



## GST CIRCULAR ON LIQUIDATED DAMAGES - OPPORTUNITIES IN CONTRACTS/CLAIMS

### SETTING THE CONTEXT...

On 3 August 2022, the Department of Revenue, Ministry of Finance issued its clarificatory Circular No. 178/10/2022-GST (“Circular”) which primarily addresses the taxability of liquidated damages and penalty. The basic principle emanating from the Circular is that there must be *necessary and sufficient nexus between the supply* (i.e agreement to do or to abstain from doing something or to tolerate an act) *and the consideration* to give rise to a taxable event.

The Circular lists several examples where GST would not be applicable on the amounts which are a *mere flow of money* to deter a breach (which would not amount to an agreement to abstain from doing something). It also lists several examples where GST would apply on the amounts (whether such amounts are termed as fine or penalty) which would be consideration for a supply (which is ancillary to the principal supply).

Basis the principles stated in the Circular, this article discusses the scope for revisiting contractual positions and particularisation of claims arising out of commercial contracts.

### CURATING CLAIMS

As the Circular is quite clear on the applicability of GST on liquidated damages, we consider aspects on which the Circular is silent, namely other claims that parties may have.

In a dispute arising from a construction contract, some of the common heads of claims include (i) claims for refund of deductions from running bills/ invoices, (ii) payment of amounts due and outstanding, (iii) change order/variation claims, (iv) delay claims (prolongation costs, disruption claims, acceleration claims, etc.), (v) claims for general damages and (vi) claims arising out of termination (While this article considers typical claims arising in a construction contract, it is relevant to note that the principles/observations below hold true for any commercial contract).

For (i) and (ii), as there is a supply element directly involved, GST would be applicable on the amounts claimed. For (iii), where the claim is for additional work performed, a similar conclusion may be reached. However, if the claim is for damages for unlawful descoping, the situation is not as straightforward. It may be arguable that since no supply was made, GST would not apply on the claimed amount (presumably the expected profits on the value of the descoped work). This would be heavily dependent on how the claim is structured and the factual matrix.

Whether GST would be applicable on delay claims is not entirely straightforward. This is because in a scenario where the claim is purely based on idling of machinery and equipment and the factual conspectus discloses that no supply occurred during such period of idling (for example, during a force majeure event), then there is a potential case to be made out that no GST should apply on the amount that may be eventually awarded. However, delay claims for extended stay often involve periods of reduced productivity rather than nil productivity. Since they are linked back to supply, it is arguable that the amounts claimed form consideration that flows from an implied agreement that parties would be



compensated for the decreased productivity. In fact, it could be considered consideration for tolerating the breach of the contract and therefore taxable.

While clarifying that liquidated damages would not attract GST, the Circular also seems to indicate a similar principle for general damages in paragraph 7.1, when it states that *“The compensation is not by way of consideration for any independent activity; it is just an event in the course of performance of that contract”*. The observation may not be universally applicable. It may hold true for a claim for compensation for failure to accept delivery of goods or services (loss of expected profits or market price damages) or a failure to perform the obligations (risk and cost claims). However, claims for loss arising from delayed payments or claims such as warehousing costs on account of delayed acceptance of delivery may be treated as consideration for a supply, ancillary to the principal supply, and hence, may attract GST.

With respect to claims arising from termination, the issue becomes even more complicated. The causation will certainly be a determinative factor, but so will be the nature of the claim. For example, compensation payable on account of termination for convenience may in fact be construed as cancellation fee (see paragraph 11 of the Circular), as the facilitation service of allowing such termination against payment of termination charges, may be considered as a natural bundle of services that are being supplied. However, a termination payout for breach could amount to mere flow of money that was stipulated to deter a breach. In a termination on account of continuing force majeure, since the claim would only pertain to payment for work performed, GST may be attracted.

Evidently, the characterization of the claim, be it at the stage when the claim is preferred during the contractual period or post contract, becomes critical for the purposes of understanding applicability of GST. There apart, at the stage of presentation of pleadings, it may also become relevant to understand on what heads one should claim GST (and interest) in addition to the quantified amounts.

In light of this Circular, it may also be interesting to see how arbitral tribunals deal with the applicability of GST on claimed amounts in the arbitral awards and how the tax authorities would treat the arbitral tribunal’s award.

## REVISITING THE CONTRACT

The Circular provides opportunities for tax planning through a surgical modification of the terms and conditions of the commercial contract. Payment events in a typical commercial contract can be innumerable. Some of these include advance payments (whether or not secured through advance bank guarantees), payment of running bills, payment of final bills, retention amounts and release thereof, penalties and fines, liquidated damages, delayed payment charges, force majeure costs, suspension costs, price escalation payments, indemnity and termination payouts.

Some of the above are directly linked to the supply and others may be categorized as ancillary to the supply or consideration for the natural bundle of obligations associated with such supply. Other events are entirely de hors the supply, or do not qualify as consideration for tolerance of act/omission/breach.

Succinct redrafting of the clauses linked to such payment events can enable parties to plan and optimize their tax strategies in advance. Often, due to imprecise language or a lack of tax planning, even payment events that are ordinarily not forming consideration for supply may end up becoming taxable events. Equally so, over zealousness in tax planning could lead to contractual complications. By way of example, interest on delayed payments may ordinarily be liable to GST. A potential recasting of such a clause to



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reflect an intention to deter a party from delaying payments may rescue such amounts from applicability of GST. At the same time, such revised clause may overstep the thresholds of reasonableness under section 74 of the Indian Contract Act, 1872, leading it to be struck down and negating its very purpose.

While the Circular obviously will result in refund applications in cases where GST liability has been imposed in disregard of the principles as laid out therein, it also acts as an important guide for contract draftsmen and dispute resolution practitioners. Tax planning and claim management can now be executed using the markers laid down in the said Circular.

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*-This article is published on Mondaq*