**Issues in taxability of enhanced compensation/ interest thereon- rural Vs. urban agricultural land**

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The government keeps acquiring the agricultural lands both in the rural as well as urban areas in order to carry out various development projects. The compensation is paid to the owners of these lands. However the compensation so paid, in most of the times, are challenged in the court of law, being lower. Many times the courts direct the government to pay additional compensation to these owners of land. Interest on such delayed payment are also provided under the Land Acquisition Act. However there have always been various controversies arising while taxing such compensation/ additional compensation and interest thereon under the Income Tax Act.

The issue of taxability of compensation/ enhanced compensation on acquisition of agricultural land and interest thereon can be understood by segregating the two portions of receipt, viz, the compensation portion and the interest portion, as the taxability of both these components have been dealt with separately in separate provisions under the Income Tax Act.

**COMPENSATION/ ENHANCED COMPENSATION:**

It is not that each and every type of compensation, whatever, received by an assessee is taxable under the Income Tax Act. There have always been controversy regarding the money so received being revenue or capital in nature.

This write up confines itself only to the taxability of amounts received as compensation/ additional compensation and interest thereon on transfer of agricultural land.

First important provision to be understood is Section 2(14) of the Income Tax Act, which provides for the definition of capital assets, which includes a reference to agricultural land and reads as under:

*“(14) “capital asset” means-*

*(a) property of any kind held by an assessee, whether or not connected with his business or profession;*

*(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992, [15 of 1992.] but does not include-*

***………..***

*(iii) agricultural land in India,* ***not being*** *land situate-*

*(a) in any area which is comprised within the jurisdiction of a municipality (whether known as a municipality, municipal corporation, notified area committee, town area committee, town committee, or by any other name) or a cantonment board and which has a population of not less than ten thousand  ; or*

*(b) in any area within the distance, measured aerially,-*

*(I) not being more than two kilometres, from the local limits of any municipality or cantonment board referred to in item (a) and which has a population of more than ten thousand but not exceeding one lakh; or*

*(II) not being more than six kilometres, from the local limits of any municipality or cantonment board referred to in item (a) and which has a population of more than one lakh but not exceeding ten lakh; or*

*(III) not being more than eight kilometres, from the local limits of any municipality or cantonment board referred to in item (a) and which has a population of more than ten lakh.*

*Explanation.-For the purposes of this sub-clause, “population” means the population according to the last preceding census of which the relevant figures have been published before the first day of the previous year”*

**In order to give incentive to agricultural operations, the agricultural land as such has been kept out of the ambit of the definition of capital asset and hence any capital gain arising on transfer of agricultural land is not taxable under the Income Tax Act. However, it is to be appreciated that the Income Tax Act is a self-contained code and it has an inclusive definition of agricultural land. Not every agricultural land is exempt under the Act. Now reading through the definition provision in section 2(14), only those lands which do not fall within the area prescribed under clauses (a) and (b) are to be treated as agricultural land for the purposes of the Act. The intention seems that the lands even if they are agricultural lands cannot be treated as agricultural lands if they are in too close proximity to an urban area.**

**It is too clear from the above that the land which does not fall under these clauses are exempt from taxation in all cases.**

**A very important aspect of this provision to be noticed is that it includes and as such does not get an agricultural land in the definition of ‘capital asset’, if it is in close proximity of an urban area. For the purposes of our further discussion, we will refer to these lands as ‘rural agricultural land’.**

So all rural agricultural lands are outside the definition of term ‘capital asset’. Hence any compensation/ enhanced compensation received on transfer will not lead to any capital gain arising to the receiver.

Now coming to section 10(37), it is to be noticed that section 10(37) of the Income Tax Act, 1961 specifically exempts the capital gains arising on transfer of some other specific agricultural lands, the same is being reproduced as under :

*10. In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included-*

*(37) in the case of an assessee, being an individual or a Hindu undivided family, any income chargeable under the head "Capital gains" arising from the transfer of* ***agricultural land****, where-*

*(i) such land is* ***situate in any area referred to in item (a) or item (b)*** *of sub-clause (iii) of clause (14) of section 2;*

*(ii) such land, during the period of two years immediately preceding the date of transfer, was being used for agricultural purposes by such Hindu undivided family or individual or a parent of his;*

*(iii) such transfer is by way of compulsory acquisition under any law, or a transfer the consideration for which is determined or approved by the Central Government or the Reserve Bank of India;*

*(iv) such income has arisen from the compensation or consideration for such transfer received by such assessee on or after the 1st day of April, 2004.*

* + *Explanation.-For the purposes of this clause, the expression "compensation or consideration" includes the compensation or consideration enhanced or further enhanced by any court, Tribunal or other authority.”*

This provision was brought into law by the Finance Act, 2004. The memorandum explaining the Finance (No.2) Bill, 2004, in this regard reads as under:

*“WELFARE MEASURES*

*Exemption of capital gains on compensation received on compulsory acquisition of agricultural land situated within specified urban limits*

*The existing provisions of section 45 provide for charging to tax the capital gains arising from transfer of agricultural land situated within specified urban limits. The said section also provides that where transfer of such land is by way of compulsory acquisition under any law or where the consideration for transfer of such land is determined or approved by the Central Government or the Reserve Bank of India, capital gains so arising is chargeable to tax as income of the previous year in which the compensation or enhanced compensation or consideration is received by the assessee.*

*With a view to mitigate the hardship faced by the farmers whose agricultural land situated in specified urban limits has been compulsorily acquired, it is proposed to insert a new clause (37) in section 10 so as to exempt the capital gains arising to an individual or a Hindu undivided family from transfer of agricultural land by way of compulsory acquisition where the compensation or the enhanced compensation or consideration, as the case may be, is received on or after 1st day of April, 2004. The exemption is available only when such land has been used for agricultural proposes during the preceding two years by such individual or a parent of his or by such Hindu undivided family.*

*The proposed amendment will take effect from 1st April, 2005 and will, accordingly, apply in relation to the assessment year 2005-2006 and subsequent years.”*

It is an undisputed fact that compensation/ enhanced compensation received on transfer of any land, except rural agricultural lands, is prone to be taxed under the head ‘capital gain’. Read through the above provision of section 10(37), however, it can be seen that the Act specifically provides exemption in the cases where compensation/ enhanced compensation has been awarded on compulsory acquisition of land, specifically on those agricultural lands which are situated **within the perimeters** as provided in clauses (a) and (b) of section 2(14) of the Act. This exemption is available only to individuals and HUFs, if the land has been used for agricultural purposes in the last two years.

For the purposes of this write up, these lands will henceforth be called ‘urban agricultural lands’.

Now if we read together the provisions of section 2(14) and section 10(37), it becomes clear that the distances as provided in these clauses (a) and (b) are very important. The agricultural lands which fall outside any of these distances, i.e. rural agricultural lands, are always outside the ambit of capital asset and hence not taxable in the hands of an assessee, irrespective of its status. However, capital gains arriving on the agricultural lands which are situated within the distances as prescribed in the clauses (a) and (b), are exempt as provided under section 10(37), only to the assesses who are individuals or HUFs. In other words, the capital gain on compulsory acquisition of rural agricultural land are exempt in all cases and capital gain on urban agricultural land is exempt only in cases of individual and HUF.

To sum up we can say that amount of compensation/ enhanced compensation received on sale of an agricultural land in exempt from tax. However in case of urban agricultural lands, this exemption is available to individuals and HUFs only.

Now in the cases of compensation/ enhanced compensation in cases other than those dealt with in any of the provisions, discussed above, the taxability provisions are contained in section 45(5), which reads as under:

**SECTION 45(5)**

*“(5) Notwithstanding anything contained in sub-section (1), where the capital gain arises from the transfer of a capital asset, being a transfer by way of compulsory acquisition under any law, or a transfer the consideration for which was determined or approved by the Central Government or the Reserve Bank of India, and the compensation or the consideration for such transfer is enhanced or further enhanced by any court, Tribunal or other authority, the capital gain shall be dealt with in the following manner, namely :-*

*(a) the capital gain computed with reference to the compensation awarded in the first instance or, as the case may be, the consideration determined or approved in the first instance by the Central Government or the Reserve Bank of India shall be chargeable as income under the head "Capital gains" of the previous year in which such compensation or part thereof, or such consideration or part thereof, was first received; and*

*(b) the amount by which the compensation or consideration is enhanced or further enhanced by the court, Tribunal or other authority shall be deemed to be income chargeable under the head "Capital gains" of the previous year in which such amount is received by the assessee;*

*Provided that any amount of compensation received in pursuance of an interim order of a court, Tribunal or other authority shall be deemed to be income chargeable under the head “Capital gains” of the previous year in which the final order of such court, Tribunal or other authority is made;*

*(c) where in the assessment for any year, the capital gain arising from the transfer of a capital asset is computed by taking the compensation or consideration referred to in clause (a) or, as the case may be, enhanced compensation or consideration referred to in clause (b), and subsequently such compensation or consideration is reduced by any court, Tribunal or other authority, such assessed capital gain of that year shall be recomputed by taking the compensation or consideration as so reduced by such court, Tribunal or other authority to be the full value of the consideration.*

***Explanation****.-For the purposes of this sub-section,-*

*(i) in relation to the amount referred to in clause (b), the cost of acquisition and the cost of improvement shall be taken to be nil;*

*(ii) the provisions of this sub-section shall apply also in a case where the transfer took place prior to the 1st day of April, 1988;*

*(iii) where by reason of the death of the person who made the transfer, or for any other reason, the enhanced compensation or consideration is received by any other person, the amount referred to in clause (b) shall be deemed to be the income, chargeable to tax under the head "Capital gains", of such other person.****”***

**From the reading of the above provision, it is very clear that in case of all other compensation/ additional compensation, which are not referred to in either of the two sections, namely 2(14) and 10(37) are to be taxed as per section 45(5) of the Act. The amount of compensation., when first received is taxable in the year of receipt, also any additional compensation has to be taxed in the year in which it is received, however any additional compensation by way of an interim order is taxed in the year in which the order for grant of such additional compensation is passed.**

**INTEREST ON ENHANCED COMPENSATION:**

The circumstances under which a particular amount of additional compensation is exempt does not lead to the fact that the interest on such additional compensation is also exempt in such circumstances. It is to be borne in mind that the interest is not always in the nature of what its underlying payment has. Therefore, for taxability of interest on additional compensation has to be looked under the Income Tax Act only.

**SECTION 56(2)(viii)**

*“56(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely :-*

*(viii) income by way of interest received on compensation or on enhanced compensation referred to in sub-section (1) of section 145B****.”***

**Since this section refers to section 145B(1), we now read section 145B(1), which is as under:**

**SECTION 145B(1)**

***“Taxability of certain income.***

*145B. (1) Notwithstanding anything to the contrary contained in section 145, the interest received by an assessee on any compensation or on enhanced compensation, as the case may be, shall be deemed to be the income of the previous year in which it is received.”*

From a bare perusal of the above two provisions, it is very clear that the interest on additional compensation has to be charged under the head ‘income from other sources’, that too on receipt basis.

The term ‘interest’ has been defined under section 2(28A) of the Act, as follows:

*“ "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised ;****”***

The question whether the interest on enhanced compensation can be treated as interest defined under the above section was considered elaborately by the Supreme Court in the case of Dr. Shamlal Narula v. CIT [1964] 53 ITR 151. Therein, considering the earlier case laws on the concept of "interest" laid down by the Privy Council and all other cases it was held as under:

*" In a case where title passes to the State, the statutory interest provided thereafter can only be regarded either as representing the profit which the owner of the land might have made if he had the use of the money or the loss he suffered because he had not that use. In no sense of the term can it be described as damages or compensation for the owner's right to retain possession, for he has no right to retain possession after possession was taken under section 16 or section 17 of the Act. We, therefore, hold that the statutory interest paid under section 34 of the Act is interest paid for the delayed payment of the compensation amount and, therefore, is a revenue receipt liable to tax under the Income-tax Act. "*

This position of law has been consistently reiterated by the Supreme Court in the cases of T. N. K. Govindaraju Chetty v. CIT [1967] 66 ITR 465 ; Rama Bai v. CIT [1990] 181 ITR 400 and K. S. Krishna Rao v. CIT [1990] 181 ITR 408. Thus by a catena of judicial pronouncements, it is well settled law that the interest received on delayed payment of the compensation is a revenue receipt exigible to income-tax. It is true that in section 2(28A) interest is defined to mean interest payable in any manner in respect of any moneys borrowed or debt incurred including a deposit, claim or other similar right or obligation and includes any service, fee or other charges in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized. It is seen that the word "interest" for the purpose of the Act was interpreted by the inclusive definition. A literal construction may lead to the conclusion that the interest received or payable in any manner in respect of any moneys borrowed or a debt incurred or enumerated analogous transaction would be deemed interest. But the question is: whether the interest on delayed payment on the acquisition of the immovable property under the Acquisition Act would not be exigible to income-tax ? It is seen that the Supreme Court court has consistently taken the view that it is a revenue receipt. The definition of "interest" is not intended to exclude the revenue receipt of interest on delayed payment of compensation from taxability.

Therefore, it becomes clear that the interest on additional compensation is interest as per Income Tax Act under the head ‘income from other sources’. However, there is a provision for allowance of certain expenditure incurred in relation to income under this head. The relevant provisions are:

**SECTION 57(iv)**

*“The income chargeable under the head "Income from other sources" shall be computed after making the following deductions, namely :-*

*(iv) in the case of income of the nature referred to in clause (viii) of subsection (2) of section 56, a deduction of a sum equal to fifty per cent. of such income and no deduction shall be allowed under any other clause of this section.”*

Here lies the main confusion, which has been observed in practical situations. The law is very clear, section 57 gives deduction on account of expenses incurred in relation to certain incomes earned only under the head ‘income from other sources’. Since interest on additional compensation has been made chargeable to tax under this head, the legislature in its wisdom has provided for deduction of expenses to the extent of 50% of such interest. The point always to be remembered is that this deduction has been provided out of interest on additional compensation, albeit taxed on receipt basis and not out of the amount of compensation itself.

**CURIOUS CASE OF GHANSHYAM HUF:**

Another question, which arises for anybody’s concern is Hon’ble Aprex Court in the case of **CIT v. Ghanshyam (HUF), [2009] 315 ITR 1 (SC),** which is seen to be used in every case of compensation/additional compensation and interest thereon. The supreme Court in this case has actually provided a big relief to the assesses by clarifying that the interest received under section 28 of the Land Acquisition Act, in fact, is not in the nature of interest and only a part of compensation only and hence not taxable.

It is to be noted that the judgement talks only about the interest on additional compensation received by an assessee under the Land Acquisition Act. It does not talk about the taxability of compensation/ additional compensation received on compulsory acquisition. These amounts are to be taxed, generally, in the way discussed above.

The Hon’ble Apex Court in the case of **CIT v. Ghanshyam (HUF), (Supra)** analysed the provision of section 28 of the Land Acquisition Act, 1894, the relevant extracts of which are reproduced as under :

*“20. We also quote hereinbelow Section 28 of the 1894 Act which reads as under:*

*"28. Collector may be directed to pay interest on excess compensation. - If the sum which, in the opinion of the court, the Collector ought to have awarded as compensation is in excess of the sum which the Collector did award as compensation, the award of the Court may direct that the Collector shall pay interest on such excess at the rate of [nine per centum] per annum from the date on which he took possession of the land to the date of payment of such excess into Court."*

*23. In addition to the market value of the land, as above provided, the Court shall in every case award a sum of 30% on such market value, in consideration of the compulsory nature of acquisition. This is under Section 23(2) of the 1894 Act. In short, Section 23(2) talks about solatium. Award of solatium is mandatory. Similarly, payment of additional amount under Section 23(1A) is mandatory. The award of interest under Section 28 of the 1894 Act is discretionary. Section 28 applies when the amount originally awarded has been paid or deposited and when the Court awards excess amount. In such cases interest on that excess alone is payable. Section 28 empowers the Court to award interest on the excess amount of compensation awarded by it over the amount awarded by the Collector. The compensation awarded by the Court includes the additional compensation awarded under Section 23(1A) and the solatium under Section 23(2) of the said Act. This award of interest is not mandatory but is left to the discretion of the Court. Section 28 is applicable only in respect of the excess amount, which is determined by the Court after a reference under Section 18 of the 1894 Act. Section 28 does not apply to cases of undue delay in making award for compensation [See: Ram Chand & others etc v. Union of India & Ors. - 1994(1) SCC 44]. In the case of Shree Vijay Cotton & Oil Mills Ltd. v. State of Gujarat - (1991) 1 SCC 262, this Court has held that interest is different from compensation.*

*24.* ***To sum up, interest is different from compensation. However, interest paid on the excess amount under Section 28 of the 1894 Act depends upon a claim by the person whose land is acquired whereas interest under Section 34 is for delay in making payment. This vital difference needs to be kept in mind in deciding this matter. Interest under Section 28 is part of the amount of compensation whereas interest under Section 34 is only for delay in making payment after the compensation amount is determined. Interest under Section 28 is a part of enhanced value of the land which is not the case in the matter of payment of interest under Section 34.***

*25. It is clear from reading of Sections 23(1A), 23(2) as also Section 28 of the 1894 Act that additional benefits are available on the market value of the acquired lands under Section 23(1A) and 23(2) whereas Section 28 is available in respect of the entire compensation. It was held by the Constitution Bench of the Supreme Court in Sunder v. Union of India - (2001) 7 SCC 211, that "indeed the language of Section 28 does not even remotely refer to market value alone and in terms it talks of compensation or the sum equivalent thereto. Thus, interest awardable under Section 28, would include within its ambit both the market value and the statutory solatium. It would be thus evident that even the provisions of Section 28 authorise the grant of interest on solatium as well." Thus solatium means an integral part of compensation, interest would be payable on it. Section 34 postulates award of interest at 9% per annum from the date of taking possession only until it is paid or deposited. It is a mandatory provision. Basically Section 34 provides for payment of interest for delayed payment.*

*33. It is to answer the above questions that we have analysed the provisions of Sections 23, 23(1A), 23(2), 28 and 34 of the 1894 Act. As discussed hereinabove, Section 23(1A) provides for additional amount. It takes care of increase in the value at the rate of 12 % per annum. Similarly, under Section 23(2) of the 1894 Act there is a provision for solatium which also represents part of enhanced compensation. Similarly, Section 28 empowers the court in its discretion to award interest on the excess amount of compensation over and above what is awarded by the Collector. It includes additional amount under Section 23(1A) and solatium under Section 23(2) of the said Act. Section 28 of the 1894 Act applies only in respect of the excess amount determined by the court after reference under Section 18 of the 1894 Act. It depends upon the claim, unlike interest under Section 34 which depends on undue delay in making the award. It is true that "interest" is not compensation. It is equally true that Section 45(5) of the 1961 Act refers to compensation.* ***But as discussed hereinabove, we have to go by the provisions of the 1894 Act which awards "interest" both as an accretion in the value of the lands acquired and interest for undue delay. Interest under Section 28 unlike interest under Section 34 is an accretion to the value, hence it is a part of enhanced compensation or consideration which is not the case with interest under Section 34 of the 1894 Act.”***

Another judgement of the Supreme Court on the same issue, which is quite an interesting read is UOI Vs. Hari Singh & Ors., CA No. 1514/2017, dt.15.09.2017, which also clarifies the proposition held in Ghanshyam HUF.

Read through the above, the hon’ble Apex Court states that the interest awarded under section 28 of the Land Acquisition Act, 1894 depends upon a claim by the person whose land is acquired. Interest under Section 28 is part of the amount of compensation and is a part of enhanced value of the land. Accordingly, the interest awarded as per section 28 is a part of enhanced compensation only and therefore is not taxable and exempt as any amount of actual compensation/ additional compensation would be under the Income Tax Act. The wording of the Hon'ble Apex Court is totally devoid of any ambiguity. It has been held in very clear term that interest received under section 28 of the Land Acquisition Act is a part of the compensation itself.

There are a catena of decisions of various High Courts as well as of various benches of the tribunal whereby, following the above Supreme Court, it has been held that interest under section 28 of the Land Acquisition Act is a part of compensation itself.

**CONCLUSION:**

1. Compensation/ enhanced compensation on acquisition of rural agricultural land is exempt in all cases [Section 2(14)].
2. Compensation/ enhanced compensation on acquisition of urban agricultural land is not taxable in the hands of individual and HUF.[Section 10(37)].
3. Compensation/ enhanced compensation on acquisition of urban agricultural land is taxable in the hands of all other assesses apart from individuals and HUFs [Section 2(14) and section 10(37)] read together.
4. Any other taxable compensation is taxed on receipt basis [Section 45(5)(a)].
5. Any other taxable additional compensation is taxed in the year in which the it is received, while interim compensation has to be taxed in the year in which the order for grant of such additional compensation is passed [Section 45(5)(b)].
6. Interest on enhanced compensation, if under section 28 of the Land Acquisition Act, being in the nature of compensation, will be treated as per points 1-3, above [SC in Ghanshyam (HUF) (supra)].
7. Interest on enhanced compensation under section 34 of the Land Acquisition Act is taxable as any other interest. [Section 56(2)(viii)].
8. Such interest is taxable on receipt basis [Section 145B(1)].
9. Once such interest is taxable an amount of 50% of such interest is deductible as expenditure [Section 57(4)].