

CBIC clarifies applicability of GST on liquidated damages, compensation received due to breach of contract

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Summary

To remove ambiguities and mitigate legal disputes, the Central Board of Indirect Taxes & Customs (CBIC) has issued a circular¹ clarifying the taxability of various activities or transactions in this regard.

The CBIC examined the scope of relevant entry² of Schedule II of the Central Goods and Services Tax Act, 2017 (CGST Act) in respect of applicability of GST on payments in the nature of liquidated damages, compensation, penalty, cancellation charges, late payment surcharge, etc. arising out of breach of contract.

It has been clarified that in absence of an express or implied promise by the recipient, payment cannot be assumed for doing an act or for refraining from an act or for tolerating an act. Further, payments such as liquidated damages, forfeiture of salary for premature leaving of the employment, penalty for cheque dishonour, etc. are not a consideration for tolerating an act or situation. Rather, such payments are for preventing breach of contract or non-performance and are therefore mere 'events' in a contract.

The CBIC has examined the scope of relevant entry of Schedule II, which has below three limbs:

- Agreeing to the obligation to refrain from an act
- Agreeing to the obligation to tolerate an act or a situation
- Agreeing to the obligation to do an act

It is clarified that there must be a necessary and sufficient nexus between the supply and the consideration. Further, following are the essential characteristics to qualify any activity or transaction under the relevant entry:

- The activities must be under an "agreement" or a "contract" (whether express or implied)
- The contract must be for a 'consideration' in return from one party to another
- The contract must be an independent arrangement in its own right. It can take the form of an independent stand-alone contract or may form part of another contract
- A contract cannot be imagined existing merely because there is a flow of money from one party to another

Further, the CBIC has provided detailed clarifications on specific activities or transactions, which are as below:

Particulars	Clarification	Taxability
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¹ Circular No. 178/10/2022-GST dated 3 August 2022

² entry 5(e) of Schedule II of the CGST Act

<p>Liquidated damages</p>	<p>In case where the amount as “liquidated damages” is paid only to compensate for injury, loss or damage suffered by the aggrieved party, without any agreement, such liquidated damages are merely a flow of money from the party who causes breach of the contract.</p> <p>Liquidated damages are not the desired outcome of a contract. Thus, such payment would not be constituted as a consideration for supply and hence, not taxable.</p> <p>However, in case payment constitutes a consideration for a supply, then it is taxable, irrespective of by what name it is called.</p> <p>Hence, it can be concluded that if the payment does not represent the “object” of the contract, then it cannot be considered “consideration”.</p>	<p>Payments do not constitute consideration for a supply, thereby not exigible to GST</p>
<p>Compensation for cancellation of coal blocks</p>	<p>The compensation to the prior allottees of mines was paid in terms of order of the Supreme Court. However, as such, there was no agreement between such allottees of coal blocks and the government.</p> <p>Therefore, it cannot be said that such prior allottees had supplied a service to the government by way of agreeing to tolerate the cancellation of the allocations. Also, it cannot be said that the compensation paid for cancellation was a consideration for such service.</p>	<p>The compensation paid for the cancellation of coal blocks is not taxable under the provisions of GST law</p>
<p>Cheque dishonour fine/ penalty</p>	<p>These transactions are in the nature of a fine or a penalty, imposed by a supplier or banker for the dishonour of a cheque. The said fine/penalty is not imposed for tolerating the act or situation. Rather, it is imposed for not tolerating, penalising and thereby deterring and discouraging such an act or situation.</p>	<p>A cheque dishonour fine or penalty is not a consideration for any service and is not taxable under the GST law</p>
<p>Penalty imposed for</p>	<p>Laws are not framed for tolerating their violation, thus, a penalty imposed for violation</p>	<p>Penalties imposed for violation of</p>

<p>violation of laws</p>	<p>of laws is not a consideration for any supply received and is not taxable.</p> <p>Further, as such, there is no agreement between the government and the violator.</p> <p>It is explained in the service tax education guide that there is no service received in lieu of payment of fines and penalties, thus same are not considered. Even the circular³ clarified that the fines and penalty chargeable by the government or a local authority imposed for violation of a statute, bylaws, rules or regulations are not leviable to Service Tax. An analogy can be drawn under the GST regime also.</p>	<p>laws cannot be treated as consideration charged by the government or a local authority for tolerating violation of laws. Hence, the same are not taxable under GST</p>
<p>Forfeiture of salary or payment of the bond amount in case of premature leaving of employment by the employee</p>	<p>The provision for forfeiture of salary or recovery of the bond amount in case of premature leaving of employment is added to the employment contract in order to discourage non-serious candidates.</p> <p>Further, recovery of such amount by the employer cannot be said as consideration for toleration of the act of such premature leaving, but it is a penalty for discouraging the non-serious employees and to deter such situations.</p> <p>Besides, the employee does not get anything in return for such payment. Therefore, such amounts recovered by the employer are not taxable as consideration.</p>	<p>Amounts recovered by the employer are not a consideration and are not taxable under GST</p>
<p>Compensation for not collecting toll charges</p>	<p>During the relevant period⁴, NHAI paid compensation to the concessionaires (toll operators) in lieu of free access to toll roads to the users. It has been clarified⁵ that the toll operators had provided services of access to a</p>	<p>Similar taxability as in case of service by way of access to a road or a bridge on</p>

³ Circular No. 192/02/2016-Service Tax, dated 13 April 2016

⁴ 8 November 2016 to 1 December 2016

⁵ Circular No. 212/2/2019-ST dated 21 May 2019

	<p>road or bridge and toll charges are mere consideration for such service. During the relevant period, the service continued to be provided for which the consideration was paid by NHAI.</p> <p>In this regard, it is hereby clarified that it cannot be said that the service has changed merely due to receipt of consideration from another person other than the actual user of the service.</p>	<p>payment of toll charges</p>
<p>Late payment surcharge or fee</p>	<p>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. 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. Therefore, it should be assessed at the same rate as the principal supply.</p>	<p>These charges are to be assessed at the same rate as the principal supply, being ancillary to and naturally bundled with the principal supply</p>
<p>Fixed Capacity charges for Power</p>	<p>The price charged for electricity has two components, i.e., minimum fixed charges/ capacity charges and the variable/energy charges per unit charge.</p> <p>The minimum fixed charges need to be paid mandatorily irrespective of the quantity of electricity during a month. However, the variable is charged as per the consumption of the electricity.</p> <p>The minimum fixed charge or part thereof cannot be considered as a charge for tolerating the act of not scheduling or consuming the minimum contracted or available capacity or a minimum threshold. Thus, it is clarified that both the components of price are charged for the sale of electricity, which is exempt under GST. Hence, the same is not taxable.</p>	<p>These charges are in respect of the sale of electricity and are not taxable under GST</p>
<p>Cancellation charges</p>	<p>A cancellation fee is basically the charges for the costs involved in planning for the intended supply and in the cancellation of the supply.</p>	<p>These charges should be assessed at the</p>

	<p>The facilitation supply of allowing cancellation 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.</p> <p>The amount forfeited should be assessed at the same rate as applicable to the service contract.</p> <p>Further, it is to be noted that forfeiture of earnest money is agreed as compensation for the losses suffered and as a penalty for discouraging the non-serious buyers or bidders. It cannot be considered as consideration for tolerating the breach of contract. There is merely a flow of money and the same cannot be said as a consideration for any supply and is not taxable.</p>	<p>same rate applicable to the service contract</p> <p>Forfeiture of earnest money is not a consideration for any supply and is not taxable</p>
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Our comments

The taxability of liquidated damages, notice pay recovery, etc. has been a matter of extensive litigation for a long time.

The present clarifications issued by the CBIC have emphasised that for a taxable supply, there must be an express or implied agreement, which may be oral or written, to do or abstain from doing something against payment of consideration. Further, it cannot be supposed that an agreement exists merely because of the flow of money from one party to another.

Depending on the facts of the case, these clarifications will play a vital role in determining the taxability of supply of service of agreeing to the obligation to refrain from any act, or to tolerate an act or a situation, to do an act.

Further, this circular is likely to put to rest the controversies and demands raised on taxpayers on the subject matter.

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