Tolerance Of An Act: A Race To Tax The Unexpected

FEBRUARY 02, 2019

By Poonam Harjani & Ashutosh Mishra

"The supreme irony of life is that hardly anyone gets out of it alive"

- Robert A Heinlein

Yes, it is true, 'Life is indeed ironic!'. Otherwise who would have imagined that whilst the nation is engaged in a political debate on the word 'intolerance', the tax authorities these days suspect everything to be an act of 'tolerance'!

Goods and Services Tax ('GST') has undoubtedly led to transformation of Indian indirect taxation landscape and has had a visible impact on ease of doing business. That said, as far as taxation of passive actions (acts of tolerance, refraining to do an act, etc) is concerned, it is an old wine in a new bottle. Since the advent of GST, the policy makers have, thus far, demonstrated a business-friendly approach. Yet, the 'sue you in the court' approach of the tax officers has not altered and with the law increasing ambit of the taxable event of 'supply', the race to tax everything under the sun has gained momentum.

The recent investigations of the Central Board of Indirect Taxes and Customs to cross-check applicability of GST, on a joint approach (by two prominent telecom operators) to enable enforcement of the arbitral award, under the garb of 'tolerance of an act' has already sparked fire in the industry. This is coupled with the fact that the recent advance rulings which upheld liability of GST on liquidated damages treating it as 'tolerance of an act,'[1]. have added fuel to the fire.

The concept of taxability of tolerance of an act as a service (under the erstwhile regime) and supply (under the GST regime) is of recent origin in India. The laws (current GST law as well as erstwhile service tax law) specifically seek to cover passive actions within the ambit of taxation. Yet, their scope has neither been clearly explained in any departmental circular nor is there concrete jurisprudence on the subject. Moreover, internationally also, there prevail multiple schools of thoughts. Thus, the tax position is still far from being settled and is prone to conflicting interpretations.

Some illustrative transactions that are susceptible to the debate as to whether the same fall under the purview of tolerating an act and thus, a supply of service include cancellation charges / no-show fee[2], non-compete / severance fee[3], forfeiture charges[4], liquidated damages[5], notice pay[6], compounding fee[7] etc.

This write-up seeks to examine the key determinative tests to understand the scope of passive actions liable to GST.

1	Maharashtra State Power Generation Company Limited, - **2018-TIOL-33-AAR-GST**, Zaver Shankarlal Bhanushali, -**2018-TIOL-84-AAR-GST** and North American Coal - **2018-TIOL-229-AAR-GST**
2	Collected in hotel and aviation industry.
3	Paid for in case of purchase of business or exit of keymen in a business.
4	Collected in case of foreclosure long term leasing / financing transactions.
5	Provided for under high value engineering, procurement and construction ('EPC') contracts.
6	Recovered by employers from exiting employees in lieu of not serving the notice period.
7	Levied under a law to ratify an act of non-compliance.

Legal provisions

Under the erstwhile regime, '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[8].

Initially, Schedule II of the **Central Goods and Services Tax Act, 2017** ('CGST Act') provided for activities to be treated as supply of goods or supply of services. As per Schedule II 'agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act' was a supply of service. Pertinent to note that the entry pre-supposes the transaction being a supply. Notably, the advance rulings mentioned above deemed activity as supply, irrespective of whether it fulfilled other parameters of supply (like consideration[9], the subject transaction being in the course or furtherance of business[10] etc).

However, the Government vide the **Central Goods and Services Tax (Amendment) Act, 2018** introduced a retrospective amendment in Section 7 of the CGST Act. The amendment is meant to make it explicit that under the CGST Act reference to Schedule II is for classification purposes only. With this amendment, while a part of the issue has been resolved, the larger debate on scope of passive actions continues to haunt the tax payers.

Our analysis

As per the provisions laid down under Section 7 of the CGST Act, the expression supply includes all forms of supply of goods / services for a consideration by a person in the course and furtherance of business. Arguably, tolerance of an act would be a supply of service. Section 2(102) of the CGST Act defines services as anything other than goods. For a finer version of the term 'service', reference may be taken to the erstwhile regime which defines service as 'an activity for a consideration'. Thus, meeting of twin conditions viz., existence of an 'activity' (which includes 'agreeing not to act') and such activity being for a 'consideration' are sine-qua-non for a transaction to qualify as a 'service'. Under the CGST Act, on the other hand, the definition of service is even wider by which anything not being goods qualifies as a 'service'. Yet, the scope of the term service cannot be so uncapped so as to cover every pay-out under the GST net as service, if it is not for sale of goods. The use of the terms 'sale, transfer, barter, exchange, licence etc.' under the scope of the term supply also pre-supposes existence of agreed activity (or a non-action) for a transaction to qualify as supply.

There is no express definition of the phrase 'tolerating or forbearance of an act'. Reliance has to be placed on the entry provided in Schedule II of the CGST Act which provides for 'agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act' as a supply of service.

Perusal of the aforesaid Schedule II entry makes it amply clear that in order to invoke the above taxable activity, there needs to be an agreement to tolerate a situation. This is not the case of pay-outs such as contractual penalties, liquidated damages / cancellation fee. These pay-outs arise on account of an 'unintentional occurrence' which both parties actually intend to avoid.

8	W.e.f. July 1, 2012.
9	Section 7(1) of the **Central Goods and Services Tax Act, 2017**.
10	Section 16 of the **Central Goods and Services Tax Act, 2017**.

Put differently, an explicit agreement towards non-compete arrangement[11] or an agreement to give up a claim by a party to a contract in lieu of payment of a fee to another party (for instance payment of money to a tenant to vacate a rented property[12], would get covered in the category of passive actions. On the other hand, deduction of damages/fee from the consideration amount cannot be enforced separately and will always be preceded by delay in original supply. Thus, it cannot be construed as an independent supply. In such cases, essentially, damages / fee is not some form of consideration paid for agreeing to an obligation to tolerate a breach of contract / law.

Relevant tests for determination of scope of passive actions

Cancellation fee / liquidated damages / penal charges are typically borne on a breach of an agreement or disobedience of the law. According such pay-outs, a character of 'consideration' paid for 'agreeing to an obligation to tolerate an act' is essentially ultra vires the legal concepts of contract law and is jurisprudentially incorrect. This is contrary to the concept of such pay-outs being compensation for a loss / breach.

The intent of the legislature is clearly to tax 'toleration of an act' as a supply; however, it is essential to lay down some criterion to determine the same. Below are some tests that need to be borne in mind for characterization of transaction as a passive action.

Primary intention of parties involved in an agreement

Determination of tax implications of a transaction should always consider the intention of the parties involved as gathered from the written agreement or conduct of the parties.

In transactions involving liquidated damages, notice pay, penal charges, compounding fee etc., pay-out of the damages/fee amounts is not the primary intention of the parties. Such amounts are sub-servient/ancillary to the primary intent and objective of performance of a contract / obedience of law. In certain cases, such amounts may be considered as an adjustment or reduction in consideration against the original supply but not as a consideration for a new supply.

Damages / cancellation charges are provided for with an intent to ensure due performance of an agreement or to further obedience of the law. It is an expression of dissatisfaction or a form of penalty resulting from unsatisfactory performance or breach of the law. Such pay-outs are not the desired result or intended to be a source of revenue for the receiving party but are incurred to compensate for loss suffered by one party upon the occurrence of an unintended event. In other words, such pay-outs are never intended to tolerate a breach of an agreement / statute.

As per the language of the law, the agreement should be expressly that of toleration of an act / situation which could trigger the levy of GST on a transaction.

Sufficient link or connection between the supply and the consideration

As per Section 2(31)(a) of the CGST Act, consideration includes the monetary value of an act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both by the recipient or any other person.

11	Clause 6.7.1 of Service Tax Education Guide dated June 20, 2012.
12	Zaver Shankarlal Bhanushali, **2018-TIOL-84-AAR-GST** .

An act may lead to unintended accrual of gains to the person carrying out such transaction (damages / fee for our current discussion purposes). However, such an act done sans a relationship i.e. without the express or implied reciprocity cannot be alleged to be a supply for a consideration.[13]

Globally, it can be seen that it is for the revenue to establish that the amount collected in such transactions is in fact a consideration for a supply of goods / services. In a New Zealand ruling,[14] it was held that payment of compensation or settlement of trust funds was unrelated to any supply made by the recipient and, therefore, did not meet the requirements to impose GST. Thus, establishing a nexus between the supply and consideration for levy of GST on a transaction has been of prime importance in foreign jurisdictions as well.

A study of international jurisprudence, brings forth that establishment of sufficient nexus between supply and consideration should include the following:

- Existence of a voluntary arrangement between the concerned parties[15]
- The benefit of an act of tolerance being towards an identified recipient of supply[16]
- Intention to create a legal relationship between parties[17]

Although, the existing Indian and international jurisprudence does help narrow down the principles to establish such a nexus; notable that different jurisdictions have come up with contradictory views when the transactions have undergone a practical legal test. For instance, an Australian ruling[18] discussed comprehensively the taxability of cancellation charges under Australian GST. One of the transactions discussed in the ruling was the hotel cancellation charges which was held to be taxable being 'consideration for a supply'. On the other hand, the EU VAT[19] in similar circumstances held hotel cancellation charges not to be taxable due to it being compensatory in nature. Contrasting views of such nature are innumerable in different jurisdictions wherein the nature of transaction becomes debatable.

In the view of the authors, irrespective of accrual of pecuniary gains which is incidental to a person suffering at times a breach of agreement / law; such consideration should have a relationship with the actual supply. Consideration received incidental to a breach of agreement/law cannot be said to be related to a supply as such breach of agreement / law does not constitute a supply on its own. The above should be considered keeping in context the law of the particular jurisdiction in mind (for example, in India the debate would extend to applicable GST rate due to classification issues) while also paying heave to the facts of the case.

Conclusion

In the view of the authors, only when the tests discussed above are in the affirmative, shall a transaction qualify to be 'tolerance of an act' and be a supply of service on which GST can be levied. Applying the above tests, the authors believe that while non-compete fee in certain situations may attract levy of GST, no GST implications should arise on the cancellation charges / no-show fee, forfeiture charges, liquidated damages, notice pay or fee for compounding of a legal offence. That said, absent any clear criteria under the Indian GST laws and jurisprudence, the debate on applicability of GST on all these charges is expected to continue. It is of utmost importance that the Government lays down comprehensive guidelines through a notification / circular etc. as to what constitutes 'tolerance of an act.' Otherwise, a rain of litigation on the issue in the near future is inevitable!

13	Goods and Service Tax Ruling 2001/6 issued by the Australian tax Office.
14	Chatham Islands Enterprise Trust v. Commissioner of Inland Revenue (1999) 19 NZTC 15,075.

15	Shaw v. Director of Housing and State of Tasmania (No. 2), [2001] TASSC 2 (Australian GST) and GSTR 2006/9 issued by Australian Tax Office.
16	Jurgen Mohr, Case C-215/94.
17	R. J. Tolsma, Case C-16/93.
18	Goods and Service Tax Ruling 2009/3 issued by the Australian tax Office.
19	Societe thermale (Case C-277/05) of EU VAT Court.

(The authors are Partner and Associate, Nitya Tax Associates and the views expressed are strictly personal)