

Taxability of Liquidated damages under GST for works completed in pre-GST era

- Priyanka Sachdeva | AMRG & Associates
- Hitesh Batra | AMRG & Associates



Liquidated damages refer to the damages whose amount the parties designate during the negotiation of a contract to be collected as a compensation to breach of terms and conditions by the either party under the contract or agreement. The clause with respect to liquidated damages are very common these days especially in case of legal contracts. These are meant as a fair representation of losses in situations where actual damages are difficult to ascertain. These damages may not be levied only in case of breach of contract but also for failure to perform as per terms of contract, deficiency in performance, non-delivery of supplies, delayed deliveries, etc. The tax authorities always intend to bring these damages under the ambit of taxation and this has led to ruckus between them and the taxpayer. The litigation on taxability on liquidated damages, which was prevalent in pre-GST era, has continued under GST as well. With different schools of thoughts giving views for and against charging GST on the said receipt of money, this matter has become litigious. And, the number of litigations are expected to increase due to surge in claims for contractual or liquidated damages post the economic slowdown triggered by the consequent lockdown on the advent of Covid-19 pandemic and the new variants expected to hit Indian economy in near future.

The whole commotion over taxability of these damages under GST revolves around treatment of this compensation/damage/loss by the tax authorities as a consideration towards agreeing to an obligation, refrain from an act or tolerate an act or situation or doing an act i.e. Entry 5 (e) of Schedule II of CGST Act, 2017. The said activity/transaction has been defined to be construed as service under GST. However, it is pertinent to note that Schedule II shall be referred to determine an activity/transaction as a supply of good or service only once it is established that the transaction is a supply under GST. Various AARs and AAARs have confirmed the levy of GST on damages ignoring the said legal aspect. The intention of the legislature to levy GST on damages is substantiated further with the FAQ issued by CBIC for the mining sector which stated that the deduction of liquidated damages/penalty from the contractor's bill and imposition of penalty for non-lifting of coal upto the actual contractual quantity shall be considered as consideration for services covered by entry 'tolerating an act' as per Schedule II to CGST Act. In the pre-GST regime, while the tax department had tried to levy service tax on liquidated damages, the Honorable CESTAT had held an altered view. It has been held in various judgements that the liquidated damages/penalties collected from the other party could not have been towards any service per se since no activity is performed to receive the compensation. Thus, it is worth considering that even though the provisions with relation to "agreeing to an act" are same in both the regimes, contrarian views have been adopted by the AARs and AAARs unlike the CESTAT.





One of the other related issues which need further clarification is with respect to liquidated damages received in relation to contracts entered and work completed prior to GST but payment being received in GST regime. There can be two school of thoughts on this. One can argue that since the liquidated damages pertain to work completed prior to GST, there is no associated supply under GST and thus it is a mere receipt of money and GST shall not be levied on the same. Another thought can be that liquidated damages can be taxable only on the conclusion of disputed matter due to the uncertainty of final amount agreeable to both the parties. Hence, even though the work has been completed prior to GST, the event that triggered taxation i.e. conclusion of the disputed matter has occurred in GST. Thus, GST shall be leviable. And, the department will always support the second school of thought being the same in favour of revenue. And, the same is substantiated from the recent ruling pronounced by AAR Telangana in case of M/s Continental Engineering Corporation [TSAAR Order No.13/2021 dated 8th Oct 2021]. The ruling pertains to an issue under which service was provided in the Pre-GST regime and payment of said service have been received in post-GST regime and further the compensation for delay in execution of works and prolongation costs were paid by the contractee to Continental Engineering Corporation. The Honorable authority although stated that the payments received against the work completed prior to GST are not liable to GST but the damages claimed by the applicant from the contractee due to delays in making available possession of site, drawings & other schedules by the contractee beyond the milestones fixed for completion of project are consideration for tolerating an act or a situation arising out of the contractual obligation i.e. they fall under the Entry 5(e) of Schedule II of CGST Act, 2017 and thus leviable to GST. The Honorable Authority has held that the time of supply of the service of tolerance is the time when such determination takes place. The contractee/employer has not determined the cost of delay before the arbitration award. It was determined only by arbitration award which is in the Post GST era. Therefore, the time of supply of this service as per Section 13 of the CGST Act is falling under GST era and thus it is leviable to GST. The ground upon which such interpretation has taken place are still unsettled and unclear keeping into consideration the fact principle supply of service pertains to pre GST regime. The taxability of damages or compensation received in respect of the delays that have taken place in pre-GST era under GST is dubious. The dichotomy in this interpretation may have a huge impact on the businesses especially in construction and infrastructure contracts with government agencies.

To conclude, it is essential to provide more clarity on this fiasco of levy of GST on contractual payments by the CBIC or the Superior Courts. Every payment received cannot be treated as consideration. It can be treated as consideration only when there is direct link with supply. Any conflicting interpretation would have shattering impact on the businesses already struggling to revive post pandemic.





NEW DELHI
18A, IInd Floor,
North Avenue Road,
West Punjabi Bagh,
New Delhi - 110026.

Rajat Mohan
Senior Partner
rajat@amrg.in

Priyanka Sachdeva
Partner - GST
priyanka@amrg.in



MUMBAI
Shop No-14, Adarsh
Nagar Building No:4,
Kolbad, Thane West,
Thane-400601

Madhu Mohan
Founding Partner
amrg@amrg.in

Kiran Awasthi Raghavendra
Partner - Assurance and Compliance
amrg@amrg.in



DEHRADUN
Villa No. 12, Upper Crest Avenue,
Jakhn, Rajpur Road, Dehradun,
Uttarakhand, India, 248001

Swati Ghoshal
Partner - Risk Advisory and compliance
swati@amrg.in



CHANDIGARH,
PUNJAB

Navdeep Sarpal
Partner - Assurance
and Compliance
amrg@amrg.in



GURUGRAM,
204, 2nd Floor, Time Center, Golf
Course Road, Sector 54, Gurugram,
Haryana 122002

Gaurav Mohan
CEO
gaurav@amrg.in



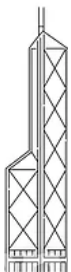
INTERNATIONAL BRANCH -
AUSTRALIA
Unit 9, 14-15 Junia Avenue,
Toongabbie NSW 2146,
Sydney, Australia

Megha Gandhi
Director- Australia
amrg@amrg.in



INTERNATIONAL DESK - USA
Wiener & Garg LLC,
6000 Executive Boulevard,
Suite 520 | Rockville,
MD 20852T: 301.881.4244
D: 240.833.4002

Subhash Garg
Wiener & Garg LLC
amrg@amrg.in



INTERNATIONAL BRANCH
HONG KONG
Hong Kong Address - Flat B,
Floor 1, Tower - 7, Yee Mei Court,
South Horizons, ap lei chau,
Hongkong

Divya Malhotra
Director - Hong Kong
amrg@amrg.in

