Chapter V

EROSION FROM DEDUCTION: COSTS OF EARNING
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Since income tax is levied on receipts minus expenses of earning erosion of the base can occur as much from excessive deduction for expenses as through exclusion of receipts. The phenomenon of tax avoidance under the cover of cost deduction is believed to be widespread. In fact wherever there is income tax there is a tendency on the part of taxpayers to obtain the maximum advantage out of deduction for costs. This is only to be expected. For with a tax on net profits every rupee of deductible expenditure carries, as it were, a subsidy from government at the same marginal rate as that of the tax. The inducement to avoid tax in this way is particularly strong in the case of companies, for the control of a company is often secured with a small shareholding - sometimes as low as 1 per cent of the equity and the gain to the persons in control from camouflaging personal expense as 'business' is enormous; indeed it can be as high as fifty times of what they can secure for themselves by economising on the company's expenditure. It is common


2 This is because in a widely held domestic company, for a director whose holding is not more than, say, 20 per cent of the equity shares, for every rupee of the company's profits, the net after-tax return which he would be entitled to appropriate to himself (footnote contd.)
knowledge that many business families live virtually out of expense accounts of concerns under their control.

Aims of progressive taxation are obviously defeated where substantial ingredients of consumption slip out of the tax base. Cost manipulation also provides an easy device for diversion of income. The attempt to siphon off business profits by sharing large expenditure is manifest in the proliferation of 'agencies' - set up mostly with friends and relatives of the proprietors - to provide various services like selling, consultancy and so on. All this not only frustrates the aims of progressive taxation but spoils the climate for saving by putting a premium on extravagance. It also creates distortions in the financing of companies by favouring borrowed capital as against equity.

Experts and policy-makers all over the world are well aware of these pernicious effects of taxation based on income and profits. Attempts have also been made in various ways to

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if the profits were all distributed would not be more than 2 paisa (assuming that the company tax rate is 55 per cent and the director pays personal income tax at the rate of 77 per cent). For an elaboration of this point see "A Proposal for Reforming Corporation Tax", by Gulati & Bagchi, EPW, Annual Number, February 1975.

3 The Indian Minister of State for Finance is reported to have said that some big business families not only live in the building owned by their companies but even their food was supplied from the company guest house. (Economic Times, August 11, 1974).

4 V. D. Lall, "Changing the Corporate Tax Base", EPW, March 22, 1975.
counter the tendency to inflate costs and indulge in extravagant expenditure which income taxation generates. Indian income tax has even banned the deduction of certain expenditures in the computation of taxable income (e.g., expenditure on entertainment and guest house maintenance). It is, however, doubtful whether these measures have had more than a marginal effect. They have probably led merely to relabelling of certain expenditures in the accounts (e.g., entertainment being shown as selling expense). To the extent costs are inflated fraudulently to reduce the figure of taxable income it is a problem in policing. It needs to be recognized however that policing of expenditures presents problems which cannot be effectively tackled merely at the administrative level.

For some of the basic difficulties attending a proper determination of costs stem from two sets of factors which are essentially conceptual in nature. These are: (1) problems of distinguishing cost from consumption - 'personal' from 'business' - and (2) problems of matching. The personal/business distinction assumes importance because of the fact that a taxpayer is at once a producing as well as a consuming unit while matching is incidental to periodic income evaluation because expenditures incurred in a period do not always expire within that period. Matching is also called for where an expenditure represents a joint cost and a portion of the revenue to which the joint cost relates happens to be partially or fully exempt from tax. Since there is no perfect solution in these matters,
one has to go by certain rules in order to minimize inequity and at the same time guard against avoidance. In this chapter we propose to examine the efficacy of the rules followed for this purpose in the Indian income tax. Problems of allocation of long-term costs over time are taken up in the next chapter.

The basic rule of business expense deduction

The basic rule of business expense deduction in the Indian income tax is that any expenditure "laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed" provided it is not "in the nature of capital expenditure or personal expense of the assessee" (Sec. 37). The stipulation that it must be laid out or expended wholly and exclusively for the purposes of the business and that it must not be in the nature of personal expense is obviously designed to ensure that deduction is made only in respect of costs incurred for earning the income in question. This aim however does not seem to have been achieved. Increasingly liberal construction put on the expression 'purposes of business' by judicial authorities has widened the scope of 'costs' to such an extent that even provisions specifically designed to limit the deduction of certain expenditures have been rendered practically inoperative.

At first the courts were quite firm. In a famous

observation, Lord Davey of the House of Lords said while interpreting the business expense deduction rule:

It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade or is made out of the profits of the trade. It must be made for the purpose of earning the profits.6

Interpreted thus, the rule was quite restrictive. This approach was however disowned subsequently as it was considered too narrow. The principle which came to be followed later is that to qualify for deduction as cost it is enough if the expenditure is undergone for purposes of business and is not capital in nature. Thus, even sums expended "not of necessity with a view to a direct and immediate benefit in the trade, but voluntarily and on the grounds of commercial expediency and in order to indirectly facilitate the carrying on of the business may yet be expended wholly and exclusively for the purposes of the trade." 7

The later, that is, less restrictive interpretation of the business expense rule has come to prevail in India also. Implications of the distinction between expenses laid out for the purposes of the business and those for the purpose of earning profits have been explained by the Indian Supreme Court on many occasions. In one such case, the Court said:

6 Lord Davey in Strong & Co. of Romsey Ltd. v. Woodfield 5 T.C. 215.

7 Atherton v. British Insulated & Helsby Cables Ltd. 10 T.C. 155.
The expression 'for the purpose of the business' is wider in scope than the expression 'for the purpose of earning profits'. Its range is wide: it may take in not only the day to day running of a business but also the rationalization of its administration and modernization of its machinery; it may include measures for preservation of the business and for the protection of its assets and property from its expropriation, coercive process or assertion of hostile title; it may also comprehend payment of statutory dues and taxes imposed as a precondition to commerce or for the carrying on of a business; it may comprehend many other acts incidental to the carrying on of a business.8

Consequences of Court Rulings on Business Expense Deduction Rule

Several important consequences have followed from this enunciation. One is that, even a reasonably precise matching of cost and revenue cannot be ensured when joint costs are involved. Thus, interest paid by a bank on sums borrowed (or taken as deposit) by it for investment in securities was held fully deductible as a business expense even though the interest from the securities in question happened to be exempt from tax. In another case the Supreme Court refused to permit apportionment of joint cost (cost of management) in the assessment of a sugar manufacturing company even though the company's activities consisted partly of agriculture,


9 CIT v. Indian Bank Ltd. (1965) 56 ITR 77 (S.C.)
income from which was not taxable.

More important, under the rule as interpreted now any expenditure can be shown as laid out for business, if only it has the potentiality of furthering business aims and no questions can be asked whether it is necessary for earning that income or not. This is what the Supreme Court said on one occasion:

In allowing deduction which is permissible the question arises: Do we look behind the expenditure and see whether it has the quality of directly or indirectly producing taxable income? The answer must be in the negative....

It seems repugnant to the courts in India that when an expenditure is made on 'commercial consideration' any inquiry at all should be made about its reasonableness. Thus when revenue authorities sought to prevent the deduction of remuneration paid to directors of a company which appeared excessive, the Madras High Court ruled out any inquiry about reasonableness of the payment, whereas in

10 CIT v. Maharashtra Sugar Mills Ltd. (1971) 82 ITR 452 (S.C.). Other instances of cases where allocation of joint cost as between exempted income and taxable income was negatived by the courts and the entire expenditure was ordered to be deducted against taxable receipts are, CIT v. Industrial Investment Trust Co. Ltd. (1963) 67 ITR 436, CIT v. Bhopal Sugar Industries Ltd. (1970) 78 ITR 209 & Hanuman Sugar & Industries Ltd. v. CIT (1970) 76 ITR 603.

11 CIT v. Maharashtra Sugar Ltd. (1971) 82 ITR 452 (S.C.)

12 Newtone Studios Ltd. v. CIT (1955) 25 ITR 378.
England there have been instances where a disallowance of expenditure on grounds of being unreasonable was upheld.

Statutory curbs on deductible expenditure - how far effective

The law was amended in 1956 to empower the tax authorities to disallow deduction of excessive remuneration by a company to its directors or 'substantially interested' persons. Even so, the courts insist that in judging whether such payments are excessive or unreasonable authorities must take into consideration the 'legitimate business need' of the company, and what is necessary for business, it is further enjoined, must be judged from the point of view of a 'prudent businessman'.

The law in India has since been tightened up further, presumably, to get over the difficulty posed by such requirements

13 Copeman v. William Flood & Sons Ltd. 24 T.C. 53.
14 Sec. 10(4A) of the Indian Income Tax Act, 1922.

There is a notable difference in the formulation of the business expense deduction rule in the Indian and the U.K. statutes. Whereas the U.K. Act narrates the prohibitions the Indian Act enumerates the items which are allowed as deductions from the receipts. The British rule seems to be designed to strengthen the hands of Revenue whereas the Indian rule seems to reflect the desire to ensure that no expenditure which comes within the definition contemplated fails to qualify. (N. Kaldor, Indian Tax Reform (1956), p. 63, fn. 7). But this difference cannot possibly account for the divergence in the views of judicial authorities on this particular issue.
as that the tax officer should cast himself in the role of a prudent businessman. Since 1972, the permissible limits of deductible salaries and perquisites have been fixed at 16 Rs. 5,000 and Rs. 1,000 p.m. respectively for an employee and, in the case of companies, for any director, and his relatives or a person having a substantial interest in the company. As indicated already, since 1970 no deduction is permitted in respect of expense incurred on guest house maintenance and entertainment. Another provision empowers the tax officer to disallow deduction for expenditure which involves any payment to relatives or persons or concerns associated with the taxpayer in the manner specified in the Act, to the extent such expenditure is considered by him (the assessing officer) as excessive or unreasonable [Sec. 40A (2)].

But these provisions have been rendered somewhat ineffectual by the caveat that what is reasonable must be judged from a businessman's viewpoint. Besides, the onus is on the Revenue to establish that a particular payment is unreasonable and that is not easy to discharge in every case. As a result, persons in top management of business concerns still find it possible to maintain their high living at their company's expense despite the wide-ranging ceilings and restrictions on the deductibility of business expenditures. In many cases the restrictions can be avoided by describing the expenditures, for accounting purposes, by a different name. Facilities for

16 Sec. 40A (5).
treatment at posh nursing homes, for instance, can be secured by companies for their top executives by paying a regular subscription fee entered in the accounts as 'staff welfare'. Some company directors whose remuneration does not exceed Rs. 72,000 a year (the maximum amount admissible as deduction in the company's account) draw travelling allowances and medical benefits running into lakhs. Sometimes even specific restrictions are rendered ineffectual by court rulings as when the prohibition on the deduction of entertainment expense was held by the Appellate Tribunal inapplicable in the case of entertainment in business.

**Personal/Business borderline - The blurring distinction**

The trend towards a permissive view of costs is evident from the way the courts have of late reversed some of their earlier decisions to make room for a wider connotation of the term 'cost'. A notable instance of this is provided by the decision of the Supreme Court whereby the wealth tax payable by a company was held to be business expense superseding an earlier decision to the contrary. The earlier decision

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19 Indian Aluminium Co. Ltd. v. CIT (1972) 84 ITR 735. The effect of this decision has since been nullified by an amendment of the Act. The earlier decision was given in Travancore Titanium Products Ltd. v. CIT (1966) 60 ITR 277 (S.C.).
was founded on the reasoning that to be a permissible deduction there must be a direct and intimate connection between the expenditure and the business, i.e., between the expenditure and the character of the assessee as a trader, and not as owner of assets, even when the assets are used in business. In the later decision the Court took the view that payment of wealth-tax is incidental to trading if the assets in question happen to be business assets, although, one would have thought that liability to pay the wealth tax is incidental to owning of wealth and has nothing to do with carrying on of business.

By the same logic the Indian Supreme Court has held, rejecting the contrary view of the House of Lords, that expenses incurred by a taxpayer in connection with his income tax proceedings are deductible. The House of Lords thought that such expenses are incurred by a trader not for purpose of trade but "partly at least for the purposes of his relationship to the Crown as a taxpayer". The view favoured by the Supreme Court seems to have gained acceptance by policy-makers too. For (since passed) in the amendment proposals now before Parliament one of the clauses seeks to permit deduction for interest paid on sums borrowed to pay income tax. It is also proposed to allow

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21 Smith's Potato Estates Ltd. v. Bolland (1949) 17 ITR (Supp) 1 (H.L.)
deduction for expenses incurred on income tax proceedings at the appellate stages, as if income tax payment is a business activity.

Interpretation of 'commercial expediency':

Sometimes 'commercial expediency' is invoked to justify deductions which do not pass the test of permissible business expenditure. Thus while illegal payments are generally held inadmissible as business expenditure - illegal activity not being incidental to trading - loss sustained in illegal trading activity is treated as deductible in arriving at taxable business income. It is argued that a loss is something quite different from an 'expenditure'. The distinction is founded on the principle that the expense of a trader is something which "comes out of his pocket" while a loss is "a thing which comes upon him ab extra."

Losses caused by embezzlement, theft or fire too have been held to be admissible deduction in the computation

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22 Clause 26 of the Taxation Laws (Amend.) Bill, 1973 as reported by the Select Committee. See for a criticism of these provisions, "Taxation Laws (Amendment) Bill" by A. Bagchi, EPW, October 6, 1973.

23 S.C. in Haji Aziz and Abdul Shakoor Bros. v. CIT (1961) 41 ITR 350 (S.C.)


of business income on the doctrine of 'commercial principle'. Here again the touchstone is whether the loss is 'incidental' to the trade. Thus, loss sustained by the proprietor of a money-lending firm through embezzlement by an employee has been held to be deductible and so also the loss caused by destruction of stock-in-trade in bombing during the war.

That it is illogical to allow deduction for losses (which are at bottom nothing but diminution of capital) in a scheme of taxation where capital accretions are not treated as income does not seem to have been considered at all. The argument which prevailed with the courts in allowing losses to be deducted so liberally is that profits of business must be computed first on commercial principles and the statutory provisions intended to govern business expense deduction come into play only after the profits have been so determined.

This supremacy of commercial principles has had the effect of nullifying the legislative intent underlying many of the provisions designed to restrict the area of admissible deductions. A case in point is the recent decision of the Allahabad High Court whereby an employer's contributions to a gratuity fund were held allowable even though under the statutory provision supposed to govern deduction for such expenditure the contributions were clearly in-

26 Badridas Daga v. CIT (1958) 54 ITR 10 (S.C.).
admissible as they did not meet the required conditions.

From the foregoing discussion, it may be seen how inadequate the business expense deduction rule has proved to be as a safeguard against erosion of the income tax base through excessively liberal deduction of costs and how the rigour implied in the use of the terms 'wholly and exclusively' has worn off.

Disparity in expense deduction rule as between different income heads

In the case of income from sources other than business however the rules of cost deduction are much less liberal and this has been a source of inequity as between taxpayers earning income from business and profession and those from employment, property or other non-business sources. The disparity

Madho Mahesh Sugar Mills Ltd. v. CIT (1973), 92 ITR 503. It is to be noted that the law had been amended in 1953 to ensure that the deductions specifically itemized (like contribution to gratuity) will not be governed by the general rule of business expense deduction (vide TEC Report, vol. II, p. 56). But the objective does not seem to have been achieved.

Against property income deduction is permitted only to the extent specified in the law (Sec. 24). In the case of income computed under the head 'other sources' the general rule is that an expenditure is deductible if it is not in the nature of capital and is "laid out or expended wholly and exclusively for the purpose of making or earning such income" (Sec. 66), which evidently is more rigorous than the business expense rule. As indicated in Chapter II under the 'business' head that claims
between employment and non-employment income in the matter of treatment of cost deduction is well-known and has been widely commented upon. It stems essentially from the stipulation in the case of employment income that, unless otherwise provided for, an expenditure, if it is to be deducted, must be incurred not merely wholly and exclusively, but necessarily in the performance of duties. The qualification implied by the expression 'necessarily' generally precludes deduction of any expenditure except those unavoidably incurred in the performance of duties. However, what makes for the disparity is not merely this difference but the fact that business affords much greater scope for manipulation of costs than income from employment as the options open to employees in such matters are necessarily limited.

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for being treated as 'business income' are often put forward in respect of income from activities like letting out assets such as hotel, factory, furniture etc. and from rendering services ancillary to letting of property. The decision of the courts in such cases usually turns on the facts of each case and the intention of the parties regarding the use of the assets. See Karanji Properties Ltd. v. CIT (1971) 82 ITR 547 S.C.7 The risk of arbitrariness in such a procedure is obvious.

31 Sec. 10 (14) of the Income-tax Act 1961.
It is impossible to estimate quantitatively, the consequence of the base erosion caused by the growing permissiveness in the application of the business expense deduction rule. The Carter Commission thought that the impact of the practice of living off expense account is not of much significance in terms of revenue loss. Nevertheless they recognized that to those who enjoy it the benefit may be very significant and failure to tax these properly can lead to loss of faith in the integrity of the tax system. A recent study on income distribution in Britain also seems to suggest that, quantitatively, perquisites have only a marginal influence on the consumption levels of different income classes. Dimensionally, value of perquisites provided by business concerns to their owners or managers may look insignificant in relation to the scale of their operations and earnings. The harm done by extravagance on the part of the private business sector is however more grievous than it might appear from the proportion of such expenditure in the totality of business outlay. For as stated earlier, by setting the pattern of consumption for the rest of the community such extravagance serves to damage the climate of saving for the country as a whole apart from undermining the progressivity


of the tax system.

Basic nature of the problem and the alternative solutions

Consequences of a liberal application of the business expense deduction rule have been apparent to authorities and experts in India as elsewhere for quite some time but one wonders if their gravity has been sufficiently appreciated. The Income-tax Investigation Commission of 1947 was well aware of the tendency on the part of the assesses to pass off personal expenditures as business expense. Even so the Commission advised the tax authorities not to be unduly strict.

The Taxation Enquiry Commission also noted the tendency "to divert personal expenses to business" under the income-tax but did not think it advisable to amend the 'wholly and exclusively' rule. The only change suggested by the Commission was that the tax authorities should be given explicit powers to examine the reasonableness of remuneration

Attempts to introduce a degree of progressivity in indirect taxation too are frustrated when personal expenditures are dressed up as 'business'. This phenomenon is very much in evidence in India at present. Thus many of the luxury articles which are subjected to heavy excise duties are brought out of business firms' accounts and a good part of the cost of such articles go into the product prices.

paid to employees especially when the payment is made to a
relative of the taxpayer or, in the case of a company, to its
directors or their relatives. As indicated already, changes
on these lines have since taken place in the law but with little
apparent effect on wasteful business expenditure.

The British Royal Commission (1955) also devoted con-
siderable attention to the question of reforming the business
expense deduction rule but agreed with the Tucker Committee
that reintroduction of the term 'necessarily' in the 'wholly
and exclusively' rule would make it unduly narrow. Both the
Royal Commission and the Tucker Committee thought that the con-
struction put earlier on the rule - that an expenditure must
be incurred necessarily in the earning of income was an uncalled
for gloss on the words of the statute. The main suggestion which
the Royal Commission put forward in this regard was that the rule
for deduction in respect of employment income should be brought

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37 These have in fact been more drastic than what was contemplated by the TEC (vide Sec. 40 of the Income Tax Act 1961).

38 Royal Commission on Taxation of Profits and Income (1955), pp. 42-43.

39 Report of the Committee on Taxation of Trading Profits (1951), paras 152-162.
in line with business income. The U.K. authorities however did not act upon the recommendations, presumably on administrative grounds. For, as one critic points out, that would probably have opened up the scope for claims for all kinds of deduction.

The Carter Commission suggested that rules should be laid down to limit the deduction for expenses in business to genuine earning costs. In their view expenditures should be deductible only if (1) they are reasonably related to 'gaining or producing and income', (2) they are not 'unreasonable' and (3) they are not of a personal nature. The Commission felt that the expense deduction rule should be the same both for employees as well as for the self-employed. However, for administrative convenience, the Commission suggested that in the case of employees an optional deduction may be allowed towards cost of earning as a percentage of gross employment income, subject to a prescribed maximum. Claims for actual expenditure

40 Op. cit., para 143. The authors of the Minority Report were however of the view that the inequity of discriminatory expense deduction rule could be removed by permitting an earned income allowance in the case of income from employment (ibid., pp. 390-395). The Minority recognized that the business expense rule was too liberal but they shied away from recommending a stricter rule on the consideration that such a recommendation would not be heeded.


would also be considered if the assessee so desired but items like commutation expense, club bills and social and recreation facilities would be treated as personal in nature under this scheme.

Kaldor felt that the proper remedy was to introduce a much stricter rule of business expense deduction which would permit deduction only for 'expenses that are wholly, exclusively, and unavoidably incurred in earning profits of the year'. Such a rule, he thought, would serve to keep out a good part of indirect costs (i.e. those other than wages, salaries, material input, power and items like rent). The argument that such a rule would be too narrow and give rise to inequities was countered by Kaldor in the following words:

There can be little doubt that the original notion of 'income' for tax purposes - the conception which underlay the original income tax legislation in the time of Napoleonic wars - was intended to confine deductible expenses to direct and unavoidable outlays of this character. The extent to which the present conception of 'income' departs from it is a measure of the erosion caused by over a 100 years of relentless pressure exerted by vested interests.

The rule proposed by Kaldor runs essentially on the lines on which the deduction for cost is permitted at present in India and in U.K. against employment income. The rigour


44 Kaldor, op. cit., para 117.

with which this rule operates in U.K. would suggest that a provision like this in the statute might help to eliminate most of the wasteful expenditures incurred by business concerns at present. There is reason to doubt however whether such a consummation could be brought about in India simply by importing the additional appellation 'necessarily' into the business expense rule. The trend of judicial thinking here warns against expecting much from such a simple remedy. It should be noted that in interpreting the expense deduction rule even for employment income courts in India seem to be taking an increasingly liberal view. For instance, in a recent case the city compensatory allowance received by an employee has been held to be deductible on the ground that it is a cost of earning. (The decision has, however, been superseded by

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46 So strictly is this rule applied in U.K. that complaints are voiced against its harshness from time to time. In some cases even though the judges felt sorry for the taxpayer they could not but disallow expenses which did not come strictly within its scope. One of the judges, in one such case, observed about this rule: "Undoubtedly its most striking characteristic is its jealously restricted language, some of it repeated apparently to heighten its effect.... The terms employed are strictly, and I cannot doubt, purposely, not personal but objective." (See Lazar, op. cit.) Such strict construction resulted in the disallowance of expenses in several cases.

47 D. R. Pathak v. ITO, since confirmed by the Bombay High Court (vide Memorandum Explaining the Provisions in the Finance Bill, 1975, para 58).
provisions of the Finance Act 1975). In another instance, reported by the Public Accounts Committee, deduction was allowed from the perquisite value of rent free residence of a Government servant in respect of a portion of the residence on the ground that it was used by him for carrying out office work. It is pertinent to note that in the latter case the regulations governing the employment of the official did not stipulate any specific condition relating to use of any part of his residential accommodation for official purposes. In other words, the benefit of deduction was extended despite the bar implied by the word 'necessarily' in the relevant rule. Inadequacy of this rule is also underscored by the range of tax-free allowance drawn by employers of some of the public sector undertakings. In Britain too there are signs of a thaw.

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48 Hundred and Nineteenth Report of the Public Accounts Committee (Lok Sabha Secretariat, March, 1974), Ch. II.

49 For instance the following allowances available to the employees of the Indian Airlines are not subjected to income-tax:

(i) Charter allowance; (ii) special travelling allowance; (iii) stay-over allowance; (iv) meal allowance; (v) daily allowance; (vi) kit maintenance allowance; (vii) telephone allowance; (viii) house rent allowance; (ix) transport/conveyance allowance. Besides, they get the following benefits tax free: (i) light refreshment on ground before each take-off; (ii) free and concessional passages; (iii) reimbursement of loss of licence insurance; and (iv) mutual benefit fund/special annuity. (Answer given in Lok Sabha, to unstarred question No. 5868 on 21st December, 1973). It was stated that the taxability of some of these items was under examination. The result however is not known.
in the judicial view of the scope of the expense-deduction rule in the case of employment income.

The way the deduction rule in US income tax has been interpreted also warns against any optimism regarding the results likely to be achieved by the change suggested by Kaldor. There, the general rule is that deduction shall be allowed for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In respect of non-business income of individuals, deduction is allowed for ordinary and necessary expenses closely related to the 'production of income'. The word 'ordinary' is taken to mean 'commonplace among similarly circumstanced taxpayers'. But, according to some, in the usual meaning of the term, 'comparable circumstances' may indeed be extraordinary. In practice all the three essential criteria have proved quite elusive. Though not explicitly stipulated, the courts have also applied the criterion of 'reasonableness' in interpreting the rule but it is more relevant in the case of related taxpayers. The criterion 'necessary', it appears, is considered the least significant, for, as in India, the courts generally do not secondguess businessmen on the necessity of making expenditures. This clearly demonstrates

51 Sec. 172 (a) of the Internal Revenue Code.
52 Sommerfeld, Anderson & Brook, An Introduction to Taxation (1972), pp. 172-74.
53 Ibid., p. 173.
the futility of introducing the word 'necessarily' in the business expense deduction rule. Qualifications like 'ordinary', 'necessary' and 'reasonable' can at best make a difference of degree and not of kind. Whether a particular expenditure is wholly, exclusively, and necessarily incurred for business and whether it is reasonable are essentially a matter of judgement in which subjectivity is unavoidable. In fact, in many situations, an objective solution to such questions is conceptually unattainable. Pitfalls attending the attempt to separate the 'personal' from the 'business' element in expenditures for which the motives can be mixed bring this out.

The 'wholly and exclusively' rule, it might appear, serves to exclude from deductible cost any expense which is 'tainted with the vice of duality of purpose'. Where however the primary purpose is business, the expense is considered eligible for deduction even if some incidental pleasure results from it. But how do the authorities decide whether in respect of a particular item the motive was primarily business

54 Ibid.


56 Simon's Taxes, B 3.203.
without running into subjective judgements?

When the motives underlying an expenditure are partly business and partly personal, tests like the 'primary test' or 'but for test' do not work, because all these refer to "a mental phenomenon of some sort", as Klein puts it, and proceed on the assumption that taxpayers can narrate their mental process truthfully and meaningfully. Apportionment of the total cost, according to the time or attention devoted to business relatively to non-business purposes - suggested by Klein as an alternative solution - also does not help. For one thing, it is too mechanical. The time actually devoted to business on a tour can be no index of the actual weight of business element in a particular situation. For another such a 'surrogate' test is inapplicable over a large area where the expenditure cannot be related strictly to business. In fact a test like this was introduced in USA in 1962 but was withdrawn in 1964.

57 That is, whether the expenditure would not be undertaken but for the business. The 'but for' test does work, because, as Klein shows, suppose a trip costs in fare alone Rs.500 whereas the value of the pleasure to the taxpayer from the trip (assuming he can evaluate it) is Rs.200 and that of business Rs.350. Here the but-for-test would not yield an unambiguous answer. (Klein, op. cit.)

58 According to Klein, it was not given a fair trial. Indian Income-tax Act also provides for apportionment in certain areas, e.g., for rent paid for building used partly for business and partly for non-business purposes (vide Sec. 38).
Remedies

Perhaps a rational solution to the problem of distinguishing costs from consumption in determining taxable income would be easier if it was recognized that the divergence in the approach of the revenue authorities and that of the taxpayers to the concept of business cost is at bottom a reflection of the conflict between social cost and private cost. No amount of restriction in the statute can succeed in resolving this conflict unless the supremacy of the society's interest is accepted as the guiding principle in the application of the tax laws. Lack of any concern for the social angle and readiness to accord priority to the private interests is evident in the increasingly liberal view taken by the courts regarding the admissibility of costs incurred for infringing the laws of the country. Such decisions would seem to be natural and justified so long as 'commercial expediency' which is another name for the private cost angle is allowed to play the decisive role. It cannot be denied however that there is considerable risk of arbitrariness in leaving it to the tax officials to decide what is reasonable from any angle whether social or private. The courts have some justification

for refusing to accept this position.

Hence the proper remedy would seem to lie not in arming the tax authorities with more and more discretion or putting some limits here and there but to change the very basis of taxation of business by switching over from profits to expenditure. A change on these lines seems urgently called for in the interests of growth. If however such a remedy appears to be too drastic, an alternative way of tackling the problem would be to adopt Kaldor's proposals for imposing arbitrary limits on not merely a few items of cost like entertainment expenditure but all indirect costs (i.e. other than cost of material, wages and salaries and a few other items like power and rent). The limits might need to be worked out separately for each industry. But norms for purposes of fixing these limits can be decided upon through systematic cost studies. At the same time, the business expense deduction rule would require to be tightened up by reintroducing the words 'necessarily' and 'unavoidably' and by bringing in, in addition, some negative criteria such as those operative in the U.S. income tax, viz., that no deduction would be available for expenses relatable to tax exempt income (even when they are incurred as joint cost) and for

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60 Such a proposal has been put forward in a recent article by Gulati & Bagchi, op. cit.
61 Kaldor, op. cit., paras 117 and 129-132.
expenses that are contrary to public policy. The distinction drawn at present by the Indian courts between losses from illegal trading and illegal expenditures, the former being allowable and the latter not, makes no sense at all.

To conclude, the business expense deduction rule as it is now working in Indian income tax is causing more serious harm to equity and growth than is generally realized. If waste is to be curbed, a drastic change from the present system of profits taxation to a tax on costs is called for. If that is not feasible, the present rule should at least be reformulated on the lines suggested by Kaldor.

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62 Sommerfeld et al., op. cit., p. 175. In U.S.A., expenses contrary to public policy include not only fines and penalties for violation of law but all bribes and kickbacks and even a portion of damages paid under anti-trust laws even though, arguably, these are all incurred for purposes of business.