

***IN THE HIGH COURT OF DELHI AT NEW DELHI**

% Order reserved on : 4th September, 2013
Order pronounced on: 2nd December , 2013

+ **ITA No. 181 of 2013**

COMMISSIONER OF INCOME TAX-XIII Petitioner
Through Mr. Kamal Sawhney,
Advocate

Versus

HEMANT SURANA Respondent
Through Dr. Rakesh Gupta, Mr.
Ashwani Taneja, Ms. Rani
Kiyala, Mr. Rishabh Kapoor
& Ms. Kanika Gupta,
Advocates

CORAM:

HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE SANJEEV SACHDEVA

SANJEEV SACHDEVA, J.

1. The revenue has filed the present appeal under Section 260A of the Income Tax Act, 1961 (hereinafter referred to as 'the Act') impugning the order dated 24.2.2012 whereby the Income Tax Appellate Tribunal



(ITAT) has confirmed the order of the Commissioner of Income Tax (Appeals) who had set aside and deleted the addition of Rs.3,11,85,809/- made by the Assessing Officer on account of disallowance of loss on trading of shares. The Assessing Officer held the same as not an allowable under Section 37(1), the transactions being in violation of Clause 11 mentioned in First Schedule of the Chartered Accountants Act, 1949.

2. The Assessee-respondent is a Chartered Accountant (CA). The Assessee had filed a return of income for the assessment year 2007-08 declaring a total income of Rs.5,13,624/- on 31.10.2007. The case was selected for scrutiny and notice under Section 143(2) of the Act was issued.
3. The Assessee had shown income from trading in shares under the head “ Business or Profession and income from other sources” . As there was business



loss on trading in shares of Rs.3,11,85,809/-, and the Assessee had set them off against his professional income.

4. The Assessing Officer on interpretation of Explanation to Section 37(1) of the Act took a view that since the Assessee was a Chartered Accountant, he was governed by the Chartered Accountants Act, 1949 and was guilty of professional misconduct as he engaged in business or occupation other than the profession of a Chartered Accountant. The Assessee as a practicing Chartered Accountant, was prohibited by law from engaging in any business or occupation of trading in shares. The Assessee was liable for punishment of reprimand, removal of name from Register or fine which may extend upto Rs. 1 lac. The Assessing Officer was of the view that since the Assessee was engaged in the business of trading in shares and had shown business loss of



Rs.3,11,85,809/- , the said business loss was a consequence of a purpose which was prohibited by law. Thus he held that the loss was not allowable in terms of Explanation to Section 37(1) of the Act. Accordingly, the Assessing Officer made an addition of the said amount in the income of the Assessee.

5. Aggrieved by the said order, the respondent Assessee filed an appeal before the CIT (Appeals). The CIT (Appeals) noted the contention of the respondent Assessee that the Assessee though was a Chartered Accountant by profession but was not in practice and had surrendered the certificate of practice *suo motu* on 31.3.2007. The CIT (Appeals) noted the contention of the respondent Assessee that what could be disallowed under the Explanation to Section 37(1) was an expenditure incurred by an Assessee for any purpose which was an offence or an occupation which was prohibited by law. The contention of the



Assessee was that the Assessee was not claiming any expenditure which could be disallowed under Explanation to Section 37(1) but was setting off a business loss which was not covered under Explanation to Section 37(1).

6. What the Chartered Accountant's Act, 1949 stipulated was that if a Chartered Accountant indulged in any of the activities which were mentioned therein, he would be liable to sanctions which include reprimand, removal or fine. The restrictions stipulated on a Chartered Accountant by the Chartered Accountants Act, 1949, would not make the business activity or the purpose, an illegal activity or purpose. The business of shares and property trading was not an illegal business under any law.
7. CIT (Appeals) relying upon the decision of the Supreme Court of India in ***DR. T.A.QURESHI V. CIT; (2006) 287 ITR 547***, held that the Explanation to



Section 37(1) was applicable in the case of business expenditure and not business loss. The CIT (Appeals) further held that the Assessing Officer has not been able to show as to how Clause 11 of the First Schedule to the Chartered Accountants Act was applicable as the Assessee had surrendered the certificate of practice and Clause 11 applied to Chartered Accountant in practice. The CIT (Appeals), thus, deleted the addition made by the Assessing Officer.

8. The revenue, thereafter, assailed the order of the CIT (Appeals) before the ITAT, who vide order dated 24.2.2012 affirmed the order of the CIT (Appeals). This order is impugned before us in appeal.
9. Learned counsel for the appellant has before us reiterated the submissions made before the CIT (Appeals) and the ITAT and has contended that as the Assessee was a Chartered Accountant by profession



he was prohibited from carrying on any other business or profession and as such loss suffered on account of such business or profession was not permitted to be set off in terms of Explanation to Section 37(1) of the Income Tax Act.

10. We are unable to accept or agree with the contention of the learned counsel for the appellant and are of the view that no substantial question of law arises for consideration in the present appeal.

11. Section 37(1) lays down as under:

“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.”

(emphasis supplied)

12. Section 37(1) of the Act enumerates that expenses laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed while computing the income chargeable under the head "Profits and gains of business or profession". The exception to the above being that the expenditure of the nature described in Sections 32 to 36 and in the nature of capital expenditure or personal expenses of the Assessee would not be allowed to be set off in computation of income.



13. Explanation to the said section was inserted by Finance (No. 2) Act, 1998 with retrospective effect from 1962. The reason, scope and effect of this explanation has been elaborated in paragraph 20 of departmental circular No. 772 dated 23rd December, 1998 as under:-

“20. Disallowance of illegal expenses.—**20.1** Section 37 of the Income-tax Act, 1961, 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 Assesseees 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.



20.2 This amendment will take effect retrospectively from 1st April, 1962, and will, accordingly, apply in relation to the assessment year 1962-63 and subsequent years. [Section 15]’.”

14. What comes under the scope and ambit of Section 37 is that any expenditure incurred for any purpose of an offence or for an act prohibited by law or expenditure for the purpose which is prohibited by law, shall not be deemed to have been incurred for the purpose of business or profession, No such tainted expenditure will be allowed as deduction or allowance. The departmental circular accordingly clarifies that protection money, extortion, bribe etc. cannot allowed as this is unlawful expenditure. The explanation does not deal with what is business or profession but only a specific type or nature of expenditure which is incurred by a person carrying on business or profession which is incurred for any purpose which is an offence or for a



purpose which is prohibited by law. It is applicable to expenditure which is for the purpose of an offence or is prohibited. For Explanation to Section 37(1) to apply two conditions must be satisfied. Firstly, the amount which is being claimed in the computation of income should be an “expenditure”. Secondly, the expenditure should have been incurred for any purposes which is an “offence” or which is “prohibited by law”.

15. In the present case, neither of the two conditions are satisfied. What the Assessee is claiming is not an expenditure incurred towards business or profession. The Assessee is claiming to set of a loss which has been incurred by the Assessee in business or profession.
16. Loss and expenditure are clearly two distinct things. Expenditure is something which an Assessee would incur on account of a voluntary action. Loss is not something which an Assessee would incur voluntarily



though the same would be a result of an action on the part of the Assessee. Expenditure is a voluntary action which is done with an intention to derive or procure something that is tangible or intangible like a spending. On the other hand, loss is not a spending or an expenditure but happens on account of certain factors. Expenditure is an action, loss is a consequence. Expenditure is an action whereas loss is a result. The two are completely distinct from each other. A result may occur on account of certain actions but an action does not become a result nor can a result be equated with an action. The loss is the net result of either circumstances or an action but expenditure is clearly an action on the part of the Assessee.

17. In the present case, the Assessee is not trying to set off any expenditure incurred in the business or profession but is claiming to set off a loss which has occurred on account of the said business or profession.



Explanation to Section 37(1) does not talk of any “loss” but deals with “expenditure” and as such on this count Explanation to Section 37 (1) is clearly not applicable to the case of the Assessee. Decision in the case of **DR. T.A. QURESHI (SUPRA)** is clearly applicable and the ratio is against the contention of the appellant.

18. Even otherwise it is not possible to accept the contention that the loss suffered is for a purpose which is an offence or prohibited by law.
19. Section 22 of the Chartered Accountants Act defines misconduct for a Chartered Accountant in practice as under:

“ 22. Profession or other misconduct defined.

For the purposes of this Act, the expression “professional or other misconduct” shall be deemed to include any act or omission provided in any of the Schedules, but nothing in this Section shall be construed to limit or abridge in any way the power conferred or duty



cast on the Director (Discipline) under sub-section (1) of Section 21 to inquire into the conduct of any member of the Institute under any other circumstances.”

20. Sections 21A and 22 B of the Chartered Accountants Act, 1949, lay down that where a Board of discipline or the disciplinary Committee respectively under Section 21A and 21B holds that a Chartered Accountant is guilty of professional and other misconduct mentioned in the first schedule they may reprimand the member, remove the name of the member from the register for a limited period or permanently or impose fine of varying nature.
21. The First Schedule, Part I-Entry 11 lays down as under:

“THE FIRST SCHEDULE

**PART I: Professional misconduct in
relation to chartered accountants in
practice**



(11) Engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage:

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (not being a managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor;”

22. Entry 11 merely defines what tantamount to misconduct. The canons of professional conduct for a profession are for regulating the profession and do not render the activity undertaken in violation as an offence and is not prohibited by law as contemplated by Section 37 of the Act. What is regulated by law does not necessarily imply that it is prohibited by law. The fact that an “Act” on the part of a Chartered Accountant amounts to misconduct does not render



that the said act an offence or an expenditure incurred as or prohibited by law.

23. In ***MADDI VENKATARAMAN & Co. (P) LTD. Vs. COMMISSIONER OF INCOME TAX (1998) 229 ITR 534 (SC)***, the Supreme Court ruled that where the entire business of an Assessee is illegal and income from such illegal business is sought to be taxed, then the expenditure incurred in the illegal activities will have to be allowed as a deduction but where the business is otherwise lawful but an Assessee resorts to unlawful means to augment his income or reduce his loss, then the expenditure incurred for the purpose of unlawful activities cannot be allowed as an expenditure.. Thus, fine or penalty paid for infraction of law cannot be allowed as deduction as this would be against public policy. But as the Act does not make any distinction between legal and illegal business and the entire income even if earned from illegal business is taxable



and, therefore, where the entire business is illegal, the expenditure incurred on illegal activities should be allowed.

24. Explanation 1 was enacted with the retrospective effect to get over the aforesaid interpretation or legal position on expenditure incurred in illegal business. The distinction between the wholly or entirely illegal business and legal business for the purpose of allowability of expenditure, was by insertion of the explanation made nugatory and inconsequential. In both cases expenditure incurred is to be disallowed if it is for any purpose which is an offence or for a purpose which is prohibited by law i.e. the expenditure incurred itself should be prohibited by law or it is for a purpose treated by law as an offence. The expression, “which is an offence” is clear and relatively easy to ascertain and apply but the expression “prohibited by law” can



be ambiguous and is capable of varied or different interpretations.

25. The word 'prohibited' means forbidden by law and it is not synonymous with the word 'regulate'. Several trades are regulated and there may be infraction or violation of the provisions relating to or for conduct trade but this does not mean that no or entire expenditure incurred by an Assessee would be allowed. Prohibited by law as stipulated in explanation to Section 37 has to be read contextually keeping in mind the object and purpose of the Legislation, otherwise it will lead to practical difficulties and unnecessary litigation and denials . Therefore, factual matrix in each case and the nature and type of business and the expenditure incurred, the purpose behind it, have to be examined on case to case basis when an issue arises whether the expenditure incurred was for a purpose which is prohibited by law. No strait



jacket formula can be applied. The purpose of the expenditure and whether the purpose is prohibited by law is the determining and salient factor.

26. Almost all and every kind of trade and profession and sometimes even entertainment activities are regulated and are now subject matter of one statute or the other. It may not be possible to have inflexible or a strait jacket formula to decide whether the regulation is merely regulatory or in fact amounts to prohibition and, therefore, would be hit by expression “prohibited by law”. This aspect can be only decided keeping in view the legislation or the statute in question regulating the activity and the nature and character of business or trade activity. For example, trading or dealing with production and sale of liquor, narcotics trafficking and similar activities can be treated as activities prohibited by law. However, trading and production of liquor requires a license and once there is a license, then



violation of the terms and conditions in a given case may not result in carrying on trade prohibited by law. Similarly, failure of a shopkeeper to obtain a particular license from municipal authority, which is required under a regulatory mechanism, will not result in entire expenditure incurred on purchase of goods etc. being disallowed under the Explanation and the receipts being taxed on gross basis. Though not fully appropriate, the aforesaid line of reasoning does get support from the decisions of the Supreme Court relating to violation of Fundamental Rights. (see **NARENDER VS. UNION OF INDIA, AIR 1960 SC 430, COLLECTOR OF CUSTOMS VS. SAMPATHU CHETTY AIR 1962 SC 316**).

27. In **SYNTHETIC CHEMICALS LTD. VS. STATE OF U.P. AIR (1991) SC 927**, it has been observed that whether a restriction amounts to prohibition is a question of fact to be determined in accordance with the facts of each



case having regard to the right in question. In the context of Section 37 this would mean nature and character of the trade, business or activity and the effect of the restriction upon exercise of the said right. Where the statute only provides mechanism in respect of how the right is to be exercised in a particular area or relates to particular matters, it does not amount to prohibition but is only regulatory. Thus, dependent upon several facets, different consequences may flow and the expenditure can be allowed or disallowed. A practical and pragmatic approach is required to be adopted and it would be travesty to treat every violation of a regulation with "prohibited by law" consequences under explanation to Section 37 of the Act.

28. Section 23 of the Contract Act 1872 uses the expression "forbidden by law". The said words have been interpreted in Indian Contract and Specific Relief



Acts – **PULLOCK AND MULLA (9TH EDITION)** at page 198
as under:-

“Forbidden by law – An act or undertaking is equally forbidden by law whether it violates a prohibitory enactment of the Legislature or a principle of unwritten law. But in India, where the criminal law is codified, acts forbidden by law seem practically to consist of acts punishable under the Penal Code and of acts prohibited by special legislation, or by regulations or orders made under authority derived from the Legislature. This definition was accepted and quoted with approval by the Supreme Court in *Gherulal Parekh v. Mohadeodas* (1959) Supp. 2 S.C.R. 406, 417. Parties are not, as a rule, so foolish as to commit themselves to agreements to do anything obviously illegal, or at any rate to bring them into Court; so the kind of question which arises in practice under this head is whether an act, or some part of a series of acts, agreed upon between the parties, does or does not contravene some legislative enactment or regulation made by lawful authority. The



decision may turn on the construction of the agreement itself, or of the terms of the Act or other authoritative document in question, or on both. In particular it may have to be considered whether the intention of the legislator was to prevent certain things from being done, or only to lay down terms and conditions on which they might be done. It is easy to say that properly drawn Acts or Regulations ought to leave no doubt on that point, but experience has shown that such doubts are possible and have not been uncommon. Broadly speaking, that which has been forbidden in the public interest cannot be made lawful by paying the penalty for it; but an act which is in itself harmless does not become unlawful merely because some collateral requirement imposed for reasons of administrative convenience has been omitted. There was a time when the English Courts almost regarded it as meritorious to evade statutory regulations, and encouraged evasions of them by fine distinctions; but that attitude is long out of



date, and examples of it cannot be now be taken as precedents.”

29. In **ANSON’S LAW OF CONTRACT** – Twenty Third Edition by A.G. Guest, M.A. at page 349, under the heading - “IV. Effect of illegality” it has been observed:-

“It has already been pointed out that the single word ‘illegal’ may embrace varying degrees of impropriety, and it should not be supposed that the effect of illegality is always identical.

In some cases, the law adopts a very severe attitude and refuses to assist a person implicated in the illegality in any way whatsoever. In others, public policy does not require that he should be so completely denied a remedy.”

30. In **HALSBURY’S LAW OF ENGLAND** – 5th Edition, Vol. 22, it has been elucidated as under:

“CONTRACTS AFFECTED BY STATUTE

450. In general. Many contracts are affected by statutory provisions,



but the effect of such provisions varies from one statute to another. For example, many professions, trades, and businesses are regulated by statute, and are subject to certain statutory restrictions as to the persons by whom or the manner in which they may be exercised or carried on.

In some cases the statute may on its proper construction prohibit the creation or enforcement of rights under the contract; in other cases the statute may not directly prohibit the contract, but may affect it indirectly by virtue of the principle that a contract with a criminal purpose (including criminality by statute) is illegal at common law; and in some cases statute expressly makes a contract 'void'.



Certain contracts not complying with statutory provisions are usually described as unenforceable and these are considered elsewhere in this title.

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EFFECT OF ILLEGALITY

452. Introduction. This section of the title is concerned with the enforceability of the contract if it is illegal. In this context a distinction must be drawn between illegality at common law and illegality arising from statutory prohibition, express or implied, of the contract, though both may be relevant in an individual case. There are two general principles.

The first principle is that a contract which is entered into with the



object of committing an illegal act is unenforceable

The second principle is that the court will not enforce a contract which is expressly or impliedly prohibited by statute.

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453. Contracts prohibited by statute. In determining whether a contract is struck down by the relevant statute where that statute contains no express provision regarding the contractual rights of the parties the first question is normally one of the contraction: does the statute intend to render the contract unenforceable (or, as it is often expressed, to prohibit the contract) by one or both of the parties or does it merely intend to impose the penalty, if any, provided by it for contravention? This issue



may arise in the context of the formation of the contract or in the context of its performance. If the formation of the contract is prohibited by statute neither party may enforce it. Thus it has been held that where a statutory order forbade the buying or selling of a commodity except under licence, a seller could not recover damages for an unlicensed buyer's refusal to accept commodity, even though the buyer had falsely represented that he did have the required licence. On the other hand, the way in which a contract, which is lawful according to its terms, is performed may turn into a contract prohibited by statute. Thus where the seller, under contract for sale of non-utility (that is, non controlled) goods upon which there was no statutory restriction, purported to perform by delivering



utility (controlled) goods without the invoice required by regulations for such goods, he failed in his claim for the price. Similarly, it has been held that where, under regulations, building works could not be executed without a licence, a builder could not recover his charges for unlicensed work, even though he believed that a licence existed.

Even if there is no express or implied prohibition in the statute, a contract may still be unenforceable by one or both parties by reason of an intention to break the law, but this result depends upon the principles of the common law.”

31. Thus, for the purpose of the Contract Act, the expression ‘forbidden by law’ has been defined in a flexible manner as the said expression has to be



interpreted in the factual context of each case which also mandates reference to the statutory provisions, their object and purpose.

32. The respondent herein is a chartered accountant and registered with the Institute of Chartered Accountants under the rules prescribed and applicable to registered Chartered Accountants. The respondent on breach of the rules of professional conduct may be guilty of professional misconduct and liable to sanctions of reprimand, suspension, removal or fine. However, the aforesaid breach or violation of the regulations or conditions of registration would not affect the head under which income from trading and shares is to be taxed. If it is accepted that the respondent carries on business of trading in shares, he shall continue and remain taxable under the said head. The explanation does not change the head under which income which includes negative income or loss is to be taxed. What



is prohibited and barred is expenditure incurred by an Assessee for the purpose of an offence or for purpose which is prohibited by law. Possibly, if a fine was imposed on the respondent and the same was claimed as expenditure, the explanation might be applicable. Carrying on business or trading in securities is not an offence or prohibited by law. The law regulates the said trade as in most of the trades certain compliances have to be made. The mere fact that there are restrictions of regulations on persons from doing a particular business would not render normal and permitted/ allowable expenditure as expenditure which is for a purpose prohibited by law.

33. There is a clear distinction between expenditure incurred on a purpose that is an offence or prohibited by law and an expenditure incurred on a purpose that is neither an offence nor prohibited by law but is incurred by a person who by certain regulations may



be liable to sanctions if he undertakes the said lawful activities. Violation of the regulations or misconduct does not amount to an offence as contemplated by explanation to Section 37(1). Neither is the purpose for which the expenditure incurred an offence nor prohibited by law. There should be, therefore, a connect or link between the purpose for which the expenditure is incurred and the said purpose should be an offence or prohibited by law. However, infraction of law or failure to comply with the rules and regulations for undertaking a particular profession or business would not necessary make the expenditure incurred for a purpose that is an offence or prohibited by law. Thus, a caveat and clarity is required. Explanation to Section 37 applies in two situations; when the expenditure is incurred by an Assessee for any purpose which is prohibited by law or which is an offence. Violation of a regulation may not result in expenditure incurred for a purpose which is prohibited



by law, but may be covered by the expression “expenditure incurred for the purpose which is an offence”. Thus, penal fine paid for violation of regulations would be hit but other expenditure incurred for carrying on the said trade which is not expenditure incurred for the purpose of an offence would not be barred or come within the four corners of the explanation. For example: for running of a hotel/business may require a licence, violation of requirement of the licence may be punishable and prohibited by law. If any penalty or fine is imposed for violation of the statutory Act, the fine or penalty paid would be covered and hit by the said explanation. But the explanation would not cover the normal and legal expenditure incurred by the said Assessee towards purchase of food, electricity etc. provided the said expenditure is not for the purpose or relating to an offence or for the purpose which is prohibited by law.



34. The business, i.e., trading in shares and properties is neither an offence nor prohibited by law. The mere fact that there are restrictions on a Chartered Accountant in carrying on any other business, violation of which restrictions would amount to a misconduct that would not per se render the purpose, i.e. trading in shares etc. an offence or purpose prohibited by law. Thus, the Explanation to Section 37(1) on this account is clearly not applicable to the facts of the present case.
35. The CIT (Appeals) has recorded a finding of fact that the Assessee had surrendered his licence to practice as a Chartered Accountant and this finding has not been disturbed by the ITAT. Appellant has not challenged and questioned the said finding.
36. In view of the above, in our considered opinion, no substantial question of law arises for consideration in



the present appeal. The same is accordingly dismissed with no order as to costs.

SANJEEV SACHDEVA, J.

2nd DECEMBER, 2013
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SANJIV KHANNA, J.

