

Taxation of Damages-“Damages paid for Breach of Contract to attract GST”



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Noida, Delhi-NCR, INDIA

Performance is the essence of a contract and hence parties to contract generally incorporate their expectation in terms of damage caused by failure of either party to perform its obligations completely or as per the agreed terms.

The contract may prescribe damages for deficiency in the performance of contract known as 'liquidated damages'. It is to dissuade unsatisfactory performance or non-performance. For instance, contracts state that time is the essence of contract, and any delay invites say, 1% of the value of the contract for every week of delay and the like. Similarly, it is common to forfeit earnest money deposit (EMD) from a bidder in case he wins the bid but fails to act thereafter. This forfeiture clause is a deterrent for non-serious bidders entering the fray. Other examples may be rent for delay in lifting goods; agreeing to shoulder testing charges for samples to meet standards; cost of removing rejected goods, etc.

Payment of damages or the forfeiture of deposit does not retribute the person to whom loss or damage is caused. Liquidated damages are in nature of a measure of damages to which parties agree, rather than a remedy. By charging damages or forfeiture, one party does not accept or permit the deviation of the other party. It is an expression of displeasure. Liquidated damages cannot be said to be the desired income or result of the contract.

However, the Authority for Advance Rulings (AAR) has ruled that payments in respect to non-performance of a contract would be liable for Goods & Service Tax (GST). This view is based on the provisions under the erstwhile Service Tax Law, “agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act” was a declared service under Section 66E(e) of Finance Act, 1994. Similar provision has been incorporated in Central Goods and Services Tax Act, 2017 (CGST Act) also under Schedule II. Under GST law, the taxable event is supply which has been defined widely and includes all forms of supply for a consideration which is made in course of or in furtherance of business. The act of tolerance or agreeing to refrain from an act is treated as supply of service under the CGST Act. As per these provisions there should be an agreement between the parties to either refrain from doing an act, or to tolerate an act/situation or to do an act.

The Maharashtra Authority for Advance ruling (AAR) has stated that liquidated damages paid on operation & maintenance and erection & commissioning contracts. Entered by the applicant- Maharashtra State Power Generation Company- shall be taxable under GST @ 18%. The Authority has concluded liquidated damages to be a deemed service, covered under the phrase ‘agreeing to tolerate an act or situation’ under Para 5 of Schedule II of GST Act.

Any activity to be taxable under GST, requirement of 'supply' and the consequent 'consumption' should be met.

However, liquidated damages may hardly satisfy the essentials of supply or service. As discussed above the purpose of agreeing to payment of liquidated damages is to ensure performance. It cannot be said to be a consideration for tolerating non-performance. The provisions of law cited above thus cannot be applied to situations where the contract does not want delay in performance rather says that time is the essence of the contract. When the aggrieved party receives damages from the defaulting party it cannot be said that the aggrieved party is tolerating the non-performance or delayed performance.

The view supporting Service Tax liability on liquidated damages and forfeiture was based on the premise that the party had 'tolerated' the non-performance. A contract cannot be read to be agreeing to a breach of a contract. A breach of contract is not tolerated and that is why an amount is imposed to deter breach. The contract is for execution and not for the breach

Damages for breach of contract can be considered as business expenditure in commercial transactions. If a contract is not executed because its execution would result in loss, damages paid for its breach are deductible as business expenditure.

There has to be a distinction between amount payable for breach of contractual terms, or delay in performance, and something specifically agreed upon for forbearance or tolerance of an act like a noncompete fees.

Though rulings by the AAR are case specific, they have a persuasive impact on tax assessment in cases of other firms under similar circumstances.

It is high time that the Government clarifies the issue with an illustrative list of what constitutes tolerance of an act, as the present ruling of AAR can lead to lot of litigation, particularly has made multinational companies, especially those executing infrastructure projects, and the mining sector jittery, and it could have implications on mergers & acquisitions along with franchise arrangements too.

For any clarification, please feel free to connect with us at admin@equicorplegal.com / 08448824659.



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