

EY Tax Alert

CBIC clarifies GST applicability on liquidated damages and taxability of various goods and services

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

Executive summary

This Tax Alert summarizes recent Circulars¹ issued by Central Board of Indirect Taxes and Customs (CBIC) clarifying Goods and Services Tax (GST) applicability on liquidated damages, compensation and penalty arising out of breach of contract or other provisions of law, and taxability of various goods and services.

Key Clarifications:

- ▶ Liquidated damages cannot be said to be a consideration received for tolerating the breach or non-performance of contract. They are rather payments for not tolerating the breach of contract. Such payments do not constitute consideration for a supply and are not taxable.
- ▶ Cheque dishonor fine, penalty imposed for violation of law and forfeiture of salary or recovery of bond amount is not a consideration for any service and hence, not taxable.
- ▶ The facility of accepting late payments with interest/fee, pre-closure of loan, allowing cancellation of an intended supply against payment of fee is a facility granted by supplier that is naturally bundled with the main supply. Therefore, the same should be assessed as principal supply.
- ▶ Representations were made seeking clarification regarding taxability of various goods and services. Accordingly, issue-wise clarifications as recommended by the GST Council have also been provided.

¹ Circular Nos. 177/09/2022-TRU, 178/10/2022-GST and 179/11/2022-GST all dated 3 August 2022

Background

- ▶ Goods and Services Tax (GST) Council had held its 47th meeting on 28 and 29 June 2022 at Chandigarh.
- ▶ In the said meeting, the Council had made recommendations relating to taxability of various goods and services².
- ▶ Central Board of Indirect Taxes and Customs (CBIC) has now issued Circulars³ giving effect to such recommendations.
- ▶ Further, it has also issued Circular⁴ clarifying GST applicability on liquidated damages, compensation and penalty arising out of breach of contract or other provisions of law.

Key Clarifications

On liquidated damages, compensation, and penalty

Questions had been raised regarding taxability of certain activities or transactions as supply of service of agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act [Entry 5(e) of Schedule II to the Central Goods and Services Tax Act, 2017 (CGST Act)].

The Circular by way of illustrations, clarify that few activities such as non-compete agreements, builder refraining from constructing more than prescribed number of floors *etc.*, were envisaged to be covered under the aforementioned entry.

The said entry would be applicable only in a case where there is an independent contractual obligation to refrain from an act, or to do an act or to tolerate an act for a consideration and the same cannot be imagined or presumed to exist merely because there is a flow of money from one party to another.

However, GST/service tax demands have been raised on payments in the nature of liquidated damage, compensation, penalty, cancellation charges, late payment surcharge *etc.*, arising out of breach of contract or otherwise under the aforementioned entry.

Circular examines taxability of these transactions as follows:

Liquidated damages

- ▶ Breach/non-performance of contract by one party results in loss and damages to other party. As per Section 73 of the Contract Act, 1872 (Contract Act), when a contract has been broken, the party which suffers by such breach is entitled to receive compensation from other party for damage/injury caused.
- ▶ The compensation is not by way of consideration for any other independent activity, it is just an event in the

course of performance of that contract.

- ▶ Section 74 of the Contract Act provides that when a contract is broken, if a sum has been named or a penalty stipulated in the contract as the amount or penalty to be paid in case of breach, the aggrieved party shall be entitled to receive reasonable compensation not exceeding the amount/penalty so stipulated.
- ▶ Where the amount paid is only to compensate for injury, loss or damage suffered by the aggrieved party due to breach (for *e.g.*, forfeiture of earnest money deposit in case of breach of agreement to sell), in absence of any independent contract to refrain from or tolerate an act, such liquidated damages are a mere flow of money. These payments do not constitute consideration for a supply and are not taxable.
- ▶ However, if any payment is made for any facility provided, such as early termination of lease agreement, foreclosure of loans *etc.*, though they may be referred to as fine or penalty, would be assessed in the nature of principal supply and taxable if the principal supply is taxable.

Compensation for cancellation of coal blocks

- ▶ In the year 2014, coal block allocations were cancelled by the Supreme Court (SC). 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 allottees of coal blocks were given compensation towards the transfer of their rights/ titles in the land, mine infrastructure, geological reports, consents, approvals *etc.*, to the new entity as per the directions of the SC.
- ▶ 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 allottees had no option but to accept the cancellation.
- ▶ Therefore, the compensation paid for cancellation of coal blocks pursuant to the order of the SC in the above case is not taxable.

Cheque dishonor fine/ penalty

- ▶ Receipt of cheques which are dishonored entails extra administrative cost to supplier and disruption of his routine activities and cash flow.
- ▶ The promise made by any supplier is to make supply against payment within an agreed time through a valid instrument. There is never an implied or express offer on part of the supplier that he would tolerate deposit of

² Refer our tax alert dated 30 June 2022 titled "GST Council recommends rate rationalization and changes in GST law and procedure"

³ Circular Nos. 177/09/2022-TRU and 179/11/2022-GST both dated 3 August 2022

⁴ Circular No. 178/10/2022-GST dated 3 August 2022

an invalid instrument of payment against consideration.

- ▶ The fine or penalty imposed for dishonor of a cheque, is a penalty imposed for discouraging such an act or situation. Therefore, cheque dishonor fine or penalty is not a consideration for any service and hence not taxable.

Penalty imposed for violation of laws

- ▶ Laws stipulate penalty for penalizing and deterring such violations. There is no agreement between the Government and the violator specifying that violation would be allowed or permitted against payment of fine or penalty.
- ▶ Accordingly, penalty imposed for violation of laws are not consideration for any supply received and are not taxable.
- ▶ It was also clarified *vide* Circular⁵ 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 would hold good for GST also.

Forfeiture of salary or payment of bond amount

- ▶ Forfeiture of salary or recovery of bond amount in the event of employee leaving the employment before the minimum agreed period are incorporated to discourage non-serious candidates from taking up employment.
- ▶ The said amounts are not recovered by the employer as a consideration for tolerating the act of such premature quitting of employment. Further, the employee does not get anything in return from the employer against payment of such amounts.
- ▶ Therefore, such amounts recovered are not taxable.

Compensation for not collecting toll charges

- ▶ During demonetization, National Highway Authority of India (NHAI) directed toll operators to allow free access of toll roads to the users for which the loss of toll charge was compensated by NHAI as per the instructions of Ministry of Road Transportation and Highways.
- ▶ A question arose whether such compensation paid to the toll operators was taxable as a service by way of agreeing to refrain from collection of tolls from users.
- ▶ It had been clarified *vide* Circular⁶ that service that is provided by toll operators is that of access to a road or bridge and merely because consideration came from a person other than the actual user of service does not mean that the service has changed. Accordingly, compensation received would be treated on par with original supply.

Late payment surcharge or fee

- ▶ The facility of accepting late payments with

interest/fee, fine or penalty is a facility granted by supplier naturally bundled with the main supply.

- ▶ 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)/ Distribution Companies (DISCOMS) or by SEBs/DISCOMS from individual customers, has two components, *viz.*, a minimum fixed charge and variable per unit charge.
- ▶ The fact that the minimum fixed charges remain the same whether electricity is consumed or not, does not mean the same is a charge for tolerating the act of not consuming the minimum contracted or available capacity or a minimum threshold.
- ▶ Both the components of the price *i.e.*, the minimum fixed charges and the variable 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.
- ▶ Therefore, 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 should be assessed as the principal supply.
- ▶ Accordingly, such cancellation fees should be assessed at the same rate as applicable to the service contract.

Taxability of various goods and services

Representations were made seeking clarification regarding taxability of various goods and services. Accordingly, issue-wise clarifications as recommended by the GST Council have been provided in the Circulars.

Clarification *inter alia* has been issued on treatment of preferential location charges (PLC) paid upfront in addition to the lease premium for long-term lease of land. As PLC forms integral part of supply of long-term lease of plot, amount charged for PLC would be eligible for same treatment as long-term lease of land.

⁵ Circular No. 192/02/2016-Service Tax dated 13 April 2016

⁶ Circular No. 212/2/2019-ST dated 21 May 2019

Comments

- a. Clarifications issued by CBIC attempts to clear the ambiguity on taxability of various goods and services and are likely to reduce unwarranted litigation to a large extent.
- b. Considering the binding nature of Circulars on the department, Industry may need to identify such issues where proceedings have been either initiated by the adjudicating authority or the matters are pending in appeal before appellate forums, in order to evaluate further course of action.
- c. Circular while clarifying on the taxability of cancellation charges does not seem to have addressed the circumstances under which such charges can be treated as liquidated damages / compensation or a consideration for provision of facility. This may be relevant due to differential tax treatment in both cases.
- d. While Circular treats early termination of contract as a facility provided and hence a service, there is a ruling of larger bench of Chennai Tribunal wherein it was held that foreclosure charges were in the nature of liquidated damages and not liable to service tax.
- e. Taxpayers may need to analyze the impact of Circular on treatment of recoveries made from employees towards loss or physical damage of employer's assets.

