision in the case of Maddi Venkataraman & Co. (P) Ltd. vs. CIT (1998) 144 CTR (SC) 214 : (1998) 229 ITR 534 (SC) and referred to us the observation made at p. 539 of the judgment. He also pointed out the order passed by the CIT(A) clearly indicates that the offence has been

compounded and the penalty was paid by the assessee. It is also his submission that the object of the Explanation is not to give deduction in respect of the expenditure incurred by an assessee who violates the law and commits an offence. It is his submission that if the benefit of expenditure incurred to compound the offence is given, it would encourage the people to violate the law and, therefore, this Court while interpreting the provision should place a construction on the provision which would not encourage violation of law and the construction to be placed must serve the object of the law. He also pointed out that the decision in the case of CIT vs. Loke Nath & (Construction) Co. (supra) referred to by the Tribunal cannot have any application to the present case as the said decision was rendered prior to the incorporation of the Explanation to s. 37 of the Act by means of amendment made to the Act. However, Sri Ashok Kulkarni, learned counsel appearing for the assessee, strongly supported the order passed by the Tribunal and also the CIT(A). It is his submission that construction of a building in violation of the sanctioned plan cannot be treated as a violation of a serious nature which is prohibited by law or amounting to commission of an offence. He submitted that the principle laid down by the Hon'ble Supreme Court in the case of Haji Aziz and Abdul Shakoor Bors. (supra) and in the case of Maddi Venkataraman & Co. (P) Ltd (supra) has no application to the facts of the present case.

**4.** In the light of the rival submissions made by learned counsel appearing for the parties, the only question that would arise for consideration in this reference case is as to whether the question of law referred to this Court is required to be answered in favour of the Revenue or the assessee?

**5.** Having elaborately heard the learned counsel appearing for the parties, while we find considerable force in the submission of Sri Seshachala, we are unable to accede to the submission of Sri Kulkarni. We are unable to agree with the submission of Sri Kulkarni that since the provision in cl. (b) of s. 483 of Corporation Act permits compounding of the offence, once the violation is compounded, there was no offence committed in the eye of law; and the offence committed is wiped out. Sec. 300 of the Corporation Act prohibits commencement of the construction or reconstruction of a building without there being a permission granted by the Corporation for the execution of the work. Sec. 303 of the said act sets out the grounds on which approval of a site for construction or reconstruction of a building or permission to construct or reconstruct a building may be refused by the Commissioner. Sec. 308 of the Act confers power on the Commissioner to direct alteration of construction work commenced by the owner of a site. Sec. 321 of the Act confers power on the Commissioner to make an order for demolition of the building after complying with the procedure set out in the said provision, if he is satisfied that the construction or reconstruction of a building has been commenced without obtaining the permission or being carried on or has been completed otherwise than in accordance with the plans or particulars on which such permission or order was based. Sec. 436 of the Act, among other things, provides that if the construction or reconstruction of any building is commenced without the permission of the Commissioner; or is carried on or completed otherwise than in accordance with the particulars on which such permission was based; or is carried on or completed in contravention of any lawful order or breach of any provision of the Act or any rule or bye-law made under it, or of any direction or requisition lawfully given or made, the owner of the building who puts up such construction shall be liable on conviction to pay a fine prescribed under the said provision. However, cl. (b) of s. 483 of the Corporation Act empowers the Commissioner to compound any offence committed in breach of the provisions of the Act., Rules, Bye-laws or Regulations which may by rules made by the Government be declared compoundable. Therefore, from the scheme of the several provisions in the Act referred to above, it is clear that nobody can put up any new construction or proceed to reconstruct the existing building without there being a sanctioned plan or permission granted by the Commissioner on that behalf; the putting up any construction without there being a sanctioned plan is made an offence under the Act and it is treated as an act prohibited by law. No doubt, as noticed by us earlier, cl. (b) of s. 483 of the Corporation Act empowers the Commissioner to compound the

offence. Bye-law 5.6 framed by the Corporation in exercise of the power conferred under it under s. 428 of the Act enables the Commissioner to set out the circumstances under which he could compound an offence. It is useful to refer to the said bye-law which reads as hereunder.

"5.6.1. Wherever any construction is in violations/deviation of the sanctioned plan, the Commissioner may, if he considers that the violation/deviations are minor, viz.; only when the deviations/violations is within 5 per cent of (1) the minimum set back to be left around the building; (2) the maximum plot coverage; (3) permissible floor area ration and maximum height of the building and that the demolition under Chapter XV of the Act is not feasible without affecting the structural stability, then he may regularise such violations/ deviations by sanctioning of a modified plan with a levy of a suitable fee to be prescribed. The Commissioner shall come to such conclusion only after recording detailed reasons for the same. Violations/deviations under the provision shall not include the buildings which are constructed without obtaining any sanctioned plan whatsoever and also the violations/deviations which are made inspite of the same being specifically deleted or rejected in the sanctioned plan."

**6.** The bye-law referred to above, read along with cl. (b) of s. 483, empowers the Commissioner to compound the violation or deviation of the sanctioned plan done by a person who constructs a building. Now, the question is whether, the compounding of such an offence by paying penalty as compounding fine will wipe out the offence or infraction of law committed by the assessee. In the instant case, undisputedly the assessee has put up 8th floor in an apartment without there being a sanctioned plan. Therefore, there cannot be any doubt that the assessee has put up the construction in violation of the Building Bye-laws and, therefore, he has committed infraction of law and also an offence within the meaning of s. 436 of the Act. The Dy. Director of Town Planning, who is the delegated authority of the Commissioner, on the request made by the assessee by means of his order dt. 30th Sept., 1982, permitted the assessee to compound the offence on payment of compounding fine. The said order reads as follows:

"In your letters cited above, you requested for compounding of the offences of unauthorised construction of 8th floor in two blocks in the above premises. The Administrator in his proceedings under subject No. 342, dt. 29th Sept., 1982, has approved the proposal to compound the offence by levying a compounding fine of Rs. 89,960 (Rs. Eighty-nine thousand nine hundred sixty only).

Please remit the above mentioned compounding fine by means of challan for issuing the orders on the compounding of the offence."

**7.** The order passed by the Dy. Director of Town Planning, referred to above, in unmistakable terms states that he had permitted for compounding of the "offences of unauthorised construction" of 8th floor in two blocks of the premises belonging to the assessee. The language employed in cl. (b) of s. 483, referred to above, also says that the Commissioner is empowered to "compound the offence". Under these circumstances, there cannot be any doubt what has been done is to permit the assessee to "compound the offence" committed by it by putting up unauthorised construction of 8th floor in the building in question on payment of compounding fine of 89,960. The Explanation given to s. 37 of the Act, as noticed by us earlier, makes it clear that the assessee who incurs expenditure for any purpose which is an offence or which is prohibited by law is not entitled for deduction of such expenditure incurred by him. The Explanation declares that such an expenditure "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. It is useful to refer to the Explanation given to s. 37 of the Act which reads as hereunder :

"Explanation—For 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."

When the Explanation to s. 37 of the Act defines that the expenditure incurred for any purpose which is an offence or which is prohibited by law is not entitled for deduction, it is not possible to take the view that the compounding of the offence or violation of the provisions of the Act, for the purpose of saving the offender of the law from the consequences of the commission of such an offence or violation of law should also be given the benefit of s. 37 of the Act by permitting the assessee to pay the compounding fee as the fine. In our view, the compounding of the offence under the Act could not take away the rigor of the Explanation given to s. 37 of the Act referred to above. The claim for deduction made by the assessee has to be considered in the light of the Explanation given to s. 37 of the Act and not with reference to the provision in the Corporation or, the Municipal Law which permits the violator of the provisions of the Corporation or the Municipal Law to compound the offence either to save the unauthorised or illegal construction put up or to relieve such violator of law from the consequences provided in such Corporation or Municipal Law. However, it is necessary to refer to the observation made by the Delhi High Court in the case of Loke Nath (supra) relied upon by Sri Kulkarni, which reads as follows:

"The charge is not on gross receipts but on profits and gains properly so called. The profits to be assessed are real profits and they must be ascertained on ordinary principles of commercial expediency. The partnership was formed for the purpose of construction of a multi-storeyed building called as Himalaya House and for the purpose of selling the major portions of the said building in the form of flats to various customers. The assessee got the original building plans sanctioned and commenced the constructions. The assessee had no right to make deviations from the sanctioned plan or to continue the construction after the sanction had lapsed. Any constructions thus made would be deemed to have been erected without a proper sanction. The committee, however, has the power to sanction revised plans so as to regularise the deviations or give ex post facto sanction for the constructions made after the sanction had lapsed by accepting by way of compensation such sum as it may deem reasonable. It is at that stage that the assessee had to consider the question of payment on the principles of ordinary commercial trading or on grounds of commercial expediency. ....

The expenditure of payment of compensation incurred by the assessee has to be regarded as an integral part of the profit earning process of the assessee."

**8.** In our view, the above observation made by Delhi High Court cannot be of any assistance to the learned counsel for the respondent to support his case as the said decision was rendered prior to amendment to s. 37 of the Act by incorporating the Explanation referred to above by means of Finance Act. 2/98 which is made retrospective effect w.e.f. 1st April, 1962. When the section itself declares the 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, it is not possible to take the view that the expenditure incurred for compounding of the offence should be allowed. When the section is clear and unambiguous, it is not permissible for the Courts to stretch the meaning attached to the provision of law to extend the benefit to a person who violates the law or the Regulations/Rules made by the corporation or the municipal authorities with impunity. Under these circumstances, the expenditure incurred to pay the penalty cannot be treated as loss in business to get the benefit. In our view, the penalty paid has enured to the benefit of the assessee to save the additional construction put up in violation of the provisions of the Act and the by-laws framed thereunder and also the consequences of penal provision provided under the Corporation or the Municipal Law.

The view we have taken above is fully supported by the decision of the Hon'ble Supreme Court in the case of Haji Aziz and Abdul Shakoor Bors. (supra), wherein the Supreme Court has observed as follows:

"If a sum is paid by an assessee conducting his business, because in conducting it he has acted in a manner which has rendered him liable to penalty, it cannot be claimed as a deductible expense. It must be a commercial loss and in its nature must be contemplable as such. Such penalties which are incurred by an assessee in proceedings launched against him for an infraction of the law cannot be called commercial losses incurred by an assessee in carrying on his business. Infraction of the law is not a normal incident of business and, therefore, only such disbursements can be deducted as are really incidental to the business itself. They cannot be deducted if they fall on the assessee in some character other than that of a trader. Therefore, where a penalty is incurred for the contravention of any specific statutory provision, it cannot be said to be a commercial loss falling on the assessee as a trader, the test being that the expenses which are for the purpose of enabling a person to carry on trade for making profits in the business are permitted but not if they are merely connected with the business." .....

"In our opinion, no expense which is paid by way of penalty for a breach of the law can be said to be an amount wholly and exclusively laid for the purpose of the business. The distinction sought to be drawn between a personal liability and a liability of the kind now before us is not sustainable because anything done which is an infraction of the law and is visited with a penalty cannot on grounds of public policy be said to be a commercial expense for the purpose of a business or a disbursement made for the purpose of earning the profits of such business."

Further, a similar view is taken by the Hon'ble Supreme Court in the case of Maddi Venkataraman & Co. Ltd. (supra). At p. 545 of the judgment, the Hon'ble Supreme Court has observed thus:

"In the instant case, the assessee had indulged in transactions in violation of the provisions of the Foreign Exchange (Regulation) Act. The assessee's plea is that unless it entered into such a transaction, it would have been unable to dispose of the unsold stock of inferior quality of tobacco. In other words, the assessee would have incurred a loss. Spur of loss cannot be a justification for contravention of law. The assessee was engaged in tobacco business. The assessee was expected to carry on the business in accordance with law. If the assessee contravenes the provisions of the FERA to cut down its losses or to make larger profits while carrying on the business, it was only to be expected that proceedings will be taken against the assessee for violation of the Act. The expenditure incurred for evading the provisions of the Act and also the penalty levied for such evasion cannot be allowed as deduction. As was laid down by Lord Sterndale in the case of Alexander Von Glehn & Co. Ltd. (1920) 12 Tax Cases 232 (CA), it was not enough that the disbursement was made in the course of trade. It must be for the purpose of the trade. The purpose must be a lawful purpose."

**9.** Therefore, we are clearly of the opinion that deduction permitted by the CIT(A) as well as the Tribunal is totally unsustainable in law. Therefore, in the light of the above conclusion reached by us, the question referred to us by the Tribunal is required to be answered against the assessee and in favour of the Revenue. Accordingly, it is answered and this reference case is disposed of. However, no order is made as to costs.

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