CUSTOMS EXCISE & SERVICE TAX APPLELLATE TRIBUNAL
CHENNAI
SOUTH ZONAL BENCH - COURT NO. 1

LARGER BENCH

Service Tax Appeal No. 511 of 2011-LB
With
Service Tax Cross Application No. 40320 of 2018

[Arising out of Order-in-Appeal No. 62/11 dated 27.05.2011 passed by the Commissioner (Appeals) Chennai]

Commissioner of Service Tax, Chennai ....Appellant
MHU Complex
6th Floor, 692 Anna Salai,
Nandanam, Chennai-600035

VERSUS

....Respondent

M/s Repco Home Finance Ltd.,
Karumuthu Centre, II Floor,
No. 634, Anna Salai, Nandanam,
Chennai-600 035

Appearance
Present for the Appellant : Ms. Sridevi T., Joint Commissioner

Present for the Respondent: Shri P Ravindran, Advocate
For the Intervener : Shri Raghavan Ramabhadran, Advocate

COARM:
HON'BLE MR. JUSTICE DILIP GUPTA, PRESIDENT
HON'BLE MS. SULEKHA BEEVI, C.S MEMBER (JUDICIAL)
HON'BLE MR. P. V. SUBBA RAO, MEMBER (TECHNICAL)

DATE OF HEARING: 10.12.2019
DATE OF DECISION: 08.06.2020

MISCELLANOUS ORDER NO. 40053/2020

JUSTICE DILIP GUPTA:

1. Divergent views have been expressed by Division Benches of the Tribunal on the issue as to whether foreclosure charges levied by the banks and non banking financial companies on premature termination of loans are leviable to service tax under the head "banking and other financial services".

2. In **Housing & Dev. Corporation Limited (Hudco) vs. Commissioner of Service Tax, Ahmedabad[1],** a Division Bench of the Tribunal at Ahmedabad held that service tax would be leviable on such charges but in **M/s Magma Fincorp Limited. vs. Commissioner of Service Tax, Kolkata,[2]** a Division Bench of the Tribunal at Kolkata held that service tax would not be leviable.

3. It needs to be noted that while dealing with an application filed for waiver of pre-deposit, a Division Bench of the Tribunal at Ahmedabad in **Small Industries Dev. Bank of India vs. Commissioner of Service Tax, Ahmedabad[3](II),** when confronted with an earlier decision of the Tribunal at Delhi in **Small Industries Dev. Bank of India vs. Commissioner[4](I)** and the decision of the Tribunal in **Hudco,** directed that the matter may be referred to a Larger Bench.

4. When this Appeal came up for hearing before a Division Bench of the Tribunal at Ahmedabad, the Division Bench, after noticing the conflicting decisions of the Tribunal in **Hudco** and **Magma Fincorp,** considered it appropriate to refer the issue to a

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1. 2012 (26) STR 531 (Tri.-Ahmd.)
2. 2016 (4) TMI 21-CESTAT KOLKATA
3. 2015 (38) STR 666 (Tri.-Ahmd.)
4. 2011 (23) STR 392 (Tri.-Delhi)

Larger Bench of the Tribunal. This Larger Bench of the Tribunal has, accordingly, been constituted.

5. The Respondent-M/s Repco Home Finance Ltd.[5] is registered with the Service Tax Department for payment of service tax on "banking and other financial services". It provides housing loan to customers. During the course of verification of the Trial Balance of Repco Finance by the Internal Audit Group of the Service Tax Commissionerate for the period commencing from October 2004 upto June 2007, it was noticed that it had shown income on charges received from the clients for foreclosure of loans under the head "miscellaneous income", but had not paid service tax to the extent of Rs. 20,50,399/- leviable on such charges collected by it from the customers for premature termination of loans.

6. A Show Cause Notice proposing to demand Rs. 20,50,399/- under the proviso to section 73(1) of the Finance Act, 1994[6] and also interest under section 75 of the Finance Act, 1994 as also for imposing penalties under sections 76 and 78 of the Finance Act was issued to Repco Finance. A reply was filed by Repco Finance to the show cause notice. The Joint Commissioner, however, confirmed the demand by Order dated 31 March 2009 but refrained from imposing penalty under section 76 of the Finance Act.

7. Feeling aggrieved by the order passed by the Joint Commissioner, Repco Finance filed an appeal before the Commissioner (Appeals). The Commissioner (Appeals), by order dated 27 May, 2011, allowed the appeal and set aside the order

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5. **the Repco Finance**
6. the Finance Act

passed by the Joint Commissioner for the reason that "the activity of foreclosure of loan cannot be treated as 'banking and other financial services' and the amount collected towards the foreclosure of loan is not for rendering any service". The Commissioner (Appeals) relied upon the decision of the Tribunal in **Small Industries (I).** The relevant portion of the order passed by the Commissioner (Appeals) is reproduced below:

> "8.0 ..... The issue to be decided in the instant case is whether service tax is payable on the "fore closure charges" collected by the appellant from their customers under the category "banking and other financial services".
>
> 8.1 xxxxxxx
>
> 8.2 xxxxxxx
>
> 8.3 **In this connection, I find that the amount received towards fore-closure of loan is not towards rendering any service. In fact, fore-closure of loan is a case of ending the service. The fore-closure charges basically are in lieu of anticipated interest loss and with a view to prevent the customers to indiscriminately seek foreclosure of the loan causing uncertainty to the bank.** In fact I find the loan sanction order issued by the banks to the respective clients clearly declares under clause 5 (iii) as follows:-
>
> > "In case of pre-closure, interest rate will stand revised and charged separately by way of pre-closure penalty"
>
> 8.4 **Thus, the loan sanctioned order clearly indicates that the pre-closure charges are nothing but interest and hence I hold that no service tax is payable on the same under the category "banking and financial services".** In this connection, I find that in an identical issue, the Hon'ble CESTAT, New Delhi, in the case of M/s Small Industries & Development Bank of India vs. CCE, Chandigarh (2011-TIOL-581-CESTAT-DEL) had held that the demand of service tax is not sustainable on the amount received towards fore closure of loans.
> .....
> 9. In view of the above discussion and also drawing strength from the decision of the Hon'ble CESTAT, New Delhi, I hold that the activity of fore-closure of loan cannot be treated as "banking and financial services" and the amount collected towards fore-closure of loan is not towards rendering of any service. Hence, I set aside the Lower Adjudicating Authority's impugned Order-in-Original and allow the appeal."
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> **(emphasis supplied)**

8. It is against this order of the Commissioner (Appeals) that the Department has filed this appeal.

9. Cross objections have also been filed by Repco Finance seeking dismissal of the appeal.

10. It transpires that banks and non banking financial companies provide lending services to borrowers for an agreed period at an agreed rate of interest subject to the terms and conditions contained in the agreement. There can be circumstances when a borrower decides to close the loan before the stipulated period. In such a situation, the banks and non banking financial companies collect foreclosure charges, which are usually determined as a percentage of the outstanding principal amount and the rate may vary depending on the nature of the loan and the period of loan that is cut short by the borrower.

11. In order to determine whether the foreclosure charges on termination of the loan prior to the agreed period can be subjected to service tax under "banking and other financial services", it is necessary to refer to the relevant statutory provisions.

12. Section 66 of the Finance Act 1994[7] seeks to levy service tax at the rate of 12% of the value of taxable services referred to in various sub-clauses of section 65 (105). "Taxable service" has been defined under section 65 (105) of the Finance Act to mean any service provided or to be provided under the various sub-clauses of

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7. the Finance Act.

section 65 (105). Section 67 of the Finance Act deals with valuation of taxable services for charging service tax. Sub-section (1) of section 67 of the Finance Act provides that where service tax is chargeable on any taxable service with reference to its value, then such value shall, in a case where the provision of service is for a consideration in money, be the gross amount charged by the service provider for such service provided or to be provided by him. However, in a case where the provision of service is for a consideration not wholly or partly consisting of money, then the value shall be such amount in money as, with the addition of service tax charged, is equivalent to the consideration. It further provides that where the provision of service is for a consideration which is not ascertainable, then such value shall be as may be determined in the prescribed manner. Explanation to section 67, of the Finance Act, as it existed prior to 14 May, 2015, defined "consideration" to include any amount that is payable for the taxable services provided or to be provided but after 14 May, 2015, the definition also seeks to include any reimbursable expenditure or the amount retained by a lottery distributor within its ambit.

13. The contention of the banks and non banking financial companies is that the foreclosure charges are not towards any "consideration" for a service provided by them but are collected to compensate the banks for the breach of the contract as the borrower seeks to make the payment before the agreed period of time. According to the banks, it is not the desire of the banks that a borrower should cut short the period of loan and make the entire payment, for the business of a bank is to earn income out of the

interest that it gets on the amount that is given as loan to a borrower. The banks contend that it is the borrower who unilaterally decides to cut short the period of loan by making the payment before the stipulated time. Thus, the promise to service the loan for an agreed period of time gets repudiated resulting in a breach of the contract. This unilateral act of the borrower is considered by the banks to be against their interest. It is contended by the banks that instead of leaving the banks to claim damages for such breach of contract, the amount is usually incorporated in the loan agreement to provide a certainty in dealings. The banks, therefore, believe that the foreclosure of the loan by making payment before the agreed time cannot be said to be a service under "banking and other financial services" since the foreclosure seeks to end the existing service.

14. The contention of the Revenue, however, is that the termination of the loan prior to the agreed term is a facility available to a borrower at a price in the same way as other facilities are available to a borrower at a price. This activity, therefore, according to the Revenue would be a service falling within the ambit of "banking and other financial services" and would be leviable to service tax. The Revenue contends that the foreclosure charges are levied over and above the interest that is charged from the borrower and do not have the character of interest income and cannot also be termed as penal interest since penal interest is chargeable only in case of default in making the regular payments and not for making payments before the stipulated period.

15. At this stage, it would be appropriate to examine the conflicting decisions rendered by the Division Benches of the Tribunal.

16. In **Small Industries (I) ,** a Division Bench of the Tribunal at Delhi held that foreclosure brings an end to the loan and cannot be treated as "lending" to the customers. Thus, no service can be said to be rendered by the banks. In fact, it results in withdrawing the services rendered, at the request of the customers, and the foreclosure premium is a kind of compensation for possible loss of interest revenue on the loan amount returned by the customer. The Division Bench, therefore, held that the activity of foreclosure of loan cannot be treated as "banking and other financial services".

17. In **Hudco,** a Division Bench of the Tribunal at Ahmedabad in its decision rendered on 25 November, 2011 concluded that there was an element of service involved in considering the request of the borrower for payment of the entire loan amount prior to the agreed term or fixing prepayment charges or closure charges. This service would, therefore, be in relation to "banking and other financial services", which definition includes "lending" after 10 September, 2004. The decision of the Division Bench of the Tribunal at Delhi in **Small Industries (I)** was distinguished for the reason that the period involved therein was prior to 10 September, 2004, when lending was not included in the definition of "banking and other financial services".

18. This issue was again examined by a Division Bench of the Tribunal at Kolkata in **Magma Fincorp Ltd.** Apart from observing

that the Commissioner had for an earlier dropped the demand in regard to the same issue and the Department had not filed any appeal against the said order, the Tribunal in its decision rendered on 3 February, 2016, held that service tax would not be leviable on prepayment charges when the period of loan is cut short. The Division Bench also relied upon the decision of the Tribunal in **Small Industries (I)**.

19. As noticed above, the issue that has arisen for consideration before this Larger Bench of the Tribunal is whether the foreclosure charges levied by banks and non banking financial companies on premature termination of a loan can be subjected to levy of service tax under "banking and other financial services".

20. Service tax would be leviable only when an activity is considered to be a service and such service classifies as a 'taxable service' defined in section 65(105) of the Finance Act. Section 66 provides that service tax shall be levied at the rate of 12 per cent **of the value of taxable services** referred to in various sub-clauses of clause (105) of section 65. Section 67 deals with valuation of taxable service for charging service tax. It is reproduced below:-

> **67.** (1) Subject to the provisions of this Chapter, where service tax is chargeable on any taxable service with reference to its value, then such value shall,-
>
> (i) in a case **where the provision of service is for a consideration** in money, be the gross amount charged by the service provider for such service provided or to be provided by him;
>
> (ii) in a case **where the provision of service is for a consideration** not wholly or partly consisting of money, be such amount in money, with the addition of service tax charged, is equivalent to the consideration;

> (iii) in a case **where the provision of service is for a consideration** which is not ascertainable, be the amount as may be determined in the prescribed manner.
>
> (2) Where the gross amount charged by a service provider, for the service provided or to be provided is inclusive of service tax payable, the value of such taxable service shall be such amount as, with the addition of tax payable, is equal to the gross amount charged.
>
> (3) The gross amount charged for the taxable service shall include any amount received towards the taxable service before, during or after provision of such service.
>
> (4) Subject to the provisions of sub-sections (1), (2) and (3), the value shall be determined in such manner as may be prescribed.
>
> **Explanation.**—For the purposes of this section,—
> (a) "consideration" includes
>
> (i) any amount that is payable for the taxable services provided or to be provided;
>
> (ii) any reimbursable expenditure or cost incurred by the service provider and charged, in the course of providing or agreeing to provide a taxable service, except in such circumstances, and subject to such conditions, as may be prescribed;
>
> (iii) any amount retained by the lottery distributor or selling agent from gross sale amount of lottery ticket in addition to the fee or commission, if any, or, as the case may be, the discount received, that is to say, the difference in the face value of lottery ticket and the price at which the distributor or selling agent gets such ticket.
>
> (b) xxxxxxxxxx
> (c) xxxxxxxxxx"
>
> **(emphasis supplied)**

21. It is, thus, clear that where service tax is chargeable on any taxable service with reference to its value, then such value shall be determined in the manner provided for in (i), (ii) or (iii) of sub-section (1) of section 67. What needs to be noted is that each of these refer to "where the provision of service is for a consideration", whether it be in the form of money, or not wholly or partly consisting of money, or where it is not ascertainable. In either of the cases, there has to be a "consideration" for the

provision of such service. Explanation to sub-section (1) of section 67 defines "consideration" to include any amount that is payable for the taxable services provided or to be provided, or any reimbursable expenditure, or any amount retained by the lottery distributor or selling agent. It is clear from the aforesaid definition of "consideration" that only an amount that is payable for the taxable service will be considered as "consideration". This apart, what is important to note is that the term "consideration" is couched in an "inclusive" definition.

22. A Larger Bench of the Tribunal in **Bhayana Builders (P) Ltd. vs Commissioner of Service Tax**[8] observed that "implicit in the legal architecture is the concept that any consideration whether monetary or otherwise, should have flown or should flow from the service recipient to the service provider and should accrue to the benefit of the latter." In the said decision, the Larger Bench made reference to the concept of "consideration", as was expounded in the decision pertaining to Australian GST Rules, wherein a categorical distinction was made between "conditions" to a contract and "consideration". It has been prescribed under the said GST Rules that certain "conditions" contained in the contract cannot be seen in the light of "consideration" for the contract and merely because the service recipient has to fulfil such conditions would not mean that this value would form part of the value of the taxable services that are provided.

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8. 2013 (32) S.T.R. 49 (Tri.-LB)

23. The Supreme Court in **Commissioner of Service Tax vs. M/s Bhayana Builders[9],** while deciding the appeal filed by the Department against the aforesaid decision of the Tribunal, also explained the scope of Section 67 of the Act, both before and after the amendment, in the following words :

> "The amount charged should be for "for such service provided": Section 67 clearly indicates that the gross amount charged by the service provider has to be for the service provided. Therefore, it is not any amount charged which can become the basis of value on which service tax becomes payable but the amount charged has to be necessarily a consideration for the service provided which is taxable under the Act. By using the words "for such service provided" the Act has provided for a nexus between the amount charged and the service provided. **Therefore, any amount charged which has no nexus with the taxable service and is not a consideration for the service provided does not become part of the value which is taxable under Section 67.** The cost of free supply goods provided by the service recipient to the service provider is neither an amount "charged" by the service provider nor can it be regarded as a consideration for the service provided by the service provider. In fact, it has no nexus whatsoever with the taxable services for which value is sought to be determined."
>
> **(emphasis supplied)**

24. The aforesaid view was reiterated by the Supreme Court in **Union of India vs. Intercontinental Consultants and Technocrafts[10]** and it was observed:

> "**23.** Obviously, this Section refers to service tax, i.e., in respect of those services which are taxable and specifically referred to in various sub-clauses of Section 65. Further, it also specifically mentions that the service tax will be @ 12% of the "value of taxable services". Thus, service tax is reference to the value of service. As a necessary corollary, it is the value of the services which are actually rendered, the value whereof is to be ascertained for the purpose of calculating the service tax payable thereupon.
>
> **24.** In this hue, the expression "such" occurring in Section 67 of the Act assumes importance. In other words, valuation of taxable services for charging service tax, the

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9. 2018 (2) TMI 1325
10. 2018 (10) GSTL 401 (SC)

> authorities are to find what is the gross amount charged for providing "such" taxable services. As a fortiori, any other amount which is calculated not for providing such taxable service cannot a part of that valuation as that amount is not calculated for providing such "taxable service". That according to us is the plain meaning which is to be attached to Section 67 (unamended, i.e., prior to May 1, 2006) or after its amendment, with effect from, May 1, 2006. Once this interpretation is to be given to Section 67, it hardly needs to be emphasised that Rule 5 of the Rules went much beyond the mandate of Section 67. We, therefore, find that High Court was right in interpreting Sections 66 and 67 to say that in the valuation of taxable service, the value of taxable service shall be the gross amount charged by the service provider "for such service" and the valuation of tax service cannot be anything more or less than the consideration paid as quid pro qua for rendering such a service.
>
> **25.** This position did not change even in the amended Section 67 which was inserted on May 1, 2006. Sub-section (4) of Section 67 empowers the rule making authority to lay down the manner in which value of taxable service is to be determined. However, Section 67(4) is expressly made subject to the provisions of sub-section (1). Mandate of subsection (1) of Section 67 is manifest, as noted above, viz., the service tax is to be paid only on the services actually provided by the service provider."

25. It would also be pertinent to refer to the judgment of the European Court of Justice (First Chamber) in Case C-277/2005, in **Societe Thermale d'Eugenic-les-Bains vs. Ministere de I'Economie, des Finances et de I'Industrie.** Under Article 2(1) of the Sixth Directive, 'the supply of goods or services effected for consideration within the territory of the country by a taxable person acting as such' is subjected to VAT. Article 6(1) of the Sixth Directive provides that "Supply of services" shall mean any transaction which does not constitute a supply of goods within the meaning of Article 5 and that such transactions may include inter alia an obligation to refrain from an act or to tolerate an act or situation. Under Article 11(A) (1) (a) of the Sixth Directive, the taxable amount in respect of supplies of services is to be 'everything which constituted the consideration which has been or

is to be obtained by the supplier from the customer or a third party for such supplies...'

26. The question referred for preliminary hearing, in essence, was whether a sum paid as a deposit by a client to a hotelier, where the client exercises the cancellation option available to him and that sum is retained by the hotelier, can be regarded as consideration for the supply of a reservation service, which is subject to VAT, or as a fixed compensation for cancellation, which is not subject to VAT. The Court found that there has to be a direct link between the service rendered and the consideration received. The same paid must constitute a genuine consideration for an identifiable service supplied in the context of a legal relationship for which performance is reciprocal. It is in this context that Court observed :

> "26. Since the obligation to make a reservation arises from the contract for accommodation itself and not from the payment of a deposit, there is no direct connection between the service rendered and the consideration received (*Apple and Pear Development Council*, paragraphs 11 and 12; *Tolsma*, paragraph 13; and *Kennemer Golf*, paragraph 39). The fact that the amount of the deposit is applied towards the price of the reserved room, if the client takes up occupancy, confirms that the deposit cannot constitute the consideration for the supply of an independent and identifiable service.
>
> 27 Since the deposit does not constitute the consideration for the supply of an independent and identifiable service, it must be examined, in order to reply to the referring Court, whether the deposit constitutes a cancellation charge paid as compensation for the loss suffered as a result of the client's cancellation.
>
> 28 In that regard, it should be noted that the contracting parties are at liberty – subject to the mandatory rules of public policy – to define the terms of their legal relationship, including the consequences of a cancellation or breach of their obligations. Instead of defining their obligations in detail, they may nevertheless refer to the various instruments of civil law.
>
> 29 Thus the parties may make contractual provision – applicable in the event of non-performance – for compensation or a penalty for

> delay, for the lodging of security or a deposit. Although such mechanisms are all intended to strengthen the contractual obligations of the parties and although some of their functions are identical, they each have their own particular characteristics.
>
> xxxxxxx xxxxxxx xxxxxxx
>
> 32. Whereas, in situations where performance of the contract follows its normal course, the deposit is applied towards the price of the services supplied by the hotelier and is therefore subject to VAT, the retention of the deposit at issue in the main proceedings is, by contrast, triggered by the client's exercise of the cancellation option made available to him and serves to compensate the hotelier following the cancellation. Such compensation does not constitute the fee for a service and forms no part of the taxable amount for VAT purposes (see, to that effect, as regards interest applied on account of late payment, Case 222/81 BAZ Bausystem [1982] ECR 2527, paragraphs 8 to 11)."

27. What follows from the aforesaid decisions is that "consideration" must flow from the service recipient to the service provider and should accrue to the benefit of the service provider and that the amount charged has necessarily to be a consideration for the taxable service provided under the Act. It should also be remembered that there is marked distinction between "conditions to a contract" and "considerations for the contract". A service recipient may be required to fulfil certain conditions contained in the contract but that would not necessarily mean that this value would form part of the value of taxable services that are provided.

28. It is also necessary to remind ourselves that the word "include" is generally used in interpretation clauses to enlarge the meaning of the words or phrases occurring in the body of the statue and when it is so used, such words or phrases must be construed to comprehend, not only such things as they signify according to their natural import, but also those things which the

interpretation clause declares that they shall include. This is what was stated in **Dilworth vs. Commissioner of Stamps[11].**

29. Justice G P Singh in "Principles of Statutory Interpretation" (Thirteenth Edition) has also remarked that where a word is defined to "include" such and such, the definition is prima facie not exhaustive and so the natural meaning of the word cannot be narrowed down by the "includes" part.

30. In this connection it would also be pertinent to refer to TRU Circular dated 20 June, 2012 issued by the Central Board of Excise and Customs as an Education Guide when the Negative List based taxation regime was introduced to clarify various aspects of the levy of service tax. The Board dealt with "consideration" in paragraph 2.2 of this Circular and pointed out that since the definition was inclusive, it will not be out of place to refer to the definition of "consideration" as given in section 2(d) of the Indian Contract Act, 1872[12]. The relevant portion of the aforesaid Circular is reproduced below:

> **"2.2 Consideration**
>
> **2.2.1 The phrase "consideration" has not been defined in the Act. What is, therefore, the meaning of "consideration"?**
>
> As per Explanation (a) to section 67 of the Act "consideration" includes any amount that is payable for the taxable services provided or to be provided.
> **Since this definition is inclusive it will not be out of place to refer to the definition of "consideration" as given in section 2(d) of the Indian Contract Act, 1872** as follows-
>
> xxxxx xxxxx xxxxx
>
> In simple terms, "consideration" means everything received or recoverable in return for a provision of service

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11. 1899 AC 99
12. the Contract Act

> which includes monetary payment and any consideration of non-monetary nature or deferred consideration as well as recharges between establishments located in a non-taxable territory on one hand and taxable territory on the other hand."
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> **(emphasis supplied)**

31. It would, therefore, be appropriate to examine the definition of "consideration" in section 2 (d) of the Contract Act, as the Contract Act deals with all kinds of contracts and pre-dates the Finance Act. The definition of "consideration" is as follows:-

> "2 (d) When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise."

32. What needs to be noted from the aforesaid definition of consideration under section 2(d) of the Contract Act is that **consideration should flow at the desire of the promisor.** Thus, if the consideration is not at the desire of the promisor, it ceases to be a consideration. The banks and non banking financial companies are promisors and the promisees are the borrowers. The contractual relationship between the banks and non banking financial companies and the customers is repayment of the loan amount over an agreed period. The banks and non banking financial companies would not desire pre-mature termination of the loan advanced by them as it is in their interest that the loan runs the entire agreed tenure for the banks thrive on interest earned from lending activities. As premature termination of a loan results in loss of future interest income, the banks charge an amount for foreclosure of loan to compensate for the loss in interest income. It is the customer who has taken the loan, who moves for

foreclosure of the loan by making the payment of the loan amount before the stipulated period and thereby breaching the promise to service the loan for the agreed period of time. This results in a unilateral act of the borrower in repudiating the contract and consequently breach of one of the essential terms of the loan agreement. A breach of contract may give rise to a claim for damages.

33. **Breach of contract** has been defined in **Black's Law Dictionary** (Eighth Edition) as follows:

> **"Breach of contract.** Violation of a contractual obligation by failing to perform one's own promise, by repudiating it, or by interfering with another party's performance.
>
> "A breach may be one by non-performance, or by repudiation, or by both. Every breach gives rise to a claim for damages, and may give rise to other remedies. Even if the injured party sustains no pecuniary loss or is unable to show such loss with sufficient certainty, he has at least a claim for nominal damages. If a court chooses to ignore a trifling departure, there is no breach and no claim arises." Restatement (Second) of Contracts § 236 cmt. a (1979)."

34. Sir Guenter Treitel has, in his book **"The Law of Contract",** described the manner in which a breach of contract can be remedied. The injured party can be placed in the same position in which he would have been if the contract was not made or the injured party can be placed in a position in which he would have been if the contract had been performed. The former protects "restitution" or "reliance interest", while the latter protects "expectation interest". The paragraphs dealing with the aspect are reproduced :

> "Remedies for breach of contract are discussed in Chapter 21; but one fundamental point relating to them must be made at this stage. Such remedies might attempt to do one of two things. First, they might attempt to put the injured party into the position in which he would have been if the contract **had never been made**. This would require the party in breach to restore anything that he had received under the contract, and also to compensate the injured party for any loss that he had suffered by acting in reliance on the contract. Such remedies are said to protect the injured party's **restitution** and **reliance** interest. But remedies for breach of contract go beyond the pursuit of these objectives. Their distinguishing feature is that they seek to put the injured party into the position in which he would have been if the contract **had been performed**. If, for example a seller agrees to sell goods for less than they are worth, and then fails to deliver them, he must compensate the buyer for not having received goods which are worth more than he had agreed to pay for them. Conversely, if a buyer contracts to buy goods for more than they are worth, and then fails to pay for them, he is liable for the agreed price. It is quite immaterial that the value of the goods with which the seller has parted was lower than that price. What the law does in these cases is to protect the injured party's **expectation** interest. Sometimes it does so directly, by actually ordering the party in breach to perform his part of the contract. Sometimes it does so indirectly by ordering him to pay the injured party damages for **loss of his bargain**.
>
> The result of awarding damages on this basis is to compensate the injured party, not because he is worse off than he was before the contract was made, but because the other party has failed to make him better off. The law of contract takes this position in response to the needs of commercial certainty. It is probably going too far to say that business could not be carried on at all if the law did not protect the injured party's expectation interest. Some industries (such as the credit betting industry) are carried on without this, or indeed any other legally recognised, sanction. But in relation to other sphere of commercial activity, such as share and commodity markets and the insurance industry (to take a few random examples) the protection of expectations is of crucial importance. In these cases, that protection promotes stability and furthers one of the central purposes of the law of contract in providing the legal framework required for commercial relations."
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> **(emphasis supplied)**

35. The "expectation interest" is a popular measure for damages arising out of breach of contract. The foreclosure charges, therefore, are not a consideration for performance of lending services but are imposed as a condition of the contract to compensate for the loss of "expectations interest" when the loan

agreement is terminated pre-maturely. In fact, fore-closure charges seek to deter the borrowers from switching over to cheaper available sources of loan, as has been so clearly stated in the Circular dated 26 June, 2012 issued by the Reserve Bank of India.

36. The basis for charging foreclosure amount has also been explained by the Karnataka High Court in **M/s Hotel Vrinda Prakash and another vs. KSFC and another[13].** The writ petitioner had borrowed a loan from the Karnataka State Financial Corporation but before the period of loan could expire made an application for foreclosure of the loan. The Corporation, however, demanded premium on the advance payment/ foreclosure amount which demand was challenged in the writ petition. The High Court, after noticing that the contract contained a clause giving discretion to the Corporation to impose premium on the balance amount of loan, observed that granting of loans is a business of the Corporation and if the loan is prepaid, the Corporation may have to suffer loss. It is to overcome this situation that premium is charged. The observations are as follows;

> "13.....Therefore, the granting of loans or advances is one of the business of the Corporation. As stated above, the Corporation borrows funds from the financial institution at the prevailing rate of interest. If an account is prepaid/ foreclosure when the interest rates are falling, the Corporation may have to suffer loss. To overcome this situation, if a premium is charged on the outstanding loan being prepaid, the same cannot be found fault with. I am of the considered view that the Corporation has the power and authority to levy prepayment/ foreclosure premium."

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13. ILR 2008 KAR 1311

37. The foreclosure of loan is, therefore, a material breach of contract as it curtails the loan service period unilaterally, which can prompt the promisor to claim damages. Damages can be determined by Courts or they can also be incorporated in the loan agreements and other commercial contracts so as to ensure certainty in dealings and also serve as a deterrent measure. This aspect of damage is known as liquidated damages.

38. Liquidated damages have been dealt with by **Pollock & Mulla** in the book titled "The Indian Contract and Specific Relief Acts" (Fourteenth Edition) and the relevant portion is reproduced below :

> **"Liquidated Damages**
>
> 'Liquidated damages' means that is shall be taken as the sum which the parties have by the contract assessed as damages to be paid whatever may be the actual damage. A fixed figure of damages, which is not assessed for all circumstances, but is graduated to correspond with passage of time between the making of contract and of its breach, is a proper estimate of the damages to be anticipated from the breach, and is liquidated damages."

39. It would thus be seen that clauses relating to damages for foreclosure of loan are usually incorporated in contracts as an agreed measure of damages which can be enforced in the event there is a breach of contract with a view to bring about certainty in contracts. These clauses do not and cannot give rise to any "consideration". These clauses also come into effect only after the contract comes to end.

40. Section 74 of the Contract Act which deals with compensation for breach of contract where penalty is stipulated also needs to be referred to. It is reproduced below;

> **"Section 74. Compensation for breach of contract where penalty stipulated for.-** When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.
>
> **Explanation.-** A stipulation for increased interest from the date of default may be a stipulation by way of penalty.
>
> **Explanation-** xxxxx
>
> **Explanation**- xxxxx"

41. Compensation for damages in the eventuality of breach of contract clearly contemplates that the sum of damage is named in the agreement. The section itself would be applicable only in cases where the eventuality of damage and the quantification for damages is specified in the agreement

42. To attract the provisions of section 74 of the Contract Act it is not necessary that the entire contract should come to an end; the breach of each term thereof can be visualised in advance and taken care of by providing an adequate clause for liquidated damages so that the parties to the contract can proceed to work out the contract in future and settle the question of damages that have accrued on the basis of the rate that has been put as a pre-estimate at the commencement of the contract. This was so held

by the Bombay High Court in **Indian Drugs and Pharmaceuticals Ltd. vs. Industrial Oxygen Co. Ltd.**[14]

43. A penalty is a sum of money so stipulated in terrorem, and liquidated damages are a genuine pre-estimate of damages. So far as the law in India is concerned there is no qualitative difference in the nature of liquidated and unliquidated damages, as section 74 eliminates the somewhat elaborate refinement made under the Common Law between stipulations providing for payment of liquidated damages and stipulations in the nature of penalty, which under the Common Law is stipulation in terrorem; a genuine pre-estimate of damages is regarded as liquidated damages, and is binding.

44. It, therefore, clearly follows that foreclosure charges are recovered as compensation for disruption of a service and not towards "lending" services. In fact, the amount for processing charges and documentation charges or like charges are subjected to service tax because they are essential for the activity of lending and are treated as activities "in relation to lending". Foreclosure is anti thesis to lending and, therefore, cannot be construed to be "in relation to lending". The phrase "in relation to lending" cannot be so stretched so as to bring within its ambit even activities which terminate the activity. In **Standard Chartered Bank vs. Commissioner of Service Tax, Mumbai-I**[15]**,** it was emphasised that this phrase should not be given a very wide meaning.

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14. AIR 1985 Bom 186
15. 2015 (40) S.T.R. 104 (Tri.-LB)

45. These foreclosure charges should not be viewed as 'alternative mode of performance' of the contract because they arise upon repudiation of specified terms of contract and are intended to compensate the injured party banks and non banking financial companies. This is because 'alternative mode of performance' still contemplates performance, whereas foreclosure is an express repudiation of the contractual terms giving rise to the levy of foreclosure charges.

46. Thus, merely because the clause relating to damage is featuring in a contract, it would be incorrect to conclude that the party has been given an option to violate the contract. Hence, to treat eventuality of foreclosure as an optional performance is incorrect. The contract cannot be understood to be providing an option to the parties to either perform or not perform/violate.

47. The decision of the Tribunal in **Hudco** now needs to be examined. It concludes that the foreclosure charges would be subjected to service tax after 10 September, 2004 as the definition of "banking and other financial services" was amended under section 65 (12) of the Finance Act by including other financial services like lending in the definition. The taxable service under section 65 (105) (zm) of the Finance Act means any service provided or to be provided to any person, by a banking company or the financial institution including non banking financial companies, or any other body corporate, in relation to "banking and other financial companies". The definition of "banking and other financial services", as it existed prior to 10 September, 2004, is as follows:

"banking and other financial service" means-

(a) The following services provided by a banking company or a financial institution including a non banking financial company or any other body corporate, namely:-

(i) financial leasing services including equipment leasing and hire purchase by a body corporate;

(ii) credit card services;

(iii) merchant banking services;

(iv) securities and foreign exchange (forex) broking;

(v) asset management including portfolio management, all forms of fund management, pension fund management, custodial, depository and trust services, but does not include cash management;

(vi) advisory and other auxiliary financial services including investment and portfolio research and advice, advice on merges and acquisitions and advice on corporate restructuring and strategy; and

(vii) provision and transfer of information and data processing;

(b) foreign exchange broking provided by a foreign exchange broker other than those covered under sub-clause (a);

48. Section 65 (12) was substituted with effect from 10 September, 2004 by adding two clauses which are as follows:

(viii) banker to an issue services; and

(ix) other financial services, namely, lending; issue of pay order, demand draft, cheque, letter of credit and bill of exchange; transfer of money including telegraphic transfer, mail transfer and electronic transfer; providing bank guarantee, overdraft facility, bill discounting facility, safe deposit locker, safe vaults; operation of bank accounts;

49. The Bench observed that when pre payment is proposed, the borrower is expected to make a request which has to be considered by the banks, charges have to be worked out and informed. Thus there is an element of service involved in considering the request of the borrower for pre payment of loan, fixing of pre payment charges collection of the same and closure of their loan. The relevant portion of the order is reproduced below:

" 10. Admittedly, the prepayment charges vary from borrower, according to the appellant themselves. Further, it is collected for premature closure of the loan and it is not the interest factor that is taken into account. It has to be noted that when a borrower makes a prepayment and therefore pays interest separately up to the date of

> payment, that amount is shown separately as interst and prepayment charges are not collected as interest, but collected as prepayment charges. Further even though the borrower has already borrowed the money and the process is over, when prepayment is proposed, borrower is expected to make a request which has to be considered by lender, charges worked out and informed and paid along with principal and interest up to the date of payment. Therefore, there is definitely an element of service involved in considering the request of the borrower for prepayment of loan, fixing of prepayment charges, collection of the same and closure of loan. These activities can be definitely in relation to Banking and other Financial Services, which includes lending after 10-09-2004. Further, when loans are foreclosed, the situation gives rise to the issue of asset liability mis-match for the lender since lender has to find alternative source for deployment of such funds. Prepayment charges are the charges leviable by a bank/lender to offset the cost of such finding such alternative source for deployment of fund and also intended to make exit difficult for the borrower. This shows that prepayment charges can never be considered to be the nature of interest."

50. The decision rendered in Small Industries (I) was distinguished for the reason that it dealt with a period prior to 10 September, 2004.

51. It is not possible to accept the reasoning given by the Bench in **Hudco** in view of the discussions made above. The amount of damages is clearly stipulated in the contracts and no element of service is sought to have been rendered by the banks to borrowers. In fact, as noticed above, the contract has been broken by the borrowers for which the banks are entitled to claim damages. The foreclosure charges are nothing but damages which the banks are entitled to receive when the contract is broken. The amendment made in section 65 (12) of the Finance Act in the definition of "banking and other financial services" by addition of "lending" is not relevant at all for the purpose of determining whether service tax can be levied on foreclosure charges.

52. The submission of the learned Authorised Representative of the Department that premature closure is a facility available to a borrower at a price in the same manner as a facility for availing a loan for a price and, therefore, the activity would fall within the ambit of "banking and financial services" cannot, therefore, be accepted.

53. Thus, for all the reason stated above, it is not possible to subscribe to the view taken by the Bench of the Tribunal in **Hudco**. Service tax cannot be levied on the foreclosure charges levied by the banks and non banking financial companies on premature termination of loans under "banking and other financial services" as defined under section 65 (12) of the Finance Act.

54. The reference is, accordingly, answered in the following terms;

> "Foreclosure charges collected by the banks and non banking financial companies on premature termination of loans are not leviable to service tax under "banking and other financial services" as defined under section 65 (12) of the Finance Act."

55. The appeal may now be listed before the regular Bench for hearing.

(Order pronounced on 08 June, 2020)

(JUSTICE DILIP GUPTA)
PRESIDENT

(SULEKHA BEEVI, C.S)
MEMBER (JUDICIAL)

(P. VENKATA SUBBA RAO)
MEMBER (TECHNICAL)

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