K.R.RAMAMANI MEMORIAL NATIONAL TAXATION MOOT PROBLEM 2019-20

The Income Tax Department filed a tax case appeal (TCA) before the Hon'ble High Court of Madras under Section 260A of the Income Tax Act, 1961 against the order of the Income Tax Appellate Tribunal ("Tribunal") passed in the case of M/s. Vulcan Laboratories Vs ACIT (ITA 1991/Mds/2018 dated 12.11.2019) for the Assessment Year 2014-15 raising the following substantial question of law which have been admitted by the Hon'ble High Court & fixed for final hearing:

Whether the Tribunal erred in holding that the fine levied on the assessee by the EU Commission for violation of competition laws is an allowable deduction under the Income Tax Act (India), 1961?

Annexure: Impugned Tribunal Order

IN THE INCOME TAX APPELLATE TRIBUNAL
CHENNAI 'A' BENCH
BEFORE SHRI F.D.LEGELLO, JUDICIAL MEMBER AND
SHRI ANTHONY VARDON, ACCOUNTANT MEMBER
ITA No. 1991/Mds/2018
Assessment Year: 2014-15

Vulcan Laboratories Pvt. Limited. New No 75A, Dr.RKSalai, Chennai . PAN: AADCM3491M (Appellant/Assessee)	Vs.	Dy.CIT, Circle 12(2) (Respondent)

For Revenue: Shri Aziz Alam
For Assessee: Shri Raman Gopalakrishnan

Date of Hearing : 13/08/19
Date of Pronouncement : 12/11/19

O R D E R

Per Bench

The appeal is filed by the assessee against the order of Ld.CIT(A)-7, Chennai dated 08.10.2018.

2. Main Ground raised by the assessee is as under (Ground 1 is a general ground) :

"2. Disallowance of fine of Rs.79,41,23,568/- levied by EU Commission.

2.1. On the facts and circumstances of the case and in law, the lower authorities erred in disallowing the fine of ~Rs.79.41 Crores levied by the ED Commission under Explanation 1 to section 37(1) of the Act.

2.2. The Ld. CIT(A) has erred in concluding that only expenses incurred for earning an income for the year should be allowed as a deduction under section 37(1) for the following reasons.

2.2.1. the settlement was purely compensatory in nature and not penal in nature.

2.2.2. the fine was designed only as a 'take back' of the amount originally received by the Appellant for entering into a non-compete agreement, which *was already offered to tax in FY 2004-05 that has been accepted by revenue as income and hence this amount should be allowed as expenditure*

2.3. Without prejudice, the levy by EU Commission is allowable as a business loss under section 28 of the Act. "

3. Brief facts of the case are that the assessee company, engaged in pharmaceuticals business, filed its return of income for the A.Y. 2014-15 on 29.11.2014 admitting a total loss of Rs.19,87,34,256/- under normal provisions of the Income Tax Act, 1961 (the Act) and book profit of Rs.21,25,79,680/- u/s 115 JB of the Act. The return was initially processed u/s 143(1) of the Act and the case was selected for scrutiny under CASS. Notices u/s 143(2) of the Act and u/s 142(1) were issued and responded to by the assessee.

3.1. The Assessing Officer (AO) observed that during the relevant Previous Year (PY), the assessee company had certain international transactions pertaining to purchases of from/with the associate enterprises. A reference was therefore made to TPO for determination of Arm's Length Price (ALP). The TPO, vide his order u/s 92CA(3) dated 30.10.2017, warranted no adjustment and therefore the TP addition was 'nil'.

3.2. During the assessment proceedings u/s 143(3) r.w.s. 92CA(3) of the I.T. Act 1961, the AO noticed from the Annual Report for the F.Y. 2013-14, that the Assessee company had charged Rs.79,41,23,568/- under heading 'litigation cost' under the head 'other expenses'. The details of expenditure were called for by the AO and the assessee furnished its replies from time to time. On verification of the submissions made by the assessee the AO observed that during the FY 2009-10, the European Commission ('EC' in short), had stated that it had initiated anti-trust proceedings against the assessee company and other companies, each of which entered into agreements with another company, Les Laboratories Markiv ('Markiv'), relating to a product "PPL", and that on 27th of July, 2012 the EC issued a Statement of Objections against the assessee and others setting out its preliminary case and that the assessee had submitted its response to EC on the Statement of Objections.

3.3. Further on 9th July, 2014 the EC issued a decision to the effect <u>that the Assessee company and its associate enterprise in USA Vulcan Inc, as well as the other companies</u> have violated European Union competition rules and for this violation, it imposed a fine/fee equivalent to the patent infringement settlement consideration received by the assessee from Markiv, of approximately Rs. 79,41,23,568/- (~EUR 9.66 Million) which includes amounts jointly and severally with Vulcan Inc. USA, the ultimate holding company. He observed that the assessee company continued to contest the case in General Court of EU, while the management has made a provision towards the same in its books of accounts on prudent basis.

3.4. The AO, therefore, issued a show cause notice to the Assessee as to why the so-called litigation expenditure of Rs. 79,41,23,568 /- claimed by assessee should not be disallowed under Explanation 1 to Sec.37(1) of the Act. The assessee filed its reply to the show cause notice stating that the payment is not towards fine, but that it is only a return back of the income received from Markiv on account of the agreement for development of generic version of "PPL" tablets. For the sake of clarity and ready reference, the relevant portion is reproduced hereunder.

> *"5.3. The assessee's reply to the SCN dated 21.12.2017 is reproduced as under.*
>
> *1. With respect to your SCN dated 21.12.2017 requesting to justify why the fine paid to EU commission should not be disallowed u/s 37.*
>
> *Further to the above and the discussion had with our good selves in relation to claim of pay back to EU Commission of EUR 9.66 million income earned earlier under a settlement agreement between Vulcan Laboratories, we submit as under,*
>
> *1. The taxpayer has developed and stabilized the process for manufacture of "PPL" and filed necessary regulatory applications (DMFs) for manufacture of API drug from its manufacturing unit.*
>
> *2. The taxpayer and Nich Generics Limited (Nich) entered into a co-development agreement to jointly develop the generic version of "PPL" tablets for which the API would be supplied by the taxpayer. Nich filed the Dossiers for manufacture of PPL at its Hamburg facility, based on the supplies from taxpayer.*
>
> *3. PPL is Markiv's most successful product in EU and Markiv is the originator company/patent company. Nich working with others would result in a generic entry of PPL .*
>
> *4. Markiv in Feb'04 warned Nich about its existing patent protection for PPL and after a series of discussions had settled on 8th February 2005, Markiv concluded with Nich a patent settlement agreement.*
>
> *5. The taxpayer did not have capability to produce a final PPL product, it had the capability to only produce an API at that time. It had no presence in the EU for applying for Market Authorization. As a result of losing Nich, taxpayer was out of the race and would not have been able to find another partner willing and able to overcome all barriers and produce in a timely manner a final PPL product*

6. With no choice left taxpayer settled with Markiv under a settlement agreement wherein for an amount of EUR 9.66 million - taxpayer shall not, and shall affirm that its affiliates shall not, (i) carry out in relation to PPL made using the process any restricted act in any country of the territory; and/or (ii) manufacture and/or supply PPL made using the process, for use anywhere in the Territory. (Territory being EU)

7. The non-compete obligation prevented taxpayer from launching a generic version of PPL manufactured on the basis of the process developed in cooperation with Nich in the Territory.

8. Markiv had entered similar settlement agreement with Krka, Lupin, Teva and Unichem.

9. The payment received from Markiv of EUR 9.66 million was fully offered to tax in F. Y 2004-05 and deferred in the books for 44 months by taxpayer.

During the impugned F. Y 2013-14 in view of the EU commission order, the equivalent amount of EUR 9.66 million was paid back to EU by Markiv.

In this connection, we would reiterate that it will fall under the provisions of

Sec 28. The same is extracted for your ready reference.

"28. The following income shall be chargeable to income tax under the head 'profits and gains of business or profession'.
(va) any sum, whether received or receivable, in cash or kind, under an agreement for –

(a) Not carrying out any activity in relation to any business; or
(b) Not sharing out any know.-how, patent, copyright, trade-mark, license, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services;
Provided that sub-clause (a) shall not apply to-
(i) Any sum, whether received or receivable, in cash or kind, on account of transfer of the right to manufacture, produce or process any article or thing or right to carry on any business, which is chargeable under the head 'capital gains'
(ii) Any sum received as compensation, from the multilateral fund of the Montreal Protocol all Substances that Deplete the Ozone layer under the United Nations Environment Programme, in accordance with the terms of agreement entered into with the Government of India

Explanation- For the purposes of this clause, -

(i) 'agreement' includes any arrangement or understanding or action in concert, -
A. Whether or not such arrangement, or understanding or action is ormal or in writing; or
B. Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings; 8

Treatment of the 'take back' under Income Tax Act, 1961

Given the above rationale for the levy of fine which is entirely related to alleged violation of competition laws of European Union (until finally adjudicated by a higher appellate authority), it is our prima-facie view that the fine is nothing but 'take back' of the non-compete settlement income received from Markiv. The recitals in the Commission orders would buttress the argument that the amount is a 'take back' and not a fine. Therefore, the amount would be allowable as a deduction under section 28 of the Income tax Act, 1961. Under the Income tax Act, 1961 non-compete receipts are taxable as part of income irrespective of their legal enforceability. Any Court decision that declares that the amount is required to be 'given back' on the ground that they are 'gains improperly made', the deduction would also be made under the same section, i.e., section 28 of the Act.

Further, this amount is not hit by Explanation 1 to Sec 37(1) and we provide our reasons below :

a. For the sake of convenience, the sub-section with explanation thereto is quoted below:

"37 (1) Any expenditure (not being expenditure of the nature described in sections 31 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.

b. The Explanation was introduced in 1998 and the amendment Was made retrospective from 1st April, 1962. The Memorandum Explaining the Provisions of the Finance Bill 1998 stated as follows:

'It is proposed to insert an explanation after sub-section (i) of section 37 to clarify that no allowance shall be made in respect of expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law.

This proposed amendment will result in disallowance of the claim made by certain tax payers of payments on account of protection money, extortion, hafta, bribes, etc. as business expenditure.'

c. The disallowance under this Explanation, therefore, rests on the following conditions precedent:
i. It should be an expenditure; and
ii. It should have been incurred for any purpose which is an offence or which is prohibited by law.

d. Once it is established that the amount is 'expenditure' the second condition precedent for attracting disallowance under Explanation to Section 37(1) is whether it has been incurred by the assessee for any purpose which is an offence or which is prohibited by law. The word "offence" is not defined in the Income Tax Act. However, it is defined in Section 3(38) of the General Clauses Act, 1887 as follows: "offence" shall mean any act or omission made punishable by any law for the time being in force;". The expression "prohibited by law", too, is not defined in the Income Tax Act. It may be viewed either as an act arising from a contract which is expressly or impliedly prohibited by statute, or contracts entered into with the object of committing an illegal act.

e. The Hon'ble Madras High Court in the case of CIT v. Parthasarathy [1995] 78 Taxman 470 held that for deciding the question whether an expenditure is hit by the Explanation 1 to section 37(1) one has to examine the scheme of the provisions of the relevant statute, providing for payment of such imposts notwithstanding the nomenclature of the impost as given by the statute to find out whether it is compensatory or penal in nature. The authority has to allow deduction under section 37(1) of the Income-tax Act, whenever such examination reveals the concerned impost to be purely compensatory in nature. Whenever such impost is found to be of composite nature, that is, partly of compensatory nature and partly of penal nature, the authorities are obliged 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.

f. The Explanation (1) to section 37(1} was brought in to nullify the Pranav Construction Co. v, Asstt. CIT (1998] 96 Taxman 323 (Mag.)(Mum.) judgment. In that case a sum of Rs. 20 lakhs had been paid as protection money by builder as the areas were vulnerable to hafta and extortion and this money was allowed as deduction. Thus, to disallow income-tax deductions for hafta, the Explanation had been incorporated. But extending the proviso to fines was never intended. Hence, disallowing income-tax deduction for any kind of fine is not proper.

g. Another noteworthy point is that the Explanation to section 37(1) is a deeming provision. It only creates a legal fiction. Next, the Explanation comes into play when expenditure, though incurred for business purpose, is coupled with purpose which is offence or prohibited by law. Here the purpose is to do business and there is no double purpose to do unlawful or illegal acts.

h. The Andhra Pradesh High Court in CIT v. Hyderabad Allwyn Metal Works Ltd. [(1988) 172 I1R 113, 118-19](AP) has taken the view that the amount of such damages comprises both an element of penalty levy as well as compensatory payment. Therefore, the entire sum can neither be considered as mere penalty nor as mere interest. In that view of the matter, that portion out of the amount of such damages, which is held to be compensation, is an allowable deduction.

i. It may be that a particular payment made by the assessee under a statutory provision, though called a penalty, is a composite one comprising both a penalty and a compensation for delayed payment. Under section 37(1), only that portion of such payment having composite nature which is attributable to its compensatory character can only 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 [Prakash Cotton Mills P. Ltd. v. CIT, (1993) 201 ITR 684, 690-91(SC) ; Standard Batteries Ltd. v. err, (J995) 211 ITR 444, 446(SC) ; Swadeshi Cotton Mills Co. Ltd. v. err. (1998) 233 ITR 199, 202(SC) ; CIT v. Bharat Television Pvt. Ltd_, (1996) 218 ITR 173, 175, J 78(AP) ; CIT v , Hyderabad Allwyn Metal Works Ltd., (1988) 172 ITR 113. 121 (AP) .

10. In view of the above, the above, the amount of EUR 9.66 million payable by Vulcan, being the same amount received from Markiv under Article 23(2) of the EU Regulation (EC) No. 1/2003, which is called fine is nothing but compensatory doesn't fall within Explanation 1 to Section 37(1) and should be allowed as deduction from Income."

The AO, however was not convinced with assessee's contentions and held that the levy of fine is for violation of rules and hence the expenditure claimed as litigation cost is to be disallowed under the Explanation 1 to Sec. 37(1) of the Act. He accordingly brought the same to tax.

4. Aggrieved, the assessee preferred an appeal before the CIT(A), who confirmed the order of AO on this issue and the assessee is in second appeal before us.

5. We deal below with main issue before us i.e. the allowability of the litigation costs.

6. The Ld.Counsel for the assessee, while reiterating the submissions made before the authorities below, submitted as under:-

(a) that prior to the year 2004, the assessee had developed and stabilized the process of manufacture of "PPL", an anti-high blood pressure drug, and filed the necessary regulatory applications (DMFs) for manufacture of the API drug from its manufacturing unit.

(b) The assessee and Nich Generics Limited ("Nich") entered into a co-development agreement to jointly develop the generic version of "PPL" drug tablets, for which the API would be supplied by the assessee and accordingly Nich filed the Dossiers for manufacture of "PPL", at its facility, based on the supplies from the assessee.

(c) that the drug "PPL" is Markiv's most successful innovator product in the European Union ("EU') region, for which it is the originator company/patent company. Nich, a competitor to Markiv, was working with Vulcan Laboratories, the assessee, for the generic entry of PP in the EU region.

(d) 'Markiv', in February 2004, warned Nich about its existing patent protection for PPL, and after a series of discussions, on 8th February, 2005, a 'Patent Settlement Agreement', was concluded by Markiv with Nich.

(e) As the assessee, Vulcan Laboratories, did not have capability to produce independently the final PPL drug product, but only had the capability to produce an API and since it had no presence in the EU region, to apply for Market Authorization the assessee had to enter into a partnership with Nich and, therefore, it had to settle with 'Markiv' under a Settlement Agreement for EUR 9.66 million.

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(f) According to this agreement, the assessee or its affiliates shall not : (i) carry out in relation to "PPL" made using the process any restricted act in any country of the territory; and/or (ii) manufacture and/or supply "PPL" made using the process, for use anywhere in the Territory.

(g) In return, 'Markiv' committed, first, not to bring any infringement actions against Vulcan based on the patents in respect of any act of alleged infringement occurring before the conclusion of the Agreement and, secondly, to pay Vulcan, the sum of EUR 9.66 million (~Rs.79.41 crores) towards consideration for the commitments made by Vulcan and for the 'substantial costs and potential liabilities' that may be incurred by Vulcan Laboratories, the assessee, as a consequence of ceasing its programme to develop and manufacture "PPL" made using the process.

(h) The said settlement obligation prevented the assessee (Vulcan Laboratories) from launching a generic version of PPL, manufactured on the basis of the process developed by it in cooperation with Nich, in the Territory.

(i) The amount of EUR 9.66 million received by the assessee in the said settlement, was recognised in the books of accounts of the assessee as income on a deferred basis, over a period of 44 months. But the entire amount of Euro 9.66 million was offered to tax as income from business, in the same year, i.e. in A.Y. 2005-06.

(j) On July 9, 2014, the order of the EU Commission was passed imposing a fine on the assessee, under its anti-trust laws in the region, for violation of the competition laws, by way of accepting a non-compete settlement from Markiv.

(k) The fine imposed on the assessee was in Euros equivalent to the amount of EUR 9.66 million received by it in settlement. The assessee was therefore required to disgorge the entire sum received by it from Markiv.

(l) Thus, the assessee incurred an amount of INR Rs. 79,41,23,568/- from its profits for the year, as Litigation costs under the head 'other expenses'. The assessee, therefore, claimed that the payment towards levy by EU Commission constitutes business loss eligible for deduction u/s 28(i) of the Act. It was submitted that for arriving at the figure of profits and gains of the business of the assessee in a particular year, business expenditure of all types, whether specifically provided for or not, may be allowed u/s 28(i) of the Act itself. He also referred to Sections 30 to 43C of the Act, submitting that these sections expressly provide for the deductions in computing business income and if an expenditure comes within any of the enumerated classes of allowances, it can be considered under the appropriate provision. He further submitted that in assessing the amount of the profits and gains of the year, account must necessarily be taken of all losses incurred besides the expenditure allowable u/sec. 30 to 43C of the Act. In support of this contention, he placed reliance upon the decision of Hon'ble Supreme Court in the case of ***Badridas Daga reported in (1958) 034 ITR 0010***. He also submitted that in the A.Y. 2005-06, the assessee had received an amount of EUR 9.66 million which was duly offered to tax and during the relevant AY, assessee was intimated that it would be required to pay back the entire amount received earlier, to the EU Commission and, therefore, it would constitute a loss to be deducted in computing the income of the assessee for the relevant AY. He submitted that if such a deduction was not allowed, it would tantamount to levying of tax on the amount which was never earned by assessee and it is a settled principle that tax should be charged only in respect of a real income of the tax payer.

6.1. Ld. Counsel for the assessee also submitted that what is to be disallowed under Explanation 1 to section 37(1) of the Act is a fee or fine which is penal in nature. He submitted that levy by EU Commission is not penal in nature but was akin to disgorgement i.e. a monetary equitable remedy that is designed to prevent a person from unjustly enriching himself. He submitted that disgorgement takes away the profits earned by the said person and therefore is not a fine or penalty but an equitable relief. He submitted that since the assessee did not incur additional amounts over and above the amounts received in settlement, the deductibility of the said payment cannot be denied under Explanation 1 to Sec.37(1) of the Act. It was also submitted that only those payments which are penal in nature are to be disallowed as per Explanation 1 to Sec.37(1) of the Act and what constitutes penal and what constitutes compensatory is to be determined independently and in the facts and circumstances of each case. He submitted that the AO had disallowed the said expenditure/ levy, merely going by its nomenclature in the order of the EU Commission and did not examine as to the exact nature of levy. In support of his contentions that AO has to allow deduction of an expenditure u/s 37(1) of the Act, wherever such examination reveals that the concerned impost is not penal in nature or that it is purely compensatory in nature, the Ld.Counsel for the assessee placed reliance upon the following cases.

- ***Prakash Cotton Mills P Ltd. (SC) (1993) 201 ITR 684;***
- ***Swadeshi Cotton Mills Co.Ltd. (SC) (1998) 233 ITR 199;***
- ***Standard Batteries Ltd. (SC) (1995) 211 ITR 444;***
- ***Hyderabad Allwyn Metal Works Ltd. (AP HC) (1988) 172 ITR 1131;***
- ***Bharat Television Pvt.Ltd. (High Court of AP) (1996) 218 ITR 172.***

6.2. The Ld.Counsel for the assessee further reiterated that the amount received from Markiv, in settlement for non-compete, was duly offered to tax in AY 2005-06 and the same has been directed to be returned except to the extent of difference in foreign exchange fluctuation rate, and since it is a payment towards patent infringement or settlement, the same is compensatory in nature and cannot be disallowed, particularly because the expenditure is purely for commercial purposes. For this proposition, he placed reliance upon the decision of Hon'ble High Court of Delhi in the case of ***Desiccant Rotors International (P) Ltd. Reported in 245 CTR 572 (2012).***

6.3. Without prejudice to the above arguments, the Ld.Counsel for the assessee submitted that the word 'law' referred to in Explanation 1 to

Sec.37(1) of the Act is only the 'law of the land' i.e. laws in force in India and violation of the provisions of the Treaty on the Functioning of the European Union (TFEU in short) cannot be considered as violation of the law under Explanation 1 to Sec.37(1) of the Act. He submitted that the treaty on the functioning of the EU (TEFU) is between the constituents of the EU i.e. 28 Member States that are located primarily in Europe and is applicable only within such states and is separate from International Law. Therefore, EU Treaties are like any other international agreements between the countries and the violation of the Articles of Agreement cannot be construed as violation of law, even if such agreement forms the basis of the laws of various countries in a region. In support of his contention that the word law mentioned in Explanation 1 to Sec.37(1) of the Act refers to laws in force in India, the Ld.Counsel placed reliance upon the ***Board's Circular no.772 dated 2.12.1998 reported in 235 ITR (St) 35 (1999)*** explaining the amendment by way of insertion of Explanation (1) to Sub-section (1 of Sec.37 of the Act and submitted that what is proposed t)o be disallowed is the payment on account of protection money, extortion, Hafta, bribes etc. (emphasis supplied by us), which may be claimed as business expenditure. He also placed reliance upon the decision of Hon'ble Calcutta High Court in the case of ***Susanta Mukherjee in CW No.412 of 1975*** wherein, Sec.3(38) of the General Clauses Act which defines "offence" to mean "any act or omission made punishable by law for the time being in force" was considered. Further, Article 13 of the Constitution of India and the decision of Hon'ble Supreme Court in the case of ***Edward Company Mills AIR 1955 (SC) 25*** were considered and it was held that any law for the time being in force as occurring in Section 3(38) of the General Clauses Act, 1897, must be construed as 'any law for the time being in force' in India and it has no reference to any law of other countries of the world. He also referred to the decision of the Full Bench of Hon'ble Allahabad High Court in the case of ***Abdul Hameed vs. Mohd. Ishaq AIR 1975 All.166*** in support of his contention that reference to the word 'law' in the relevant section means the law of the land i.e. the law of India as the definition under the General Clauses Act is applicable to all the Central Acts and Regulations, including the Income Tax Act.

6.4. The Ld.Counsel for the assessee further submitted that the expenditure incurred towards levy by EU Commission was incurred for the purpose of carrying on its business and, therefore, it cannot be disallowed u/s 37(1) of the Act. He placed reliance upon the decision of Hon'ble Supreme Court in the case of ***Udaipur Distillery Co.Ltd. reported in 224 CTR 32 (2009)***. Thus, he prayed that the disallowance of litigation cost made by AO and confirmed by CIT(A) be deleted.

7. The Ld.DR, on the other hand, supported the orders of the authorities below and submitted that the assessee had resorted to Anti Competitive Practices by way of delaying the entry into market of certain generic medicines and this issue was investigated by the European Commission and the EC has levied the fine for infringement of EC Treaty Rules that outlaws cartels and other restrictive business practices as well as abuse of dominant position. He submitted that the EC levies fines as a measure of deterrence so that the companies do not resort to such type of anti-competitive behaviour, and that the General Court has also confirmed the levy of penalty imposed by EU Commission. Therefore, he argued that the amount is paid as penalty for breach of law and not as a compensatory settlement. He submitted that fine is not compensation but is a payment made for infringement of law and hence cannot be allowed under Explanation 1 to Sec. 37(1) of the Act. In support of his contentions, he placed reliance upon the following cases.

i. Haji Aziz and Abdul Shakoor Bros (1961) 41 ITR 350 (SC)
ii. Maddi Venkataraman & Co. (P) Ltd. (1998) 96 Taxman 643 (SC).
iii. Mamta Enterprises (2004) 135 taxman 393 (Kar.).
iv. Sushil Gupta (2019) 102 taxmann.com 409 (Bom.).
v. Nahar Spinning Mills Ltd. (2014) 49 taxmann.com 565 (P&H).

7.1 The Ld.DR also filed the copy of the judgement of General Court and other documents on guidelines of European Commission on levy of fines etc. as additional evidence and prayed for admission of the same under Rule 29 of ITAT Rules. Thus, he prayed for confirmation of the disallowance made by AO and CIT(A).

8. Having regard to rival contentions and the material placed on record, we find that the allowability of the claim of litigation costs of Rs. 79,41,23,568/- u/s 37(1) of the Act is before us. While the assessee has claimed it as business expenditure, the revenue has treated it as payment of penalty for infringement/violation of EU Treaty in law and, hence not eligible for deduction due to application of Explanation 1 to S.37(1) of the Act to the said payment. The assessee has taken various grounds to claim it as deduction i.e.:

i The levy constitutes business loss;
i The levy is not penal in nature;
ii Treaty on the functioning of the EU is not law as provided in Explanation 1 to Sec.37(1) of the Act;
iii The word 'law' referred to in Explanation 1 to Sec.37(1) of the Act refers to laws in force in India.

8.1. The Ld.Counsel for the assessee had relied upon various case laws and also CBDT Circular to argue that the violation should only be of the laws in India to be considered for disallowance under Explanation 1 to Sec.37(1) of the Act.

8.2. The CBDT Circular, explained the amendments made to the Finance Act, 1998 for the introduction of the Explanation 1 to Sec.37(1) of the Act as under:

> *"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 assessees 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."

8.3. The General Clauses Act also defines an 'offence' u/s 3(38) of the Act to mean "any act or omission made punishable by law for the time being in force".

8.4. The Hon'ble Allahabad High Court in the case of ***Abdul Hameed vs. Mohd. Ishaq*** cited (supra) had the occasion to deal with this provision of the General Clauses Act. The Hon'ble High Court was dealing with the Provisions of U.P. (Temporary) Control of Rent and Eviction Act, 1947 and the applicability of Sec.7A of the Act, while dealing with the said provision, the Hon'ble Court was considering the meaning of the word 'law' and at Para 12 of its decision, has held as under:

"12. The expression 'law' has not been defined in the Contract Act, nor in the U. P. General Clauses Act, 1904, but in the Central General Clauses Act. 1897, 'Indian Law' is defined in Section 3 (29) as below:-

" 'Indian law' shall mean any Act, Ordinance, Regulation, rule, order, bye-law or other instrument which before the commencement of the Constitu1ion had the force of law in any Province of India or a part thereof, or thereafter has the force of law in any Part A State or Part C State or part thereof, but , does not include any Act of Parliament of the United Kingdom or any Order in Council, rule or other instrument made such Act."

This definition is applicable to all the Central Acts and Regulations made after the commencement of the General Clauses Act. The Contract Act was enacted in 1872 before the commencement of the General Clauses Act, 1897. Therefore, this definition is not directly applicable to the Contract Act, but there appears to be no reason why the principles contained in the above definition be not made applicable to even the earlier enactments. 'Law' must, therefore, include not only an Act and Ordinance but also Regulations, rule, order, bye-Law or other instrument which has the force of law. Similar inference can be drawn from the provisions of the Constitution also. For the purposes of

Article 13 of the Constitution the term law' includes any Ordinance, order, bye-law, rule, regulation, notification, custom or usage having in the territory of India the force of law. In Article 366(10) the expression 'existing law'; has been defined for the purpose of the Constitution, to mean any law, Ordinance, order, bye-law, rule or regulation passed or made before the commencement of this Constitution by any Legislature, authority or person having power to make such a law, Ordinance, order, bye-law, rule or regulation. By virtue of Article 367(1), the General Clauses Act, 1897, is, subject to such adaptations and modifications that may be made therein under. Article 372, apply for the interpretation of the Constitution as it applies for the interpretation of an Act of the Legislature of the Dominion of India."

8.5. Further, in the case of ***Susanta Mukherjee cited (supra)***, the Hon'ble Calcutta High Court was considering the case of a person, who was an employee of Food Corporation of India at Calcutta, and on a visit to Switzerland, he was arrested by Swiss Police and later was convicted and sentenced to imprisonment for a period of eight days on a charge of repeated thefts. After release from imprisonment, the said person returned to India and resumed his duties. However, on receipt of information about the imprisonment and conviction in Switzerland, he was put under suspension under the CCS Rules. In this context, the Hon'ble Calcutta High Court, after considering various provisions of the Constitution of India and also the Hon'ble Supreme Court judgements on the issue, held that a reference to the word 'law' is any law for the time being in force in Indian territory and not in the foreign country. For the sake of clarity and ready reference, the relevant para is reproduced hereunder.

"4. The point that arises for consideration is whether the words "offence", "conviction" and 'imprisonment" occurring in Rule 10 (2)(b) also includes an" offence", "conviction" and "imprisonment" under the penal law of a foreign country. In other words, whether, when a Government servant is convicted of an offence and sentenced to a term of imprisonment exceeding forty-eight hours under the law of a foreign country, he can be suspended in accordance with Rule 1O(2)(b). The Rules do not define these terms. The words "offence" and "imprisonment" have, however, been defined in the General Clauses Act. Under Section 3(38) of the said Act "offence" shall mean any act or omission made punishable by any law for the time being in force. The expression "any law for the time being in force" undoubtedly refers to any Indian law for the time being in force, for it is apparent from Section 3 of the General Clauses Act that the definitions given under that section shall apply to the General Clauses Act and all Central Acts and Regulations made after the commencement of the said Act. It is unthinkable that the General Clauses Act has been enacted by

Parliament not only for the interpretation of the Central Acts and Regulations hut also of the provisions of any fa reign law, as can fended on he half of the appellants. The word "offence" as referred to in Rule 10 (2) (b) or the Rules read with Section 3(38) of the General Clauses Act means any act or omission made punishable by any Indian law for the time being in force if any act or omission which is not punishable under any Indian law it will not he an offence, although such an act or omission may he an offence under the law of a foreign country. We do not think that the decision in Edward Milts Co. Ltd. v. State of Ajmer , has any hearing on the question whether the word "offence" as defined in Section 3(38) of the General Clauses Act also includes an offence under the law of another country beyond India. In that ease, the Supreme Court has considered the difference between the expressions "an existing law" and "a law in force" as used in Section 94(3) of the Government of India Act, 1935 and Article 372 of the Constitution respectively. It has been held by the Supreme Court that there is no material difference between "an existing law" and a "a law in force". It has been further observed that the words "a law in force" a used in Article 372 are wide enough to include not merely a legislative enactment but also any regulation or order which has the force of law. "As already stated, the proposition of law which has been laid down by the Supreme Court in the above decision is not relevant to the issue with which we are concerned."

8.6. Therefore, according to him, it is only laws of the land i.e. the laws in force in India, if violated, the extent of such violation is to be disallowed.

8.7. He also placed reliance on the decision of Hon'ble Supreme Court in the case of ***Hari Shanker Jain vs. Sonia Gandhi dated 12th September, 2001*** in CA no.4400/2000 wherein it has been held as under:

"Italian law is a foreign law so far as the Courts in India are concerned. U/s 57(1) of Indian Evidence Act, 1872, the Court shall take judicial notice of, inter alia, all laws in force in the territory of India. Foreign laws are not included therein. Sections 45 and 84 of Evidence Act permit proof being tendered and opinion of experts being adduced in evidence in proof of a point of foreign law. Under Order VI Rule 2 of the Code of Civil Procedure, 1908, every Pleading shall contain a statement in concise form of the material facts relied on by a party but not the evidence nor the law of which a Court may take judicial notice. But the rule against pleading law is restricted to that law only of which a Court is bound to take judicial notice. As the Court does not take judicial notice of foreign law, it should be pleaded like any other fact, if a party wants to rely on the same (See Moghas Law of Pleadings, 13th Edition, Page 22). In Guaranty Trust Company of New York Vs. Hannay & Co., 1918 (2) KB 623, it was held that, Foreign law is a question of fact

to an English Court the opinion of an expert on the fact, to be treated with respect, but not necessarily conclusive. In Beatty Vs. Beatty, 1924 (1) KB 807, it was held that the American law in English courts must be proved by the evidence of experts in that law. In Lazard Brothers and Company Vs. Midland Bank, Limited, 1933 AC 289, their Lordships of Privy Council observed that what the Russian Soviet law is, is a question of fact, of which the English court cannot take judicial cognizance, even though the foreign law has already been proved before it in another case. The Court must act upon the evidence before it in that actual case. The statement of law by Halsbury in Laws of England (Third Edition, Vo1.15, Para 610, at page 335) is that the English courts cannot take judicial notice of foreign law and foreign laws are usually matters of evidence requiring proof as questions of fact."

8.8. Further the Hon'ble Delhi High Court in the case of ***Desiccant Rotors International (P) Ltd. (supra)*** has held that violation of a patent in a foreign country cannot be considered as violation of India laws. The relevant paras are as under:-

"11. Learned counsel also took support from the reasons given by the AO as well as the CIT(A) in their respective orders. He pointed out that the CIT(A) had clearly held that it was a case where there was an infringement of United States Patent Law by the assessee. The goods were manufactured and sold by the assessee to VENMAR for sale in US and Canada markets and as a manufacturer, the assessee could not escape the primary responsibility by stating that it was not directly involved in infringement. Further, for making a disallowance under Section 37 in respect of penalty, etc. finding by a competent Court was not a condition precedent to attract the Explanation to Section 37(1). According to the CIT (A), the Explanation simply states that if expenditure is incurred for any purpose, which is an offence, or which is prohibited by law, such expenditure will not be deeded to have been incurred for the purpose of business. The Explanation does even imply that there must be a finding of a Competent Authority or Court that an offence was committed or that any law was infringed. In fact, there may be numerous situations where expenditure is incurred for a purpose, which is prohibited by law, but there may not necessarily be any order of any authority or Court to this effect. Payment of protection money, hafta money, ransom, etc. are examples of such expenditure. There may not be any order prohibiting a person from making payment of protection money but nonetheless the payment will be for a purpose prohibited by law and would not be allowable under Section 37 of the Act.

18. At the outset, we are inclined to accept the submission of the assessee that the paramount and governing consideration behind such a settlement/agreement can be to avoid the expenses and uncertainty of further litigation. It is a matter of common knowledge that litigation can turn out to be quite expensive and it cannot be even possible, what to talk of feasible, for a small time/middle level company in India like the assessee to litigate in US Court. Furthermore, the settlement agreement contains a specific recital to this effect inasmuch as it records "whereas, in order to avoid the expenses or uncertainty or further litigation, the parties desired to settle and adjust all differences and controversies among themselves subject to the terms of this Agreement." No doubt in the Agreement, the assessee accepted the patent of SEMCO. That by itself would not mean that the assessee also accepted that it was infringing the said patent. Secondly, payment is made by the assessee to SEMCO for "loss of goodwill and damages to its capital and for terminating of case US Courts" as is clearly mentioned in Clause (3) of the Agreement. No finding is given by any Court that the assessee had violated the patent right of SEMCO. With the aforesaid payment, the "Covenants to Release" recorded in Clause (2) is as under:

> *"2. COVENANTS TO RELEASE 2.1 SEMCO hereby releases, remises and forever discharges the Settling Entities and their agents, attorneys, consultants, offices, employees, representatives, heirs, successors and assigns and their Customers form any and all claims, demands, or causes of action that arise out of or relate to the Action, and any and all obligations, actions, causes of action, suits, debts, contracts, controversies, agreements, promises, damages, judgments, awards, executions, claims and demands whatsoever in law or in equity, and any and all claims for damages (and attorneys" fees and costs) based upon the violation of a federal, state or other statute, regulation or law or arising out of any conduct, contract, employments, action, event or circumstance, under the law of any and all nations, whether known or unknown, which occurred at any time up to an including the date of the execution of this Agreement, except obligations created by this Agreement, any associated licence Agreement and/or by the Consent Judgment to be filed in accordance with this Agreement."*

19. It would be pertinent to highlight that the Agreement is applicable within the area defined as "territory". This territory mentions some specific countries in Europe as well as Japan, Australia and Korea. There is no mention of India at all. That clearly implies that SEMCO has no objection if the assessee continues to manufacture the goods in the same manner using same patent which it has been using and marketing *it in India or any other countries, which are not stipulated in the territory with respect to which only restraint is provided in the agreement. It is for this reason the assessee even today continues to manufacture those goods and is selling the products in this country. Once we find that the settlement has arrived at under the aforesaid circumstances, there is no room to hold that it was because of the reason that the assessee was violating the patent laws or the payment was made for an objective prohibited by law. This is our view even when we presume that the expression prohibited by law would include US laws and would not be confined to law in India.*

20. Moreover, we also agree with the contention of the learned counsel for the assessee that the payment under the settlement is compensatory in nature. The remedy for infringement of patent involves civil action for compensating the damage to private properties. It may be noted that in the plaint filed by it, SEMCO has sought civil damages under Sections 284 and 285 of the US Paten Code (US 35). Criminal Suit is scored out in the plaint. The relevant provisions of US 35 (Patent Code) read as follows:

> *"Section 284. Damages Upon finding for the claimant the Court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the sue made of the invention by the infringer, together with interest and costs as fixed by the Court.*
> *Section 285. Attorney fees The Court in exceptional cases may award reasonable attorney fees to the prevailing party."*

21. It will be seen from the above that the damages are calculated for compensating the owner of the patent rights for the loss of profit/royalty even under the laws of USA. There is no element of penalty even in USA. Even the Indian Patents Act, 1970 (as amended by the Act of 2005) does not prescribe any penalty or fine for infringement of a patent registered under that Act. This is clear from the Section 108 of the Indian Patent Act, which reads as under:

> *"Sec. 108 Reliefs in suit for infringement The reliefs which a Court may grant in any suit for infringement include an injunction (subject to such terms, if any, as the Court things fit) and, at the option of the plaintiff, either damages or an account of profits."*

22. Therefore, any payment for infringement of patent, being purely compensatory in nature, cannot be disallowed as per the law settled by the Supreme Court in the case of Prakash Cotton Mills (supra), where the Apex Court observed as under:

"... 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."

23. It was an expenditure which was motivated purely by commercial purpose and would be allowable under Section 37(1) of the Act as held by the Apex Court in the case of Sri Venkata Satya Narayana Rice Mill Contractor Co. Vs. Commissioner of Income Tax [223 ITR 101]."

8.9. Thus, from the above decisions, it is clear that what has to be disallowed under Explanation 1 to Sec.37(1) of the Act is a payment made, for contravention of laws in force in India and not of any foreign country. The laws are specific to each of the countries according to their rules and regulations and an offence in one country may not be so in another country. <u>Therefore, we agree with the contentions of Ld. Counsel for the assessee that it is only payment made for contravention of laws in force in India that disallowance under Explanation 1 to Sec.37(1) of the Act is to be made.</u> *(emphasis supplied)*

8.10 Furthermore, we consider for completeness sake, the alternate plea by the assessee in its grounds of appeal 2.3 claiming the amount as a business loss u/S. 28. Ld.DR vehemently argued that this payment is not a disgorgement because though the receipt is from Nich, <u>the payment by the assessee is to European Commission and it is nothing but a penalty, though the same in quantum as the patent settlement amount</u>, and therefore cannot be treated as business loss allowable u/s 28. The contention of the assessee is that without such payment and without such agreement, the assessee could not have carried out its business in EU and therefore it is towards commercial expediency and to carry on business of assessee, and, therefore, it is business loss. <u>While this payment may not appear to be a disgorgement simplicitor, we find merit in the assessee's argument that this payment directly relates to carrying on of business of assessee and hence allowable as a business loss u/s 28.</u> *(emphasis supplied)*

Appeal allowed in favour of the assessee.

Sd/-
Accountant Member

Sd/-
Judicial Member