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Analysing developments impacting business

IMPORTANT CLARIFICATION VIS A VIS GST ON PAYMENTS ARISING OUT OF CONTRACTUAL OBLIGATIONS LIKE NON-COMPETE FEES, LIQUIDATED DAMAGES, EARLY TERMINATION PENALTIES, LATE PAYMENT FEES ETC

5 August 2022

Introduction

Taxability of payments made under contractual obligations like non-compete fees, early termination charges, liquidated damages, notice pay payments by employees, cancellation charges, late payment charges etc have been a subject matter of debate under Goods and Services Tax ("GST") as well as service tax before that - a debate that has revolved around the interpretation of the words "Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act" (which have effectively been made part of the definition of 'service' / 'supply' under both GST and service tax laws).

Under service tax, several judgments from the indirect tax tribunal concluded favorably that such payments do not qualify as 'consideration' for any 'service' and thus would not be liable to service tax. Unfortunately, under GST, numerous advance rulings from across the country took a contrary position and held in favor of levy of 18% GST on all such payments; similar view has been taken almost across the board by GST officers.

This dichotomy led to multiple contractual disputes and significant contract negotiation time being spent on (i) whether or not GST ought to be factored vis a vis such payments; and (ii) which party will be responsible to bear the litigation risk, in case no such GST has been factored.

The Circular No. 178/10/2022-GST dated 3 August 2022 (the "Circular") clarifies the position vis a vis many such payments and tries to lay down an intelligible distinction between payments like liquidated damages and forfeiture of salary / payment of bond amount in case of an employee leaving employment before the minimum agreed period (which have been clarified to be non-taxable) versus payments like non-compete fees paid under an independent non-compete agreement, cancellation charges by a hotel / tour operator, late payment fees, etc (which have been clarified to be liable to GST).

It is interesting to note that like in the case of GST and service tax in India, similar disputes also arose under European Union Value Added Tax ("EU VAT") - in fact, even EU VAT went through a series of changes in positions vis a vis such payments in the last few years and the dust has somewhat settled only now. While the Circular does not specifically refer to judgements / clarifications under EU VAT, the positions as clarified in the Circular are largely consistent with the corresponding positions under EU VAT laws as they stand today.

Key clarifications

<p>Key types of payments that have been clarified to qualify as consideration for the services of "Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act" and thus liable to GST:</p>	<p>Key types of payments that have been clarified not to qualify as consideration for services and thus NOT liable to GST:</p>
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| <ol style="list-style-type: none"> 1. Non-compete fees paid under an independent non-compete agreement | <ol style="list-style-type: none"> 1. Liquidated damages |
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| <p>2. Compensation paid to a builder by the neighbouring housing project for refraining from constructing more than a certain number of floors, even though permitted to do so by the municipal authorities</p> | <p>2. Compensation for cancellation of allocated coal blocks vide Supreme Court order</p> |
| <p>3. Payment made to a shopkeeper by a hawker for operating from the common pavement in front of the shop</p> | <p>3. Fine or penalty charged for cheque dishonor</p> |
| <p>4. Payment by a residents' welfare association to an industrial unit in lieu of the said unit agreeing to install equipment for zero emission (even though the emission from the industrial unit was within permissible limits and there was no legal obligation upon the unit to do so)</p> | <p>4. Penalty imposed for violation of legal provisions</p> |
| <p>5. Late fee / penalty / surcharge for failure to make payment by a pre-agreed date between parties.</p> <p>Vis a vis such payments, it has also been clarified that even though these are being concluded to be taxable by describing the same as a service of tolerating the act of late payment, it is an ancillary supply naturally bundled and supplied in conjunction with the principal supply (such as of electricity, water, telecommunication, cooking gas, insurance etc.) and therefore should be assessed as the principal supply.</p> | <p>5. Forfeiture of salary or payment of bond amount in the event of an employee leaving employment before the minimum agreed period</p> |
| <p>6. Forfeiture of ticket amount / deposit /advance payment in the event of a 'no-show' by the passenger/ cancellation of package tour</p> | <p>6. Forfeiture of earnest money by a seller in case of breach of 'an agreement to sell' an immovable property by the buyer</p> |
| <p>7. Early termination fees / penalty for termination of a lease before a pre-agreed period</p> | <p>7. Forfeiture of earnest money by Government or local authority in the event of a successful bidder failing to act after winning the bid</p> |
| <p>8. Cancellation fees / charges for cancellation of services such as booking of hotel accommodation, an entertainment event or a journey</p> | <p>8. Penalties under mining laws for excess stock found with the mining company</p> |
| <p>9. Pre- payment penalty charged by banks if the borrower wishes to repay the loan before the maturity of the loan period</p> | <p>9. Payment of damages resulting from damage to property, negligence, piracy, unauthorized use of trade name, copyright, etc.</p> |

The rationale that can be gleaned from the Circular for differential GST treatment vis a vis different types of payments

The Circular has tried to lay down detailed reasoning behind the above clarifications and the same has been encapsulated below:

- As per the Circular, "Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act" has to be interpreted in light of the Indian Contract Act - there has to be a clear contractual obligation for one party to do something or to abstain from doing something and the other party to pay for the said act / abstinence.
- The Circular clarifies that while such contractual arrangement can take the form of a stand-alone contract or may form part of another contract, it must be an independent arrangement in its own right - payment needs to have been made for an independent activity of tolerating an act under an independent arrangement entered into for such activity of tolerating an act, to attract GST. If the payment is merely an event in the course of the

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performance of an agreement and it does not represent the 'object', as such, of the contract then it cannot be considered 'consideration'.

Also, such an agreement / contract cannot be imagined or presumed to exist just because there is a flow of money from one party to another.

- It has been clarified that payments such as liquidated damages, penalties for cheque dishonour etc cannot qualify as consideration for tolerance of a situation. Performance is the essence of a contract - these payments are rather collected only to compensate for injury, loss or damage suffered by the aggrieved party due to breach of the contract since a situation of breach is not being tolerated and is sought to be deterred. There can never be a contract / agreement between parties for a breach of that very contract.
- An example of the rationale as clarified by the Circular for reaching differential GST conclusions: Forfeiture of earnest money by a seller in case of breach of 'an agreement to sell' an immovable property by the buyer or by Government or local authority in the event of a successful bidder failing to act after winning the bid, has been clarified to be a mere flow of money, as the buyer or the successful bidder does not get anything in return for such forfeiture of earnest money.
 - ✓ On the contrary, forfeiture of security deposit in the event of cancellation of tour by the customer or early termination charges has been clarified to constitute consideration for the supply of a facility, namely, of acceptance of early termination of a lease agreement, or of making arrangements for the intended supply by the tour operator and are thus liable to GST.
- Specifically apropos cancellation fees, the Circular clarifies that the same can be considered as the charges for the costs involved in making arrangements for the intended supply and the costs involved in cancellation of the supply, such as in cancellation of reserved tickets by the Indian Railways. The Circular goes on to clarify that services such as transportation travel and tour constitute a bundle of services and the facilitation service of allowing cancellation against payment of cancellation charges is also a natural part of this bundle.

The above points need to be kept in mind while analysing and concluding vis a vis levy of GST in the context of real-world transactions.

Comments

The Circular is indeed a welcome development and should help mitigate contractual disputes / negotiation time vis a vis some of these payments; Especially in the context of payment of liquidated and other damages, this Circular should help in early disposal of pending litigations / arbitrations.

However, it may be argued that the rationale adopted doesn't seem to be consistent across the spectrum of transactions covered. While liquidated and other damages have been rightly clarified not to qualify as consideration for services of tolerance since contracting parties couldn't have agreed for a breach, it is not wholly clear as to why the same logic would not extend to forfeiture of security deposit in the event of cancellation of tour by the customer or early termination charges. After all, it can be argued equally strongly even in the context of such forfeiture / early termination charges that the contracting parties couldn't have agreed for a breach and the said forfeiture / early termination charges are compensation amounts to deter against such breaches (and not consideration for tolerating such breaches).

Further, there are aspects in the rationale that could have been better articulated - for example, while clarifying that a contractual agreement for 'tolerance' must be an independent arrangement in its own right, it could have been elaborated that, a mere 'condition in a larger contract' is different from an independent agreement of tolerance - this is a line of argument that has been blessed by various judgements in the context of service tax and is a more straightforward analytical framework to evaluate whether or not a particular contractual payment attracts GST. This omission may become particularly relevant vis a vis the question of levy of GST on non-compete obligations forming part of a larger contract for transfer of business / merger / demerger. There have been instances where GST authorities have tried to raise GST demands by artificially treating non-compete clauses (forming one of the conditions in such larger transactions) to be an independent contract of service of tolerance. While the Circular provides enough inferences against any such demand, this aspect could have been clarified more specifically.

Nonetheless, this Circular is indeed a step in the right direction.

The Way Forward

This Circular may necessitate the following points of review and analysis for taxpayers:

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- Review of payment streams in their financials / ongoing transactions which are similar in nature to the payments cover in this Circular and re-assessing / confirming GST positions taken thereon;
 - Reviewing pending litigations under service tax / GST apropos issues which can be said to be covered by the Circular and evaluate filing early hearing applications wherever possible
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