

## JSA Prism Indirect Tax

August 2022

CBIC<sup>1</sup> has issued a circular which deals with the issue of applicability of GST on liquidated damages, contractual payments, penalties, etc., with an intent to settle the ongoing controversies on such payments under both GST as well the erstwhile Service Tax regime. This update highlights the key principles laid down in determining the taxability of such transactions.

This update also covers other circulars issued with respect to rates applicable to supply of certain goods and services.

### Applicability of GST on liquidated damages and other contractual payments

#### Circular No. 178/10/2022-GST (“Circular”)

The tax authorities, under GST as well as Service Tax laws, have construed transactions involving liquidated damages, non-compete fees, early termination charges, notice pay payments by employees, cancellation charges, late payment charges, etc., arising out of breach of contract or otherwise, as taxable as services of “*agreeing to an obligation to refrain from an act or to tolerate an act or a situation, or to do an act*”. The Circular attempts to clarify the scope of this entry with regards to such payments:

As per the Circular, the entry consists of the following 3 (three) limbs:

1. **Agreeing to the obligation to refrain from an act**

**Examples:** Non-compete agreements, industrial units refraining from carrying out manufacturing activities against agreed consideration, etc.

2. **Agreeing to the obligation to tolerate an act or a situation**

**Examples:** Shopkeeper allowing a hawker to operate in front of his shop against a monthly payment by a hawker, residential welfare association tolerating use of loudspeakers in schools for morning prayers for an agreed compensation, etc.

3. **Agreeing to the obligation to do an act**

**Examples:** Installation of pollution control equipment at the behest of residential welfare association for an agreed compensation, which is otherwise not mandated by law, etc.

The Circular lays down the following criterion to be met for a transaction to fall under the ambit of the said entry:

1. Presence of an element of contractual relationship, at the desire of the other person.
2. An independent arrangement in its own right, express or implied.
3. Sufficient nexus between supply and consideration.
4. Just an event in the course of performance of a contract cannot be construed to be consideration for an independent activity.

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<sup>1</sup> Central Board of Indirect Taxes and Customs

The taxability and the rationale thereof, of specific transactions discussed in the Circular are as below:

Sr. No.	Nature of Transaction and Taxability	Rationale
1.	Liquidated Damages (“LDs”) <b>Not taxable</b>	Compensation paid for loss/ damage due to breach or non-performance of a contract. LD is a payment for <u>not</u> tolerating the breach of contract; acts as a deterrent for non-performance of a contract; compensation for injury, loss or damage.
2.	Compensation for cancellation of coal blocks <b>Not taxable</b>	Compensation paid pursuant to the order of a court of law cannot be treated as a consideration for “ <i>agreeing to tolerating the cancellation of allocation of coal blocks</i> ” – no option available to the allottees (i.e., not at the desire of the allottees).
3.	Cheque dishonor fine/penalty <b>Not taxable</b>	Fine/ penalty is not imposed for tolerating an act or situation, but is imposed for not tolerating an act, and thereby deterring and discouraging such act.
4.	Penalty imposed for violation of laws <b>Not taxable</b>	No contractual arrangement between the government and the violator for violation of law – an agreement to violate the law is never a lawful object or consideration.
5.	Notice-pay recovery or payment of bond amount <b>Not taxable</b>	Forfeiture of salary included as a condition of the employment contract to discourage premature quitting, causing disruption – Penalty to dissuade such acts and not a consideration for “ <i>tolerating the act of premature quitting of job</i> ”.
6.	Compensation for not collecting toll charges <b>Taxable, as the service of allowing access to a road/ bridge</b>	Consideration remains to be towards the service of allowing access to a road/ bridge, even if received from National Highways Authority of India (instead of the actual user of the service).
7.	Late payment, surcharge, or fee <b>Taxable, as principal supply</b>	The facility of accepting late payments with interest/ late payment fee, fine or penalty is granted by the supplier as a bundled supply with the principal supply
8.	Fixed Capacity charges for power – <b>Exempt, as principal supply of electricity is exempt</b>	Payment continues to be towards supply of electricity and not for “ <i>tolerating the act of not consuming the minimum threshold of electricity</i> ”
9.	Cancellation fee or forfeiture of consideration or security deposit <b>Taxable, as principal supply</b>	Cancellation fee can be considered as the charges towards costs involved in making arrangements for the intended supply, therefore, such charges will be assessed at the same rate as the principal supply

### JSA Comment

The Circular brings in clarity on the scope of “*agreeing to an obligation to refrain from an act or to tolerate an act or a situation, or to do an act*” and is a step towards settling ongoing disputes pertaining to LD, penalties, compensation for breach of contracts, etc. The principles laid down in the Circular will help in determining the taxability of such

transactions. These principles will have to be applied for each fact pattern to determine, whether the transaction would qualify as a taxable transaction or otherwise.

However, it is highlighted that the tax position clarified in the Circular in respect of cancellation charges, pre-payment charges, foreclosure charges, etc. is divergent from some of the past rulings pronounced by the Courts/ Tribunals under the erstwhile Service Tax regime, and therefore, may continue to be a bone of contention with the tax authorities.

## **Clarifications regarding classification and rate of GST on supply of certain goods and services**

### **Circular No. 177/11/2022-GST and Circular No. 179/11/2022-GST dated August 3, 2022**

#### **Electrically operated vehicles ("EVs") whether or not fitted with a battery pack at the time of supply, attract GST at the rate of 5%**

The circular clarifies that EVs, where battery is not fitted to such vehicle, at the time of supply, will be classified under tariff heading 8703<sup>2</sup> and subject to GST at the rate of 5%.

#### **Mangoes, including mango pulp (other than fresh mangoes and sliced and dried mangoes) attract GST at 12%**

Applicable rates of GST on mangoes covered under CTH 0804, are as below:

- a) Fresh mangoes : exempted from GST;
- b) Sliced and dried mangoes : concessional GST rate of 5%; and,
- c) All forms of mangoes other than described above including mango pulp : GST rate of 12%.

#### **Location charges or preferential location charges ("PLC") collected in addition to lease premium constitute part of upfront amount charged for long term lease of land - exempt from GST**

Allowing choice of location of land is fundamental to the supply of a long-term lease of land and therefore, the location charges or PLC forms part of the consideration charged for said long-term lease of land. Location charges or PLC paid upfront along with lease premium and other charges payable in respect of service by way of granting of long-term lease [30 (thirty) years, or more] of industrial plots or plots for development of infrastructure for financial business, which is exempt under entry 41 of Notification No. 12/2017- Central Tax (Rate) dated June 28, 2017, will also be exempt.

#### **Additional toll fee collected in the form of higher toll charges from vehicles not having FASTag at par with toll charges, exempt from GST**

Additional charges collected from users of the road on account of invalid functional FASTag<sup>3</sup> should be treated at par with toll charges and therefore, exempt from the levy of GST as per Entry No. 23 of Notification No.12/2017- Central Tax (Rate) dated June 28, 2017.

#### **Sale of land after levelling, laying down of drainage lines etc. outside the ambit the GST**

Sale of developed land (after levelling, laying down of drainage lines, water lines, electricity lines, etc.) to be treated as sale of land and accordingly, outside the ambit of GST.

<sup>2</sup> Entry no. 242A of Schedule I of Notification No. 1/2017-Central Tax (Rate) dated June 28, 2017 - Electrically operated vehicles, including 2 (two) and 3 (three) wheeled electric vehicles ["*Electrically operated vehicles*" means vehicles which are run solely on electrical energy derived from an external source or from one or more electrical batteries fitted to such road vehicles and shall include E- bicycles].

<sup>3</sup> As per directions issued by Ministry of Road Transport & Highways *vide* circular dated February 16, 2021.

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