Analysis of GST Implications in case of Breach of Contracts due to COVID-19

With the onset of Covid-19, the business disruptions, already faced and likely to be faced is giving corporate India sleepless nights. Amongst others, one cause of concern is the impact of the wide-scale defaults of the contractual obligations to be fulfilled during this pandemic. The uncertainty brought into by Covid-19 has raised doubts on the future course of action to be adopted by entities in light of serious commercial consequences arising out of Government restrictions, shut-down of industries, labour shortage, delays in supplies, cancellation of contracts etc.

Whilst we continue to deal with Covid-19 in our daily lives by social distancing, it is important to address the risks associated with the ongoing contracts due to the advent of this unprecedented pandemic.

Ideally, inability to perform the respective obligation should be examined qua the *'Force Majeure'* clause which is generally mentioned in all contracts. The term *'Force Majeure'*, also known as *cas fortuit* (French) or *casus fortuitus* (Latin), means 'superior force',[1]. Vide the clause of *Force Majeure* in a contract, both the parties are essentially provided reasons to justify non-performance thereof due to events arising beyond the control of the parties, such as war, strike, plague, Act of God etc. In the present case, one may contend that the pandemic of Covid-19 is as an 'Act of God' / 'plague' and invoke the *Force Majeure* clause to terminate the contract without being made liable for the loss caused to the other party by non-performance. However, this clause cannot be invoked as a standard defense in each and every contract. The steps taken to mitigate the non-performance of the contract and the manner in which *Force Majeure* is contractually defined would be crucial in determining whether a relief is warranted or not.

Alternatively, businesses may consider the relief provided under Section 56 of the Indian Contract Act, 1872 which deals with doctrine of frustration of a contract. This principle can be applied where the basic purpose of the contract is frustrated by the occurrence of an unspecified event, which was not contemplated by either parties. However, the party seeking relief from the loss caused to the other party may be required to substantiate the impracticability in performance of the contract, which has been caused due to circumstances beyond its control.

In view of the above, it is of utmost importance to study the contractual terms in detail from a perspective of Indian Contract Act, 1872 and other commercial and legal aspects in order to evaluate the likelihood of any liquidated damages to be borne due to non-fulfilment of contractual obligations.

Be that as it may and despite the above, considering the unprecedented times that businesses are facing, it is highly likely that various businesses may go into arbitration and be dragged to Courts for compensation of the losses incurred on account of the non-performance of the contract. While this would result in additional loss for businesses, it also needs to be examined as to whether there will be any Goods and Services Tax (GST) implications, which would add fuel to the fire.

To elucidate on this further, let us examine the position under the Central Goods and Services Tax Act, 2017 (CGST Act), which states that 'supply'[2] includes "*all forms of supply*". This prima facie implies that 'supply' can be considered to encompass everything in its sweep without any limitations whatsoever.

However, in order to qualify within the 'scope of supply', there should be a presence of an activity performed by the supplier, which is wanted or desired by the recipient. Such presence can be established by way of a

[1] Force Majeure – Definition from Wikipedia
[2] Section 7 of Central Goods and Services Tax Act, 2017 (CGST Act)

contractual relationship pursuant to which there is a reciprocal obligation between the parties. Hence, an element of *quid pro quo* is essential for any activity to qualify as a 'supply' and be liable to tax. Accordingly, the amount receivable under an Arbitration Award, needs to be tested on the nexus of reciprocity/ *quid pro quo* depending upon the contract.

As the GST legislation is in its nascent stage with very few rulings on issues therein, reference may be made to the international precedents on this issue. In the case of *GSTR 1/2004 Ruling*, it has been held that a damage, loss or injury, being the substance of the dispute, cannot in itself be characterized as a supply made by the aggrieved party. Further, in one of the rulings in Australia, it has been held that there must be a nexus between the payment awarded and the taxable supply. It has also been clarified that GST is levied on or in respect of supplies and is not a tax on receipts or on turnover but a tax on transactions. Therefore, it is necessary to distinguish between supplies and the taxable activity in the course of which they are made. Applying the principle laid down vide the said judgments, one may argue that since the amount awarded under the Contract does not relate to provision of any activity between the parties, it is not a 'supply' and is merely a Compensatory damage arising out of a Court order or termination of the contract. Hence, GST on receipt of an amount under an Arbitration Award may not be leviable.

However, the aforesaid position is highly litigious. In fact, in a few recent Advance Rulings, in the specific facts and circumstances of the said cases, the Tax authorities have been taking a view that payments under an Arbitration Award would be liable to GST as it amounts to *"agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act"* as per Clause (e) of Entry No. 5 of Schedule II of the CGST Act. In such a situation, it may be possible to contend that the amount under arbitration, being awarded with no obligation of a *quid pro quo* ought not be seen as a 'supply' under Section 7 of the CGST Act including Entry 5(e) of Schedule II thereof.

While an ideal scenario would be to term the non-fulfilment as being on account of *Force Majeure* or Frustration of a Contract, in cases where Arbitration award is finally granted for non-performance of the contract, one can only hope that GST does not add fuel to the fire.

Authors: Harsh Shah, Partner & Shreya Mundhra, Associate Manager, Economic Laws Practice

- *This article has been published by Tax Sutra*