

**COMMISSIONER OF INCOME TAX
GUJARAT III, AHMEDABAD & ANOTHER**

v.

KURJI JINABHAI KOTECHA

February 18, 1977

[P. K. GOSWAMI AND JASWANT SINGH, JJ.]

Income Tax Act 1922—Section 24(1)(2)—Whether expenses incurred in carrying on illegal business to be deducted—Whether loss arising out of illegal business can be set off against profits from legal business—Whether loss of illegal business can be carried forward to future years—Interpretation of statutes—Whether ought to be consistent with morality—Whether continuation of illegal activity to be recognised.

Forward Contracts (Regulation) Act 1952—Section 15(4)—Illegal contracts—Effect of income tax law.

The assessee carries on business of running Oil Mill and dealing in groundnuts, groundnut seeds and oil, speculative business in groundnuts, groundnut oil and groundnut seeds, and speculation business in cotton errands etc. The I.T.O. disallowed loss in forward contracts and groundnut oil, groundnuts and groundnut seeds on the ground that it arose out of illegal contracts on account of the same being banned under section 15(4) of the Forward Contracts (Regulation) Act, 1952. The Appellate Assistant Commissioner on appeal confirmed the decision of the I.T.O. but bifurcated the loss into two headings, namely, loss incurred in hedging transactions in the banned items and loss incurred in speculative transactions. On second appeal, the Tribunal held that notwithstanding the illegality of the transactions the loss could be set off and carried forward in accordance with the provisions of section 24(1) and 24(2) of the Income Tax Act, 1922. The Tribunal accordingly directed that the loss in hedging transactions of forward business in the banned contracts be set off against the other profits of the assessee for the relevant accounting year under section 24(1) and that balance of loss relating to the speculative transactions in the banned contracts be carried forward to the following year under section 24(2) of the Act to be set off against profit of the following year from speculative business. On reference to the High Court, the High Court answered both the questions in favour of the assessee and upheld the judgment of the Tribunal. The High Court relied on its earlier judgment in the case of *C.I.T. v. S.C. Kothari*.

Allowing the appeal by certificate,

HELD :

(1) The loss incurred in the hedging transactions cannot be set off against other profits in the previous year in view of the decision of this Court partly reversing the judgment of the High Court in the case of *S.C. Kothari*. [31C-D]

Commissioner of Income-tax v. S.C. Kothari, 69 ITR 1, applied.

(2) It is admitted that the contract for speculation in the commodity in question is banned under the Forward Contracts (Regulation) Act 1952. To allow such a loss to be carried forward is to permit a benefit of adjustment of loss from an illegal business to spill over and continue in the following year even in a lawful speculative business. The speculative business which is carried on in the following year must be a business of lawful speculation pertaining to the lawful and enforceable contracts. An assessee carrying on a lawful speculative business in the following year cannot derive benefit by carrying forward and setting off a loss from illegal speculative business of the earlier year. Law will assume an illegal business to die out of existence with all its losses to the assessee in the year of loss itself. The assessee can derive no benefit on account of the unlawful business in the following year. The matter will be different if a lawful speculative business after incurring loss is

discontinued and loss thereupon is carried forward for set off against any other lawful speculative business in the following year. It is inconceivable that law can permit an illegal activity to be carried on from which a benefit could be obtained. The concept of carry forward is not the same thing as the setting off of loss in a particular illegal business against profit of that illegal business in a particular year. The two concepts have to be kept distinctly separate even in a taxing statute. It is true that by earning income from illegal trading activity the business does not get tainted so far as exigibility to tax is concerned. While computing income from illegal activity in a particular year all losses incurred in earning that particular income are also taken into account for computation of real profits even in the illegal business. There is a marked distinction between the computation of a particular year's profit from illegal trading activity and carry forward of a loss to set it off against income in the subsequent years even assuming that such illegal activity is continued against the provisions of law. No illegal activity can be perpetuated under any provisions of law nor benefit out of it. Law will miss its paramount object if it is not consistent with morality and any interpretation by courts cannot lead to a result where continuation of illegal activity or benefit attached to it is given recognition. [31D-H, 32A-D]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 580 of 1972.

(From the Judgment and Order dated 8-9-1970 of the Gujarat High Court in Income-tax Reference No. 9/68).

B. B. Ahuja and R. N. Sachithy, for the Appellants.

K. L. Hathi and P. C. Kapoor, for the respondent.

The Judgment of the Court was delivered by

GOSWAMI, J. This appeal by certificate is from the judgment of the Gujarat High Court in an Income-tax Reference under section 66(1) of the Indian Income-tax Act, 1922 (briefly the Act).

The two questions which were earlier referred by the Tribunal to the High Court at the instance of the Commissioner of Income-tax, Gujarat III, are as follows :—

“(2) Whether, on the facts and in the circumstances of the case, the assessee was entitled to set off hedging loss of Rs. 31745/- against other profits of the previous year ?

(2) Whether, on the facts and in the circumstances of the case, the assessee was entitled to carry forward the speculation loss of Rs. 41603/- to the next year ?”

The following facts appear from the statement of case and the order of the Tribunal :

The assessment year in question is 1957-58 and the corresponding previous year is the Samvat year 2012. The assessee is carrying on business by running an oil mill, and also doing business in sales and purchase of groundnuts, groundnut seeds and oil; speculation business in groundnuts, groundnut oil and groundnut seeds; and speculation business in cotton, errands, etc. His total income for the year in question was determined by the Income-tax Officer as Rs. 1,71,632/-. This was after allowing set off of loss brought forward from the year 1955-56 amounting to Rs. 2,11,431/-. In arriving at the figure of the total income, the Income-tax Officer disallowed loss amounting to

- A** Rs. 73,348/- in forward contracts in groundnut oil, groundnuts and groundnut seeds. He disallowed this loss on the ground that it arose out of illegal contracts on account of the same being banned under section 15(4) of the Forward Contracts (Regulation) Act, 1952.

It will appear that the break-up of losses in the business of illegal forward contracts is as follows :—

B	(1) Groundnut oil Account	Rs. 49,664/-
	(2) Groundnut Account	Rs. 22,522/-
	(3) Singdana (Groundnut seeds Account) at Veraval	Rs. 1,162/-
	Total	Rs. 73,348/-

- C** The above third item of loss is arrived at by the Income-tax Officer after adjusting the profit of the forward business in groundnut seeds at Rajkot.

- On appeal by the assessee the Appellate Assistant Commissioner affirmed the order of the Income-tax Officer. The Appellate Assistant Commissioner, however, bifurcated the loss into two categories as follows :—

D	(1) Loss incurred in hedging transactions in the banned items	Rs. 331,745/-
	(2) Loss incurred in speculative transactions (other than hedging transactions) in the banned items.	Rs. 41,603/-
	Total :	Rs. 73,348/-

- E** The Appellate Assistant Commissioner held that the assessee was not entitled to the set off of the loss against the assessee's other business under section 24(1) of the Act and also that such loss could not be carried forward to the following year under section 24(2) of the Act.

- F** On a second appeal by the assessee before the Appellate Tribunal, the Tribunal held that notwithstanding the illegality of the transactions the loss could be set off and carried forward in accordance with the provisions of section 24(1) and 24(2) respectively of the Act. The Tribunal accordingly directed that the loss in hedging transactions of forward business in the banned contracts amounting to Rs. 31,745/- be set off against the other profits of the assessee for the relevant accounting year under section 24(1) and that the balance loss of Rs. 41,603/- relating to the speculative transactions in the banned contracts be carried forward to the following year under section 24(2) of the Act to be set off against profits of the following year from speculative business.

- G** As stated earlier, at the instance of the Commissioner of Income-tax, the two questions set out above were referred to the High Court under section 66(1) of the Act. The High Court relying upon its

earlier judgment in the *Commissioner of Income-tax v. S. C. Kothari*⁽¹⁾ answered both the questions in the affirmative in favour of the assessee. That decision was, however, partly reversed by this Court in the *Commissioner of Income-tax Gujarat v. S. C. Kothari*⁽²⁾ (hereinafter to be referred to as Kothari decision). This Court held in the Kothari decision as follows :

“ . . . the taint of illegality of the business cannot detract from the losses being taken into account for computation of the amount which can be subjected to tax as ‘profits’ under section 10(1) of the Act of 1922. The tax collector cannot be heard to say that he will bring the gross receipts to tax. He can only tax profits of a trade or business. That cannot be done without deducting the losses and the legitimate expenses of the business”.

This Court, however, held that the High Court was in error in considering that any set off could be allowed in that case under the first proviso to section 24(1). This Court observed :

“The contract contemplated by Explanation 2 to the first proviso to section 24(1) of the Income-tax Act, 1922, has to be an enforceable contract and not an unenforceable one by reason of any taint of illegality resulting in its invalidity. Set-off cannot be allowed under the first proviso to section 24(1), read with Explanation 2 thereto, of losses in contracts which are illegal and unenforceable on account of contravention of Section 15(4) of the Forward Contracts (Regulation) Act, 1952”.

This Court held the contracts in that case in respect of which the loss was incurred by the assessee as illegal contracts. It also held that the assessee was not entitled to a set off under the first proviso to section 24(1) of the Act of the loss against its profit in speculative transactions. It, however, held that if the business in which the loss was sustained in that case was the same as the business in which the profit was derived then the loss had to be taken into account while computing the profits of the business under section 10(2) of the Act. In the view it took this Court remitted the matter to the High Court to decide the point which was not clear on the findings whether the profits and losses were incurred in the same business even though that business involved the entering into of contracts some of which were illegal.

In the present case there is no dispute that the losses were incurred in connection with forward contracts which were banned under section 15(4) of the Forward Contracts (Regulation) Act. It is also clear that the Income-tax Officer adjusted the profit against the loss with regard to the illegal business in groundnut seeds which was carried on in two places, Veraval and Rajkot. This set off is permissible under section 10(2) of the Act because it is only by

(1) 69 I.T.R. 1.

(2) 82 I.T.R. 794.

- A setting off of the loss of the particular business in groundnut seeds that true profit with regard to that particular business can be computed under section 10(2). There is, therefore, no reason to remit this case as the course earnestly suggested by Mr. Hathi for the respondent. In *Kothari* decision (supra) it was observed by this Court while remitting the case that "enough attention was not devoted to the business which the assessee was doing and in which the profit
- B of Rs. 2,19,046/- was made and the loss of Rs. 3,40,443/- was sustained". Such an uncertainty, however, is not present in the instant case. The submission of Mr. Hathi, therefore, cannot be accepted.

The present case rests upon section 24 of the Act. That section so far as material for our purpose reads as follows :—

- C "24(1) Where any assessee sustains a loss of profits or gains in any year under any of the heads mentioned in section 6, he shall be entitled to have the amount of the loss set off against his income, profits or gains under any other head in that year :

- D Provided that in computing the profits and gains chargeable under the head 'Profits and gains of business, profession or vocation, any loss sustained in speculative transactions which are in the nature of a business shall not be taken into account except to the extent of the amount of profits and gains, if any, in any other business consisting of speculative transactions:

- E (2) Where any assessee sustains a loss of profits or gains in any year, being a previous year not earlier than the previous year for the assessment for the year ending on the 31st day of March, 1940, in any business, profession or vocation, and the loss cannot be wholly set off under sub-section (1), so much of the loss as is not so set off or the whole loss where
- F the assessee had no other head of income shall be carried forward to the following year, and

- G (i) where the loss was sustained by him in a business consisting of speculative transactions, it shall be set off only against the profits and gains, if any, of any business in speculative transactions carried on by him in that year;

- H (ii) whether loss was sustained by him in any other business, profession or vocation, it shall be set off against the profits and gains, if any, or any business, profession or vocation carried on by him in that year, provided that the business, profession or vocation in which the loss was originally sustained continued to be carried on by him in that year; and

(iii) if the loss in either case cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following year and so on but no loss shall be so carried forward for more than eight years".

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In the instant case there is no dispute about the following findings of facts :

The assessee sustained losses in the relevant accounting year amounting to Rs. 73,348/-. This figure was arrived at on a legitimate computation under section 10(2) of the Act. No further question survives for a recomputation of the income under section 10(2) of the Act in this case. The only question remains is as to whether the loss of Rs. 31,745/- can be set off against other profits in the previous year. This is the first question in the reference. This question has to be answered in the negative in view of *Kothari* decision (*supra*). The hedging loss being in respect of a banned contract under section 15(4) of the Forward Contracts (Regulation) Act, 1952, cannot be set off against the profits of other business of the previous year.

The second question is with regard to the assessee's claim for entitlement to carry forward the speculation loss of Rs. 41,603/- to the next year. It is also admitted that the contract for speculation in the commodity in question is banned under the Forward Contracts (Regulation) Act, 1952. It also appears that the said loss could not be set off in the previous year against profit in the same business in that year. The assessee contends that this loss should be allowed to be carried forward under section 24(2) of the Act. To allow such a claim is to permit a benefit of adjustment of loss from an illegal business to spill over and continue in the following year even in a lawful speculative business. A speculative business which is carried on in the following year must be a business of lawful speculation pertaining to lawful and enforceable contracts. The assessee carrying on a lawful speculative business in the following year cannot derive benefit by carrying forward and setting off a loss from an illegal speculative business of the earlier year. Law will assume an illegal business to die out of existence with all its losses to the assessee in the year of loss itself. The assessee can derive no benefit on account of the unlawful business in the following year. The matter will be different if a lawful speculative business after incurring loss is discontinued and loss therefrom is carried forward for set off against any other lawful speculative business in the following year. This is the true legal effect of section 24(2)(i) of the Act in this case.

It is inconceivable that law can permit an illegal activity to be carried on from which a benefit could be obtained. The concept of carry forward is not the same thing as the setting off of loss in a particular illegal business against profit of that illegal business in a particular year. The two concepts have to be kept distinctly separate

- A even in a taxing statute. There is no express warrant for the submission either under section 20(2) or under any other provision of the Act, far less on general principles.

- B It is true that by earning income from illegal trading activity the income does not get tainted so far as exigibility to tax is concerned. While computing income from illegal activity in a particular year all losses incurred in earning that particular income are also taken into account for computation of real profits even in the illegal business. That does not mean that fines imposed on the illegal activities detected, prosecuted and punished or otherwise penalised, will be taken into account for ascertainment of real profits. There is, therefore, a marked distinction between computation of a particular year's profit from illegal trading activity and carry forward of a loss to set it off against income in subsequent years even assuming that such illegal activity is continued against the provisions of law. No illegal activity can be perpetuated under any provisions of law nor benefit out of it. Law will miss its paramount object if it is not consistent with morality and any interpretation by courts cannot read to a result where continuation of illegal activity or benefit attached to it is given recognition.
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- D

The second question, therefore, must be answered in the negative and against the assessee.

- E In the result the judgment of the High Court is set aside and the two questions set out above are answered in the negative and in favour of the Department. The appeal is allowed with costs.

P.H.P.

Appeal allowed.