L&S UPDATE

An e-update to clients from Lakshmikumaran & Sridharan

5 AUGUST 2022

INDIRECT TAX

GST clarification relating to Entry 5(e) of Schedule II to the CGST Act, 2017

UPDATE NO. 45 OF 2022

Lakshmikumaran & Sridharan attorneys

exceeding expectations
SINCE 1985

Entry 5(e) of Schedule II to the Central Goods and Services Tax Act, 2017 (**'CGST Act'**) provides that agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act is a supply of service. Numerous disputes have arisen in the past few years as to whether certain fines, penalties, and other sums, by whatever name called, the payment of which has been stipulated in the contract itself, would constitute a supply under Entry 5(e).

Against this background, Circular 178/10/2022-GST dated 3 August 2022 has been issued to clarify the scope and applicability of Entry 5(e) of Schedule II to the CGST Act with respect to such payments.

PRINCIPLES LAID DOWN:

- The element of a contractual relationship, where one supplies goods or services at the desire of another, is an essential element for an activity to form a supply.

- Performance is the essence of a contract, and any stipulated compensation payable for the breach thereof cannot be in *lieu* of a supply.

- A consideration cannot be considered *de hors* a contract, wherein one party does something for the other party and the other pays the first in return.

- However, if the payment is merely an event in the course of the performance of a contract and it does not represent the object of the contract, then it cannot be considered to be consideration.

- A stipulation for payment of a sum in a contract does not constitute liquidated damages, where it forms a consideration for another independent contract, which envisages tolerating an act or situation or refraining from doing any act or simply doing an act.

- There has to be an express or implied agreement to do or refrain from or tolerate an act against payment of consideration for the same purpose, for a taxable supply to exist. An agreement to do an act or abstain from doing an act or to tolerate an act or a situation cannot be imagined or presumed to exist just because there is a flow of money from one party to another.

- If there is mere flow of money where the payer does not receive anything in return, it cannot be said to be consideration for a supply.

- If a payment constitutes a consideration for a supply, then it is taxable irrespective of whatever name it is given in a contract.

TREATMENT OF LIQUIDATED DAMAGES:

Since performance is the essence of a contract, the liquidated damages stipulated for the breach thereof cannot be consideration for tolerating such breach. Such **liquidated damages are not payments for tolerating the breach,** but rather for ensuring the performance and deterring non-performance, or unsatisfactory or delayed performance of the contract.

Further, there is no agreement where the aggrieved party agrees to refrain from or to tolerate or to do anything against the payment of liquidated damages, and thus, it is a mere flow of money from the party causing the breach to the party suffering as a result of such breach, which is not taxable.

However, a key *caveat* has been provided that where such a payment forms a consideration for another independent contract, which envisages tolerating of an act or situation or refraining from doing any act or simply doing an act, it will become taxable under the GST law.

Activities which do not qualify to be the supply of the service of agreeing to an obligation to refrain from or to tolerate or to do an act:

Sl.No	Description of payments	Taxability and basis
1)	**Compensation for cancellation of allocation of coal blocks, where they are re-allocated to new allottees**	No GST is leviable because: • There is no contract between the previous allottees and the Government for toleration of the cancellation of coal blocks against the compensation. • The previous allottees have no option other than to accept the compensation.
2)	**Fine / Penalty for cheque dishonour**	No GST is leviable because the fine / penalty is for not tolerating, but penalising and thereby, deterring and discouraging such cheque dishonour.
3)	**Fine / Penalty imposed for the violation of any law**	No GST is leviable because: • It is penalty for the purpose of not tolerating and deterring the violation of the law. • An agreement to tolerate the violation of the law will form an unlawful object / consideration in terms of the Indian Contract Act, 1972.

Sl.No	Description of payments	Taxability and basis
4)	**Forfeiture of salary or payment of bond amount where the employee terminates the employment before the minimum agreed period**	No GST is leviable since such forfeiture/payment is not consideration for tolerating the premature quitting of employment, but for the purpose of discouraging and deterring such a situation.
5)	**Fixed capacity charges for power**	Exempt from the levy of GST since they form a part of the price for the supply of electricity.
6)	**Compensation for not collecting toll charges from the users of toll roads**	Exempt from tax since the nature of the services does not change where the consideration is paid by any person other than the actual users of the toll roads.

Activities which are taxable as ancillary to the main supply:

Sl.No	Description of payments	Taxability and basis
1)	**Late payment surcharge / fee**	Taxable at the same rate of GST as applicable on the main supply under the contract, because the facility of accepting delayed payments with the payment of late fine / penalty is naturally bundled and supplied in conjunction with the main supply in the ordinary course of business.
2)	**Cancellation charges and forfeiture of part of the consideration / security deposit / earnest money in case of no-show, in relation to booking of hotel accommodation, entertainment events, transportation, etc.**	Taxable at the same rate of GST as applicable on the main supply under the contract, since the facility of allowing cancellation of the supply on payment of cancellation fees, or allowing no-show on forfeiture of an amount will be naturally bundled with the main supply.

Furthermore, it has been clarified that the following penalties, charges, etc. will also be taxable at the same rate of GST as applicable on the main supply under the relevant contract, on the basis that such amounts form the consideration for a supply, and are ancillary to the principal supply under the contract:

1. Early termination fee / penalty stipulated for terminating a lease of a movable or immovable property before a certain period prescribed under the lease contract;

2. Foreclosure charges / pre-payment penalty charged by the banks where the borrower wishes to repay the loan before the maturity of the loan period.

L&S comments:

- The treatment of late fine/penalty is in line with the treatment of such amounts under Section 15(2)(d) of the CGST Act, where such amounts are included in the value of the main supply.

- A major question that arises is whether an ancillary supply can take place where the principal supply is not made or cancelled? This is in the context that the Circular clarifies that the supply of a service (such as hotel accommodation, transportation, etc.) and the cancellation or non-availment thereof, against a cancellation fee / forfeiture, will be assessable to GST as naturally bundled with the principal supply under the contract.

- The Circular has clarified that the forfeiture of salary or payment of bond amount in case of premature termination of employment is not leviable to GST. It has to be further examined whether the same principles will apply in case of recovery of notice pay amount.

- The Circular states that a payment constitutes "consideration" for a supply (and not liquidated damages) where it is a consideration for an independent contract. Thus, a question arises as to whether the damages paid through a separate settlement agreement would constitute a consideration and be taxable.

- It has been clarified that the forfeiture of salary or payment of bond amount in case of premature termination of employment is not leviable to GST, and acts as a deterrent for non-serious employees. However, it is not ascertainable why the same principle has not been applied in the case of fees / penalty charged for early termination of lease.

- Loan foreclosure charges are charged due to breach of the terms of the loan contract, which causes loss to the banks, and it discourages such early repayment. The Circular does not clarify why foreclosure charges are being treated as consideration for a supply ancillary to the provision of the loan, and not as liquidated damages.

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