

SUVIDYA is the knowledge arm of **Suri & Co.** aimed at keeping the spirit of learning continuously running by sending curated update documents, holding knowledge sharing sessions, and many other programs.



# GST Circular No: 178/10/2022

## DISCLAIMER

For clients and firm use only. We have taken all steps to ensure that the information contained herein has been obtained from reliable resources and that this publication is accurate. However, this publication is not intended to give legal, tax, accounting or other professional advice. We recommend appropriate advice be taken prior to initiating action on specific issues.

# 2022

## **Clarification on applicability of GST on Liquidated Damages, Compensation and penalty arising out of breach of contract or other provisions of law**

There have been ambiguities regarding the taxability of liquidated damages, compensation, and penalty under indirect tax structures in India. These situations have been there in the old tax regime and has extended into the GST era.

This circular clarifies on a transaction becoming a supply which is in the nature of obligation to refrain from act or to tolerate an act or a situation.

Before moving on to the content of circular, we need to understand entry 5 (e) of schedule II of the CGST act which comprises three distinct set of activities:

- i) the obligation to refrain from an act.
- ii) obligation to tolerate an act or a situation; and
- iii) obligation to do an act.

Hence, from the above its inferred that either of the three activities must have happened under an "agreement" or a "contract" (express or implied) to fall within the ambit of the said entry. Such contractual arrangement must be independent in its own right, either as a standalone contract or as a part of another contract.

Further there should be a consideration that flows from one party to another for the actions and there needs to be a proper connection between the supply and the payment made.

Amount transferred by one party to other in a contract should be treated as a consideration if the same pertains to consideration for toleration of an act or situation.

Payments such as liquidated damages for contract violations, fines under the mining act for excess stock discovered with the mining company, forfeiture of salary or payment of an amount as specified in the employment bond for terminating employment before the minimum stipulated period, fines for cheque dishonour, etc are not factors in determining whether an act or circumstance is tolerable. They are instead sums of money collected for refusing to put up with an action or circumstance and to discourage such behaviour; such sums are for preventing contract breach or non-performance and are thus only "events" in a contract.

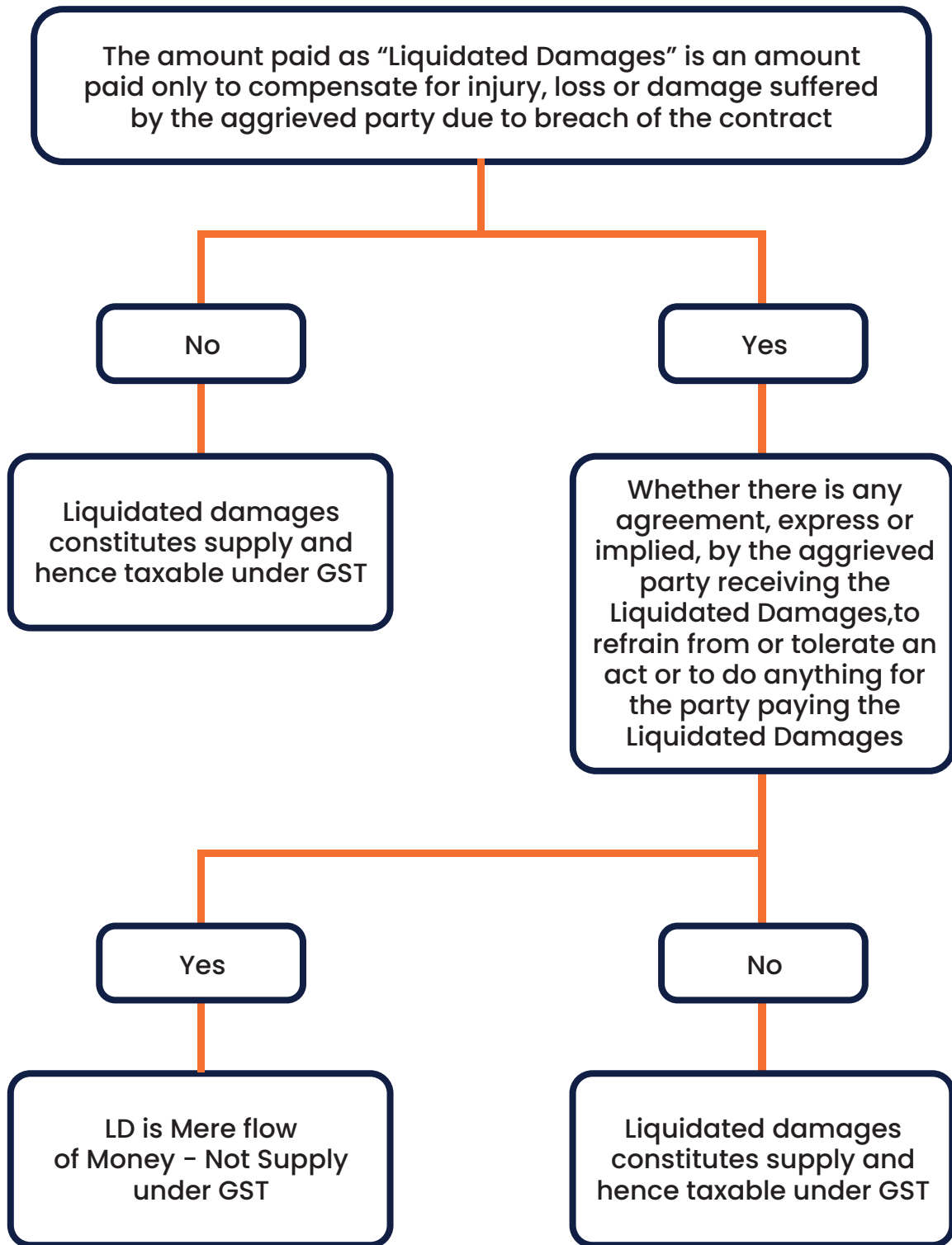
The circular clarifies the tax implications of specific transactions which are discussed here:

### **Liquidated Damages for breach of contract – No GST Liability**

#### **What is liquidated damages?**

According to Section 73 of the Contract Act, the party that suffered a loss as a result of a breach and non-performance of the contract is entitled to compensation. Liquidated Damages are the damages paid under a written contract for a breach of such contract.

The taxability on above will not arise if the amount paid by one party to the contract are merely in the nature of penalty or compensation for any loss incurred by the other party. The detailed analysis on the same has been summarised in the below chart.



**Taxability of fines or penalties in certain cases – Taxable under GST**

The sums paid for accepting late payments, early lease termination, prepayment of loans, or sums forfeited upon customer cancellation of service as contemplated by the contract as part of commercial terms agreed to by the parties, constitute consideration for the provision of a facility.

Even though they may be referred to as fines or penalties, these payments are essentially amounts of money that are paid in exchange for a supply, and in situations where the primary supply is taxable, this supply is also subject to GST.

### **Compensation given to previous allottees of coal blocks for cancellation of their licenses – No GST Liability**

It has been explained that compensation paid for cancellation of coal block licences pursuant to the Hon. Supreme Court's order and the Coal Mines (Special Provisions) Act, 2015 was not taxable because there was no agreement between previous coal block allottees and the Government to tolerate cancellation of the coal block allotted to them on payment of compensation.

### **Cheque dishonour fine / penalty charged – No GST Liability**

It has been made clear that the fine or penalty the supplier or banker imposes for the dishonour of a check is not a fine or penalty imposed for tolerating the act or situation, but rather a fine or penalty imposed for not tolerating, penalising, and thereby deterring and discouraging such an act or situation. A fine or penalty for cheque dishonour is therefore not a consideration for any service and hence taxability on the same does not arise.

### **Penalty imposed for violation laws – No GST Liability**

Penalties imposed for breaking the law are not supply received and hence are not subject to taxation. Additionally, the Mining Department imposes fines and penalties when mining surplus minerals beyond the permitted limit or engaging in mining activities in violation of the mining permission, which is also a comparable scenario.

Similar clarification was available under the service tax regime pursuant to Service Tax Circular No. 192/02/2016, dated April 13, 2016.

### **Forfeiture of salary or payment of the bond amount by an employee leaving the employment before the minimum agreed period – No GST Liability**

The employment contract contains provisions that, in the event that an employee leaves their position before the minimum period of time agreed upon, could result in the forfeiture of their salary or the recovery of their bond money. These provisions are there to deter unreliable applicants from applying and to avoid any disruption of work caused by an employee's early departure.

The aforementioned sums are recovered by the employer in order to discourage and deter situations like this from occurring rather than as compensation for tolerating the act of such premature departure of employment. So, such collection will not fall under the purview of GST.

### **Late payment charges collected by any service provider for late payment of bills – Taxable under GST**

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 such as of electricity, water, telecommunication, cooking gas, insurance etc. Accordingly, it has been clarified that these charges should be assessed at the same rate as the principal supply.

### **Fixed Capacity charges for Power – No GST Liability**

A minimum fixed fee (or capacity charge) and a variable per unit charge are the two parts of the price of energy that power companies charge to State Electricity Boards (SEBs)/DISCOMS or to individual consumers of SEBs/DISCOMS. Regardless of the amount of electricity they have scheduled or purchased during a month, SEBs, DISCOMS, and individual customers are required to pay the minimum fixed prices. They are in charge of the electricity's fixed costs of production and supply. According to the amount of electricity used, the variable fees are assessed per unit of electricity purchased and change monthly.

The fact that the minimum fixed charges are constant regardless of whether electricity is used, scheduled, or consumed below the contracted, available, or minimum threshold does not imply that the entire minimum fixed charge or a portion of it is a fee for tolerating the act of not using the contracted, available, or minimum threshold.

Capacity charge and variable per unit charge, both these components are charged for the sale of electricity and are thus not taxable since the supply of electricity is exempt from GST.

### **Cancellation charges recovered by suppliers – Taxable under GST**

It is normal business practice for services providers like hotels, tours operators, transportation, and others to allow customers to cancel their orders within a predetermined window of time in exchange for a price. The aforementioned fees are only assessed to facilitate the provision of services that permit cancellation in exchange for payment of cancellation fees. The aforementioned fees are naturally bundled with the primary supply.

It has been clarified that supply of 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 in such cases should be assessed as the principal supply.

However, the forfeiture of earnest money by a seller in the event that the buyer violates the terms of the contract to buy an immovable property or by a government agency or local authority in the event that a successful bidder fails to take action after winning the bid for the allocation of natural resources is merely a flow of money because neither the buyer nor the winning bidder receives anything in exchange for the forfeiture of earnest money. The forfeiture of earnest money is required in certain situations, but not as payment for tolerating the violation of the contract; rather, it serves as recompense for losses incurred and as a deterrent to potential nonserious buyers or bids. Such payments being merely a flow of money are not a consideration for any supply and are not taxable. fixed charge or a portion of it is a fee for tolerating the act of not using the contracted, available, or minimum threshold.

### **Conclusion**

These clarifications are a major development toward resolving long-running issues regarding the interpretation of the provision "Agreeing to the responsibility to refrain from an act or to tolerate an act or a circumstance, or to do an act" under the GST system. There are several case laws, advance rulings etc relating to the same issue, which is now clarified through this circular.

<https://www.cbic.gov.in/resources//htdocs-cbec/customs/cs-act/notifications/notfns-2022/cs-others2022/cir-178-08-2022-cgst.pdf>