

Liquidated Damages

The issue circling around charging of tax in cases of 'Liquidated Damages' (LD) under Goods and Service Tax (GST) law has been an issue from the beginning of GST law coming into force as even in the earlier regime under Service tax (ST) the issue had cropped many times. With different school of thoughts giving views for and against charging GST on the said receipt of money.

Advance Ruling Authority, Maharashtra State in the case of '**Maharashtra State Power Generation Company Limited**' has given a rather disturbing view leading to further eruption of questions in regard to the matter by considering LD as separate supply under GST. It has brought LD under Entry no. 5 (2) (e) of Schedule II of GST Act vide SAC code 9997 (Other services) making it taxable at 18%. The Authority has taken a literal interpretation in the said case by taxing LD where specifically mentioned in contract and deductible from contract price to be supply under GST.

Further recent Advance ruling on time of supply on payment of GST on liquated damage

LD/68/112,2019-TIOL-479-AAR-GST (AAR- Andhra Pradesh) Rashtriya Ishpat Nigam Ltd. 11.01.2019

AAR held that time of supply for payment of GST on liquidated damages and other penalties for delay in supply of goods / services, is not the time when the delay is occurring. The time of supply shall arise at the time, when the payment of liquidated damages is determined after the delay in execution of work on part of contractor is established.

As per the judgement of above Advance ruling authority the following assertion can be made:

- 1. Liquidated Damages are treated as service**
- 2. GST is applicable in terms of clause 5 (e) of Schedule II of CGST Act**
- 3. There is no specific schedule entry for tax or for exemption**
- 4. S. No. 35 in Schedule in Notification No. 11/2017-CT (Rate) would cover levy of GST on liquidated damages**
- 5. Relevant HSN code will be 9997**
- 6. Applicable rate of GST on liquidated damages shall be 18% (CGST 9% and SGST9%)**

In the below paragraphs we shall try to analyse the above question on taxability of 'Liquidated Damages' or other similar payments. Let us elucidate the above question of taxability of LD under GST stepwise: -

What constitutes Liquidated Damages?

The Indian Contract Act, 1872 provides explanation vide section 73 & 74 in relation to unliquidated damages (UD) and LD from which it can be interpreted that the only difference between the two is UD does not provide the exact amount in the contract while in LD the exact amount of damages is provided in the contract for breach by other party. But the Court is at discretion to decide the actual compensation with regard to the loss suffered to be payable and where the amount claimed is exorbitant or dissuading it may be classified as penalty and not LD/UD.

Also we may consider ***The Black's Law*** Dictionary according to which,

"An amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches; also

If the parties to a contract have 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."

As per the above definition it may be interpreted that LD is pre-estimated damage, which parties agree while making the contract, as likely to arise in case of breach.

But mere breach will not constitute Liquidated Damages unless the loss suffered is proved as held by Delhi High Court in ***[Indian Oil Corporation Vs. Messrs Lloyds Steel Industries Limited; 2007 (144) DLT 659]***

Therefore, from above understanding it can be concluded that LD/UD is compensation for non-performance and not any separate supply. Further, penalty is nothing but high amount of compensation charged for loss suffered which also not intended as supply for tolerating an act.

What is Supply under GST law?

All forms of supply of goods and 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 of or furtherance of business.

Further it includes the activities to be treated as supply of goods or supply of services as referred to in Schedule II, Entry no.5, Clause (e) in the said schedule which reads as follows 'agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act' is supply which has been used as the entry under which LD has been made taxable.

Whether incurring loss be equated to toleration?

Schedule II begins with ***"Agreeing to the obligation to..."*** and then defines various acts such as *to refrain from an act, or to tolerate an act or situation, or to do an act.*

In order to invoke the above clause there needs to be consensus to tolerate, to enter into a contract agreeing to tolerate a situation which is not the case of Liquidated Damages. They occur as an unintentional event which both party intend to avoid but due to unforeseen events have to suffer the consequence as fixed in the main contract.

Considering the case of Lump sum turnkey (LSTK) contract, where delay in completion of projects leads to breach of contract entitling to reimburse the damages due to such occurrence. But over here none of the parties entered to tolerate such an act.

Mere receipt of Liquidated damages cannot be equated with supply of taxable services falling under Schedule II which gets invoked only where there is obligation in relation to such an act and the consideration as a consequence of the activity to tolerate.

Another example that would be considered to toleration of an act would be entering into a contract to not carry on any business, the restriction leads to tolerating the dominance and not carrying on business which would be considered as a separate contract of agreeing to tolerate.

But in the Maharashtra Advance Ruling, LD has been brought under Schedule II which would be pure unjust as it cannot be construed to entering into contract for tolerating an act but to ensure performance and not breach of contract. Further, to interpret LD as different supply is to read a contract to be entered for agreeing to breach.

Therefore, liquidated cannot be considered as Supply under GST.

International Jurisprudence

The view of not considering LD as supply for tolerating an act has been supported by various International Jurisprudence. We may refer,

- Ruling GSTR 2001/4 (GSTR 2003/11 issued by the **Australian Tax Office**, where it has been clarified that damage or loss or injury does not constitute a supply under the provisions of Australian GST.
- The **European Court of Justice** in the case of Societe Thermale v. Ministere de l'Economie [2007] S.T.I 1866, Celex No. 650J0277 has held that where the client exercises the cancellation option available to him as compensation for the loss suffered and which has no direct connection with the supply of any service for consideration, it is not subject to tax.
- The **Court of Appeal (UK)** in case of Vehicle Control Services Limited (2013) EWCA Civ 186, has said that payment in the form of damages/penalty for parking wrong places/ wrong manner is not a consideration for services as the same arises out of breach of contract with the parking manager.

To conclude LD should not be considered as separate supply liable to GST. Rather it is a form of compensation which is not taxable the same may be argued in higher authorities.

As per our view matters related to liquidated damages need more clarity. It would help the Industry if this controversy is put to rest by way of suitable clarification, else this could lead to litigation , given that there is merit in the position that GST should not be levied thereof.

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