Ambit of tolerance and refrain under GST

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Sec 7(1) of the CGST Act[1] defines "supply" in an inclusive manner and Sec 7(1A) which is relevant for the present purpose states that where certain activities or transactions, constitute a supply in accordance with the provisions of Section 7(1), they shall be treated either as supply of goods or supply of services as referred to in Schedule II. There is a deeming principle involved since, the expression employed is that "they shall be treated….." Sl. No 5(e) to Schedule II reads thus: *"Agreeing to obligation to refrain from an act, or to tolerate an act or situation, or to do an act"*. The nature of supply will be one of supply of services.

Under the erstwhile Finance Act, 1994 (which administered Service Tax) with the introduction of the negative list, certain services were designated as "declared services" with effect from July 1, 2012. This measure was adopted to remove ambiguity with regard to certain activities and transactions and the applicability of service tax on the same. Schedule II to the CGST Act now incorporates the enumeration of certain transactions and activities with respect to their nature of supply either as goods or as services.

The entry in Schedule II through Sl. No 5(e) provided scope for roping in any and every activity or transaction even in the absence of a 'supply' in the first place. This had led to dispute under the GST regime[2]. The issue has been addressed after insertion of Section 7(1A) which states that Schedule II will come into operation only after an activity or transaction qualifies as 'supply' under Section 7(1).Some of the other disputes have had their origin in the service tax regime[3] wherein more or less similar entry was laid down as part of the declared services for purpose of service tax.

At this stage, it may be useful to take stock of the view taken in this context in VAT/GST jurisdictions in UK and Australia and under the erstwhile service tax regime. There are rulings of the AAR[4]and there is a recent circular of the CBIC[5] under the GST regime.

Consideration

The concept of "money flow" or pure transaction in money has been adopted in the recent CBIC Circular to show that there is no consideration as defined in Section 2(31) of the CGST Act. It must be noticed that the words employed in the Model GST Law under Section 2(28) was: *(28) "**consideration**" in relation to the supply of goods and/or services **to any person**, includes…..*The words "to any person" are singularly absent in the current definition of "consideration" in the CGST Act.

Overseas Jurisprudence

With this background, we may notice the Australian High Court decision in A.P. Group Ltd versus FC of T Federal Court (18-9-2013) where in the context of dealer incentives being received from the manufacturer, it was held as follows:

'The fact that the dealer receives a payment as an incentive when certain thresholds associated with running the business in this way does not mean that the dealer is supplying a service to the manufacturer for consideration. If the incentive payment were not available there is no basis to infer that the dealer would not behave in the same way for free. For

1 *Central Goods and Services Tax Act, 2017*
2 *Period after 01July 2017*
3 *Period prior to 01 July 2017*
4 *Authority for Advance Ruling*
5 *Central Board of Indirect Taxes and Customs*

these reasons there cannot be said to be any supply for consideration in these arrangements'

In the matter of Reliance Carpet Co Pty Ltd[6] (**Reliance Carpet**) the facts were that Reliance Carpet entered into a contract of sale to sell a commercial property. Reliance Carpet and the purchaser under the contract were both registered for GST. The purchaser paid a deposit of $297,500 but failed to pay the balance of the purchase price when required. Because of this default, the contract was rescinded. The Commissioner assessed Reliance Carpet for GST on the forfeited deposit. The Federal Court held in favour of Reliance Carpet. When the matter reached the High Court, it held that the payment of the deposit by the purchaser was "in connection with" a supply by Reliance Carpet and was within the meaning of the definition of "consideration" in section 9-15(1)(a) of the GST Act. The payment by the purchaser of the deposit was to be treated as "consideration" for a "supply" only if and when the deposit was forfeited because of the failure by the purchaser to perform its obligation to complete the Contract. The High Court held that this followed from section 99-5 of the GST Act.

In the case of Qantas the dealings between Qantas and passengers were such that there was no more than one projected "taxable supply", namely the supply of air travel; this supply did not come to pass; and it was claimed that no GST was exigible. On the other hand, the Commissioner argued that the unused fares were received pursuant to the making of a contract between the airline and the customer under which the airline supplied rights, obligations, and services in addition to the proposed flight and that these rights, obligations etc. comprised a payment in connection with a supply. The majority of the High Court agreed with the Commissioner. In doing so, they first examined the contractual arrangement between Qantas and its passengers (which emphasized that Qantas would "take all reasonable measures necessary to carry you and your baggage and to avoid delay in doing so") and the definition of "supply" in the GST Act as including, *inter alia*, "a supply of services", "a creation of any right", and "an entry into an obligation".

They then concluded that the contractual arrangement "did not provide an unconditional promise to carry the passenger and baggage on a particular flight. They supplied something less than that. This was at least a promise to use best endeavors to carry the passenger and baggage, having regard to the circumstances of the business operations of the airline. This was a 'taxable supply' for which the consideration, being the fare, was received." ([2012] HCA 41 (High Court)).

The view of not considering Liquidated Damages as supply for tolerating an act has also been supported by ruling GSTR 2001/4 (GSTR 2003/11 issued by the Australian Tax Office, where it has been clarified that damage or loss or injury does not constitute a supply under the provisions of Australian GST. The European Court of Justice in the case of Societe Thermale v. Ministere de l'Economie [2007] S.T.I 1866, Celex No. 650J0277 has held that where the client exercises the cancellation option available to him as compensation for the loss suffered and which has no direct connection with the supply of any service for consideration, the same would not be subject to tax. The Court of Appeal (UK) in the case of Vehicle Control Services Limited (2013) EWCA Civ 186, has said that payment in the form of damages/ penalty for parking in wrong places/ wrong manner is not a consideration for services as the same arises out of breach of contract with the parking manager. A contract is usually entered for performance and to benefit the parties involved.

Situation in India

Under the erstwhile law in India, the Hon'ble CESTAT Allahabad in the case of KN FOOD INDUSTRIES PRIVATE LIMITED V. COMM OF CGST - 2019-VIL-731-CESTAT-ALH-ST dealt with a case involving delay in delivery of project or breach of any other terms of the contract, which were expected to cause some damage or loss to the appellant. The contract itself provided for compensation to make good the possible damages owing to delay, or breach, as the case may be, by way of payment of liquidated damages by the contractor to the appellant. The ex-gratia charges paid to the appellant were towards making good the damages, losses or injuries arising from "unintended" events and does not emanate from any obligation on the part of any of the parties to tolerate an act or a situation and cannot be considered to be the payments for any services.

[6] *Federal Commissioner of Taxation v Reliance Carpet Co Pty Ltd [2008] ATC 20-028*

There are Advance rulings under GST law on liquidated damages for delay in commissioning the plant; amounts forfeited in tenders; penal charges in terms of the loan agreements; notice pay recovery under employment contracts; cheque dishonor fees etc. These rulings have upheld the recovery of tax employing Schedule II Entry 5(e) as a supply for purpose of GST.

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The recent Circular of the CBIC No. 178/10/2022 dated 03.08.2022 has clarified with regard to liquidated damages, compensation, penalty, cancellation charges, late payment surcharge etc. It has also provided some examples of where the entry could be attracted such as in non-compete agreements; restraint from construction in building contracts; etc.

Is every act or forbearance of any kind, a supply? The decisions from the other jurisdictions show that UK treats the issue of supply as a question of law. Australia treats the same as one of fact. UK emphasises terms of the contract (Refer *Secret Hotels*[7]). EU and Australia stress commercial and economic reality. In UK/EU, it is necessary that there must be consumption to qualify as a supply (Refer *Mohr*[8]). There must be reciprocity (Refer *Tolsma*[9]). EU has a policy agenda in the preamble of the VAT Directives to guide them.

In Australia, there is less policy guidance and a wide view taken, just making an agreement to supply can be a supply (Refer *Qantas*[10]). In *AP Group* by Federal Appeal Court, recognition was shown that some limits are required to be placed against this wide view. All GST/VAT systems are built on three conceptual pillars: Concept of Supply, Concept of Consideration and Concept of Input tax deduction. These, and especially the last, are the hallmarks of a true GST/VAT system. But they can and do differ in their application from one country to the next. The boundary between paying for a supply and paying money to someone other than for a supply can be uncertain. UK/EU requires a ‘direct link’ between the payment and the supply. This excludes payments made for uncertain descriptions of goods or for activities that cannot really be measured, or things actually described as ‘free’. There has to be reciprocity (See *Tolsma*). Australia has a looser link and less stress on reciprocity: *for* or *in connection with*. The nexus can be indirect.

In most systems, there needs to be a consideration before a ‘supply’ can exist. Australia is an exception (save for financial services). Consideration can be in cash or kind, in all systems. It can come from the customer or a third party, in most systems. Valuation issues cluster around barter or ‘in kind’ consideration (which is also a supply in its own right, except where it is merely ‘facilitation’, e.g. lending the hammer to the plumber). Nexus issues are the most common: i.e., was the payment for the supply? In a complex transaction, it is not always easy to say who paid what for which supply.

Various tests have been evolved in other jurisdictions to make meaning of transactions combining disparate elements. Some of these are:

- Necessity test
- Top-down test - overall label, no analysis of detail
- Bottom-up test – look at the basic elements, ask how they interact, and slowly build a model going upwards from detailed level to see which elements dominate over others, and which elements simply function in parallel to others.
- Dominant elements impose their GST status onto the ancillary ones.
- All elements coalesce into a unique and different whole
- Historic trend towards taxing every element separately, more recently replaced by trend to seek to find unity and/or coalescence.
- No one test is absolute

In India under the erstwhile law, the CESTAT in Repco Finance Ltd 2020 (117) taxmann.com 755 (LB) dealt with the question whether the foreclosure charges collected by banks from customers would be subjected to service tax under the category of banking

7 *2014 UKSC 16*
8 *VAT SC 06344*
9 *C-16/93(1994 STC 509*
10 *[2012] HCA 41 (High Court)).*

and other financial services. Reference was made to the European Court of Justice in the case of C-277/2005 in Societe Thermaled'Eugenic-les- Bains (supra).The other decision of the CESTAT is in South Eastern Coal fields (2021)124 taxmann.com 174 (Delhi) where it was held that compensation or penalty from contractors for material breach was not taxable under provisions of the service tax law namely Sec 66E (e) which is similar to Entry at Sl No 5(e) of Sch II to CGST Act.

What emerges from the above and the recent Circular No 178 (supra) is that there is a distinction between "condition of the contract" and consideration for the supply. This is referred to as the "event" in the recent circular No 178. This principle has been adopted in the context of examination of the contractual terms under the Central Excise Law in Racold Appliances[11] upheld by the Supreme Court in 1998(100) ELT A64(SC). This principle was also applied by the CESTAT in McDonalds India Private Ltd[12] in the context of whether there is consideration flowing from the franchisee to the franchisor when the franchisee is conditioned to incur certain expenses to mainly augment his business. It was held that such a condition shall not constitute consideration for purpose of service tax.

Holding of Shares by Holding Company – Tolerate an Act?

There are cases outside the instances covered by the CBIC circular (supra) such as the holding of shares by the overseas holding company in the Indian subsidiary being treated as an act of tolerance by the subsidiary for tax under reverse charge in the hands of the subsidiary invoking Sl No 5(e). (Service Code 997171). Given the reasoning in the Circular that there is requirement for an independent contract the mere holding of shares in the subsidiary should not attract tax.

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Reward Schemes and Reward Points

Next would be with regard to reward schemes and reward points held as actionable claims which are in any case neither supply of services nor supply of goods under Schedule III to the Act. The forfeiture of such points in the event of non-redemption should also not attract any tax since the principal supply itself is not taxable.

Similarly in the case of forfeiture of ESoPs issued to an employee pursuant to the employment contract, the same principle as in case of reward points should apply. The payment towards the employment being covered by Schedule III the principal supply itself will be not taxable in this case and hence the same should follow with respect to the ESoPs forfeited.

Arbitration Amounts

Another area could be whether the amounts awarded pursuant to arbitration proceeding that is enforceable in a court of law could be taxed under GST. This was held taxable by AAR in North American Coal Corporation India [(2018) 98 taxmann.com 331 AAR – Mah]. But now given the fact that this is in the nature of contractual term and there is no separate settlement or compromise, one should be able to say that there is no tax when there is no independent contract. However, when there is an independent compromise arrangement whereby several civil and criminal litigation already pending in various courts is withdrawn (criminal proceeding cannot be settled without the permission of court of competent jurisdiction) and payments are made, then this may give rise to an independent supply except in the case of a decree passed after filing of the memo of compromise in court.

Conclusion

From a survey of the judgments in other jurisdictions and under the erstwhile indirect tax law and the clarification in Circular No 178, it could be said that as long as there is an independent and identifiable supply the amounts paid in respect of the same may amount to consideration and be subjected to tax. However, the nagging question that will of course evolve in terms of an answer would be as to what the line of demarcation is when the payment made under a contract would be treated as for an ancillary or an incidental supply to the principal supply. And the real ambit of this entry at Sl No 5 (e) of Schedule II is yet to come. ■■■

[11] *1994(69) ELT 312*

[12] *2019 (9) TMI 1141 (Delhi)*