

MAY 2018

GOODS AND SERVICES TAX ON LIQUIDATED DAMAGES

1. INTRODUCTION

The Maharashtra Authority for Advanced Ruling (the “AAR”) recently held in an advance ruling that goods and services tax (“GST”) is applicable on liquidated damages imposed on delayed performance or non-performance of contracts executed in relation to certain services.¹

The decision comes in response to the application (the “Application”) for advance ruling made by the Maharashtra State Power Generation Company (the “Applicant”) under section 97 of the Central Goods and Services Act, 2017 (the “GST Act”).

2. THE RULING

Under section 97 and section 100 of the GST Act, any person may obtain an advance ruling from the relevant authorities (the Authority for Advance Ruling and/or the Appellate Authority) on one or more questions in relation to the supply of goods or services (or both) being undertaken or proposed to be undertaken by such applicant.

Pursuant to the Application, the Applicant had, among other things, sought clarification from the AAR on whether the recovery of liquidated damages from a contractor, would amount to a ‘supply’ of goods or services under the GST Act and consequently attract GST.

The AAR ruled that the consideration amount and liquidated damages are two different parts of a transaction and cannot be considered a consolidated ‘supply of service’.

Further, the AAR held that an adjustment of the original consideration to the extent of liquidated damages is a mere facilitation in terms of accounting, which should not affect the valuation of the services involved.

However, it was further held that the impugned liquidated damages constituted income of the Applicant against bearing the delay or non-performance by the contractor and hence, should be construed a deemed ‘supply of service’ by the Applicant under entry 5(e) of Schedule II to the GST Act, attracting GST at the rate of 18% (eighteen percent) as *Other Services*.

¹ https://mahagst.gov.in/sites/default/files/ddg/GST-ARA%20ORDER_MAHA%20STATE%20POWER%20GEN%20CO%20LTD.pdf

INDUSLAW VIEW

The payment of liquidated damages has been held subject to GST as a ‘supply of service’ falling under entry 5(e) of Schedule II to the GST Act, which covers “agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act”.

In our view, payment of liquidated damages is not *consideration* for the recipient of the services to refrain from any act or tolerate any act. Instead, liquidated damages are paid as *compensation* for the losses arising from a breach.

It is worthwhile to note that an identical provision was found in section 66E(e) of the Finance Act, 1994. However, legal commentators were divided on the question of whether service tax was chargeable on liquidated damages under the previous regime.

The levy of GST is based on the component of ‘supply’, which we do not find in the case of liquidated damages. The AAR has taken an extremely aggressive view to consider the tolerance of delay or the failure to deliver services by a service provider or contractor to be a ‘supply of service’.

Parties to an agreement do not agree for a breach of the contract, but for the performance of the contract. Liquidated damages are a genuine pre-estimate of damages to be imposed in order to deter breach, which should not be considered a consideration for a default or a breach. Therefore, we take the view that this ruling is likely to be challenged in the near future.

For any flow of amounts to be considered within the phrase “agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act”, there should be an explicit consideration and intent for any waiver, forbearance or tolerance.

A classic example of such consideration is a fee paid against non-compete. The same reasoning cannot make sense in the case of liquidated damages. The payment or deduction of liquidated damages is not a desired outcome of a contract and does not discharge the contractor from its obligations under the agreement.

Hence, a distinction should be made between the two circumstances, that is, circumstances where the outcome is desirable or intended by the parties and circumstances where such event is not desired or intended by the parties.

Lastly, the AAR has held that the facts of each agreement need to be observed for determining the applicability of GST on liquidated damages. If this ruling is not challenged in the future, it will go a long way in casting an impact on agreements of all kinds, especially agreements in the infrastructure sector where liquidated damages are very common.

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