

## Intricacies revolving around liquidated damages taxability under GST



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**Damages awarded pursuant to a contract are quite prevalent in day-to-day transactions undertaken by business entities. Since the quantum of damage borne by defaulting party may be huge, one has to be mindful of the tax controversies revolving around the taxability under the Goods and Services tax Act. There is a plethora of contradictory judgements on the tax implications in the erstwhile Service tax regime and GST law. It is evident from the Advance rulings pronounced under the GST that the authority has not taken into consideration the fact whether the damages paid pursuant to a contract would qualify as a 'supply' under GST which is the taxing event.**

**I**n common parlance of trade, before executing any transaction, parties enter into a legal contract wherein the rights and obligations of both the parties are clearly laid down. The basic structure of the contract is governed by the Indian Contract Act, 1872 which highlights the provisions relating to performance, non-performance and the breach of contract.

Going by the literal understanding of the word 'damage', it is a remedy in the form of monetary reward paid to a claimant as compensation to loss or injury. Black's Law Dictionary defines damage as under:

*"A pecuniary compensation or indemnity, which may be recovered in the courts by any person who has suffered loss, detriment, or injury, whether to his person, property, or rights, through the unlawful act or omission or negligence of another."*

Indian Contract Act clearly provides for compensation<sup>1</sup> for loss or damage caused by breach of contract to the affected party. Such damages may be a pre-estimated damage which the parties agree while making the contract or may be left to be decided by court on basis of assessment of loss or injury.

The Black's Law Dictionary defines the terms as under:

### Liquidated Damages

*"An amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches; also if the parties to a contract have agreed on Liquidated Damages, the sum fixed is the measure of damages for a breach, whether it exceeds or falls short of the actual damages."*

### Unliquidated Damages

*"Damages that cannot be determined by a fixed formula and must be established by a judge or jury."*

Having set the context of the importance of the term damage, its significance in the contract, let us deep dive into the intricacies which revolve around taxability of such damages under the indirect tax laws.

<sup>1</sup> Section 73 and 74 of the Indian Contract Act

### Provisions under the Central Goods and Services Tax Act, 2017 ('the CGST Act')

- With effect from 1 July 2017, GST is applicable on supply of goods or services or both. The term "Supply" has been defined<sup>2</sup> as under:

"(1) For the purposes of this Act, the expression "supply" includes--

- (a) *all forms of supply of goods or services or both such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business;*

.....

*(1A) where certain activities or transactions constitute a supply in accordance with the provisions of sub-section (1), they shall be treated either as supply of goods or supply of services as referred to in Schedule II."*

- Schedule II to the CGST Act which lists out certain activities to be treated as supply of goods or supply of services specifically provides in Para 5(e) as under:

*"(5) The following shall be treated as supply of services, namely:*

*(e) agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;"*

- The aforementioned terms have not been defined under the CGST Act, however, same were explained in detail by

Maharashtra Appellate Authority for Advance Ruling<sup>3</sup> as under:

- Refrain from act:** An agreement for non-compete with each other.

For example: Sale of brand name by X to Y where X agree that he will not sell similar product under any other brand in the market for a specified number of years. In this case, as per the contract, X specifically refrain himself from acting (selling) the product.

- Tolerate an act or situation :** The person or institution may agree to tolerate an act of others. Toleration is defined in Black's Law Dictionary (Tenth Edition) as

*"The act or practice of permitting or enduring something not wholly approved of; the act or practice of allowing something in a way that does not hinder."*

For example:

In a society, for work to be permitted to be carried in the lift during a particular time etc., society charges the person carrying out the repair for the inconvenience caused to other members. This, in commercial term, is known as

"hardship amount". In such situation, the

members agree to tolerate the act carried out by other person. This benefits the society in the form of certain considerations.

- To do an act:** Service provider may sometimes agree for doing a particular act for which he receives payment.

For example: The retailers enter into agreement with the companies that they will sell the cold drink of particular brand of the Company, and he will not sell the cold drink of other company. In such case, retailers agree to act in a particular manner for which he is paid the amount.

- Since supply is undertaken for a consideration, one may refer to the definition of 'Consideration' which in relation to supply of goods or services includes:

*"(a) any payment made or to be made, whether in money or otherwise, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government;*

*(b) the monetary value of any act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether*

<sup>2</sup> Section 7 of the CGST Act

<sup>3</sup> Order No.MAH/AAAR/SS-RJ/09/2018-19

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*by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government”*

- In terms of Notification no. 12/2017 – CT (Rate), exemption is provided on the ‘Services provided by the Central Government, State Government, Union territory or local authority by way of tolerating non-performance of a contract for which consideration in the form of fines or liquidated damages is payable to the Central Government, State Government, Union territory or local authority under such contract’.
- The above notification exempts taxability of damages in case of government contracts, opening a Pandora box of interpretation for usual contract between business entities.
- There is a plethora of advance rulings under GST which held liquidated damages to be taxable under GST. However, it would be worthwhile to analyse the guidelines and precedence set in the erstwhile Service tax law since the similar provision existed under earlier laws as well.

### Analysis of provisions of the erstwhile law and judicial precedents

- Service law was leviable on provision of service, which means an activity for consideration carried out by one person for another.

The term was explained in “Taxation of Services: An Education Guide”<sup>4</sup> as under:

*The concept ‘activity for a consideration’ involves an element of contractual relationship wherein the person doing an activity does so at the desire of the person for whom the activity is done in exchange for a consideration. An activity done without such a relationship i.e., without the express or implied contractual reciprocity of a consideration would not be an ‘activity for consideration’ even though such an activity may lead to accrual of gains to the person carrying out the activity.*

- It is a well settled law that mere flow of money cannot be a subject matter of service tax and consideration should have ‘nexus’ with an identified supply of service.
- Reliance may be placed to decision of Hon’ble CESTAT in the case of Cricket Club of India v. Commissioner of Service Tax<sup>5</sup> wherein such nexus was clearly laid down. A relevant extract is enumerated below:

*‘.....Neither can monetary contribution of the individuals that is not attributable to an identifiable activity be deemed to be a consideration that is liable to be taxed merely because club or association is the recipient of that contribution.’*

- Similar view on the consideration was taken in the matter of Mormugao Port Trust v. Commissioner of Customs, Central Excise and Service Tax, Goa<sup>6</sup>

*“...In our view, in order to render a transaction liable for service tax, the nexus between the consideration agreed and the services activity to be undertaken should be direct and clear. Unless, it can be*

*established that a specific amount has been agreed upon as a quid pro quo for undertaking any particular activity by a partner, it cannot be assumed that there was a consideration agreed upon for any specific activity so as to constitute a service.”*

- Given aforementioned legal provisions and judicial precedents, it is evident that it is a well settled law that mere receipt of money would not tantamount to consideration. Unless and until consideration is flowing at the desire of the party for undertaking a particular activity, same would not qualify as consideration.

### Judicial Precedents

In the Service laws, various judgements have held that liquidated damages shall not be taxable. Some of these are given below:

- In M/S South Eastern Coalfields Ltd. Versus Commissioner of Central Excise and Service Tax, Raipur<sup>7</sup>, Hon’ble CESTAT took the following grounds while deciding penalties paid by defaulting parties on account of breach of contract would not be taxable.
  - ♦ *There is a marked distinction between ‘conditions to a contract’ and ‘consideration 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 provided.*
  - ♦ *The purpose of imposing compensation or penalty is to ensure that the defaulting act is not undertaken or repeated and*

<sup>4</sup> Para 2.3 of Education Guide issued by CBEC

<sup>6</sup> 2015-VIL-607-CESTAT-MUM-ST

<sup>5</sup> 2015-VIL-549-CESTAT-MUM-ST

<sup>7</sup> 2020 (12) TMI 912 - CESTAT NEW DELHI

the same cannot be said to be towards 'toleration' of the defaulting party.

- In M/S K.N. Food Industries Pvt. Ltd. Versus The Commissioner Of CGST & Central Excise, Kanpur<sup>8</sup>, Hon'ble CESTAT held that:

*"liquidated damages were received to make good the losses or injuries from 'unintended' events and does not arise from any obligation on part of any of the parties. Hence, the same cannot be considered as the payments for any service."*

- In Commissioner of Service Tax Vs. M/s. Repco Home Finance Ltd.<sup>9</sup>, it was held:

*"Damages are to compensate for disruption of a service and not towards performance of the service. They should not be viewed as alternative mode of performance and accordingly, should not be subject to tax."*

On similar lines, we will come across multiple rulings decided in the favour of taxpayers denying taxability under Service tax.

### Relevant judgement under GST regime

Under GST law, multiple Authority for Advance rulings while pronouncing their decision on taxability of liquidated damages under GST held:

*"The empowerment to levy liquidated damages is for the reason that there had been a delay and the same would be tolerated, but for a price or damages."*

*The income though presented in the form of a deduction from the payments to be made to the contractor was the income of the applicant and would be a supply of 'service' by the applicant in terms of*

*clause (e) of Para 5 of Schedule II appended to the Central Goods and Services Tax Act, 2017"*

However, it is worthwhile to refer the judgement of Bombay High Court in the matter of **Bai Mamubai Trust and Ors. Vs. Suchitra**<sup>10</sup> which laid the basic ground rules for attracting GST on damages:

*"The nature of "damages" for the purpose of GST held that compensation paid as damages for a violation of a legal obligation was not a supply under GST. The legal doctrine of supply did not include wrongful unilateral acts that resulted in the payment of damages."*

*The reciprocal obligations are essential to constitute supply and accordingly any payment in the nature of damages to balance equities between parties, in the absence of enforceable reciprocal obligations, would not constitute supply and would not attract GST."*

### Global precedence

One may take reference of the Global tax laws to understand the positions taken therein.

Under Australian GST law, different rulings issued by the Australian Tax Office<sup>11</sup> clarified damage or loss or injury does not constitute a supply.

Likewise, UK VAT instruction Manual<sup>12</sup> clarifies liquidated damages not to be a consideration for supplies and are outside the scope of VAT.

Entry 22.3 of VAT notice 708 issued by HM Revenue and



**The purpose of imposing compensation or penalty is governed by the provisions of Indian Contract Act to ensure the defaulting act is not undertaken or repeated. Same cannot be equated as receipt of consideration on account of toleration of an act.**



Customs, UK highlights:

*'Liquidated damages are agreed pre-estimated sums to be paid in the event of breach of a contract by one of the parties. If you receive liquidated damages, you are not receiving payment for a supply by you and no VAT is due on that amount.'*

### Conclusion

Aforementioned rulings clearly outline recovery of liquidated damages or penalty from other party cannot be said to be supply

of service, as neither the receiving party is carrying on any activity to receive compensation nor there is any intention of the defaulting party to breach or violate the contract and suffer the loss.

The purpose of imposing compensation or penalty is governed by the provisions of Indian Contract Act to ensure the defaulting act is not undertaken or repeated. Same cannot be equated as receipt of consideration on account of toleration of an act.

Further, taking reference from the global tax laws, one may infer that the Indian GST provisions should be read in line with the positions taken across various countries as well as erstwhile Service tax law. The need of the hour is to streamline the provision relating to taxability of liquidated damages as it constitutes a significant amount of cost for industries engaged in the supply of exempted goods or services and hampering their ease of doing business. ■■■

<sup>8</sup>. 2020 (1) TMI 6 - CESTAT ALLAHABAD

<sup>9</sup>. 2020 (7) TMI 472 - CESTAT CHENNAI

<sup>10</sup>. [2019] 109 taxmann.com 200/31 GSTL 193 (Bom.)

<sup>11</sup>. Australian Taxation Office, 'Goods and Services Tax: Supplies', Goods and Services Tax Ruling GSTR 2006/9

<sup>12</sup>. VATSC35600