

BRIEF ANALYSIS OF CLARIFICATION ISSUED ON TAXABILITY OF LIQUIDATED DAMAGES, COMPENSATION AND PENALTY ARISING OUT OF BREACH OF CONTRACT OR OTHER PROVISIONS LAW

The CBIC has released detailed clarifications vide Circular No. 178/10/2022 dated August 03, 2022, to clarify certain Goods and Services Tax ('GST') related issues/concerns/doubts.

The said circular has in detail discussed the ambit of para 5(e) of Schedule II to CGST Act, 2017 and have observed that agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act has been specifically declared to be a supply of service in para 5(e) of Schedule II and has following three limbs:

- a. Agreeing to the obligation to refrain from an act
- b. Agreeing to the obligation to tolerate an act or a situation
- c. Agreeing to the obligation to do an act

It is highlighted that the said circular has acknowledged the fact that all above mentioned three activities must be under an "agreement" or a "contract" (whether express or implied) to fall within the ambit of the said entry.

We have tabulated below a summary of key clarifications, for your ease of reference:

S.No.	Issues	Clarification	Status
1.	Forfeiture of salary or payment of bond amount in the event of the employee leaving the employment before the minimum agreed period.	It has been clarified the activities such as forfeiture of salary or payment of bond amount in the event of the employee leaving the employment before the minimum agreed period is not a compensation for loss suffered by the employer due to premature leaving of the employment by the employee. Rather, it is to discourage non-serious candidates from taking employment and to discourage or deter such situations. Therefore, amount recovered is not a consideration. Consequently, it fails to take colour of the supply and thereby, not leviable to GST	Non-taxable
2.	Cancellation Charges	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 within a certain time period 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 the cancellation of the supply. Therefore, the facility to allow the cancellation is an intended supply against payment of consideration and hence, taxable under GST.	Taxable if main supply is taxable

3.	Cheque dishonour fine/ penalty	The fine or penalty that the supplier or a banker imposes, for the dishonor of a cheque, is a penalty imposed not for tolerating the act or situation but a fine, or penalty imposed for not tolerating, penalizing, and thereby deterring and discouraging such an act or situation. Therefore, a cheque dishonor fine or penalty is not a consideration for any supply and thus are not taxable under GST.	Non-taxable
4.	Penalty imposed for violation of laws	Penalty imposed for violation of laws such as traffic violations, or for violation of pollution norms or other laws are also not consideration for any supply received and therefore, are not taxable under GST.	Non-taxable
5.	Penalty paid by builder for delayed construction of house/flat	Such penalty has been paid for delayed construction and not for getting anything in return from the buyers. Therefore, it does not constitute a consideration for another independent contract and hence, falls outside the scope of supply.	Non-taxable
6.	Late payment surcharge or fee	It is a facility granted by supplier naturally bundled with the main supply and therefore should be assessed at the same rate as the principal supply.	Taxable if main supply taxable
7.	GST applicability on Liquidated Damages.	'Liquidated damages' represents consideration paid only to compensate for injury, loss or damage suffered by the aggrieved party due to breach of the contract and if 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, then liquidated damages are merely flow of money from the party who causes breach of the contract to the party who suffers loss or damage due to such breach. CBIC circular clarifies that the payments received in the form of 'liquidated damages will not be treated as 'consideration' for a supply.	Non-taxable
8.	Fixed capacity charges for power.	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.	Non-taxable
9.	Compensation paid by government on cancellation of coal blocks/ rights to extract coal from a mine	There was no prior promise by government that govt will pay compensation on such cancellation of coal blocks to the allottee.	Non-taxable