

# TAX FLASH NEWS

5 August 2022



## CBIC issues clarification on services of agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act

Taxability of an activity as supply of service of agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act (paragraph 5(e) of Schedule II to CGST Act, 2017) has been prone to multiple interpretations which has led to numerous litigations. In this regard, CBIC has issued a detailed circular<sup>1</sup> clarifying the scope of these services and associated services such as applicability of GST on liquidated damages, recovery from employee, compensation and penalty for breach law.

### Gist of clarifications

#### I. Scope of paragraph 5(e) of Schedule II to CGST Act, 2017

- Three sets of activities (i.e. obligation to refrain from an act, or to tolerate an act or a situation, or to do an act) must be under an agreement or a contract, whether express or implied.
- Consideration must flow in return from the other/second party to the contract/agreement to the first party for such refraining or tolerating or doing.
- Unless there is an express or implied promise by the recipient of money to agree to do or abstain from doing something in return for the money paid, it cannot be assumed that such payment was for doing an act or for refraining from an act or for tolerating an act or situation.

#### II. Taxability of associated transactions

Based on above parameters, CBIC has provided clarification on taxability of associated transactions which are described below:

#### Liquidated damages

- Where the amount paid as 'liquidated damages' is an amount paid only to compensate due to breach of the contract and there is no agreement, express or implied, by the aggrieved party receiving the liquidated damages, to refrain from or tolerate an act or to do anything for the party paying the liquidated damages, in such cases liquidated damages are mere a flow of money from the party who causes breach of the contract to the party who suffers loss or damage due to such breach.
- Such payments do not constitute consideration for a supply and are not taxable.

#### Compensation for cancellation of coal blocks

Compensation paid by Government for cancellation of coal blocks in accordance with Coal Mines (Special Provisions) Act, 2015 and directions of Supreme Court is not taxable.

#### Fine or penalty for cheque dishonor

- Fine or penalty that the supplier or a banker imposes for dishonor of a cheque is a penalty imposed not for tolerating the act or situation but a fine or penalty imposed for not tolerating, penalizing and thereby deterring and discouraging such an act or situation.
- Fine or penalty for cheque dishonor is therefore not a consideration for any service and thus not taxable.

<sup>1</sup> CBIC Circular No. 178/10/2022-GST dated 3 August 2022

## Penalty imposed for violation of laws

Penalty imposed for violation of laws is not a consideration for any supply and thus not taxable since there cannot be an agreement between Government and the violator specifying that violation would be allowed or permitted against payment of fine or penalty.

## Recovery due to premature leaving of employment

Forfeiture of salary or recovery of bond amount by the employer is not a consideration for tolerating the act of such premature quitting of employment but is a penalty for dissuading employees from taking up employment. Thus, these recoveries are not taxable.

## Surcharge or fee for late payment

Facility of accepting late payments with interest or fee, fine or penalty by supplier is an ancillary supply naturally bundled and supplied in conjunction with the principal supply. These payments are therefore to be assessed as principal supply and not as a service of tolerating the act of late payment.

## Fixed capacity charges for power

- The minimum fixed charges collected by power generating companies are not towards tolerating the act of not scheduling or consuming the minimum contracted or available capacity or a minimum threshold.
- Both the components of the price i.e. minimum fixed charges and variable charges are charged for sale of electricity and are thus not taxable as electricity is exempt from GST.

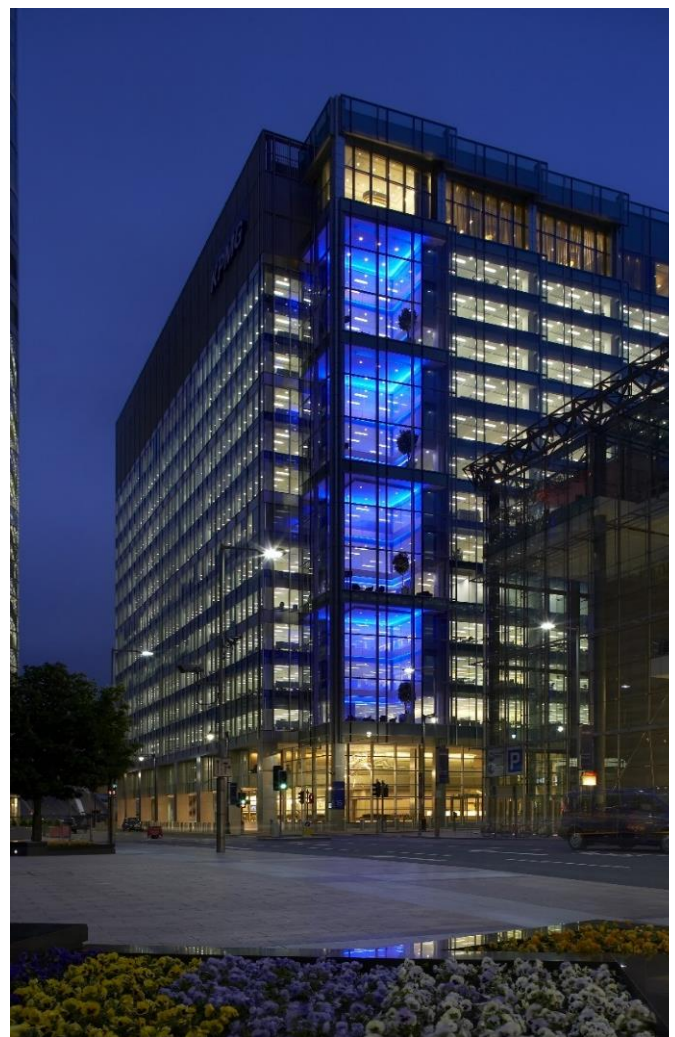
## Cancellation charges

- Facilitating supply of allowing cancellation of an intended supply against payment of cancellation fee or retention or forfeiture of a part or whole of the consideration or security deposit should be assessed at same rate as that of principal supply.
- Forfeiture of earnest money by a seller in case of breach of 'an agreement to sell' an immovable property by the buyer or such forfeiture by Government or local authority in the event of a successful bidder failing to act after winning the bid for allotment of natural resources is a mere flow of

of money as the buyer or the successful bidder does not get anything in return for such forfeiture of earnest money. Such payments are thus not taxable.

## Our comments

It is one of the most awaited circular and Government has provided much needed clarity on the contentious issue. The circular has clarified where the transaction cannot be treated as supply and also stresses on naturally bundled supplies. Business entities will have to reassess the positions taken earlier and will have to take corrective measures.



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