

## Clarification regarding GST applicability on liquidated damages, compensation and penalty arising out of breach of contract or other provisions of law

[Circular No. 178/10/2022-GST dated 03.08.2022](#) is issued to clarify the scope of Entry 5(e) of Schedule II of the Central Goods and Services Tax Act, 2017 (hereinafter referred to as "CGST Act") and to examine the applicability of GST on payments in the nature of liquidated damages, compensation, penalty, cancellation charges, late payment surcharge, etc. arising out of breach of contract or otherwise.

Schedule II of the CGST Act provides for activities to be treated as supply of goods or supply of services. Entry 5(e) of the said schedule which is treated as a supply of service reads as under:

*"(e) Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act;"*

The above entry considers three sets of activities as a supply of service:

- 1) Agreeing to the obligation to refrain from an act;
- 2) Agreeing to the obligation to tolerate an act or a situation;
- 3) Agreeing to the obligation to do an act.

The Circular provides that for any of the above activities to get covered under the ambit of Entry 5(e), the activities must be covered specifically under an "agreement" or a "contract" (whether express or implied) i.e. one of the parties to such agreement/ contract must be under a contractual obligation to either (a) refrain from an act, or (b) to tolerate an act or a situation or (c) to do an act.

Further, some "consideration" must flow in return from the other party to the first party. Such a contractual arrangement must be an independent arrangement in its own right. In such a scenario, first party can be said to be making supply by way of refraining from doing something or tolerating some act or situation or doing something to another person, if the first party was under an obligation to do so and then performed accordingly

The Circular further clarifies that just because there is flow of money from one party to another under an agreement the same cannot be presumed to be against doing or abstaining from doing an act or against tolerating an act or situation. It states that unless a payment has been made for an independent activity

of tolerating an act under an independent arrangement entered into for such activity of tolerating an act, the payment will not constitute 'consideration' and hence, such activities will not constitute 'supply' within the meaning of the Act.

Through the said Circular, taxability in respect of various transactions has been examined and clarified. The same has been tabulated as under:

Sr. No.	Transaction	Taxability
1	Liquidated damages for breach or non-performance of contract	<p>Breach or non-performance of contract by one party results in loss or damages for other party. Thus, it is common for the parties, to specify in the contract itself, the compensation would be payable in event of breach of contract.</p> <p>It is stated that performance is the essence of a contract. Liquidated damages cannot be said to be a consideration received for tolerating the breach or non-performance of contract. They are rather payments for not tolerating the breach of contract. Payment of liquidated damages is stipulated in a contract to ensure performance and to deter non-performance, unsatisfactory performance or delayed performance. It is further stated that a contract is entered into for execution and not for its breach. The liquidated damages or penalty are not the desired outcome of the contract. By accepting the liquidated damages, the party aggrieved by breach of contract cannot be said to have permitted or tolerated the deviation or non-fulfilment of the promise by the other party.</p> <p>Liquidated damages are an amount paid only to compensate for injury, loss or damage suffered by the aggrieved party 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 a mere flow of money from the party who causes breach of the contract to the party who suffers loss or damage due to such breach.</p> <p><b>Such payments do not constitute consideration for a supply and are not taxable.</b></p>
2	Compensation for cancellation of coal blocks	<p>In 2014, the coal block/ mines allocations were cancelled in pursuance of Hon'ble Supreme Court order in lieu of certain compensation to be paid by the Government. Since there was no prior agreement/ promise between the allottees and the Government that the allottees shall agree</p>

Sr. No.	Transaction	Taxability
		to tolerate cancellation of coal blocks if Government pays compensation, <b>the same cannot be treated as consideration for providing taxable supply.</b>
3	Cheque dishonour fine/ penalty	When a supplier supplies any goods/ services, it is against a promise that recipient shall make payment within agreed time through valid instrument. There is never an implied or express offer or willingness on part of the supplier to accept an invalid instrument. The charges/ penalty levied is not for tolerating the act/ situation but for not tolerating and thereby deterring and discouraging such an act.  <b>Thus, the fine/ penalty is not a consideration for any services and not taxable.</b>
4	Penalty imposed for violation of laws	Penalty imposed for violations of laws such as traffic violations, or for violations of pollution norms or other laws or fines/ penalties imposed under any act cannot be considered as consideration for any supply received. These are penalties levied under various laws and laws are not framed for tolerating violations. Also, there is no agreement between the Government and the violator specifying that violation would be allowed against payment of fine/ penalty.  <b>Thus, fines and penalties would not be taxable under GST.</b>
5	Forfeiture of salary on payment of bond amount in the event of the employee leaving the employment before the minimum agreed period	Premature leaving of employment results in disruption of work and undesirable situation. The provisions of forfeiture of salary or recovery of bond amount are incorporated in contract to discourage non-serious candidates from taking up employment. The said amounts are recovered by the employer not as a consideration for tolerating the act of such premature quitting of employment but as penalties for dissuading the non-serious employees from taking up employment and to discourage and deter such a situation.  <b>Therefore, such amounts recovered by the employer are not taxable as consideration for the service of agreeing to tolerate an act or a situation.</b>
6	Compensation for not collecting toll charges	During the period 08.11.2016 to 01.12.2016, NHAI directed toll operators to allow free access of toll roads. The loss of toll amount was compensated by NHAI. The fact that, during this period, the consideration was received from a person other than the actual user, it did not alter the service and hence, <b>the same would not be taxable.</b>

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7	Late payment surcharge or fees	It is an ancillary supply naturally bundled and supplied in conjunction with the principal supply such as of electricity, water, telecommunication, cooking gas, insurance, etc. Therefore, the late payment surcharge or fees <b>should be assessed at the same rate as the principal supply.</b>
8	Fixed Capacity charges for Power	<p>The price charged for electricity by the power generating companies from individual customers has two components namely a minimum fixed charge and variable per unit charge.</p> <p>Minimum fixed charges remaining the same irrespective of whether electricity is consumed or not or it is scheduled/ consumed below the contracted or available capacity or a minimum threshold, does not mean it is a charge for tolerating the act of not scheduling or consuming the minimum contracted or available capacity or a minimum threshold.</p> <p><b>Both the components of the price, the minimum fixed charges/ capacity charges and the variable/ energy charges are charged for sale of electricity and are thus, not taxable as electricity is exempt from GST.</b></p>
9	Cancellation charges	<p>It is a common business practice for suppliers of services such as hotel accommodation, tour and travel, transportation, etc. to provide the facility of cancellation of the intended supplies on payment of cancellation fee. Cancellation fee can be considered as charges for the costs involved in making arrangements for the intended supply and the costs involved in cancellation of the supply.</p> <p>The facilitation service of allowing cancellation against payment of cancellation charges is invariably supplied by all suppliers as naturally bundled and in conjunction with the principal supply and therefore, <b>should be taxable at the rate of principal supply.</b> For e.g. cancellation charges of railway tickets for a class would attract GST at the same rate as applicable to the class of travel (i.e., 5% GST on first class or air-conditioned coach ticket and nil for other classes such as second sleeper class). <b>Same is the case for air travel.</b></p> <p>Accordingly, the amount forfeited in the case of non-refundable ticket for air travel or security deposit, or earnest money forfeited in case of the customer failing to avail the travel, tour operator or hotel accommodation service or such other intended supplies should be assessed at the same</p>

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		<p>rate as applicable to the service contract, say air transport or tour operator service, or such other services.</p> <p>However, forfeiture of earnest money by a seller in case of breach of 'an agreement to sell' an immovable property by the buyer or 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 money. Forfeiture of earnest money is stipulated in such cases not as a consideration for tolerating the breach of contract but as a compensation for the losses suffered and as a penalty for discouraging the non-serious buyers or bidders.</p> <p>Such payments being merely flow of money are not a consideration for any supply and are not taxable.</p>

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