

GST

Foreclosure charges are not liable to service tax – CESTAT Larger Bench

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ISSUE

Whether 'foreclosure charges' levied by banks and non-banking financial companies on premature termination of a loan can be subjected to levy of service tax under Banking and Other Financial Services ("**BoFS**").

RELEVANT FACTS

The assessee provided housing loans to borrowers for a specified period subject to terms and conditions contained in the agreement. In circumstances where the borrower decided to terminate the loan before the stipulated period, the assessee collected foreclosure charges, which were usually determined as a percentage of outstanding principal amount.

During audit conducted for the period commencing from October 2004 to June 2007, it was found by the revenue authorities ("**Revenue**") that no service tax was paid by the assessee on the income received from its customers in respect of foreclosure charges.

CONFLICTING DECISIONS LEADING TO LARGER BENCH ("LB") REFERRAL

Divergent views had been expressed by the division benches of several tribunals on this issue. In *Housing & Dev. Corporation Ltd. ("HUDCO") v. Commissioner* [2012 (26) STR 531 (Tri-Ahmd)], the CESTAT Ahmedabad entertained a view that such charges would be subject to levy of service tax. On the other hand, in *Magma Fincorp Ltd. v. Commissioner* [2016 (4) TMI 21-CESTAT Kolkata] the CESTAT Kolkata as well as in *Small Industries Dev. Bank of India ("SIDBI") v. Commissioner* [2011 (23) STR 392 (Tri-Del)] the CESTAT Delhi held that such charges would not be subject to levy of service tax.

RELEVANT ARGUMENTS ON BEHALF OF THE ASSESSEE

- 'Foreclosure charges' are collected as compensation for breach of the loan agreement arising on premature termination. These receipts do not constitute 'consideration' as per Section 67 of the *Finance Act, 1994* for provision of lending services.
- Foreclosure charges paid by the borrowers are not 'at the desire of' the banks / non-banking financial companies. The foreclosure charges are recovered as compensation for disruption of a service, and not towards lending services as such.
- It is the borrower who unilaterally decided to cut short the period of loan by making the payment before the stipulated time. Thus, the promise to service the loan for an agreed period of time gets repudiated resulting in a breach of the contract. This unilateral act of the borrower is against the bank's interest.

RELEVANT ARGUMENTS ON BEHALF OF THE REVENUE

- The termination of loan prior to the agreed term is a facility provided to the borrower for a price.
- The definition of BoFS contains the phrase 'in relation to lending'. Therefore, any activity in relation to lending will be subjected to service tax.
- The 'foreclosure charges' cannot be termed as an 'interest' or 'penal interest' (since penal interest would only be chargeable on default in making payment). Hence, these charges would have to be subjected to service tax.



FINDINGS OF THE LB

- 'Consideration' must flow from the service recipient to the service provider and should accrue to the benefit of the service provider. The amount charged has necessarily to be a consideration for the taxable service provided.
- 'Consideration' ought to be understood in light of Section 2(d) of the *Indian Contract Act, 1872* ("**Indian Contract Act**"). Therefore, consideration must necessarily flow 'at the desire of the promisor'. Since premature termination of loan only results in loss of future interest income, 'foreclosure charges' do not flow 'at the desire' of such banks.
- The distinction between 'condition to a contract' and 'consideration to a contract' must be borne in mind. 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 that are provided.
- 'Foreclosure charges' are compensation paid to the banks as a result of a unilateral repudiation / breach of contract and not towards 'lending services'. For a breach to occur as per Section 74 of the *Indian Contract Act*, it is not necessary that the entire contract must come to an end.
- Though the definition of BoFS uses the term 'in relation to lending', it cannot be read in so widely so as to include even those acts which terminate the activity. In fact, 'foreclosure' is an anti-thesis to lending and therefore, cannot be construed as in relation to lending.
- 'Foreclosure charges' cannot be viewed as an 'alternative mode of performance' of contract because 'alternative mode of performance' still contemplates performance, whereas foreclosure is an express repudiation of the contractual terms. Treating eventuality of foreclosure as an optional performance is incorrect.

RATIO DECIDENDI

The LB held that 'foreclosure charges' collected for premature termination of loans are not liable to service tax.



IMPLICATIONS AND COMMENTS

- This decision deals extensively with the interpretation of the term 'consideration'. Though rendered in the context of 'Banking and Other Financial Services' for the period prior to July 1, 2012, the LB's interpretation of 'consideration' will remain significant to disputes under the negative list era as well as in the GST regime.
- The decision will be of great relevance in all disputes involving taxability of 'liquidated damages'.

[Commissioner of Service Tax, Chennai v. Repco Home Finance Ltd. - Miscellaneous Order No. 40053/2020, dated June 8, 2020, CESTAT Larger Bench].

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