COMPENSATION BY WAY OF DAMAGES FOR BREACH OF CONTRACT FOR SALE OF LAND – WHETHER LIABLE TO INCOME-TAX ?

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The expression 'contract for sale' is defined in S.54 of the Transfer of Property Act (T.P. Act). As per S.54 of the T.P. Act, a contract for the sale of immovable property is a contract that sale of such property shall take place on terms settled between the parties. It is important to note that a contract for sale, does not, by itself, create any interest in or charge on such property.

Property is a bundle of rights, which the owner can lawfully exercise to the exclusion of all others. As per the decision of the Supreme Court in the case of **A. G. H. Ariff Vs C.W.T., 76 I.T.R. p.471,** property is a term of the widest import and subject to any limitation, which the context may require, it signifies every possible interest, which a person can clearly hold and enjoy.

2. **Whether a contract for sale or an agreement to sell, an immovable property is a capital asset.**

The expression 'capital asset' means **a property of any kind** held by an assessee .... . ., as per S.2(14) of the I. T. Act. There is a controversy whether a contract for sale or an agreement to sell an immovable property, is a capital asset.

As per S.54 of the T. P. Act an agreement to sell or a contract for sale of immovable property, does not, by itself, create any interest in such a property. Such a right is, therefore, not an interest in property and consequently not a capital asset. This view is further supported by the decision of Delhi High Court in the case of **C.I.T. Vs R. Dalmia (Decd.), 163 I.T.R. p.517.** As per this decision the right acquired on agreement to sell, is not a proprietary right and hence it is not a capital asset.

The Bombay High Court has, on the other hand, taken a contrary view in this respect in the case of **C.I.T. Vs Tata Services Ltd., 122 I.T.R. p.594.** According to this decision a contract for sale of land is capable of a specific performance. It is also assignable. Therefore, a right to obtain conveyance of immovable property is clearly property as contemplated by S. 2(14) of the I. T. Act. This decision has been followed in the cases of **C.I.T. Vs Sterling Investment Corporation Ltd., 123 I.T.R. p.441 (Bom.)** and **C.I.T. Vs Vijay Flexible Containers, 186 I.T.R. p.693 (Bom.)**

The Gujarat High Court, in the case of **Rustom Spinners Ltd. C.I.T., 198 I.T.R. p.351**; has taken a similar view. In this case the assessee entered into an agreement with a party by which it assigned its benefits, advantages and obligations under an agreement to sell a textile mill, for a consideration of Rs. 9 lakhs, whereas the vendor joined in the sale agreement as a confirming party. The Court held that there was no frustration of the contract and therefore, it could not be said that there was no

assignment by the assessee and accordingly the assessee was held to be liable to tax on capital gains in respect of the aforesaid sum of Rs. 9 lakhs.

In the light of the aforesaid decisions a better and preferable view would be to treat a contract for sale of land as a capital asset and plan one's tax-affairs accordingly, at least till an authoritative judgement on the issue, is rendered by the Apex Court.

3. **Whether right to receive compensation for breach of contract for sale of land is a capital asset and compensation so received liable to capital gains tax.**

The issue at hand requires to be examined in detail. For this purpose the relevant decisions need to be critically looked into. All such decisions are dealt with one by one, as follows:

(i) **C.I.T. Vs A. A. Dehgamwalla & others, 195 I.T.R. p.28 (Bom.)**

In this case there was a breach of contract for sale of land. The assessee was, therefore, entitled to compensation by way of damages for breach of contract, which was paid to the assessee as per a consent decree of the Court.

It was held that the right that a person acquires on the establishment of a breach of contract is at best, a mere right to sue. Despite the definition of the expression 'capital asset' in the widest possible terms in S.2(14) of the I.T. Act, a right to a capital asset must fall within the expression 'Property of any kind' and must not fall within the exceptions. S.6 of the T.P. Act which uses the same expression 'Property of any kind' in the context of transferability makes an exception in the case of **a mere right to sue.** The right to sue for damages is not an actionable claim. The right to sue for breach of contract, no doubt, is capable of maturing into a right to receive damages for breach of contract. But that happens only when the damages claimed for breach of contract are either admitted or decreed and not before.

For this purpose, the Court has visualised three stages. The first stage is a finding as to the breach of contract. The second stage will be a finding that the party claiming damages for breach of contract has, established that it suffered loss as result of the breach of contract by the other party and is required to be compensated by way of damages for the breach of that contract. The last stage is that the amount of loss established to have been suffered by the assessee is either agreed to by the other party or decreed by the Court.

Thus the Bombay High Court in the above case, has held that the right to receive compensation for breach of contract for sale of land, was not a capital asset and therefore, the damages received for such a breach of contract, were not assessable as capital gains. In this judgement the earlier decisions in the cases of **C.I.T. Vs Tata Services Ltd., 122 I.T.R. p.594 (Bom.)** and **C.I.T. Vs Vijay Flexible Containers, 186 I.T.R. p.693 (Bom.)**, **have been duly considered.**

(ii) **C.I.T. Vs J. Dalmia, 149 I.T.R. p.215 (Del.)**

In this case there was an agreement for construction and sale of a building. There was failure on the part of the contractor to sell. A suit was filed which was followed by arbitration. The assessee gave up his claim to specific performance but retained his right to damages.

Thereafter, damages were awarded by the arbitrator. It was held by the High Court that **the right to damages, being a mere right to sue,** cannot be transferred and therefore, the same was not a capital asset and accordingly no capital gains liability arose on receipt of damages awarded.

While coming to the aforesaid decision Their Lordships made a reference to S.21 of the Specific Relief Act 1963. This section provides that the purchaser, in a suit for specific performance of a contract, may also claim compensation for its breach, either in addition to, or in substitution of such performance. It was a suit for permanent injunction wherein it was prayed that the contractors be restrained from selling, alienating or in any other way transferring the property in question and from executing the transfer in the name of any person other than J. Dalmia. The parties, instead of proceeding with the suit, agreed to refer their disputes to arbitration. J. Dalmia as well as Krishna Prasad gave up their claim for specific performance of the contract but retained their claim and right for damages only, in accordance with law. This right was in addition to and not in lieu of, the right of specific performance as provided in the contract.

It may be seen that in the aforesaid case also the breach of contract had already taken place and the assessee only pursued his right to sue for damages. It was in the light of the aforesaid reasons that the Hon. High Court held that the damages received were not exigible to capital gains tax.

(iii) **Bharat Forge Co. Ltd. Vs C.I.T., 205 I.T.R. p.339 (Bom.)**

It was held in this case that the only right, which the assessee had in the given circumstances, was the right to sue the Bank of India for damages for breach of contract. This right was extinguished by the settlement. **This right, however, to sue for damages could not be considered as a capital asset at all, since a mere right to sue is not a property which can be transferred.** Hence in the present case, by virtue of this settlement, there was no extinguishment of any right in a capital asset by transfer of which the assessee received Rs. 24.92 lakhs.

In this case also it is noteworthy that a breach of contract, had already taken place.

(iv) **Rustom Spinners Ltd. Vs C.I.T., 198 I.T.R. p.351 (Guj.)**

The judgement in this case is not directly on the issue at hand. In this case there was an agreement for purchase of a textile mill. The rights under this agreement were assigned. The

original contract for purchase of the mill was not frustrated. It was held that the amount received from the assignee was exigible to capital gains tax.

The important point to note in this case is that there was no frustration or breach of contract.

The sum and substance of the aforesaid decisions

A careful reading of all the aforesaid judgements, leads us to the criteria as laid down by the Bombay High Court in the case **C.I.T. Vs A. A. Dehgamwalla & others, 195 I.T.R. p.28.** The Hon. High Court has laid down three stages, which are as follows :

(a) The first stage is a finding that there is a breach of contract.

(b) The second stage is that the party claiming damages for breach of contract establishes that it suffered loss as the result of breach of contract by the other party and is required to be compensated by way of damages for the breach of that contract; and

(c) The third and last stage is that the amount of loss established to have been suffered by the assessee is either agreed to by the other party or decreed by the Court.

If the aforesaid conditions are fulfilled then the compensation received by way of damages for breach of contract for sale of land, is not liable to capital gains tax.

4. **Tax-Planning measures**

In view of the aforesaid decisions it is advisable that the deed of settlement or consent decree in case of breach of contract for sale of land; is carefully drafted in the light of the aforesaid case-law, so that the capital gains liability in respect of the aforesaid compensation, is avoided.

It is further advised that if the facts and circumstances of the case so warrant, then an attempt must be made to fit in the same within the parameters of a breach of contract rather than an assignment of the right to sell, which will definitely lead to the taxation of the excess so realised, by way of capital gains.

An attempt should also be made to fit in the facts of the case within the parameters of the decision of the Apex Court in the case of **C.I.T. Vs B. C. Srinivasa Shetty, 128 I.T.R. p.294.**

5. **Whether the receipt of the aforesaid compensation constitutes 'Income' as defined U/s. 2(24) of the I.T. Act.**

If the aforesaid compensation is not found to be taxable as capital gains, the Department may attempt to tax the same as casual and non-recurring receipt. However, such an attempt of the Department may not succeed in view of the following decisions.

(i) **B.K. Roy Pvt. Ltd. Vs C.I.T., 211 I.T.R. p.500 (Cal.)**

It has been held in this case that S.10 of the I.T. Act lays down certain categories of income, which will not be included in the total income of a person. The proviso (i) to S.10 (3), clearly recognizes that capital gains chargeable U/s.45 will not come within its ambit. The Hon. High

Court has consequently held that amount not assessable as capital gains, can not be charged as a casual and non-recurring receipt.

(ii) **C.I.T. Vs Seshasayee Brothers Pvt. Ltd., 222 I.T.R. p.818 (Mad.)**

In this case the assessee, who was carrying on agency business, entered into an agreement to sell land. The earnest money given by the prospective purchaser was forfeited by the assessee for breach of contract on the part of the prospective purchaser. The amount of earnest money so forfeited, was held not to be a revenue receipt.

It has been held in this case that when a receipt is referable to a fixed capital, it is not taxable. It is taxable as revenue item when it is referable to circulating capital or stock-in-trade. It was further held that such a receipt could not, at all, be considered as income so as to bring it within the term 'casual receipt' as contemplated U/s.10 (3) of the I.T. Act.

(N.B.: The position may be different in case of an assessee who is regularly dealing in land.)

(iii) **Fattechand Rajmal Jain Vs I.A.C of I.T., 60 I.T.D p.47 (Pune-Trib.)**

In this case the assessee had sold silver utensils, which had been purchased by him for domestic and personal use and claimed the gains thereon as not liable to be taxed U/s.45 of the Act. The Assessing Officer (AO) accepted the claim of the assessee. However, the C.I.T. invoked the provisions of S.263 by treating the gains as casual and non-recurring receipt. **It was held by the I.T.A.T. that the sale proceeds of utensils were neither accidental, nor gratuitous and therefore, the same could not become a casual and non-recurring income.**

It is not difficult to visualise that any receipt by way of compensation for breach of contract for sale of land would be referable to a fixed capital and it would, therefore, not partake the character of income. Further it can neither be treated as accidental nor gratuitous and therefore, it could not become a casual and non-recurring income.

In view of the aforesaid case-law, the aforesaid compensation received by way of damages for breach of contract for sale of land, can not be taxed as a casual and non-recurring receipt also.

6. **Conclusion**

In the light of the reasons given in the earlier paras, the compensation received by way of damages for breach of contract for sale of land, is not liable to income-tax either as a revenue receipt or as a capital receipt. In other words the aforesaid compensation is not, at all, taxable under the I.T. Act 1961.

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