Damages have become less damaging

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The Government of India has issued the much-awaited clarification (vide Circular No. 178/10/2022-GST dated 3rd August 2022) on what could get covered as a 'supply' under the entry of *"Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act"*. The entry has been a subject matter of deliberation and dispute since its introduction under the service tax regime, which then continued into the GST regime.

The key question for determination has been that when a Party (say 'A') recovers compensation or damages or cancellation charges from another Party (say 'B') for non-performance or any breach of contract by it, then is that non-performance or breach a separate independent supply of 'tolerating an act' by Party A, and consequently whether GST is applicable.

The Circular clarifies that the following key aspects would be determinative of whether GST applies:

- There is a contract [express or implied] between parties for a consideration – A contract to do something or to abstain from doing something cannot be said to have taken place unless there are two parties, one of which expressly or impliedly agrees to do or abstain from doing something and the other agrees to pay consideration to the first party for doing or abstaining from such an act.
- There cannot be said to be a contract where a party agrees to tolerating a breach or to an illegal act or violating the provisions of law.
- There must be a necessary and sufficient nexus between the supply (i.e., agreement to do or to abstain from doing something) and the consideration.
- An agreement to do an act or abstain from doing an act or to tolerate an act or a situation cannot be imagined or presumed to exist just because there is a flow of money from one party to another.
- The amounts are recovered as a deterrent to avoid the event – if yes, they cannot be considered as consideration.
- The recoveries arise out of mere events in the contract and are not an independent supply.
- The recoveries are to compensate for the loss / damage that has been incurred.
- There is no option but to bear / tolerate the act when it happens (such as cancellation of coal block by the Government or dishonour of cheque)
- The other party does not get anything in return.

Basis the above principles, it is clarified that that amount received towards liquidated damages, compensation for cancellation of coal blocks, cheque dishonor fine/ penalty, penalty imposed for violation of laws, forfeiture of salary or payment of bond amount from employee on leaving the employment before minimum agreed period, is not liable to GST. The recoveries / payments are not made for tolerating an act, rather, they are amounts for not tolerating the act or a situation.

Another aspect that has been clarified are of instances where amounts received are not to be treated as damages or penalty for breach or amount towards refraining from an act, however, are liable basis the taxability or the tax rate applicable to the dominant or principal service. In such case, if the service is exempt or not liable, the question of levy of GST on such recoveries do not arise. The specific instances that have been clarified are compensation for not collecting toll charges (user of service remains toll charges – which is exempt), late payment surcharge fee (taxable as principal

supply), fixed capacity chargers for power (are charges for electricity which is exempt) and cancellation charges (such as cancellation charges train / flight tickets – liable at the rate at which the class booked is taxable).

Industry Impact and Way forward

The Clarification issued has aptly distinguished between a situation where two parties, whether by way of an express or implied contract, agree to tolerate an act, or an obligation to do an act or refrain from doing act in lieu of agreed consideration (such as a non-compete agreement) ***versus*** a situation where the flow of money is not arising out of a contractual quid pro quo between the parties, but is a compensation / penalty or charges to be recovered from another party for the loss / damages that it might have incurred consequential to the breach or a non-performance. Consequently, in every contract, the key question for determination would be whether payments received constitute consideration for another independent contract envisaging tolerating an act or situation or refraining from doing any act or situation or simply doing an act. If the answer is yes, then it constitutes a 'supply' within the meaning of the Act, otherwise it is not a "supply."

In this context, a key aspect that needs to be evaluated is whether the contracts in place communicate the proper characterisation of the payments to be made under the contract e.g., whether the payment say for damages under the contract is arising out of a breach or is it for amounts payable say arising out of a force majeure and not a breach – will the taxability defer. The true nature and essence of the payment becomes critical here. Also, there could be instances where the contract provides for series of payments, such as consideration for a supply, or delayed payment charges or penalty for termination of a contract or waiver of payments etc some of which could be taxable and some not. It would become important to differentiate between each of the aspects while drafting the contract and demarcate amounts individually – either immediately or subsequently. The same would also apply while for any claim in a litigation or any arbitration claim filed by the parties. Where such amounts are not broken up, there will be another debate on whether the supplies are mixed supply or composite supply and if composite supply, and what is the dominant intent.

Also, now that the position on taxability stands clarified by the circular, it is important for companies to have a re-look at their past positions and assess the future course of action. Where the amounts are not liable basis the principles laid down in the circular, companies should immediately correspond with their employer/customers indicating the new position on applicability of tax. At this stage, it is to be noted that since GST is not attracted basis that there is no supply or that amount received is not consideration, there will also not be any reversal of credit (as the same is not an exempt supply).

There will be a need to carry out system changes for recoveries such as late payment charges or cancellation charges etc. which may either become non-taxable if principal supply is exempt or may now become liable at a lower rate of tax applicable to the principal supply. Additionally, there could be some loss of credit arising out of enhancement in reversal for common services.

For past instances, where the supplier has paid GST, filing of a refund claim can be evaluated in instances where the company has not recovered GST from the recipient (e.g., amount recovered

from employee for his early exit) or where a company being a recipient has been charged GST and has borne the burden of tax. The refund would be available subject to the bar of unjust enrichment. Companies will also have to analyse whether such refund claims are barred by limitation. Needless to also mention that where any litigation is pending on the subject matter, the same should be dealt with expeditiously either by filing additional submissions and / or requesting for an early hearing in the matter.

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