GST on Damages: Moment of Reckoning

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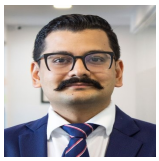

Jigar Doshi
Founding Partner, TMSL

Ronak Gandhi
Manager, TMSL

Almost after a decade, finally the government clarified on what all services would fall under the infamous entry (both in Service tax and in GST) 'agreeing to an obligation to refrain from an act or tolerating an act or to do an act' vide Circular no. 178/10/2022-GST dated 3 August 2022. An issue which has been a bone of contention right from the time the negative list was introduced under service tax has shown its fangs even in the GST regime. A bone of contention for many has been finally put to bed by the CBIC. However, is it really put to bed … is a question that needs to be pondered upon!

The tax research unit of the department of revenue under the Ministry of Finance has released a detailed Circular which elucidates all services falling under entry 5(e) of the Schedule II of the CGST Act, 2017 and have simplified various open issues on this front.

Moreover, the said circular has laid down a test to classify the any given service under entry 5(e) of the Schedule II of the CGST Act, 2017. The test primarily has three conditions as under:

1. Existence of an express or implied agreement by one person to do or abstain from doing something; and
2. Presence of consideration for doing or abstaining from such an act
3. Contractual agreement must be an independent arrangement in its own right

The circular states that if any one of the above attributes are missing then the said services will not fall under entry 5(e) of the Schedule II of the CGST Act, 2017. The said circular further clarifies that, 'agreement to do' or 'refrain from an act' should not be presumed to exist in the contract. There are some clauses in the contract which are meant to prevent the breach of the contract or non-performance and are thus mere **'events'** to the contract and any money received for the said event does not tantamount to supply of services.

Further, the said circular has given some set of examples to understand the three different sets of activities in a better way. Below is the gist of the said example:

Agreeing to the obligation to refrain from an act	Agreeing to the obligation to tolerate an act of a situation	Agreeing to the obligation to do an act
•1. Non-compete agreement •2. Refraining from constructing more than a certain floor on compensation paid by the neighboring projects, even when the permission is available	•1. Allowing a hawker from the common pavement by the shopkeeper against monthly payment •2. RWA tolerating the use of loud speaker for early prayer by the school on payment of compensation to RWA	•Installation of zero emission equipment by the industry at the behest of the RWA against a consideration, when the emission was under the permissible limit.

The circular further clarifies, common examples on which demands are raised under Services tax and GST and the TRU's stand on the same. Below is the tabulation of such of the cases along with the our take on the same:

Sr.	Issue	Clarification by Circular	Implication
1.	Liquidated damage	1. Liquidated damages are payment for not tolerating the breach of the contract 2. It is mentioned to ensure performance and to deter non-performance, unsatisfied or delayed performance 3. There is a flow of money from the party who causes the breach of the contract to the party who suffer the loss or damage 4. It's charged to discourage the non – serious buyer. Further, it is merely an event in the course of the performance of the agreement 5. The said compensation is	A big relief to the industries majorly to the Infra sector and sector where there are turn key projects.

		payable as per Section 73 and 74 of the Contract Act, 1972 6. **Therefore, the Liquidated damages are not liable to GST**	
2.	Compensation for cancellation of coal blocks	1. The Hon'ble Supreme Court in the year 2014 has cancelled allocation of all the coal block/mines vide an order dated 24.09.2014. 2. Post enactment of Coal Mines (Special Provisions) Act, 2015, the old allottee were given compensation for transfer of the rights /titles in the land, etc. to the new successful bidder. 3. **The said compensation cannot be treated as a service of agreeing to or tolerating the cancellation** as the compensation was not under the contract of an agreement between the prior allottees and the government but under the provision of statute and in pursuance of Supreme Court order	A welcome clarification and a relief to the coal miners as there was a huge demand on such damages paid to them.
3.	Cheque dishonor fine/ penalty	1. The cheque dishonor fine/penalty are the charges charged by the banker to discourage such act or situation of	Specific to the financial services sector, cheque bounce charges, interest on delayed EMI payments, etc. have been discussed time and again. Several AARs have been pronounced on these

		bouncing of cheques and 2. **Therefore, the fine and penalty on cheque dishonor would not be liable to GST**	issues. This circular will act as a torch in the dark tunnel.
4.	Penalty imposed for violation of laws	1. Laws are not framed for tolerating violation of the law and therefore the penalty imposed under the said law are not in the nature of tolerating an act of the violation. 2. The same was also clarified under the service tax education guide 2012 and vide circular no. 192/02/2016-Service Tax, dated 13.04.2016	Any payment made to Government is usually subject to GST under RCM. With this understanding, taxpayers generally pay GST even on penalties charged under any law under RCM. In light of this circular, ambiguity on this front will be removed.
5.	Forfeiture of salary or payment of bond amount in event of employee leaving the employment before the minimum agreed period	1. Forfeiture of salary or payment of bond are recovered by the employer not as a consideration for tolerating the act of premature quitting of the employment but as penalties for dissuading the non-serious employees from taking up the employment and to discourage and deter such a situation. 2. Further the employee does not get anything in return from the employer against payment of such amounts and therefore, **such amount charged are not taxable.**	A clarification which is applicable to almost all industries and maximum taxpayers. With multiple ongoing litigations on notice pay front, this clarification may act as a respite.
6.	Compensation for not collecting toll charges	1. In the wake of demonetization,	1. A big relief to the concessionaries

		NHAI had directed the concessionaries to not collect the toll and the said money was compensated by the authority in lieu of suspension of toll collection 2. The compensation are in lieu of toll for the services to the access to a road or bridge and **therefore the same would not fall under agreeing to refraining from an act.**	under BOT – toll model.
7.	Late payment surcharge or fee	1. The facility of accepting late payment with interest or late payment fee, fines or penalty is a facility granted by the supplier which is naturally bundled with the main supply and are accepted worldwide. 2. **Therefore, late payment surcharge or fees in respect to late payment of water, electricity, telecommunication charges, etc. shall be chargeable at the rate of principal supply**	Wherever supplier charged interest or penalty on delayed payment, there was always a question on the applicable SAC code and GST rate. The circular has classified such supply as a composite supply, thereby clearing the air.
8.	Fixed capacity charges for Power	1. The fact that the minimum fixed charges remains the same does not mean that minimum fixed charges are for tolerating the act of not scheduling or consuming the minimum capacity 2. **Both the**	This will bring a closure to the open issue in electricity generating industry.

		minimum fixed charges and variable charges are charge for supply of electricity which is exempt from GST	
9.	Cancellation charges	1. It is a common business practice for suppliers of service to provide the facility of cancellation of the intended supplies within a certain time period on payment of cancellation charges. 2. These charges can be considered as the charges for the costs involved in making arrangements for the intended supply and the costs involved in the cancellation of the supply. 3. Therefore, the same shall be treated as a naturally bundled services and GST should be assessed as the principal supply	This clarification has been given for industries like tourism, hospitality, events, cinema, transportation etc.

Our comments:

A detailed circular on one of the most litigated topic was much needed and TRU needs an applaud for the same. Drawing a line between the ‘events to a contract’ and the ‘supply under a contract’ is of utmost importance. This is because this line shall define whether a penalty or damage would fall within the ambit of the entry 5(e) of Schedule II of the CGST Act, 2017 or not.

Various Courts have opined those liquidated damages are not an alternate consideration to a contract. It is a mere condition to a contract which is triggered in a scenario where, for some reason, the parties are unable to fulfil the contract. Rightly so, because the agreement when entered was not entered to earn liquidated damages or penal charges. It was entered for supply of goods and/or services. Therefore, the primary intention or purpose behind an agreement is the supply of goods and/or services. In case such supply does not take place for any reason, the penalty provisions get triggered and liquidated damages come into play. However, such damages cannot be called consideration and made taxable. Hence, such provisions are only events to a contact.

As the clarification are clarificatory in nature and are effective from the inception of law, there are some questions which remain unanswered on the introduction of this circular, namely:

1. Whether a taxpayer can file a refund claim where the taxpayer have paid tax due to negative AAR’s and AAAR’s pronounced by the authorities in the above cases?
2. Can a taxpayer file a refund claim against the order passed by the officer stating that GST is applicable on the said services and the taxpayer has paid the tax along with interest?
3. Whether the time limit prescribed under the GST law would be applicable when the tax is collected with the power of the law as per the Article 265 of the Constitution of India, 1950?
4. The way the circular describes forfeiture of salary or breach of bond, it seems that salary forfeiture is only covered. However, the major question that was looming was on taxability of notice pay recovery. The Circular nowhere uses the term notice pay recovery.

To conclude, while it may be said that the larger issue is clarified, the granular issues or the fine lines still need some work. Nonetheless, CBIC has indeed taken a stand and finally clarified key issues on taxability of damages.