GST Alert:

Summary of Circular No. 178/10/2022-GST – GST implications on liquidated damages, notice pay recovery, penalty etc.

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The Central Board of Indirect Taxes and Customs ('CBIC') issued ***Circular No. 178/10/2022-GST*** *dated August 3, 2022* to clarify certain issues pertaining to applicability of Goods and Services Tax ('GST') on liquidated damages, penalty imposed for violation of laws, notice pay recovery etc.

We have summarized the circular below for ease of understanding.

Circular No. 178/10/2022-GST

As per **Entry 5(e) of Schedule II of the Central Goods and Services Tax Act, 2017**, ('the CGST Act, 2017') *"Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act"* is specifically declared as a supply of service.

However, the description of entry 5(e) of Schedule II of the CGST Act, 2017 is similar to the definition of 'Contract' as per the Contract Act, 1872 which is defined as a set of promises, forming consideration for each other.

Accordingly, 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 must be a necessary and sufficient nexus between the supply (i.e. agreement to do or to abstain from doing something) and consideration.

This circular clarifies the applicability of GST on the scope and ambit of *"Agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act"*. The taxability on certain transactions is summarized below:

Event	Taxability
Liquidated damages • Liquidated damages is not a consideration that is received for tolerating the breach or non-performance of contract. • The consideration received is for not tolerating the breach or non-performance of contract. • The amount paid as 'liquidated damages' is an amount paid only to compensate for injury, loss or damage suffered by the aggrieved party due to breach of the contract. • There should be 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 mere a flow of money from the party who causes breach of the contract to the party who suffers loss or damage due to such breach. • Such payments do not constitute consideration for a supply and are not taxable. For instance: - Damages resulting from damage to property, negligence, piracy, unauthorized use of trade name, copyright, etc. - Penalty demanded in a contract for delayed construction of houses. - Forfeiture of earnest money by a seller in case of breach of 'an agreement to sell' an immovable property by the buyer/ government/ local authority in case of a bid. • However, if amount is paid for acceptance of late payment, early termination of lease, pre-payment of loan, amounts forfeited on cancellation of service by the customer as contemplated by the contract as part of commercial terms agreed to by the parties, shall constitute consideration for the supply. • Therefore, such payments, even though they may be referred to as fine or penalty, are actually payments that amount to	Not taxable *(The key element in such cases is to consider whether the impugned payments 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'.)*

consideration for supply and are subject to GST, in cases where such supply is taxable.	
Cheque dishonor fine/ penalty • The fine/ penalty imposed by the supplier or a bank, for dishonor of a cheque, is a penalty imposed not for tolerating the act or situation. It is on the contrary imposed for not tolerating a particular act, penalizing and thereby deterring and discouraging such an act or situation. • Therefore, fine/ penalty imposed for dishonor of cheque is not a consideration for any service and hence not taxable.	Not taxable
Penalty imposed for violation of laws • Penalty imposed for violation of laws like traffic violation, pollution norms violation, mining excess mineral beyond the permissible limit etc. is not a consideration charged by Government for tolerating violation of laws. On the contrary the same is imposed for not tolerating such violations. • There is no such agreement between the Government and the violator specifying that violation would be allowed or permitted against payment of fine/ penalty. • In the erstwhile regime, such fines and penalties charged by Government or a local authority for violation of a statute, bye-laws, rules or regulations were not liable to tax. • Accordingly, department has taken the same stand from a GST perspective and hence such fines/ penalties are not taxable.	Not taxable
Forfeiture of salary or payment of bond amount in the event of the employee leaving the employment before the minimum agreed period • The provisions for forfeiture of salary or recovery of bond amount in the event of the employee leaving the employment before the minimum agreed period, are incorporated in the	Not taxable

employment contract to discourage non-serious candidates from taking up employment. • The said amount is recovered by the employer not as a consideration for tolerating the act of such premature quitting of employment but as penalties to discourage the non-serious employees from taking up the employment offer and to deter such a situation. • In such cases, the employees do not get anything in return from the employer against payment of such amounts. • Therefore, such amounts recovered by the employer are not taxable as consideration for the service of agreeing to tolerate an act or a situation.	
Late payment surcharge or fee • The facility of accepting late payments with interest or late payment fee, fine/ penalty is a facility granted by supplier which is naturally bundled with the main supply. For instance, - Late payment fee pertaining to electricity, water, telecommunication services etc. • Even if the service is described as a service of tolerating the act of late payment, it is an ancillary supply naturally bundled and supplied in conjunction with the principal supply. • Hence, it should be assessed at the same rate as the principal supply.	To be treated as per the taxability of the principal supply
Cancellation charges • A supply contracted for, such as booking of hotel accommodation, entertainment event etc. may be cancelled by a customer or may not proceed as intended due to his failure to show up for availing the same at the designated place and time.	To be treated as per the taxability of the principal supply

• In this case, the supplier may allow cancellation of supply by the customer within a certain specified time period on payment of cancellation fee as per commercial terms of the contract. • The facilitation service of allowing cancellation against payment of cancellation charges is a natural part of the bundle and is supplied in conjunction with the principal supply in the ordinary course of business. • Therefore, facilitation supply of allowing cancellation of an intended supply against payment of cancellation fee/ retention/ forfeiture of a part or whole of the consideration or security deposit should be assessed as the principal supply. • 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 rate as applicable to the service contract.	

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