

Cost of goods ordered to be destroyed as per prevention of Food Alteration Act not allowed as deduction

Summary – The Ahmedabad ITAT in a recent case of Vishnu Packaging., (the Assessee) held that Amount spent by assessee in respect of manufacturing goods which were ordered to be destroyed by court in terms of provisions of prevention of Food Alteration Act, could not be allowed as deduction in view of applicability of Explanation to section 37(1)

Facts

- The assessee was a manufacturer of pan masala. During the course of scrutiny assessment proceedings, the Assessing Officer noticed that the assessee claimed deduction in respect of the goods produced by the assessee which, in terms of a court order under the Prevention of Food Adulteration Act, had to be destroyed as it was found the said goods had magnesium carbonate, a known carcinogenic substance, in excess of permissible limits. The claim of the assessee was that since the loss so incurred was in the course of business inasmuch as the goods had to be destroyed by the FDI authorities ceasing it, as was the scheme of the prevention of food adulteration law, the related costs of producing the said goods was to be allowed as deduction.
- The Assessing Officer, however, declined said claim of deduction by invoking the provisions of *Explanation* to section 37(1).
- The Commissioner (Appeals) held that the destruction of stock containing impermissible levels of magnesium carbonate was a loss incurred during the course of *bona fide* business and was not hit by *Explanation* to section 37(1). The deduction was thus allowed.
- On revenue's appeal:

Held

- It is no doubt true that under section 37(1) of the Act, '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', and, therefore, as long as the stock containing impermissible limits of magnesium carbonate was destroyed in the course of assessee's business, which admittedly it was, the assessee is entitled to deduction under section 37(1).
- However, there is a paradigm shift in the scheme of the Act, by insertion of *Explanation* to section 37(1) by Finance (No. 2) Act, 1998 with retrospective effect from 1st April 1962, which lays down the rider to the mandate of section 37(1) by stating that "for the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an offence or which

is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure". The additional test to be satisfied, in order to ensure deductibility of an expenditure, is that it must not be incurred for any purpose which is an offence or prohibited by law.

- The reason as to why the stock had to be destroyed in the present case was that it contained impermissible high levels of a carcinogenic substance by the name of magnesium carbonate. Pan masala is a controversial product and, even when it is manufactured within the permissible legal norms, it is considered to be responsible for oral cancer and other severe ill effects on health. In the present case, the assessee has gone even further against the public interests. He has used the carcinogenic substance, which is direct cause of cancer, much in excess of permissible limits, resulting in manufacture of product with substantial health hazards and that is the reason that the related stocks had to be destroyed by the law enforcement agencies. Whether this situation is due to a *bona fide* mistake of the assessee or a conscious decision to make the product even more attractive to the customers, is irrelevant.
- The magnesium carbonate levels in the products manufactured by the assessee were impermissible in law and thus the expenditure, on account of making this product, was something which is admittedly 'prohibited by law'. The expenses on manufacturing such a noxious product, whether deliberately or inadvertently cannot, therefore, be allowed as deduction under section 37(1) on account of disabling provisions of *Explanation 1* to section 37(1). What has been claimed as a deduction in the present case is the expense incurred on manufacturing the product which was destroyed by the law enforcement agencies due to its high carcinogenic content levels. The Assessing Officer was indeed justified in declining the said deduction.
- Another plea of the assessee is that since the assessee was not imposed any penalty or any other proceedings for manufacturing the said product, it was clearly a case of inferior quality but the assessee has not been faulted for the same. However, what this plea overlooks is the undisputed position that admittedly the product had level of carcinogenic substance in excess of permissible levels and the manufacturing of such product was prohibited by law, and that is all that is necessary for invoking *Explanation* to section 37(1). Whether the penalty was actually imposed, or even initiated for such an infraction of law, is not really relevant for the purpose of satisfying the requirements of *Explanation 1* to section 37(1) because as long as the expenditure is incurred for a purpose which is prohibited by law, it is immaterial whether the said act of the assessee constitutes an offence or not. The plea of the assessee is thus devoid of legally sustainable merits.
- Technicalities apart, even if manufacturing pan masala with impermissible carcinogenic contents, directly responsible for promoting cancer, is not treated as an offence, it is certainly prohibited in law. It is, of course, said that laws sometime appear to be so lax and unresponsive that even those responsible, with or without any ulterior motives, for such serious health hazards escape the exemplary punishment. What is even more disturbing is the indifferent attitude of the assessee to the possible damage their products could have caused, and, without any remorse or regret in his

conduct, claim business deduction of expenses incurred in products which could have seriously endangered health of the consumers of his product.

- Be that as it may, as held on the merits, the *Explanation 1* to section 37(1) comes into play in this case, and, accordingly, the claim is legally inadmissible.
- In view of the above the entirety of the order of the Commissioner (Appeals) is vacated on this point and the disallowance is restored.