MEHRA GOEL & CO. Since 1963 Chartered Accountants

09 August 2022

SUBJECT

GST applicability on liquidated damages, compensation and penalty arising out of breach of contract or other provisions of law.

CIRCULAR NO:

178/10/2022-GST

Date :

03/08/2022

"Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act" has been specifically declared to be a supply of service in para 5 (e) of Schedule II of CGST Act if the same constitutes a "supply" within the meaning of the Act. The said expression has following three limbs: –

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Agreeing to the obligation to refrain from an act: –
Example of activities that would be covered by this part of the expression would include non-compete agreements, where one party agrees not to compete with the other party in a product, service or geographical area against a consideration paid by the other party. Another example of such activities would be a builder refraining from constructing more than a certain number of floors, even though permitted to do so by the municipal authorities, against a compensation paid by the neighbouring housing project, which wants to protect its sunlight, or an industrial unit refraining from manufacturing activity during certain hours against an agreed compensation paid by a neighbouring school, which wants to avoid noise during those hours.

"

Agreeing to the obligation to tolerate an act or a situation-
This would include activities such a shopkeeper allowing a hawker to operate from the common pavement in front of his shop against a monthly payment by the hawker, or an RWA tolerating the use of loud speakers for early morning prayers by a school located in the colony subject to the school paying an agreed sum to the RWA as compensation.

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Agreeing to the obligation to do an act
This would include the case where an industrial unit agrees to install equipment for zero emission/discharge at the behest of the RWA of a neighbouring residential complex against a consideration paid by such RWA, even though the emission/discharge from the industrial unit was within permissible limits and there was no legal obligation upon the individual unit to do so.

Agreement to do or refrain from an act should not be presumed to exist: –

There has to be an express or implied agreement; oral or written, to do or abstain from doing something against payment of consideration for doing or abstaining from such act, for a taxable supply to exist. An agreement to do an act or abstain from doing an act or to tolerate an act or a situation cannot be imagined or presumed to exist just because there is a flow of money from one party to another.

Judgement:

During the court proceedings, the Learned Counsel appearing for the petitioner cited a similar order dated 14.03.22 passed by the Telangana State Authority for Advance Ruling in A.R. Com/28/2021 in which case application for advance ruling was filed on 11.07.20 and subsequently investigation was initiated by DGGI in August 2020 on the question raised by the applicant. Ruling was granted by the Authority quoting that an application for Advance Ruling cannot be rejected on the grounds that investigation was initiated by the revenue after filing of application seeking advance ruling.

The respondents Counsel argued that the petitioner was well aware of the ongoing investigation by the DGGI but had erred by not disclosing the same to the Authority, and hence the rejection of application by the authority is justified.

Taking into consideration the submissions made by both the parties, the Hon'ble Jurists held that it is clearly ascertainable that the application for advance ruling was made by the petitioner on 11.05.2019 and thereafter on 15.12.2021 notice was issued by the DGGI to the petitioner on the same question raised in the application regarding rate to be charged for works contract services undertaken for Government organisations. Since on the date of filing of application by the petitioner there was no proceeding pending or decided on the question raised in the application, there was no requirement on the part of the petitioner to intimate the Authorities regarding any enquiry initiated by the revenue after the date of filing of application. Thus the rejection of application by the Authorities is unjustified and hence the order dated 03.06.22 is null and void. Further the Authority was directed to pass appropriate order on the application filed by the petitioner on 11.05.2019 after giving him a reasonable opportunity of being heard.

Taxability of various transactions is discussed as under: –

Liquidated Damages: –

Section 73 of the Contract Act, 1972 provides that when a contract has been broken, the party which suffers by such breach is entitled to receive from the other party compensation for any loss or damage caused to him by such breach. It is common for the parties entering into a contract, to specify in the contract itself, the compensation that would be payable in the event of the breach of the contract. Such compensation specified in a written contract for breach of non-performance of the contract or parties of the contract is referred to as liquidated damages.

A reasonable view that can be taken with regard to taxability of liquidated damages is that where the amount paid as 'liquidated damages' is an amount paid only to compensate for injury, loss or damage suffered by the aggrieved party due to breach of the contract and there is no agreement, express or implied, by the aggrieved party receiving the liquidated damages, to refrain from or tolerate an act or to do anything for the party paying the liquidated damages, in such cases liquidated damages are mere a flow of money from the party who causes breach of the contract to the party who suffers loss or damage due to such breach. Such payments do not constitute consideration for a supply and are not taxable.

Examples of such cases are damages resulting from damage to property, negligence, piracy, unauthorized use of trade name, copyright, etc. Other examples that may be covered here are the penalty stipulated in a contract for delayed construction of houses. It is a penalty paid by the builder to the buyers to compensate them for the loss that they suffer due to such delayed construction and not for getting anything in return from the buyers. Similarly, forfeiture of earnest money by a seller in case of breach of 'an agreement to sell' an immovable property by the buyer or by Government or local authority in the event of a successful bidder failing to act after winning the bid, for allotment of natural resources, is a mere flow of money, as the buyer or the successful bidder does not get anything in return for such forfeiture of earnest money. Forfeiture of Earnest money is stipulated in such cases not as a consideration for tolerating the breach of contract but as a compensation for the losses suffered and as a penalty for discouraging the non-serious buyers or bidders. Such payments being merely flow of money are not a consideration for any supply and are not taxable

The key in such cases is to consider whether the impugned payments constitute consideration for another independent contract envisaging tolerating an act or situation or refraining from doing any act or situation or simply doing an act. If the answer is yes, then it constitutes a 'supply' within the meaning of the Act, otherwise it is not a "supply". If a payment constitutes a consideration for a supply, then it is taxable irrespective of by what name it is called. If the payment is merely an event in the course of the performance of the agreement and it does not represent the 'object', as such, of the contract then it cannot be considered 'consideration'.

For example, a contract may provide that payment by the recipient of goods or services shall be made before a certain date and failure to make payment by the due date shall attract late fee or penalty. A contract for transport of passengers may stipulate that the ticket amount shall be partly or wholly forfeited if the passenger does not show up. A contract for package tour may stipulate forfeiture of security deposit in

the event of cancellation of tour by the customer. Similarly, a contract for lease of movable or immovable property may stipulate that the lessee shall not terminate the lease before a certain period and if he does so he will have to pay certain amount as early termination fee or penalty. Some banks similarly charge pre- payment penalty if the borrower wishes to repay the loan before the maturity of the loan period. Such amounts paid for acceptance of late payment, early termination of lease or for pre-payment of loan or the amounts forfeited on cancellation of service by the customer as contemplated by the contract as part of commercial terms agreed to by the parties, constitute consideration for the supply of a facility, namely, of acceptance of late payment, early termination of a lease agreement, of pre-payment of loan and of making arrangements for the intended supply by the tour operator respectively. Therefore, such payments, even though they may be referred to as fine or penalty, are actually payments that amount to consideration for supply, and are subject to GST, in cases where such supply is taxable. Since these supplies are ancillary to the principal supply for which the contract is signed, they shall be eligible to be assessed as the principal supply. Naturally, such payments will not be taxable if the principal supply is exempt.

Cheque dishonor fine/ penalty:

The supplier of goods or services enters into a contract to make supply against payment within an agreed time (including the agreed permissible time with late payment) through a valid instrument. There is never an implied or express offer or willingness on part of the supplier that he would tolerate deposit of an invalid, fake or unworthy instrument of payment against consideration in the form of cheque dishonour fine or penalty. The fine or penalty that the supplier or a banker imposes, for dishonour of a cheque, is a penalty imposed not for tolerating the act or situation but a fine, or penalty imposed for not tolerating, penalizing and thereby deterring and discouraging such an act or situation. **Therefore, cheque dishonor fine or penalty is not a consideration for any service and not taxable.**

Penalty imposed for violation of laws:-

Penalty imposed for violation of laws such as traffic violations, or for violation of pollution norms or other laws are also not consideration for any supply received and are not taxable, which are also not taxable. Same is the case with fines, penalties imposed by the mining Department of a Central or State Government or a local authority on discovering mining of excess mineral beyond the permissible limit or of mining activities in violation of the mining permit. Such penalties imposed for violation of laws cannot be regarded as consideration charged by Government or a Local Authority for tolerating violation of laws. Laws are not framed for tolerating their violation. They stipulate penalty not for tolerating violation but for not tolerating, penalizing and deterring such violations.

The service tax education guide issued in 2012 on advent of negative list regime of services explained that fines and penalties paid for violation of provisions of law are not considerations as no service is received in lieu of payment of such fines and penalties.

It was also clarified vide Circular No. 192/02/2016-Service Tax, dated 13.04.2016 **that fines and penalty chargeable by Government or a local authority imposed for violation of a statute, bye-laws, rules or regulations are not leviable to Service Tax. The same holds true for GST also.**

Compensation for not collecting toll charges:-

In the wake of demonetization, NHAI directed the concessionaires (toll operators) to allow free access of toll roads to the users from 8.11.2016 to 1.12.2016 for which the loss of toll charge was paid as compensation by NHAI as per the instructions of Ministry of Road Transportation and Highways. A question arose whether the compensation paid to the concessionaire by project authorities (NHAI) in lieu of suspension of toll collection during the demonetization period (from 8.11.2016 to 1.12.2016) was taxable as a service by way of agreeing to refrain from collection of toll from users.

It has been clarified vide Circular No. 212/2/2019-ST dated 21.05.2019 that the service that is provided by toll operators is that of access to a road or bridge, toll charges being merely a consideration for that service. During the above-mentioned period, the service of access to a road or bridge continued to be provided without collection of toll from users but from the project authority. **The fact that for this period, for the same service, consideration came from a person other than the actual user of service does not mean that the service has changed.**

Forfeiture of salary or payment of bond amount in the event of the employee leaving the employment before the minimum agreed period: –

The provisions for forfeiture of salary or recovery of bond amount in the event of the employee leaving the employment before the minimum agreed period are incorporated in the employment contract to discourage non-serious candidates from taking up employment. The said amounts are recovered by the employer not as a consideration for tolerating the act of such premature quitting of employment but as penalties for dissuading the non-serious employees from taking up employment and to discourage and deter such a situation. Further, the employee does not get anything in return from the employer against payment of such amounts. **Therefore, such amounts recovered by the employer are not taxable as consideration for the service of agreeing to tolerate an act or a situation.**

Late payment surcharge or fee

The facility of accepting late payments with interest or late payment fee, fine or penalty is a facility granted by supplier naturally bundled with the main supply such as of electricity, water, telecommunication, cooking gas, insurance etc. **Even if this service is described as a service of tolerating the act of late payment, it is an ancillary supply naturally bundled and supplied in conjunction with the principal supply, and therefore should be assessed as the principal supply.**

Fixed Capacity charges for Power:-

The price charged for electricity by the power generating companies from the State Electricity Boards (SEBs)/DISCOMS or by SEBs/DISCOMs from individual customers has two components, namely, a minimum fixed charge (or capacity charge) and variable per unit charge. The minimum fixed charges have to be paid by the SEBs/DISCOMS/individual customers irrespective of the quantity of electricity scheduled or purchased by them during a month. The variable charges are charged per unit of electricity purchased and increase or decrease every month depending on the quantity of electricity consumed. The fact that the minimum fixed charges remain the same whether electricity is consumed or not or it is scheduled/consumed below the contracted or available capacity or a minimum threshold, does not mean that minimum fixed charge or part of it is a charge for tolerating the act of not scheduling or consuming the minimum the contracted or available capacity or a minimum threshold. **Both the components of the price, the minimum fixed charges/capacity charges and the variable/energy charges are charged for sale of electricity and are thus not taxable as electricity is exempt from GST.**

Cancellation charges:-

It is a common business practice for suppliers of services such as hotel accommodation, tour and travel, transportation etc. to provide the facility of cancellation of the intended supplies within a certain time period on payment of cancellation fee. Cancellation fee can be considered as the charges for the costs involved in making arrangements for the intended supply and the costs involved in cancellation of the supply, such as in cancellation of reserved tickets by the Indian Railways.

Services such as transportation travel and tour constitute a bundle of services. The transportation service, for instance, starts with booking of the ticket for travel and lasts at least till exit of the passenger from the destination terminal. All services such as making available an online portal or convenient booking counters with basic facilities at the transportation terminal or in the city, to reserve the seats and issue tickets for reserved seats much in advance of the travel, giving preferred seats with or without extra cost, lounge and waiting room facilities at airports, railway stations and bus terminals, provision of basic necessities such as soap and other toiletries in the wash rooms, clean drinking water in the waiting area etc. form part and parcel of the transportation service; they constitute the various elements of passenger transportation service, a composite supply. The facilitation service of allowing cancellation against payment of cancellation charges is also a natural part of this bundle. It is invariably supplied by all suppliers of passenger transportation service as naturally bundled and in conjunction with the principal supply of transportation in the ordinary course of business.

Therefore, facilitation supply of allowing cancellation of an intended supply against payment of cancellation fee or retention or forfeiture of a part or whole of the consideration or security deposit in such cases should be assessed as the principal supply. For example, cancellation charges of railway tickets for a class would attract GST at the same rate as applicable to the class of travel (i.e., 5% GST on first class or air-conditioned coach ticket and nil for other classes such as second sleeper class). Same is the case for air travel.

Accordingly, the amount forfeited in the case of non-refundable ticket for air travel or security deposit or earnest money forfeited in case of the customer failing to avail the travel, tour operator or hotel accommodation service or such other intended supplies should be assessed at the same rate as applicable to the service contract, say air transport or tour operator service, or other such services.

Compensation for cancellation of coal blocks: –

In the year 2014, coal block/mine allocations were cancelled by the Hon'ble Supreme Court vide order dated 24.09.2014. Subsequently, Coal Mines (Special Provisions) Act, 2015 was enacted to provide for allocation of coal mines and vesting of rights, title and interest in and over the land and mines infrastructure together with mining leases to successful bidders and allottees. In accordance with section 16 of the said Act, prior (old) allottee of mines were given compensation in the year 2016 towards the transfer of their rights/ titles in the land, mine infrastructure, geological reports, consents, approvals etc. to the new entity (successful bidder) as per the directions of Hon'ble Supreme Court.

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There was no agreement between the prior allottees of coal blocks and the Government that the previous allottees shall agree to or tolerate cancellation of the coal blocks allocated to them if the Government pays compensation to them. The compensation was given to them for such cancellation, not under a contract between the allottees and the Government, but under the provisions of the statute and in pursuance of the Supreme Court Order. The allottees had no option but to accept the cancellation.

Therefore, it would be incorrect to say that the prior allottees of the coal blocks supplied a service to the Government by way of agreeing to tolerate the cancellation of the allocations made to them by the Government or that the compensation paid by the Government for such cancellation in pursuance to the order of the Supreme Court was a consideration for such service.

Therefore, the compensation paid for cancellation of coal blocks pursuant to the order of the Supreme Court in the above case was not taxable.

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