

Levy of GST on Liquidated Damages

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Levy of GST on liquidated damages has been a debatable issue. Section 7(1) (d) of the GST Act, 2017 includes activities referred to in Schedule II in the scope of supply. Entry 5(e) thereof declares that “agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act” shall be treated as supply of service. The view supporting levy of tax on liquidated damages and forfeiture of earnest money is based on premise that the party has ‘tolerated’ the non-performance.

Meaning of Liquidated Damages:

Black’s Law Dictionary (Tenth Edition) on page 473 defines Liquidated damages thus:

“An amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches. If the parties to a contract have properly 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.”

The distinction between a penalty and genuine liquidated damages, as they are called, is not always easy to apply. In the first place, if the sum payable is so large as to be far in excess of the probable damage on breach, it is almost certainly a penalty. Secondly, if the same sum is expressed to be payable on any one of a number of different breaches of varying importance, it is again probably a penalty, because it is extremely unlikely that the same damage would be caused by these varying breaches.¹

Why liquidated damages:

Performance is the essence of a contract and hence parties to contract generally incorporate their expectation in terms of damage caused by failure of either party to perform its obligations completely or as per the agreed terms. The contract may prescribe damages for deficiency in the performance of contract known as ‘liquidated damages’. It is to dissuade unsatisfactory performance or non-performance. For instance, contracts state that time is the essence of contract, and any delay invites, say, 1% of the value of the contract for every week of delay and the like. Other examples may be rent for delay in lifting goods; breach of agreement for not accepting alternate employment offer from competitor up to a stipulated period of time and so on.

Liquidated and unliquidated damages:

¹ See citation below definition of ‘liquidated damages’ in Black’s Law Dictionary (Tenth Edition)

Liquidated damages (also referred to as liquidated and ascertained damages) are damages whose amount the parties designate during the formation of a contract for the injured party to collect as compensation upon a specific breach (e.g., late performance). Liquidated damages clauses are used in many types of contracts, most frequently in IT and construction contracts. Including a liquidated damages clause in a contract provides certainty to the parties, facilitates the recovery of damages by avoiding the requirement of proof of loss, simplifies the dispute resolution procedure and may induce performance of a contract. Liquidated damages clauses regulate the rights of parties after a contract is breached, or alternatively quantify the party's secondary obligation to pay damages (which survives termination).

Unliquidated damages is not pre-fixed or determined. A claim for unliquidated damages is governed by common law. When damages are not predetermined/ assessed in advance, then the amount recoverable is said to be 'at large' (to be agreed or determined by a court or tribunal in the event of breach). For example, in a personal injury lawsuit, the exact amount of an award for actual and punitive damages aren't known and can't be calculated at the time of filing. Black's Law Dictionary (Tenth Edition) on page 475 defines unliquidated damages thus:

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

Sometimes liquidated damages clauses in contract provide for 'NIL' or 'N/A' for rate of liquidated damages. There have been varied line of judicial thinking on interpretation of 'NIL' or 'N/A' clause for liquidated damages.

Court in Australia¹ took the view that use of 'NIL' did not exclude right to claim unliquidated damages. The court emphasised that 'clear words' are required to rebut the presumption that a contracting party does not intend to abandon a common law breach of contract remedy. The liquidated damages clause here read as "If the builder breaches sub-clause 11.1, it shall be liable to pay the Proprietor liquidated damages at the rate of NIL Dollars (\$00.00) per day for each day beyond the due date for practical completion until practical completion is deemed to have taken place." The Court found that the clause here did not contain clear words to express the intention that the owner could not claim unliquidated damages; it only provided that no liquidated damages could be claimed.

In a leading English case², unliquidated damages were excluded by the use of '£ NIL' as the rate of liquidated damages. The Court decided that the liquidated damages clause was an exhaustive agreement for the treatment of damages. As the parties agreed that damages for late completion were to be liquidated damages, it could not have been intended that the Principal should also be allowed unliquidated damages.

So far as the law in India is concerned, there is no qualitative difference in the nature of the claim whether it be for liquidated damages or for unliquidated damages. Section 74 of The Indian Contract Act, 1872 eliminates the some-what elaborate refinements made under the English common law in distinguishing between stipulations providing for payment of liquidated damages 'and stipulations in the nature of penalty. Under the common law a genuine pre-estimate of damages by mutual agreement is regarded as a stipulation naming liquidated damages and binding between the parties. A stipulation in a contract in terrors is a penalty and the Court refuses to enforce it, awarding to aggrieved party only reasonable compensation. The

¹ J-Corp Pty Ltd v Mladenis (J-Corp) (2010) 26 BCL 106

² Temloc Ltd v Errill Properties Ltd (1987) 39 BLR 30

Indian Legislature has sought to cut across the web of rules and presumptions under the English common law, by enacting a uniform principle applicable to all stipulations naming amounts to be paid in case of breach, and stipulations by way of penalty, and according to this principle, even if there is a stipulation by way of liquidated damages, a party complaining of breach of contract can recover only reasonable compensation for the injury sustained by him, the stipulated amount being merely the outside limit.¹

View supporting levy of GST on Liquidated Damages:

The view supporting levy of tax on liquidated damages is based on premise that the party has ‘tolerated’ the non-performance.

‘Tolerate’ is ‘verb’ for ‘noun’ ‘toleration’. ‘Toleration’ is defined in Black’s Law Dictionary (Tenth Edition) on page 1716 as “1. *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.* 2. *The allowance of opinions and beliefs, esp. religious ones, that differ from prevailing norms.....*”

Erstwhile service tax regime, through the concept of declared service, levied tax on “agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act.”²

Authorities administering the law have taken a view that payment of liquidated damages or fine for non-performance of a contract is an activity liable to tax. Entry 57³ in Notification number 25/2012-Service Tax dated June 20, 2012 provided for exemption in respect of “Services provided by Government or a 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 Government or the local authority under such contract” GST Act has continued with the scheme of taxation and exemption under Service Tax law. Entry 5.(e) in Schedule II of the GST Act is identically worded and declares that “agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act” shall be treated as supply of service. Notification number 12/2017-Central Tax (Rate) dated June 28, 2017 provides for exemption from tax. Relevant entry in the said Notification reads thus:

Sl.No.	Chapter, Section, Heading, Group or Service Code (Tariff)	Description of services	Rate (per cent.)	Condition
77	Heading 9991 or Heading 9997	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	Nil	Nil

¹ Union of India v Raman Iron Foundry, AIR 1974 SC 1265; 1974 SCC (2) 231

² Section 66E(e) of the Finance Act, 1994

³ Inserted by Notification number 22/2016-Service Tax dated April 13, 2016

		Government, State Government, Union territory or local authority under such contract.		
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In a matter before the Maharashtra Authority for Advance Ruling in the case of Maharashtra State Power Generation Company Limited 2018-TIOL-33-AAR GST¹ on applicability of GST on Liquidated damages under the phrase ‘agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act’ appearing in clause (e) of para 5 of Schedule II of the GST Act, the taxpayer had contention that

1. There is no explicit agreement between the company and the contractor wherein the company is intending to supply service of tolerance of delay.
2. The delay is neither desired by the company nor by the contractor but to impress upon the contractor to adhere to timelines.
3. Payment of damages, deducting the liquidated damages or the forfeiture of deposit does not reconstitute the person to whom loss or damage is caused.
4. Liquidated damages are in nature of a measure of damages to which parties agree, rather than a remedy.
5. By charging damages or forfeiture, one party does not accept or permit the deviation of the other party. It is an expression of displeasure.
6. Liquidated damages cannot be said to be the desired income, it is the compensation for loss suffered by recipient.
7. Damages are not received by the person for the tolerance of an act, but it is made to compensate the loss suffered.
8. Recovery of liquidated damage is not for supply of service for tolerance of an act. The word ‘obligation’ used in clause clearly means that person should undertake to tolerate an act. There should be a contract for the said purpose and the consideration should be received for such an act of tolerance.
9. Under the Australian GST, it has been clarified that if clause relating to early termination has been specified in the original contract of lease and early termination has been in accordance with the said contract then termination payment will be considered as change of consideration of earlier supply (i.e. redetermination of consideration). It will not be considered as separate supply, but will be considered as adjustment even in relation to that earlier supply.

The Authority however held that tax was payable on Liquidated damages observing that

1. The value of work done and which is to be paid is not effected by the amount deducted therefrom towards liquidated damages. Thus the consideration for work done remains unaltered.
2. The act of delayed supply has happened. The same is being tolerated by an additional levy in the nature of liquidated damages.
3. The impugned income though presented in the form of a deduction from payments to be made to the contractor is the income of the applicant and would be a supply of ‘service’ in terms of clause (e) of para 5 of Schedule II of the GST Act.

¹ [2018] 13 GSTL 177 (AAR-GST) ruling dated May 08, 2018

In yet another matter¹, the same authority held that the act of vacating rented premises for redevelopment as per the redevelopment agreement is agreeing to the obligation to refrain from an act or tolerating an act or situation of redevelopment in place of old premises and of not causing hindrance or creating obstacles in the same.

Above understanding of sub-ordinate legislature and also of quasi-judicial authorities leads to undefined or boundary less expanse of entry “agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act.”

View opposing levy of GST on Liquidated Damages:

It is settled law that an exemption entry cannot presuppose the existence of levy.² An exemption notification clearly is not a charging provision and it cannot be interpreted so as to create a duty liability where none existed under the Act (Tariff entry)³.

The purpose of agreeing to payment of liquidated damages is to ensure performance. It cannot be said to be a consideration for tolerating non-performance. On the face of it, payments of compensation or damages are not consideration for supplies for tax purposes. This is because they invariably amount to financial settlement of losses caused by breach of agreement or infringement of rights rather than the provision of goods or services. Payment of damages or the forfeiture of deposit does not reconstitute the person to whom loss or damage is caused. Liquidated damages are in nature of a measure of damages to which parties agree, rather than a remedy. By charging damages or forfeiture, one party does not accept or permit the deviation of the other party. It is an expression of displeasure. Liquidated damages cannot be said to be the desired income or result of the contract. Liquidated damages are recovered for compensating the loss suffered by the recipient. Section 73 and 74 of the Indian Contract Act, 1872 provide for recovery of liquidated damages in case of breach of contract.

Liquidated damages whether re-determination of consideration:

There is one school of thought that levy of liquidated damages in effect reduces the consideration for supply. Thus, it is re-determination of price of supply. Under Australian GST, in one of the Commissioner’s ruling relating to payment on early termination of lease of goods, it was clarified that if clause relating to early termination has been specified in the original contract of lease and early termination has been in accordance with the said contract then payment will be considered as change of consideration of earlier supply (i.e. re-determination of consideration). It will not be considered as separate supply, but will be considered as adjustment event in relation to that earlier supply. Thus, Australian GST has treated the payment of liquidation damages as part of the same supply and mere re-determination of the

¹ In Re: Zaver Shankarlal Bhanushali 2018-TIOL-84-AAR-GSR ruling dated May 22,2018

² Commissioner of Central Excise and Customs, Kerala and Others v Larsen and Toubro Limited and Others [2015] 84 VST 403 (SC); [2015] 39 STR 913 (SC); 2015-TIOL-187-SC-ST para 44 – “We have been informed by counsel for the revenue that several exemption notifications have been granted qua service tax "levied" by the 1994 Finance Act. We may only state that whichever judgments which are in appeal before us and have referred to and dealt with such notifications will have to be disregarded. Since the levy itself of service tax has been found to be non-existent, no question of any exemption would arise.”

³ Kiran Spinning Mills, Thane v Collector of Central Excise, Bombay-II [1984] 17 ELT 396 (Tri-Delhi)(SB). Revenue’s appeal against this judgment was dismissed by the Supreme Court in Collector of Central Excise, Bombay v Kiran Spinning Mills [1988] 34 ELT 5 (SC).

consideration of the same supply if it has been specified in the original contract i.e. if liquidation of damages are to be borne by the service provider then same will be considered as towards deficiency of services and thereby reduces the original consideration and it will not be considered as separate service and hence it is not covered by the term ‘obligation to tolerate an act or a situation’.¹

Is GST leviable on Unliquidated Damages, penalties etc:

Penalties may be statutory such as penalty for late filing of tax returns, penalty for over speeding on a public road. Penalties may also be private such as loan prepayment penalty, penalty for wrong parking or not wearing helmet in an industrial township and so on. As discussed earlier, unliquidated damages are in the nature of penalty.

Black’s Law Dictionary (Tenth Edition) on page 1313 defines ‘penalty’ as *“punishment imposed on a wrongdoer, usually in the form of imprisonment or fine; especially, a sum of money exacted as punishment for either a wrong to the state or a civil wrong (as distinguished from compensation for the injured party’s loss). Though usually for crimes, penalties are also sometimes imposed for civil wrongs.”*

CBEC Education Guide, at the time of introduction of Negative list based taxation of services², in para 2.3.1 explained that “to be a service an activity has to be carried out for a consideration. Therefore fines and penalties which are legal consequences of a persons’ actions are not in the nature of consideration for an activity.” Frequently Asked Questions on applicability of GST on Banking, Insurance and Stock Brokers Sector released by CBIC in June, 2018 through question 49 has clarified that “fines and penalties are imposed for breaking the law by a person. They are not in the nature of a consideration for an activity and hence, would not constitute a supply of service.”

Breach of contract is between the two contracting parties, whereas breach of law is one between a citizen and the Government. The question whether any impost is in essence compensatory or is by way of penalty will have to be decided having regard to the relevant provisions of the law under which it is imposed and the circumstances under which it has been imposed. The mere nomenclature as interest, penalty or damages in the relevant Act may not be conclusive. Expenditure for violating traffic rules by entering town on no entry times, one way traffic violation, penalty imposed by police in the course of regulating traffic all are in the nature of penalty.

Whenever certain damages are to be paid for the breach of a contract, such damages are treated to be normal incidences of business. Extending this logic, charges levied by airlines/ railways/hotels for cancellation of bookings as per terms of contract are not penalty, even if described as such. Similarly payments made for regularising certain deeds/ events on payment of prescribed fees are not penalty.

In *Kaira Can Company Ltd v DCIT [2010] 127 TTJ 514 (ITAT-Mumbai)*³ the assessee made certain payments to SEBI under a scheme framed by SEBI to regularize default of certain

¹ See arguments from taxpayer in proceedings before The Maharashtra Authority for Advance Ruling in the matter of Maharashtra State Power Generation Company Limited 2018-TIOL-33-AAR GST; [2018] 13 GSTL 177 (AAR-GST) ruling dated May 08, 2018

² TRU Circular dated June 20, 2012

³ Judgment dated January 9, 2009

disclosures under SEBI Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Revenue disallowed these payments as expenditure holding them hit by explanation to section 37(1) of the Income-tax Act, 1961. The Tribunal held that such payments cannot be said to be a penalty under section 15A of the SEBI Act hence not hit by explanation to section 37(1) of the Income-tax Act. In *Ashok Kumar Damani v Addl CIT* [2011] 130 ITD 287 (ITAT-Mumbai)¹ the assessee made short payment of margin money to the stock exchange. The penalty levied by the stock exchange for the same was paid by the assessee during the period under consideration. The AO disallowed the same on belief that the said expenditure is not an allowable expenditure being in the nature of penalty. It was held by the Tribunal that the payment had been made to stock exchange on account of short payment of margin money. This is only a compensatory payment under the rules of the stock exchange which is allowable as revenue expenditure as the same is not for infraction of law. In *Agarwal Roadlines P Ltd v Dy. Comm. of Income Tax* [2010] 129 TTJ (ITAT-Ahmedabad) (UO) 49² the assessee paid overloading charges under a scheme of 'Gold Card' introduced by the Government of Gujarat which allowed carrying excess load in vehicle on payment of additional fees fixed for that gold card. Revenue contended that carrying overloaded goods being a cognizable offence and infringement of law and payment being penal in nature and not incidental to the assessee's regular business, the same is liable for disallowance. The contention of the assessee was that this expenditure is incurred in the normal course of business and corresponding income out of carrying of overload was subjected to tax as the party was billed as per tonnage carried. It was further contended that overloaded vehicles were not detained or confiscated even when overloading was done on regular basis. These were allowed to ply if overloading fee was paid. The Tribunal held that such fees was compensatory in nature and not penal. Payment of this fees entitled transporters to carry over load to final destination without stopping them to unload the excess weightage. The fact that excess weight was not required to be unloaded demonstrates that payment under the scheme was compensatory and not penal as no Government machinery would encourage violation or infringement of legal provisions. Expenditure incurred was allowed as deduction.

Post GST Act amendment:

Schedule II of the GST Act was supposed to be mere an authoritative declaration as to nature of activity, whether it entails supply of goods or services. However, its positioning in definition of supply as clause (d) of sub-section (1) of section 7 of the GST Act made all the items listed in the Schedule 'supply'. This also led to several unintended conflicts in the scheme of Act.

The Lok Sabha on 9th August, 2018 has passed four amendment bills relating to GST. Section 7 of the CGST Act, 2017 defining 'supply' is being amended w.e.f. 1st July, 2017 itself. A new sub-section (1A) is inserted in section 7 and clause (d) of sub-section (1) is omitted. Thus now the role of Schedule II will be limited to classification of supply as 'goods' or 'service'. For levying tax on liquidated damage, transaction will have to first pass the test of supply, which appears to be a difficult proposition. Erstwhile service tax law, on introduction of negative list based taxation, declared activity of 'agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act', to be a service. GST law does not

¹ 9 taxmann.com 69 - AY 2005-06 judgment dated December 3, 2010

² A.Y.2005-06 judgment dated September 18, 2009

