# Taxability of Passive acts haunts the taxpayers

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Indeed, it is valid, 'Life is unexpected!'. Who might have envisioned that while the country occupied with a political discussion on the word 'intolerance', the GST Department, nowadays suspect everything to be an act of tolerance.

One of the most contentious issues under the service tax as well as the GST regime has been the scope of "agreeing to the obligation to refrain from an act, or to tolerate an act or situation, or to do an act" appearing in Section 66E(e) of the Finance Act, 1994 and Schedule II of the CGST Act, 2017.

| Legal Provisions – Service Tax Era | Legal Provisions – GST Era |
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| *"Section 66E. Declared services:*<br>*The following shall constitute declared services namely: -*<br>***********<br>*(e) agreeing to the obligation to refrain from an act or to tolerate an act or situation or to do an act."* | Schedule II 5(e): 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 |

Let us see the provisions that existed in the Pre GST era first:

Section 65B (44) defines service to mean any activity carried out by a person for another for consideration and includes a declared service.

There has, therefore, to be a flow of consideration from one person to another when one person agrees to the obligation to refrain from an act, or to tolerate an act, or a situation, or to do an act, In other words, the agreement should not only specify the activity to be conducted by a person for another person but should specify the:

(i) consideration for agreeing to the obligation to refrain from an act; or

(ii) consideration for agreeing to tolerate an act or a situation; or

(iii) consideration to do an act.

Thus, a service conceived in an agreement where one person, for a consideration, agrees to an obligation to refrain from an act, would be a 'declared service' under section 66E(e) read with section 65B (44) and would be taxable under section 68 at the rate specified in section 68.

There is no express definition of the phrase 'tolerating or forbearance of an act'. The following issue has, to be dealt in relation to Rules of Interpretation. The Literal Rule means that the words need to be interpreted in the strict ordinary meaning and the scope of words should not be considered more than its ordinary meaning.

Now under the GST regime, the entry provided in Schedule II of the CGST Act provides for agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act' as a supply of service.

Section 7 of CGST Act 2017 defines the Scope of supply.

Section 7(1) defines supply through an inclusive definition and clause (a) covers all forms of supply of goods or services or both such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business.

Section 7(1A) of the CGST Act (1A) where certain activities or transactions constitute a supply in accordance with the provisions of sub-section (1), **they shall be treated either as supply of goods or supply of services as referred to in Schedule II.**

Schedule II of Central Goods and Services Act 2017 defines Activities to be treated as supply goods or supply of services.

Further let us understand the meaning of Goods and Services.

Section 2(102) **"services" means anything other than goods**, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency, or denomination to another form, currency, or denomination for which a **separate consideration is charged**.

For a finer version of the term **'service', reference may be taken to the erstwhile regime** which defines service as **'an activity for a consideration'**. Thus, meeting of twin conditions viz., **existence of an 'activity'** and such activity being for a **'consideration'** are **prerequisites** for a transaction to qualify as a service.

It is important to look into the meaning of consideration for the purpose of understanding the intention of the parties who have entered into a contract.

Section 2(31) "consideration" in relation to the supply of goods or services or both includes-

(a) any payment made or to be made, whether in money or otherwise, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government.

(b) **the monetary value of any act or forbearance**, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government:

Provided that a deposit given in respect of the supply of goods or services, or both shall not be considered as payment made for such supply unless the supplier applies such deposit as consideration for the said supply.

*From Joint reading of the provisions of Services tax as well as goods & Services Tax, it can be clearly stated that for taxability of Toleration of an act, the following must be fulfilled:*

a. *Agreement between the parties to refrain, tolerate an Act:* There must be agreement from both sides; mere consensus from one side cannot result into an agreement.

b. *Agreement should be a result of voluntary action of parties:* No Tax Liability shall arise in cases where it is mandated by Law or a compulsion by court. For instance, where the Govt acquires land of a person, and the latter is compensated by fiat of law, tax payment shall not arise.

c. *Consideration must flow from the recipient to the supplier in relation to Toleration of an Act:* Absence of consideration does not tantamount to an agreement, hence the same shall not be considered as a service.

d. *Refrainment or Toleration of an Act should be independently identifiable service:*

   For the activity being carried out consequent to the agreement for refrainment, toleration, or commission of an act to be taxed, it should be independently identifiable as service. The said activity should not merely be a consequence of some other activity. In other words, the said activity should be the transaction which the parties had intended to carry out while entering into the agreement.

Under the GST regime, disputes as to the applicability of GST on the following instances under the toleration of an act category has been a subject matter of litigation:

- Penal or Default Interest in case of any delay in repayment of EMI
- Advance Forfeited in case of cancellation of the agreement
- Forfeiture of Security for Damages
- Liquidated Damages and other Penalties.
- Compensation given for termination of contract
- Non-Compete Fee for not Competing
- Cancellation Charges charged for Cancelling Travel Ticket by way of train, bus, or air.

As per the intention of the law, the agreement should be expressly that of toleration of an act / situation which could trigger the levy of GST on a transaction. Tolerating non-performance of a contract for which consideration in the form of fines or liquidated damages are payable to any other entity would be considered as a supply of services and liable to GST @ 18% under Heading 9997, i.e. 'Other services' of GST Tariff on the number of liquidated damages.

According to CTR No. 12 of 2017 sr. 62, Services provided by the Government ("Central, State, 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 these "governments or local authorities" under such contract, are 'exempt supply' and GST is not applicable on such supplies.

The above further fortifies the views that the Government is very keen on taxing the liquidated damages as a service under the GST regime.

Under the above background, let us analyse some of the judicial pronouncements on the above issues:

## JUDGEMENTS:

1. LIQUIDATED DAMAGES:

A Liquidated damages clause specifies the amount of damages to be paid by the breaching party if it fails to perform specified obligations and otherwise in the event of certain types of breaches under the contract. In recent Advance Rulings, Liquidated damages have been considered as consideration and that by collecting the amount the assessee is tolerating the act of Non-Performance.

The Maharashtra Authority for Advance Ruling ("AAR") in the case of *Maharashtra State Power Generation Company Limited* ("Applicant") held that Goods and Services Tax ("GST") at the rate of 18% would be payable on liquidated damages ("LD") received by the Applicant for delayed supply under a contract.

The AAR has considered LD to be a consideration for agreeing to the obligation to tolerate an act or a situation, which is treated as a supply of service under para 5(e) of Schedule II of the Central Goods and Services Act, 2017 ("CGST Act") / Maharashtra Goods and Services Act, 2017 ("MGST")

Similar Rulings are made in the following AARs:

- *In North American Coal Corporation India Private limited (GST AAR Maharashtra); Advance Ruling No. GST-ARA-07/2018-19/B-63 DT 11/07/2018 = 2018 (10) TMI 1339 - AUTHORITY FOR ADVANCE RULING - MAHARASHTRA*

- *In Rashtriya Ispat Nigam Ltd (GST AAR Andhra Pradesh); Advance Ruling No. AAR 01/AP/GST/2019 DT. 11/01/2019 = 2019 (1) TMI 1668 - AUTHORITY FOR ADVANCE RULING, ANDHRA PRADESH*

- *In Dholera Industrial City Development Project ltd. (GST AAR Gujarat); Advance Ruling No. GUJ/GAAR/R/2019/06 DT 04/03/2019 = 2019 (8) TMI 1217 - AUTHORITY FOR ADVANCE RULING, GUJARAT*

- *In Bajaj Finance Limited (GST AAAR Maharashtra); Order No. MAH/AAAR/SS-RJ/24/2018-19 DT 14/03/2019 = 2019 (8) TMI 116 - APPELLATE AUTHORITY FOR ADVANCE RULING MAHARASHTRA*

**Judgment of the Hon'ble CESTAT, New Delhi in the case of M/s. South Eastern Coalfields Ltd. VS Commissioner of Central Excise, Raipur 2020-VIL-559-CESTAT-DEL-ST**

M/s SECL is charging & collecting amount in the name of compensation/penalty from the buyers of coal on the short-lifted/un-lifted quantity of coal & non-compliance of terms & conditions of coal supply agreements including forfeiture of EMD/SD. M/s SECL is also collecting amount in the name of compensation/penalty from the contractors engaged by them for providing various types of services viz. transportation, OBR. removal, etc. for breach of terms & conditions of the respective contracts, it is also noticed that SECL were also recovering/claiming amount in the name of liquidated damages from the material suppliers for breach of terms & conditions of the contracts. It was also stated that the appellant collects penalty (compensation) and forfeits security deposit/earnest money deposit for non-compliance of the terms of contract. **The Hon'ble CESTAT after a detailed analysis of the service tax provisions held that forfeiture of earnest money deposit and liquidated damages cannot be stated to have been received by the Appellant towards consideration for tolerating an act leviable to service tax under section 66E(e ) of the Finance Act, 1994.**

## 2. NOTICE PAY RECOVERY DIVERGENT VIEWS:

Notice recovery is the amount recovered by the employer from the employee if the employee leaves the job without serving the notice period. Usually, an option is provided to the employees that if they are not in a position to stay and serve out the notice period, then, the employee will be required to pay the equivalent pay of salary for the period for which notice was not served.

In *Syngenta India Limited*, a company engaged in the manufacturing of pesticides and various types of seeds, recovers money from employees if they leave the job without serving the complete notice period. The company offers various incentives to its employees as a part of the employment policy like a group insurance policy, parental insurance policy. For the same, it recovers the amount from employees.The company approached **Maharashtra authority for advance ruling (AAR)** on whether GST would be applicable on the amount recovered from employees by way of parental insurance and notice pay recovery. *The AAR ordered that GST would not be leviable on these kinds of recoveries.*

Earlier, in a matter related *Bharat Oman Refineries Ltd, Madhya Pradesh AAR* held that "relieving an employee without notice period or by accepting a shorter notice period" is a supply of service and hence *GST is applicable on payment of notice pay* by an employee to the employer.

Similar reliance has been placed in the case of *M/s. Emcure Pharmaceuticals Limited VS Maharashtra Authority.*

*Though the AAR of Maharashtra has come into the favour of no GST liability, there are instances where the AAR of other jurisdictions have different view. Thus, it is apt time for the CBIC to come up with a circular on these activities to avoid unnecessary litigation in near future.*

The Allahabad bench of the CESTAT in the matter of M/s. HCL Learning Ltd. vs. Commissioner of CGST, 2019-TIOL-3545 held that *"notice pay recovery is out of the salary already paid and we also note that salary is not covered by the provisions of service tax."*

*In our view, the definition in Clause (e) of Section 66E is not attracted to the scenario, the employer has not tolerated any act of the employee but has permitted a sudden exit upon being compensated by the employee in this regard.*

3. FORFEITURE ON CANCELLATION:

When a booking is done for a service or a commodity, the contract may provide for cancellation charges if the service is not availed or the commodity is not purchased for any reason. Can cancellation charges fall under Entry 5(e)?

M/s Lemon Tree Hotel vs, Commissioner, Goods and Service Tax

The Tribunal held that the retention of the amount on cancellation would not attract service tax under section 66E (e). The appellant, during their business of running a hotel, offers advance booking to its customers, on payment of rent or deposit. Sometimes in the event of cancellation or of no show i.e. if the guest does not come for stay, the appellants retains the full or part of the amount towards cancellation charges. Amount payable for breach of contract or breach of a term of a contract cannot be treated as the consideration for the contract per se, hence, would not be taxable under the GST regime. Cancellation charges are in the nature of forfeiture charges for the breach of the term in the contract and it is not necessary for the entire contract to be terminated. The breach of a specific term of the contract which results in hotel booking cancellation charges in the form of an identification of liquidated damages or penalty and does not have the character of consideration for it to be taxed under GST.

4. Compensation:

Where the Appellant receives compensation from a contractor due to short coming in service, the said compensation was held to be an amount to safeguard the loss of appellant by the New Delhi Bench of CESTAT in Ruchi Soya Industries Ltd. vs. Commissioner of CGST (2021). The sole purpose of imposing compensation or penalty is to ensure that the defaulting act is not undertaken or repeated and the same cannot be said to be towards "toleration of the defaulting party".The Tribunal observed that the compensation received does not make the appellant a service provider and most importantly, once the appellant receives the compensation for downfall in service quality, "it is because he is not inclined to tolerate the loss as he may suffer on account of the downfall."

## CONCLUSION:

From the above discussion what can be concluded is that there are divergent judgments on the scope of the entry of toleration of an act in Sch II to the CGST Act, 2017 and even after a half decade of the application of the GST law in the country, the taxpayers are living in an uncertain environment and with the audits going on in full force now for 2017-18, it is imperative we are looking for quite a good number of litigations in times to come.