**REPORTABLE**

**Customs, Excise & Service Tax Appellate Tribunal**
**West Zonal Bench at Ahmedabad**

REGIONAL BENCH-COURT NO. 1

**Service Tax Appeal No. 12085 of 2018-DB**

(Arising out of OIO-VAD-EXCUS-002-COM-007-17-18 dated 26/03/2018 passed by the Commissioner of Central GST and Central Excise -Vadodara-II)

**COMMISSIONER OF CENTRAL GST**
**AND CENTRAL EXCISE-VADODARA-II ........Appellant**
1ST FLOOR... ROOM NO.101,
NEW CENTRAL EXCISE BUILDING,
VADODARA, GUJARAT- 390023

*VERSUS*

**LANXESS INDIA P LTD ......Respondent**
PLOT NO. 748/2/A, 748/3 & 748/4/B,
JHAGADIA INDUSTRIAL ESTATE, GIDC, JHAGADIA,
BHARUCH, GUJARAT

**APPEARANCE:**
Shri Rajesh Nathan, Assistant Commissioner (AR) appeared for the Appellant
Shri V. Sridharan, Senior Advocate with Shri Jigar Shah, Advocate, Shri Amber Kumrawat, Advocate & Ms. Devanshi, Advocate appeared for the Respondent

**CORAM:**
**HON'BLE MEMBER (JUDICIAL), MR. SOMESH ARORA**
**HON'BLE MEMBER (TECHNICAL), MR. SATENDRA VIKRAM SINGH**

**Final Order No. 10143/2026**

DATE OF HEARING: 16.12.2025
DATE OF DECISION: 26.02.2026

**SOMESH ARORA**

1. M/s Lanxess India Pvt. Ltd. ("Respondent") are manufacturing excisable goods of Chapter 29 and 38 of the First Schedule to the Central Excise Tariff Act, 1985. The period involved in this case is from July, 2012 to March, 2016 for which show cause notice was issued on 23.01.2017. They are a subsidiary of M/s Lanxess Deutschland GmbH, Kennedyplatz, 1, Germany (hereinafter referred to as "LXD"). Respondents and LXD entered into contract manufacturing agreement wherein the Respondent agreed to maintain, hold and use the capacity to manufacture specified products for LXD at its site in Jhagadia, in accordance with the instructions and specification of LXD and in turn, LXD agreed to take off the products and pay to the Respondent the agreed remuneration. The holding company (LXD) also agreed to pay remuneration/compensation, in case there is any underutilization of capacity.

1.1 During audit, it was observed that during the period between July 2012 to March 2016, the Respondent have claimed charges/compensation of an amount of Rs. 67,53,90,865/ from its holding company LXD towards underutilization of installed production capacity at Jhagadia factory. After investigation, the department issued a Show Cause Notice dated 23.01.2017 to the respondent proposing to demand service tax of Rs.8,68,67,341/- under proviso to Section 73(1) of the Finance Act, 1994, on the basis that the compensation so received by the Respondent from LXD towards under-utilization of committed production capacity of the plant, shall constitute consideration for the 'declared service' Section 66E(e) of the Finance Act, 1994 and hence, service tax on the aforesaid amount is liable to be paid by the Respondent. The Respondent filed a detailed reply explaining that even if the above amount is treated as consideration for services rendered by the Respondent, no service tax is payable because as per Rule 3 of the Place of Provisions of Service Rules, 2012 (herein after referred to as 'POPs Rules'), it will be export of service since place of provision of service shall be the location of the service receiver, which in this case is outside India.

1.2 The aforesaid show cause notice, was adjudicated by the commissioner vide Order-in-Original dated 26.03.2018 wherein he dropped the entire demand. Being aggrieved by the aforesaid order, Revenue filed the present appeal before this Tribunal.

2. Department took the following grounds:-

- As per manufacturing agreement, respondent agreed to maintain, hold and use the capacity to manufacture the specified products for LXD at its factory in Bharuch, in accordance with the instructions and specification of LXD who in turn agreed to take off the products and pay to the respondent the agreed remuneration pursuant. The respondent claimed and received of Rs. 67.53 Cr. towards underutilization of installed production capacity of their plant at Jhagadia factory during the period from 212-13 to 2015-16. The revenue submitted relevant part of the sample manufacturing agreement dated 28.04.2015 and Invoice No. LIPL/DRST/14-15/EX/JHG-001 dated 31.03.2015, raised by the respondent claiming compensation. The respondent themselves had classified said transactions i.e. idle compensation for underutilization of installed capacity, as a 'declared service' under Section 66E(e) of the Finance Act but they neither charged nor paid service tax on the said service, by treating the same as export of service.

- In this case, compensation/remuneration has been received on account of underutilization of the manufacturing capacity (i.e. fixed establishment of plant and machinery which is an immovable property in terms of Rule 3 of the General Clauses Act, 1897). The agreement between the respondent and LXD is in the nature of grant of right to use the immovable property. As per Rule 5 of the POPs Rules, 2012, place of provision of services relating to immovable property, shall be the place where the immovable property is located. The contention of the Respondent is that the place of provision shall be the recipient's location which is outside India (non-taxable territory) and accordingly, Rule 3 of the POPs Rules, 2012, shall apply.
- As per Rule 14 of the POPs Rules, 2012, when the provision of a service is determinable in terms of more than one rule, then it shall be determined in accordance with the Rule that occurs later among the Rules that merit equal consideration, and accordingly, Rule 5 shall apply.
- For a service to qualify as an export of service, it has to satisfy all the conditions as laid down under Rule 6A of the Service Tax Rules, 1994. Sub-rule 1(f) lays down that the provision of any service or agreed to be provided, shall be treated as export of service, when the provider and the recipient of service are not merely establishments of a distinct person in accordance with item (b) of Explanation 3 of clause (44) of Section 658 of the Finance Act, 1994. The respondent located in taxable

territory, is a subsidiary company of the recipient located in a non-taxable territory, and therefore, provision of service between the respondent and LXD shall be treated as merely between the establishments of distinct persons, and therefore, will not be considered as export of service.

**Grounds of appeal of the department**

(1). The respondent have themselves declared in their invoice that the gross value charged therein to LXD is in respect of "Declared Service" in terms of clause (e) of Section 66E of the Finance Act, 1994. Still the Adjudicating authority has erroneously taken shelter of the clarifications given in the CBEC Education Guide (which does not have legal backing) with regard to applicability of Rule 5 of the Place of Provision rules, 2012.

(2). The agreement in this case was to "maintain, hold available and use the capacity to manufacture the products for LXD at the respondent's site in Jhagadia. Thus, the agreement was for dual purpose of (i) maintaining and to hold available the manufacturing facilities, and (ii) manufacturing the products for LXD.

(3). Clause 2(1) of the agreement provided for payment of a **'manufacturing fee'** and an **'idle cost compensation'**. While 'manufacturing fee' was to be paid per unit of the product delivered to LXD, the 'idle cost compensation' is based on the cost of idle capacity which meant the capacity unutilized (remained idle) during the relevant period and as such has no relation to the export of goods, as it thus, 'Idel Cost Compensation' has a direct relationship to the dedicated unutilized Plant & Machinery is paid towards non-utilization of the plant & machinery (an immovable property), in respect of which the right to use of the same has been dedicated/granted and reserved in favour of LXD. Thus, present dispute, being related to immovable property with regard to unutilized production capacity of the respondent's factory, would be covered under

Rule 5 of the Place of Provision Rules, 2012, and the general rule 3 will not apply the Adjudicating authority has erred in dropping the demand.

(4). The Adj. Authority erred in deciding the place of provision of service in this case as outside India, whereas place of provision of service is where such immovable property i.e. in India. Also, as per Rule 6A (1) (f) of the Service Tax Rules, in the instant case, provision of service between the respondent and LXD shall be treated as merely between the establishments of distinct persons and hence, the service shall not be treated as export of service. In view of the above, order of dropping the demand of Rs. 8.68 crores against the respondent, by the Adj. Authority is not legal and proper and therefore, needs to be quashed.

3. The respondent submitted as follows:-

**A. Idle cost compensation received by the Respondents for under-utilization of capacity of plant is towards cost of goods manufactured by the Respondents and exported. Hence, no duty is liable to be paid.**

A.1 The Respondents are, manufacturing products like lon Exchange Resins used for purification of liquid. These are exported to LXD either on payment of duty of excise under claim for rebate of such duty or under LUT/bond without payment of duty. They entered into an agreement dated 28.04.2015 with LXD in terms of which Respondents agreed to manufacture and supply the aforesaid product to LXD. The amount to be paid by LXD as consideration for sale of aforesaid product, has been arrived at as Manufacturing fee and Idle Cost Compensation. As per clause 2(1)(a), "*The* ***MANUFACTURING FEE*** *shall be paid per unit of PRODUCT delivered to LXD and shall cover cost of INPUT MATERIALS, PRODUCTION COST, SELLING EXPENSES, GENERAL ADMINISTRATION AND OTHER COST plus the MARK UP."* The **MARK UP** has been defined in the agreement as a "*factor applied to the cost of INPUT MATERIALS, PRODUCTION COST, SELLING EXPENSES, GENERAL*

*ADMINISTRATION EXPENSES, OTHER COSTS to arrive at the MANUFACTURING FEE AND to the fixed manufacturing cost allocated to the IDLE CAPACITY to arrive at the idle cost compensation so as to ensure that LIPL receives a fair and adequate compensation for the functions performed, assets employed and risks assumed under this AGREEMENT that meets arm's length principles. Unless amended by the PARTIES' mutual written agreement, the MARK-UP shall be equal to 7.5%.”*

A.2 The Idle Cost Compensation is defined in the agreement as compensation towards the fixed manufacturing cost allocated to IDLE CAPACITY and shall have the same meaning ascribed to it in Clause 2(1)d of the agreement. The Respondents had purchased raw material and arranged for their own capital and labour, which clearly shows that the Respondents had manufactured and sold the products to LXD. Hence, the amount received as manufacturing fee and Idle Cost Compensation would represent the consideration for sale of goods to LXD. The Idle Cost Compensation therefore does not represent consideration for any service rendered by the Respondents to LXD and hence, not liable to service tax.

A.3 To determine idle cost compensation following factors are considered in the cost sheet:-

(i) **Operating Income** which includes sales of scrap materials, miscellaneous operating income, Export incentives etc.

(ii) **Standard cost of goods sold** after adjusting the same with preceding financial year revenue recognition

(iii) Total Variance which includes raw material price variance, spending variance, volume variance, other variances & other mfg cost etc calculated on the basis of sales ratio.

(iv) **Gross margin** arrived by considering factors mentioned at para (i) to (iii)

(v) **Mark-up** of 7.5%/10% is added

(vi) **Arm's length sales** of goods is arrived

(v) **Actual sales to group**

Thus, idle cost compensation depends on the fixed cost, i.e. cost of plant and machinery, volume variance which includes unabsorbed fixed costs, like salary, wages, repairs & maintenance etc. based on sales ratio.

A.4 Remuneration for sale of goods manufactured by the Respondent is equal to manufacturing fee plus idle cost compensation. The manufacturing fee per unit is arrived at by taking into account total cost divided by the number of units agreed to be purchased by LXD. When actual units purchased are less than the agreed quantity, manufacturing fee has to be re-worked out. The idle cost compensation is nothing but the differential manufacturing fee when actual units purchased and thus, it is for the goods manufactured and not for any service rendered by the Respondents. A clarification was sought by Inox on the issue of inclusion of FFC and MTOP charges in the assessable value of the gases being manufactured and supplied to the customers for the purpose of charging central excise duty.

A.5 In the case of Inox Air Products Ltd, upon direction of Hon'ble High Court of Bombay, CBIC vide Letter No F.No.6/03/2013/CX.1 dated 10.11.2014 under General Instruction No. 30/2014-15 dated 19.12.2014 clarified that charges of Fixed facility charges (FFC) and Minimum take or pay charges (MTOP) are directly linked with manufacture and supply of gases irrespective of the fact whether these are paid at the time of sale or at subsequent time. The categorical clarification given by the board are as follows :-

(i) In the months where there is a supply of gas, all elements of consideration as such, price of gas and FFC would be added to determine the assessable value for payment of central excise duty.

(ii) For the months when there is no supply of gases, FFC paid is to be added in the price of gas supplied in the subsequent months.

(iii) when there is no supply of gas in the subsequent months. FFC paid has to be added to earlier months by raising supplementary invoices.

Above makes it clear that the charges in nature of fixed facility charges or minimum take or pay charges which are recovered over and above the actual sale price of goods, are towards price of goods on which excise duty is payable. Here also, idle cost compensation claimed by the Respondents over and above actual supply of goods is towards the cost of goods. Hence, cannot be subjected to service tax. They rely on following decisions:-

- KN Food Industries Pvt. Ltd. v. Commissioner of CGST & C Ex., Kanpur, 2020 (38) GSTL 60 (Tri. All) [Para No. 4,5]
- South Eastern Coalfields Ltd. v. Commr. of C. Ex. & ST Raipur, 2021 (55) GSTL 549 (Tri. Del) [Para No. 27,28,29 & 43]

**B. They being subsidiary company of LXD are 'not merely establishments of a distinct person' in accordance with item (b) of Explanation 3 of clause (44) of section 65B of the Act, hence fulfils all the condition of Export of Service under Rule 6A of the Service Tax Rules, 1994.**

B.1 It is alleged in SCN that provision of service is between the Respondent and LXD which shall be treated as merely between the establishments of distinct persons as the Respondents are a subsidiary company of LXD which has its establishment in Germany. Therefore, as per SCN, service if any provided by the Respondents to LXD shall not be treated as export of service as per sub-rule (f) of Rule 6A of the Rules as the provider of service and recipient of service should not be the establishments of a distinct person in accordance with item (b) of Explanation 3 of Section 65B(44) of the Finance Act, 1994. This reasoning is unsustainable in the eyes of law.

B.2 Clause (f) of Rule 6A, item (b) of Explanation 3 of Section 65B(44) and Explanation 4 of clause (44) of Section 65B of the Act, are extracted herein below:-

> *"(f) the provider of service and recipient of service are not merely establishments of a distinct person in accordance with item (b) of Explanation 3 of clause (44) of section 65B of the Act."*
>
> *Explanation 3*
>
> *(b) an establishment of a person in the taxable territory and any of his other establishments in a non-taxable territory <u>shall be treated as establishments of distinct persons.</u>"*
>
> *Explanation 4*
>
> *A person carrying on a business <u>through a branch or agency or representational office</u> in any territory shall be treated as having an establishment in that territory"*

A combined reading of above provisions makes it clear that a person carrying on business through a branch or agency or representation office in any territory shall be treated as having establishment in that territory, meaning thereby, agency or branch of a company in the taxable territory and the head office in a non-taxable territory shall be treated as establishments of distinct persons.

B.3 In the case of Director of Income Tax v. E-Funds IT Solution reported at [2014] 42 taxmann.com 50 (Delhi), assessee namely e-Fund Corp. and e-fund Inc were incorporated in USA. They entered into international transactions with their Indian subsidiary company, i.e., e-Fund India which performed back-office operations in respect of ATM management, electronic payments, decision support and risk management services rendered by the assessee. The revenue authorities opined that income of two assesses were attributable to India because they had permanent establishment in India and should be taxed in India, irrespective of whether the said assesse had paid taxes in USA. In this case, Hon'ble High Court of Delhi on perusal of provisions of Income Tax Act, 1961 along with DTAA between India and USA (Permanent Establishment) held that where an assessee does not have any branch office or factory or workshop in India and merely because it has a subsidiary in India that by itself does not create a fixed place of business/location PE. This order has been upheld by the Apex Court vide order dated 24.10.2017. To further substantiate above submission, they place reliance on following decisions where it is held that the mere presence of subsidiary company cannot create a fixed place of business for a parent company which further makes it clear that both the entities are separate entity and same are not merely establishments of a distinct person: -

- Linde Engineering India Pvt. Ltd. v. Union of India, 2022 (57) GSTL 358 (Guj HC) [Para No. 12-14]
- CELTIC Systems Pvt Ltd. v CCE & ST, Vadodara-1, 2023 (70) GSTL 74 (Ahd.) [Para No. 4]

**C. Without prejudice, value of idle cost compensation which is not fixed in nature cannot be considered as consideration for grant of rights to use immovable property.**

C.1 The provisions of Finance Act, 1994 are silent on such aspect. However, in the case of Gopinath Vs. CIT 6 ITR 243 and Parvathaneni v CIT 20 ITR 610, the Court held that if the agreement is to pay the owner of premises a share of profits, such a fluctuating item may not be treated as rent in absence of special circumstances pointing to a contrary conclusion. Similarly, any amount which is not fixed in value towards any activity in relation to immovable property, no tax can be levied on the same under the garb of Finance Act, 1994. Hence, for this reason, subject proceedings deserve to be concluded in favour of the Respondents.

4. Issue involved in this case is Whether M/s Lanxess India Pvt. Ltd. (Respondents) are liable to pay Service Tax on the value of compensation received towards underutilization of installed production capacity, by treating the same as declared service under Section 66E(e) of the Finance Act, 1994?

4.1 The relevant portion of Section 66E(e) is reproduced below: -

> ***66E.*** *The following shall constitute declared services, namely: —*
>
> *(e)* ***agreeing to the obligation*** *to refrain from an act, or to tolerate an act or a situation, or to do an act;*

Under the Central Goods and Service Tax Act, 2017, somewhat similar expression in relation to deemed supply appears in Schedule II of the Act in Paragraph 5 – Supply of Services Clause (e) states as under:

> *"**Paragraph 5- Clause (e)-*** agreeing *to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;"*

As per Section 2(d) of the Indian Contract Act, 1872, expression, "Consideration" has been defined as follows:-

> *"When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise"*

It was thus pointed out that doing or abstaining from doing, or promising to do, or abstaining from doing something will be treated as an act and abstinence or promise which itself is a consideration for the promise. Both sides submitted their arguments during the course of first hearing based on the fact that an act of abstinence at the desire of the promiser would also amount to consideration for service tax.

5. On 09.10.2025, learned Authorized Representative made his submissions with the support of various case laws and circulars etc. as follows:-

(a) In M/s Madhya Pradesh Poorva Kshetra Vidyut Vitaran Co. Ltd. Vs. Commissioner of CGST and Central Excise, Madhya Pradesh 2022 (4) TMI 773-CESTAT New Delhi, it was held that liquidated damages received by the appellant from other parties who failed to perform as per the contracts would not be leviable to service tax. The coordinate bench ruled that if the suffering party sues the other in a Court and damages are awarded by the Court, such damages are unliquidated damages. The quantum of damage is decided by the Court taking into account the facts and circumstances of the case and the damage suffered. Liquidated damages are those damages which are built into the contract itself where the defaulting party shall pay to the other party a certain amount in case of default to dissuade the parties from reneging from the contract.

(b) In Ratnamani Metals and Tubes Ltd vs. Commissioner of Central Excise and Service Tax, Kutch (Gandhidham) as reported in 2021 (47) GSTL 352(Tri. - Ahmd.), the issue was of liquidated damages or amount recovered by the assessee towards poor quality of goods purchased by them. The case was whether there was consideration or liquated damages involved so as to come within the purview of deemed service? While remanding the matter, it was accepted that the liquidated damages will not be leviable to service tax.

(c) In Pankaj Ispat Ltd Vs. Commissioner of Central Excise Raipur reported at 2024(8)TMI263 Cestat New Delhi, it was held that the amount charged has to, necessarily, be a consideration for the taxable service under the Finance Act. The compensation received for making good the financial damages/injury cannot said to be a consideration at all as it has no nexus with any taxable services. A number of decisions were cited and relied upon on this point.

(d) In Northern Coalfields Ltd Vs. Commissioner of CGST, Central Excise and Customs, Jabalpur, it was held that recovery of liquidated damages/ penalty from other party could not be said to be towards any service per se, since the said party was not carrying out any activity to receive compensation nor could there be any intention of other party to breach and violate the contract and suffer a loss. It was decided that such penalty and liquidated damages on supply of goods could not be considered for a deemed service. It relied on the decision of South Eastern Coal Fields Ltd. as well as on CBIC Circular No. 178/10/2022- GST dated 03.08.2022. The relevant paras 18,19,20 are reproduced below:-

> ***"18.*** *In South Eastern Coalfields, the Tribunal examined at length the provisions of Section 66E(e) of the Finance Act and made the following observations :*
>
> > *"27. It is trite that an agreement has to be read as a whole so as to gather the intention of the parties. The intention of the appellant and the parties was for supply of coal; for supply of goods; and for availing various types of services. The consideration contemplated under the agreements was for such supply of coal, materials or for availing various types of services. The intention of the parties certainly was not for flouting the terms of the agreement so that the penal clauses get attracted. The penal clauses are in the nature of providing a safeguard to the commercial interest of the appellant and it cannot, by any stretch of imagination, be said that recovering any sum by invoking the penalty clauses is the reason behind the execution of the contract for an agreed consideration. It is not the intention of the appellant to impose any penalty upon the other party nor is it the intention of the other party to get penalized.*
> >
> > *28. It also needs to be noted that Section 65B(44) defines "service" to mean any activity carried out by a person for another for consideration. Explanation (a) to Section 67 provides that "consideration" includes any amount that is payable for the taxable services provided or to be provided. The recovery of liquidated damages/penalty from other party cannot be said to be towards any service per se, since neither the appellant is carrying on any activity to receive compensation nor can there be any intention of the other party to breach or violate the contract and suffer a loss. The purpose of imposing compensation or penalty is to ensure that the defaulting act is not undertaken or repeated and the same cannot be said to be towards toleration of the defaulting party. The expectation of the appellant is that the other party complies with the terms of the contract and a penalty is imposed only if there is non-compliance.*
> >
> > *29. The situation would have been different if the party purchasing coal had an option to purchase coal from 'A' or from 'B' and if in such a situation 'A' and 'B' enter into an agreement that 'A' would not supply coal to the appellant provided 'B' paid some amount to it, then in such a case, it can be said that*

*the activity may result in a deemed service contemplated under Section 66E(e).*

*30. The activities, therefore, that are contemplated under Section 66E(e), when one party agrees to refrain from an act, or to tolerate an act or a situation, or to do an act, are activities where the agreement specifically refers to such an activity and there is a flow of consideration for this activity.*

*xx xx xx*

*32. In the present case, the agreements do not specify what precise obligation has been cast upon the appellant to refrain from an act or tolerate an act or a situation. It is no doubt true that the contracts may provide for penal clauses for breach of the terms of the contract but, as noted above, there is a marked distinction between 'conditions to a contract' and 'considerations for a contract'."*

***19.*** *The issue in the present case is covered by the aforesaid decision rendered by the Tribunal and, therefore, it has to be held that service tax could not have been demanded from the appellant.*

***20.*** *In this connection it would also be pertinent to refer to the Circular dated 3-8-2022 issued by the Department of Revenue regarding applicability of goods and service tax on liquidated damages, compensation and penalty arising out of breach of contract in the context of 'agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act'. This Circular emphasizes that there has to be an express or implied agreement to do or abstain from doing something against payment of consideration for a taxable supply to exist and such an act or a situation cannot be imagined or presumed to exist merely because there is a flow of money from one party to another. It also mentions that unless payment has been made for an independent activity of tolerating an act under an independent arrangement entered into for such activity or tolerating an act, such payment will not constitute 'consideration' and such activities will not constitute 'supply'. The relevant portion of the Circular is reproduced below :*

*"**Agreement to do or refrain from an act should not be presumed to exist***

*There has to be an express or implied agreement: oral or written, to do or abstain from doing something against payment of consideration for doing or abstaining from such act, for a taxable supply to exist. An agreement to do an act or abstain from doing an act or to tolerate an act or a situation cannot be imagined or presumed to exist just because there is a flow of money from one party to another. Unless there is an express or implied promise by the recipient of money to agree to do or abstain from doing something in return for the money paid to him, it cannot be assumed that such payment was for* *doing an act or for refraining from an act or for tolerating an act or situation. Payments such as liquidated damages for breach of contract, penalties under the mining act for excess stock found with the mining company, forfeiture of salary or payment of amount as per the employment bond for leaving the employment before the minimum agreed period, penalty for cheque dishonour etc. are not a consideration for tolerating an act or situation. They are rather amounts recovered for not tolerating an act or situation and to deter such acts; such amounts are for preventing breach of contract or non-performance and are thus mere "events' in a contract. Further, such amounts do not constitute payment (or consideration) for tolerating an act, because there cannot be any contract : (a) for breach thereof, or (b) for holding more stock than permitted under the mining contract, or (c) for leaving the employment before the agreed minimum period or (d) for doing something leading to the dishonour of a cheque. As has already been stated, unless payment has been made for an independent activity of tolerating an act under an independent arrangement entered into for such activity of tolerating an act, such payments will not constitute 'consideration' and hence such activities will not constitute "supply" within the meaning of the Act."*

(e) Learned AR stated that the department's appeal is admitted in Apex Court as reported at 2021 (54) GSTL J54 (SC). He also cited decision of Bhagwati Power and Steel Ltd Vs. Commissioner of Central Excise, Raipur (CG) as reported in 2023 (8) TMI 900- CESTAT New Delhi in which it was held that amount deducted by the appellant towards compensation for not supplying WHR Boiler in time would not be a deemed service for lack of consideration. CBIC circular No. 214/1/2023 dated 28.02.2023 was also considered in para 7 & 8 as below:-

*"7. The Circular dated 28th February, 2023 issued by the Board, on which reliance has been placed, is as follows:*

***" Subject: Leviability of Service Tax on the declared service***

***"Agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act" under clause (e) of section 66E of the Finance Act, 1994 - reg.***

*An issue has arisen on the levy of service tax on liquidated damages arising out of breach of contract, forfeiture of salary or payment of bond amount in* *the event of the employee leaving the employment before the minimum agreed period and similar other issues arising out of clause (e) of section 66E of the Finance Act, 1994. Reference has also been invited to Circular No. 178/10/2022-GST dated 3rd August, 2022 regarding applicability of GST on liquidated damages, compensation and penalty arising out of breach of contract or other provisions of law, and its applicability to service tax related issues.*

*2. It may be seen that "Agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act" is a Declared Service as per clause (e) of section 66E of the Finance Act, 1994.* ***A service conceived in an agreement where one person agrees to an obligation to refrain from an act or to tolerate an act or to do an act, would be a 'declared service' under section 66E(e) read with section 65B(44) and would be leviable to service tax.***

*3. The description of the declared service in question, namely, agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act is similar in GST. "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 of the CGST Act, 2017.*

*4. As can be seen, the said expression has three limbs: -*

*i) Agreeing to the obligation to refrain from an act,*

*ii) Agreeing to the obligation to tolerate an act or a situation,*

*iii) Agreeing to the obligation to do an act. Service of agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act is nothing but a contractual agreement. A contract to do something or to abstain from doing something cannot be said to have taken place unless there are two parties, one of which expressly or impliedly agrees to do or abstain from doing something and the other agrees to pay consideration to the first party for doing or abstaining from such an act. Such contractual arrangement must be an independent arrangement in its CBIC-*

*110267/14/2023-CX-VIII SECTION-CBEC I/62066/2023 own right. There must be a necessary and sufficient nexus between the supply (i.e. agreement to do or to abstain from doing something) and the consideration.*

*5. The issue also came up in the CESTAT in Appeal No. ST/ 50080 of 2019 in the case of M/s Dy. GM (Finance) Bharat Heavy Electricals Ltd in which the Hon'ble Tribunal relied on the judgement of divisional bench in case of M/s South Eastern Coal Fields Ltd Vs. CCE Raipur {2021(55) G.S.T.L 549(Tri-Del)}. Board has decided not to file appeal against the CESTAT order ST/A/50879/2022-CU[DB] dated 20.09.2022 in this case and also against Order A/85713/2022 dated 12.8.2022 in case of M/s Western Coalfields Ltd. Further, Board has decided not to pursue the Civil Appeals filed before the Apex Court in M/s South Eastern Coalfields Ltd. supra (CA No. 2372/2021), M/s Paradip Port Trust (Dy. No. 24419/2022 dated 08-08-2022), and M/s Neyveli Lignite Corporation Ltd (CA No. 0051-0053/2022) on this ground.*

*6. In view of above, it is clarified that the activities contemplated under section 66E(e), i.e. when one party agrees to refrain from an act, or to tolerate an act or a situation, or to do an act, are the activities where the agreement specifically refers to such an activity and there is a flow of consideration for this activity. Field formations are advised that while taxability in each case shall depend on facts of the case, the guidelines discussed above and jurisprudence that has evolved over time, may be followed in determining whether service tax on an activity or transaction needs to be levied treating it as service by way of agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act. Contents of Circular No. 178/10/2022-GST dated 3rd August, 2022, may also be referred to in this regard.*

*7. In the present case, it is not the case of the department that the agreement provides for a consideration for an obligation to refrain from an act or for agreeing to tolerate an act or a situation. The demand, therefore, could not have been confirmed in view of decision of the Tribunal in **South Eastern Coalfields** and the Circular dated 28.02.20223."*

(f) Learned AR has also relied on Taxation of Services and Education Guide dated 20.06.2012 of TRU which particularly para 2.3.2 in tabulated form to para 2.4.1 deal with as to what is the consideration and whether compensation will not be considered as deemed service, same is reproduced below:-

***"2.3.2 Would the payments in the nature as explained in column A of the table below constitute a consideration for provision of service?***

| *S. No.* | ***A*** | ***B*** |
|---|---|---|
| | *Nature of payment* | *Whether consideration for service?* |
| *1.* | *Amount received in settlement of dispute.* | *Would depend on the nature of dispute. Per se such amounts are not consideration unless it represents a portion of the consideration for an activity that has been carried out. If the dispute itself pertains to consideration relating to service then it would be a part of consideration.* |
| *2.* | *Amount received as advances for performance of service.* | *Such advances are consideration for the agreement to perform a service.* |
| *3.* | *Deposits returned on cancellation of an agreement to provide a service.* | *Returned deposits are in the nature of a returned consideration. If tax has already been paid the tax payer would be entitled to refund to the extent specified and subject to provisions of law in this regard* |
| *4.* | *Advances forfeited for cancellation of an agreement to provide a service.* | *Since service becomes taxable on an agreement to provide a service such forfeited deposits would represent consideration for the agreement that was entered into for provision of service.* |
| *5.* | *Security deposit that is returnable on completion of provision of service.* | *Returnable deposit is in the nature of security and hence do not represent consideration for service. However if the deposit is in thenature of a colorable device wherein the interest on the deposit substitutes for the consideration for service provided or the interest earned has a perceptible impact on the consideration charged for* |

| | | |
|---|---|---|
| | | *service then such interest would form part of gross amount received for the service. Also security deposit should not be in lieu of advance payment for the service.* |
| *6.* | *Security deposits forfeited for damages done by service receiver in the course of receiving a service* | *If the forfeited deposits relate to accidental damages due to unforeseen actions not relatable to provision of service then such forfeited deposits.* |
| *7.* | *Excess payment made as a result of a mistake* | *If returned it is not consideration If not returned and retained by the service provider it becomes a part of the taxable value.* |
| *8.* | *Demurrages payable for use of services beyond the period initially agreed upon e.g. retention of containers beyond the normal period.* | *This will be consideration and is covered by clause (x) of sub -rule (1) to Rule 6 of the Valuation Rules.* |

***2.3.3 Can a consideration for service be paid by a person other than the person receiving the benefit of the service?***

*Yes. The consideration for a service may be provided by a person other than the person receiving the benefit of service as long as there is a link between the provision of service and the consideration. For example, holding company may pay for services that are provided to its associated companies.*

***2.4 By a person for another***

***2.4.1 What is the significance of the phrase 'carried out by a person for another'?***

*The phrase 'provided by one person to another' signifies that services provided by a person to self are outside the ambit of taxable service. Example of such service would include a service provided by one branch of a company to another or to its head office or vice-versa.*

***2.4.2 Are there any exceptions wherein services provided by a person to oneself are taxable?***

*Yes. Two exceptions have been carved out to the general rule that only services provided by a person to another are taxable. These exceptions, contained in Explanation 2 of clause (44) of section 65B, are:*

*•an establishment of a person located in taxable territory and another establishment of such person located in non-taxable territory are treated as establishments of distinct persons. [Similar provision exists presently in section 66A (2)].*

*•an unincorporated association or body of persons and members thereof are also treated as distinct persons. [Also exists presently in part as explanation to section 65].*

*Implications of these deeming provisions are that inter-se provision of services between such persons, deemed to be separate persons, would be taxable. For example, services provided by a club to its members and services provided by the branch office of a multi-national company to the headquarters of the multi-national company located outside India would be taxable provided other conditions relating to taxability of service are satisfied."*

6. Responding to the arguments on case law advanced by the learned AR, the Learned Senior Advocate for the respondent emphasized on following case laws indicating the scope of expression "Consideration" and that the same has to be understood with the common law expression and that use in the Contract Act in Section 2(d). He stated that there cannot be any service without consideration. He relied upon decision in the matter of Commissioner of Service Tax, Chennai Vs. M/s Repco Home Finance Ltd reported at 2020 (7) TMI 472 -CESTAT Chennai wherein in relation to foreclosure charges levied by the banks, it was held that there was no consideration and therefore, no service is involved as far as foreclosure charges are concerned. Para 27 to 41 of the decision are reproduced below:-

***"27.*** *What follows from the aforesaid decisions is that "consideration" must flow from the service recipient to the service provider and should accrue to the benefit of the service provider and that the amount charged has necessarily to be a consideration for the taxable service provided under the Act. It should also be remembered that there is marked distinction between "conditions to a contract" and "considerations for the contract". A service recipient may be required to fulfil certain conditions contained in the contract but that would not necessarily mean that this value would form part of the value of taxable services that are provided.*

***28.*** *It is also necessary to remind ourselves that the word "include" is generally used in interpretation clauses to enlarge the meaning of the words or phrases occurring in the body of the statute and when it is so used, such words or* *phrases must be construed to comprehend, not only such things as they signify according to their natural import, but also those things which the interpretation clause declares that they shall include. This is what was stated in Dilworth v. Commissioner of Stamps [1899 AC 99].*

***29.*** *Justice G.P. Singh in "Principles of Statutory Interpretation" (Thirteenth Edition) has also remarked that where a word is defined to "include" such and such, the definition is prima facie not exhaustive and so the natural meaning of the word cannot be narrowed down by the "includes" part.*

***30.*** *In this connection it would also be pertinent to refer to TRU Circular dated 20 June, 2012 issued by the Central Board of Excise and Customs as an Education Guide when the Negative List based taxation regime was introduced to clarify various aspects of the levy of service tax. The Board dealt with "consideration" in paragraph 2.2 of this Circular and pointed out that since the definition was inclusive, it will not be out of place to refer to the definition of "consideration" as given in Section 2(d) of the Indian Contract Act, 1872 [the Contract Act]. The relevant portion of the aforesaid Circular is reproduced below:*

*"2.2 Consideration*

*2.2.1 The phrase "consideration" has not been defined in the Act. What is, therefore, the meaning of "consideration"?*

*As per Explanation (a) to section 67 of the Act "consideration" includes any amount that is payable for the taxable services provided or to be provided.*

*Since this definition is inclusive it will not be out of place to refer to the definition of "consideration" as given in section 2(d) of the Indian Contract Act, 1872 as follows -*

*xxxxx xxxxx xxxxx*

*In simple terms, "consideration" means everything received or recoverable in return for a provision of service which includes monetary payment and any consideration of non-monetary nature or deferred consideration as well as recharges between establishments located in a non-taxable territory on one hand and taxable territory on the other hand."*

*(emphasis supplied)*

***31.*** *It would, therefore, be appropriate to examine the definition of "consideration" in Section 2(d) of the Contract Act, as the Contract Act deals with all kinds of contracts and pre-dates the Finance Act. The definition of "consideration" is as follows :-*

*"2(d) When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises*

*to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise."*

***32.*** *What needs to be noted from the aforesaid definition of consideration under Section 2(d) of the Contract Act is that consideration should flow at the desire of the promisor. Thus, if the consideration is not at the desire of the promisor, it ceases to be a consideration. The banks and non-banking financial companies are promisors and the promisees are the borrowers. The contractual relationship between the banks and non-banking financial companies and the customers is repayment of the loan amount over an agreed period. The banks and non-banking financial companies would not desire premature termination of the loan advanced by them as it is in their interest that the loan runs the entire agreed tenure for the banks thrive on interest earned from lending activities. As premature termination of a loan results in loss of future interest income, the banks charge an amount for foreclosure of loan to compensate for the loss in interest income. It is the customer who has taken the loan, who moves for foreclosure of the loan by making the payment of the loan amount before the stipulated period and thereby breaching the promise to service the loan for the agreed period of time. This results in a unilateral act of the borrower in repudiating the contract and consequently breach of one of the essential terms of the loan agreement. A breach of contract may give rise to a claim for damages.*

***33.*** *Breach of contract has been defined in Black's Law Dictionary (Eighth Edition) as follows :*

*"Breach of contract. Violation of a contractual obligation by failing to perform one's own promise, by repudiating it, or by interfering with another party's performance.*

*"A breach may be one by non-performance, or by repudiation, or by both. Every breach gives rise to a claim for damages, and may give rise to other remedies. Even if the injured party sustains no pecuniary loss or is unable to show such loss with sufficient certainty, he has at least a claim for nominal damages. If a court chooses to ignore a trifling departure, there is no breach and no claim arises." Restatement (Second) of Contracts § 236 cmt. a (1979)."*

***34.*** *Sir Guenter Treitel has, in his book "The Law of Contract", described the manner in which a breach of contract can be remedied. The injured party can be placed in the same position in which he would have been if the contract was not made or the injured party can be placed in a position in which he would have been if the contract had been performed. The former protects "restitution" or "reliance interest", while the latter protects "expectation interest". The paragraphs dealing with the aspect are reproduced :*

*"Remedies for breach of contract are discussed in Chapter 21; but one fundamental point relating to them must be made at this stage. Such remedies*

*might attempt to do one of two things. First, they might attempt to put the injured party into the position in which he would have been if the contract had never been made. This would require the party in breach to restore anything that he had received under the contract, and also to compensate the injured party for any loss that he had suffered by acting in reliance on the contract. Such remedies are said to protect the injured party's restitution and reliance interest. But remedies for breach of contract go beyond the pursuit of these objectives. Their distinguishing feature is that they seek to put the injured party into the position in which he would have been if the contract had been performed. If, for example a seller agrees to sell goods for less than they are worth, and then fails to deliver them, he must compensate the buyer for not having received goods which are worth more than he had agreed to pay for them. Conversely, if a buyer contracts to buy goods for more than they are worth, and then fails to pay for them, he is liable for the agreed price. It is quite immaterial that the value of the goods with which the seller has parted was lower than that price. What the law does in these cases is to protect the injured party's expectation interest. Sometimes it does so directly, by actually ordering the party in breach to perform his part of the contract. Sometimes it does so indirectly by ordering him to pay the injured party damages for loss of his bargain.*

*The result of awarding damages on this basis is to compensate the injured party, not because he is worse off than he was before the contract was made, but because the other party has failed to make him better off. The law of contract takes this position in response to the needs of commercial certainty. It is probably going too far to say that business could not be carried on at all if the law did not protect the injured party's expectation interest. Some industries (such as the credit betting industry) are carried on without this, or indeed any other legally recognised, sanction. But in relation to other sphere of commercial activity, such as share and commodity markets and the insurance industry (to take a few random examples) the protection of expectations is of crucial importance. In these cases, that protection promotes stability and furthers one of the central purposes of the law of contract in providing the legal framework required for commercial relations."*

*(emphasis supplied)*

***35.*** *The "expectation interest" is a popular measure for damages arising out of breach of contract. The foreclosure charges, therefore, are not a consideration for performance of lending services but are imposed as a condition of the contract to compensate for the loss of "expectations interest" when the loan agreement is terminated prematurely. In fact, foreclosure charges seek to deter the borrowers from switching over to cheaper available sources of loan, as has been so clearly stated in the Circular dated 26 June, 2012 issued by the Reserve Bank of India.*

***36.*** *The basis for charging foreclosure amount has also been explained by the Karnataka High Court in M/s. Hotel Vrinda Prakash and Another v. KSFC and Another [ILR 2008 KAR 1311]. The writ petitioner had borrowed a loan from the Karnataka State Financial Corporation but before the period of loan could expire made an application for foreclosure of the loan. The Corporation, however, demanded premium on the advance payment/foreclosure amount which demand was challenged in the writ petition. The High Court, after noticing that the contract contained a clause giving discretion to the Corporation to impose premium on the balance amount of loan, observed that granting of loans is a business of the Corporation and if the loan is prepaid, the Corporation may have to suffer loss. It is to overcome this situation that premium is charged. The observations are as follows;*

*"13………………….Therefore, the granting of loans or advances is one of the business of the Corporation. As stated above, the Corporation borrows funds from the financial institution at the prevailing rate of interest. If an account is prepaid/foreclosure when the interest rates are falling, the Corporation may have to suffer loss. To overcome this situation, if a premium is charged on the outstanding loan being prepaid, the same cannot be found fault with. I am of the considered view that the Corporation has the power and authority to levy prepayment/foreclosure premium."*

***37.*** *The foreclosure of loan is, therefore, a material breach of contract as it curtails the loan service period unilaterally, which can prompt the promisor to claim damages. Damages can be determined by Courts or they can also be incorporated in the loan agreements and other commercial contracts so as to ensure certainty in dealings and also serve as a deterrent measure. This aspect of damage is known as liquidated damages.*

***38.*** *Liquidated damages have been dealt with by Pollock & Mulla in the book titled "The Indian Contract and Specific Relief Acts" (Fourteenth Edition) and the relevant portion is reproduced below :*

***"Liquidated Damages***

*'Liquidated damages' means that it shall be taken as the sum which the parties have by the contract assessed as damages to be paid whatever may be the actual damage. A fixed figure of damages, which is not assessed for all circumstances, but is graduated to correspond with passage of time between the making of contract and of its breach, is a proper estimate of the damages to be anticipated from the breach, and is liquidated damages."*

***39.*** *It would thus be seen that clauses relating to damages for foreclosure of loan are usually incorporated in contracts as an agreed measure of damages which can be enforced in the event there is a breach of contract with a view to bring about certainty in contracts. These clauses do not and cannot give rise to* *any "consideration". These clauses also come into effect only after the contract comes to end.*

***40.*** *Section 74 of the Contract Act which deals with compensation for breach of contract where penalty is stipulated also needs to be referred to. It is reproduced below;*

***"Section 74. Compensation for breach of contract where penalty stipulated for.*** *- When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.*

*Explanation. - A stipulation for increased interest from the date of default may be a stipulation by way of penalty.*

*Explanation. - xxxxx*

*Explanation. - xxxxx"*

***41.*** *Compensation for damages in the eventuality of breach of contract clearly contemplates that the sum of damage is named in the agreement. The section itself would be applicable only in cases where the eventuality of damage and the quantification for damages is specified in the agreement."*

6.1 The point of emphasis of the learned Senior Advocate was that the damages in any form which arise because of breach of contract as compensation cannot be taken as consideration because these cannot be visualised in Advance and taken care of by providing for consideration. He advanced the argument that anything which is incorporated or is received as damages or compensation, cannot give rise to any consideration.

7. The Bench after initial arguments from both sides, found that the initial view emerging from various case laws, quoted by either side or even the Board's instructions upto 2017, only indicate as to what cannot be included in the phrase, as has been used in Section 66E(e) (ibid) or even for that matter in relation to "deemed supply" as defined in Annexure-II of CGST Act, 2017. To have better understanding of the proposition, both sides were given time

to submit their arguments firstly by indicating as to what can included in the phrase used in Section 66E(e) of Finance Act, 1994 as legislature is not known to have wasted any word and it has to be equally understood by juxtaposing as to what can get included and what cannot be in the phrase of Section 66E(e) "***agreeing to the obligation*** *to refrain from an act, or to tolerate an act or a situation, or to do an act;".* Bulk of the case law as well as clarifications only indicated as to what cannot be included in the phrase. As **"Verba legis non sunt superflua"** (for words of law cannot be superfluous), therefore the Bench directed both sides to advance arguments as to what activities/actions/ abstinence can get included within the ambit of Section 66E(e) of Finance Act, 1994. Accordingly, during the course of next hearing, both sides made elaborate arguments.

8. Learned AR relied on Australian law to indicate as to what can be included in the phrase 'to tolerate an act'. Learned AR pointed out that Australian law has similar deemed supply provisions. Relying on decision pronounced by High Court in Commissioner of Taxation Vs. MBI Property Pty Ltd HCA 49, decided on 03.12.2014, he stated that the case involved MBI Property which purchased reversionary interest in residential apartments that were already subjected to existing lease with tenant. The central question was whether MBI by acquiring the reversion became obliged to observe the lease covenants and made a supply to the tenant. The High Court observed as follows:-

> *"The High Court took a broad reading of the definition of "supply" in section 9-10 and concluded that there was no reason, either in the wording or policy of the GST Act, for limiting the meaning of supply only to those that occur at the time of entering into a lease. Instead, the Court held that the definition should extend to later supplies that occur where a lessor observes and continues to observe an express or implied covenant of quiet enjoyment under the lease.*
>
> *Crucially, the High Court explicitly recognized that the tenant's enjoyment of the premises is something being tolerated by the landlord, and that this toleration constitutes a supply. By acquiring the reversionary interest and assuming the landlord's obligations under the lease, MBI entered into an obligation to tolerate*

*the tenant's occupation and use of the premises. The Court reasoned that this entering into an obligation was itself a form of supply within section 9-10(2)(g), regardless of the fact that it occurred upon acquisition of an existing property right rather than through a new contractual bargain."*

8.1 Similarly view was taken in Westley Nominees Decision (2006) by their Full Federal Court as given hereunder:-

*"The Full Federal Court's decision in Westley Nominees Pty Ltd v Coles Supermarkets Australia Pty Ltd 152 FCR 461 marked an important development in understanding how courts approach obligations to "tolerate" under GST law. In that case, the appellants purchased the reversionary interest in a property that was already subject to an existing lease. The issue before the court was whether, by acquiring the reversion, the appellants made a supply within the meaning of section 9-10.*

*The Full Federal Court found (at paragraphs-) that "when the appellants purchased the reversion, they assumed the obligation of Lake Eerie to honour the lease according to its terms and in that sense entered into an obligation to tolerate an act or situation and in consequence, made a 'supply' by virtue of s 9-10(2)(g)." This decision confirmed that a supply could arise by operation of law through the assumption of obligations, including the obligation to tolerate the tenant's rights of occupation. The Court noted that the concept of "supply" in section 9-10(2)(g) is arguably broader than the ordinary meaning in section 9-10(1), which seemed to require "some act of provision, furnishment, conferral or giving of something."*

*However, the Westley Nominees decision remained unclear on whether positive acts of the supplier are required for a supply to arise. The Full Federal Court itself acknowledged that "the question was by no means free of doubt," and commentators noted that the scope of section 9-10(2)(g) in relation to purely involuntary or passive obligations remained ambiguous."*

8.2 It was thus argued by Learned AR that an obligation which is already subsisting if it is tolerated by another person who supplied a right can also be considered as tolerating an act. It was his line of argument that an undertaking to utilize a particular level of capacity is also a subsisting obligation which can be considered as an act of tolerating. For the purposes of giving an example for what could be taken as covered in the phrase *"agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;"*, learned AR focussed on the decision of The Westley Nominees PTY

Ltd Vs. Coles Supermarkets Australia Pty Ltd under Australian GST law, in which case, Coles Supermarkets Australia Pty Ltd operated a supermarket as a tenant in a Queensland Shopping Centre. Under the lease agreement, Coles paid to Westley (the owner) a base amount of rent and the annual percentage rent calculated from the functioning of the Supermarket's turnover or contribution to the lessor's operating expenses, after-hour charges and a "promotion fund contribution". It was held that the reversionary right is to be regarded as continuing to make the supply, which will constitute tolerating an act and hence, subjected to tax on supply.

8.3 The Learned AR pointed out that the ruling of considering concept of "supply" held that there was sufficient nexus between 'payment' and 'supply' in order to establish the relationship of the supply for consideration. He also emphasized on various kinds of supplies relating to an out-of-court settlement and the treatment by the Australian Courts:

> ***"'Supplies' related to an out-of-court settlement***
>
> *42. The statutory definition of 'supply' is very broad. In the context of an out-of-court settlement, a supply referred to under any of the paragraphs within subsection 9-10(2) could be related to an out-of-court settlement.*
>
> *43. A supply related to an out-of-court settlement may have occurred prior to the settlement (and in fact have been the subject of the dispute in the first place), or it may be created by the terms of the settlement itself. There may be more than one supply that is related to a settlement. In addition, the subject of the dispute may not be a supply at all (refer paragraph 71)*
>
> *44. For the purposes of this Ruling, supplies that are related to an out-of-court settlement fall within the three categories of supply described below. This characterization assists in the subsequent analysis of consideration for a supply, which commences at paragraph 100. The existence of a particular supply in relation to a given settlement will not necessarily mean a sufficient nexus exists between that supply and a payment made under the settlement.*
>
> *Supply [F26] The GST Act does not prescribe any sequencing or hierarchy of supplies for taxing purposes. GST becomes payable on the relevant supply.*
>
> *46. In these circumstances, where the subject of the dispute is an earlier transaction which a supply was made involving the parties, that supply is referred to in this ruling as an 'earlier supply'.*

*Example-Earlier supply*

*47. Widget Company supplies toys to a retailer. A dispute between the parties over payment for the toys is subsequently resolved through an out-of-court settlement, with the retailer paying all monies owed. The supply of the toys, that is the subject of the dispute, is an earlier supply because it occurred before the dispute arose.*

*Current supply*

*48. A new supply may be created by the terms of the settlement. In this Ruling, such a supply is referred to as a 'current supply'.*

*Example - Current supply*

*49. A dispute arises over a claim by Beaut Enterprises Pty Ltd that Plagiariser Pty Ltd is using their trade name. Negotiations between the parties follow, resulting in Beaut entering into an agreement with Plagiariser that allows Plagiariser to use its trade name in the future. This would constitute the supply of a right under the agreement between Beaut and Plagiariser that amounts to a 'current' supply,*

*Supply related to discontinuance of action*

*50. Even where there is no earlier or current supply, the very wide range of things that can constitute a supply" means that one or more new supplies will probably crystallise on an out-of-court settlement being reached.*

*51. Generally (it is suggested in most if not all cases), the terms of a settlement, in finalising a dispute, will ensure no further legal action in relation to that dispute, provided that the terms of the settlement are complied with. This often takes the form of a plaintiff releasing a defendant from some (or all) of the existing claims and from further claims and obligations in relation to that dispute.*

*52. Sometimes, where a dispute involves counter claims, the terms of the settlement may provide for each party to release the other from such claims and obligations,*

*53. Where court proceedings have commenced, the filing of a notice of discontinuance pursuant to the relevant court rules may also be required to ensure the court is advised that a particular action will col proceed.*

*54. We consider that these conditions of settlement can create supplies for GST purposes. The supplies may be characterized as:*

*i) surrendering a right to pursue further legal action (paragraph 9-10(2)(e)); or ;*

*ii)entering into an obligation to refrain from further legal action (paragraph 9-10(2)(g)], or* *iii) releasing another party from further obligations in relation to the dispute (paragraph 9-10(2)(g))*

*55. In this Ruling, we refer to supplies of these kinds as 'discontinuance supplies However, whether a discontinuance supply would be a taxable supply would then depend on the requirements of section 9-5 being met in relation to that supply.*

***Disputes resolved by a court order***

*56 Three recent court judgments have considered the possible application of the provisions of the GST Act to the decisions of the court and payments made in compliance with the orders of the court*

*57. The three reported decisions are:*

*(i) White J in Interchase Corporation Ltd v ACN 010 087 573 Pty Ltd & Ors [Interchase]:*

*(ii) Underwood Jin Shaiv v Director of Housing and State of Tasmania (No 2) (Shaw), and*

*(iii) Hunter J in Waller Construction Group Limited v Walker Corporation Ltd & Ors [WCG].*

*58. In each of these cases, the plaintiff had been awarded a judgment sum and was seeking an indemnity for any future liability to pay GST on the judgment sum, In Interchase, Justice White dismissed the application largely for procedural reasons, though her Honour nevertheless considered the requirements of the GST Act and made the following observations:*

*It is not easy to see how a court giving judgment or the payment of a judgment sum or the granting of a stay of execution could constitute a 'supply' within the meaning of those expressions[s.-9-10]"*

8.4 On the point of "Consideration" and "supply", learned AR relied upon the following criteria evolved by the Australian courts:

***<u>"Consideration:-</u>***

*In determining whether a payment satisfies the requirements of subsection 9-15(1), the test is whether there is a sufficient nexus between the supply and the payment made.*

*This test may establish a nexus between consideration and supply in a broader range of cases than the 'direct link' test which applies in the European Community and in Canada. While caution needs to be exercised in applying decisions on connective terms in other contexts, the term "in connection with" has been held to be broader in scope than "for".*

*The meaning given to the term 'in connection with' in Berry's Case is similar to that which was described by the Court of Appeal in New Zealand Refining, but needs to be applied with regard to the structure of the definition of supply in the GST Act. In Berry's Case, Kitto Jheld that in connection with was a brooder last than for at page 659 he commented that consideration will be in connection with property where:*

*'the receipt of the payment has a substantial relation, in a practical business sense, to that property'.*

*In determining whether a sufficient nexus exists between supply and consideration, regard needs to be had to the true character of the transaction. An arrangement between parties will be characterized not merely by the description which parties give to the arrangement, but by looking at all of the transactions entered into and the circumstances in which the transactions are nude.*

***Can a settlement or court awarded payment be consideration?***

*Subsection 9-15(2A) makes it clear that the fact that a payment is made in compliance either with a court order, or with a settlement relating to proceedings before a court will not, prevent it from being consideration for a supply.*

*Subsection 9-15(2A) states:*

*(2A) It does not matter*

*(a) whether the payment, act or forbearance was in compliance with an order of a court, or of a tribunal or other body that has the power to make orders, or*

*(b) whether the payment, act or forbearance was in compliance with a settlement relating to proceedings before a court, or before a tribunal or other body that has the power to make orders.*

*This provision negates any argument that the characterisation of a payment according to section 9-15 either as consideration for a supply or otherwise could be affected by the payment being made in compliance with a court order or settlement relating to proceedings before a court."*

8.5 Learned AR also emphasized on the principle of apportionment evolved by various Australian Courts:-

***"Apportionment***

*115. Where payment made under a court order or out-of-court settlement has a sufficient nexus with more than one supply, with one or more supplies being taxable and one or more being GST-free or input taxed, the payment will be for* *each of the relevant parts. This will also be the case where the payment is partly for an item of damages.*

*116. Where a court order (issued in accordance with the court's judgment on the case) itself dissects and itemises the payment into the heads of claim relating to the individual supplies and/or item of damages, that itemisation will be accepted as representing the amounts of these relevant parts*

*117. In the case of an out-of-court settlement, where the terms of the settlement include a dissection and itemisation of the payment into the heads of claim, that itemisation will be accepted as representing the amounts of these relevant parts to the extent that it is made on a reasonable basis*

*118. Where no dissection is made, even though the payment has a sufficient nexus with more than one supply, or to a supply and an item of damages which is not a supply, the payment should be apportioned into amounts representing these relevant parts in order that the correct GST consequences result.*

*119. The apportionment should be determined by the parties on a reasonable basis. Where a payment is apportioned in a manner that cannot be justified in terms of reasonableness, the general anti-avoidance provisions of the GST Act may have application.*

***Example-apportionment where no earlier supply***

*120. Triple dot, an Australian based provider of music services on the internet, is sued by Ozy Rockers, a local rock group, for infringement of copyright in relation to its material. The infringement relates to similarities between the website signature tune and the music and lyrics of one of the band's top forty hit tunes. The infringement occurred at the time the website first appeared in October 2000. Since then Triple dot has achieved unparalleled success in attracting 'surfers' to the site*

*121. Ozy Rockers is seeking damages for the infringement in the order of $550,000, Prior to the matter being considered by the courts Oz Rockers and Triple dot entered into negotiations in an attempt to resolve the dispute. During the discussions a settlement is reached which provides that Triple dot will make* *a one off payment of $200,000 to Ozy Rockers. The payment is for the past infringement and the ongoing right for Triple dot to use the signature tune*

*122. Apportionment is necessary for the correct GST consequences to attach to the supply of the ongoing right to use the copyright. A reasonable approach is required for calculating the necessary apportionment. In the absence of any further information, it may be reasonable to apportion $50,000 to damages for the breach of contract (which would not attract GST) and $150,000 to the use of the copyright (a taxable supply). An alternative basis for apportionment may be to use industry standards to calculate copyright fees*

***Example-apportionment whore an earlier supply***

*123. Just before Valentines Day, Flowerbox, a GST registered gift shop, receives a supply of wilted flowers for which it has paid $5,500 and claimed an input tax credit of $500. The supplier refuses to refund any part of this amount and Flowerbox sues the supplier for damages, in the amount of $12.000. Flowerbox has based the amount of its claim on the cost of the flowers ($5,500) plus an amount of $6,500 that it asserts is equal to the loss of profits it would have made from the sale of the flowers. The court rules in favour of Flowerbox, but the total award is reduced to $9,900. The court does not dissect in amount of the award.*

*124. To apportion this amount, it is reasonable that $5,500 is applied to the reduction in the price of the flowers and the balance ($4,400) to the loss of business. As an alternative, it might be appropriate to use the relative proportions of the original heads of claim as the basis for dissecting the amounts awarded by the court.*

*126. The GST consequences of a payment made under a court order or out-of-court settlement may be:-*

*(i) attribution of GST payable or input tax credit in the tax period the payment made or*

*(ii) attribution of increasing or decreasing adjustments in respect of changes to the consideration for a supply or*

*(iii) no attribution or adjustment action required."*

8.6 Learned AR further relied on the decision of European Union and various principles laid down based on the case law on Provisions similar to Section 66E(e). He also pointed out that as per the European Union, situations like non-compete fees or exclusivity fees and early termination or minimum commitments can be taxable where the economic reality shows that the payment is for ongoing availability of services promised by the supplier. He argued that the charges received by the respondent were in the nature of minimum commitment charges and therefore, the same are taxable.

9. The learned Senior Advocate appearing for the party rebutted these arguments that the compensation was due to fixed manufacturing cost or due to idle capacity and there was admission by the party which made the services taxable. He pointed out that in the Contract Act, 1872 for any breach normally three kinds of compensations are permitted which are (i) damages, (ii) liquidated damages & (iii) in some cases penalties. He pointed that the expression of Section 66E(e) of the Finance Act, "agreeing to the obligation" is a phrase which is exclusive to Indian legislature only and does not find mention in Australian or European Union Law. He pointed out that liquidated damages in Indian context can only include pre-determined damages and cannot include penalty, which is not the case with British common law as even the element of penalty, if contained in liquidated damages is allowed by the British Courts. Whereas, Indian Courts have been specifically excluding element of penalty in the pre-determined liquidated damages and therefore, both the concepts are different to that extent. He pointed out that it is by law settled that amount paid for breach of contract cannot be consideration or a contract as defined in Section 2(d) of the Indian Contract Act, 1872. It is for this reason that Tribunal in various cases has also decided that damages do not afford "consideration" and therefore, there cannot be any quid pro quo or element of service whenever the quantified damages under the contract are

received. He submitted that both 'liquidated damages' as exist in Indian context as well as the other 'damages' cannot be considered as service for lack of consideration. On the specific issue of compensation on capacity as in the instant case, he relied upon the proposition that 'damages' can have no consideration on the basis of decision reported in 2021 (55) GSTL 549 (Tri.-Delhi) in the matter of South Eastern Coalfields Ltd Vs. Commissioner, Central Excise and ST, Raipur, in which case compensation/penalty was received from the buyers by coal mining supplier company for short lifted, un-lifted quantity of coal. The security deposit/finance money deposit forfeited for non-compliance of contract by the contractor and liquidated damages from raw material buyer were not considered as "consideration" for tolerating an act and hence, not "declared service" as per Section 66E(e) of Finance Act, 1994, specially when contract did not specify or provide for obligation on assesse to refrain from an act or tolerate an act or a situation and in which decision, it was held that liquidated damages/penalty cannot be considered towards any "service" as asssessee is not carrying out any "activity" to receive compensation nor there can be any intention of party to commit breach or violate contract and suffer a loss. Thus, he pointed out that the penalty provision stipulated in contract for breach cannot be considered as a consideration for contract. He also relied upon decision of K N Food Industries Pvt Ltd Vs. Commissioner of CGST & Central Excise, Kanpur reported at 2020 (38)GSTL 60 (Tri.-All.) in which it was held that when assessee's capacity, as a manufacturer is not being fully utilized by Principal, ex-gratia charges paid to compensate them from financial damage/injury and in which case ex-gratia amount was not fixed and mutually decided between two parties, the same could not be considered as not being towards "damages" and therefore, the act did not emanate from any obligation on the part of any of the parties to tolerate an act or a situation and cannot be considered to be payments for any services and therefore, not liable to service tax. The learned Senior Advocate also relied upon Board's Circular No. 178/10/2022-GST dated

03.08.2022 on the GST Law. As an example in para 3.1, following has been taken as not covered in the phrase ' agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act':-

> *"3.1 Some of the important examples of such cases are Service Tax/GST demands on-*
>
> *(i) Liquidated damages paid for breach of contract:*
>
> *(ii) Compensation given to previous allottees of coal blocks for cancellation of their licenses pursuant to Supreme Court Order,*
>
> *(iii) Cheque dishonour fine/penalty charged by a power distribution company from the customers:*
>
> *(iv) Penalty paid by a mining company to State Government for unaccounted stock of river bed material*
>
> *(v) Bond amount recovered from an employee leaving the employment before the agreed period,*
>
> *(vi) Late payment charges collected by any service provider for late payment of bills*
>
> *(vii) Fixed charges collected by a power generating company from State Electricity Boards (SEBs) or by SEBS/DISCOMs from individual customer for supply of electricity:*
>
> *(viii) Cancellation charges recovered by railways for cancellation of tickets, etc.*
>
> *In some of these cases, tax authorities have initiated investigation and in some advance ruling authorities have upheld taxability."*

9.1 He also took us to para 4,5,6 of the clarification to show the scope as it has existed under service tax law as well as GST law now.

> *"4. In Service Tax law, 'Service' was defined as any activity carried out by a person for another for consideration. As discussed in service tax education guide, the concept 'activity for a consideration involves an element of contractual relationship wherein the person doing an activity does so at the desire of the person for whom the activity is done in exchange for a consideration. An activity done without such a relationship i.e., without the express or implied contractual reciprocity of a consideration would not be an 'activity for consideration'. The element of contractual relationship, where one supplies goods or services at the desire or another, is an essential element of supply.*

> *5. The description of the declared service in question, namely, agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act in para 5(e) of Schedule II of CGST Act is strikingly similar to the definition of contract in the Contract Act, 1872. The Contract Act defines 'Contract' as a set of promises, forming consideration for each other. 'Promise' has been defined as willingness of the 'promisor' to do or to abstain from doing anything. 'Consideration' has been defined in the Contract Act as what the 'promisee' does or abstains from doing for the promises made to him.*
>
> *6. This goes to show that the service of agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act is nothing but a contractual agreement. A contract to do something or to abstain from doing something cannot be said to have taken place unless there are two parties, one of which expressly or impliedly agrees to do or abstain from doing something and the other agrees to pay consideration to the first party for doing or abstaining from such an act. There must be a necessary and sufficient nexus between the supply (i.e. agreement to do or to abstain from doing something) and the consideration."*

9.2 On the point of where the service was received and point of taxation, he placed reliance on decision in case of Linde Engineering India Pvt Ltd Vs. UOI reported in 2022 (57) GSTL 358 (Guj.) wherein it was provided that even services to a holding company located outside India will have to be considered as export of services between the petitioner and parent company and both cannot be considered as merely establishment of the same business, so as not to be distinct persons. He pointed out that to get included as part of levy under the phrase of Section 66E(e) of the Finance Act, 1994 and mutatis mutandis under GST Law, a positive act or affirmation is required as a part of the contract and same should not be an outcome of breach of contract as in the latter case, the test of 'consideration' within the ambit of section 2(d) of the Indian Contract Act, 1872 fails and therefore, even under Section 65B (44) of the Finance Act 1994, the service as defined which includes activity carried by a person for another for consideration fails. After being pointed out that Section 65(44) mentions that *"service" means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include…….*", he was asked as to whether the expression after coma "," "and includes a declared service" will not extend the scope of service to work beyond "consideration" and "includes a declared service" even if without consideration as defined in Section 66E(e) and whether agreeing to obligation, has to be prior to and pre-exist in contract or can exist at any stage latter or even at the stage of breach of the contract to extend the scope of the service and exactly what kind of obligation would have been envisaged by the legislature to include in the scope of declared service. The learned Counsel sought time as was also sought by the other side to make further detailed submissions with the help of provisions of Indian Contract Act, 1872 and other legislations, in which similar or somewhat similar phrase is existing for the purposes of levy and other rulings of various countries.

10. Accordingly, during second hearing, following detailed submissions were made by the Senior Advocate.

10.1 The term "consideration" has not been defined in the Finance Act,1994 and therefore, same can be understood through common law or well-established definition under Section 2(d) of the Indian Contract Act,1872 which is of more than 150 years vintage and can be considered to be generally and customarily defining various concepts. Therefore, going by the definition as given under Section 2(d), there has to be a nexus between 'activity carried out' and "consideration" and consideration should flow out of such nexus. The Learned Senior Advocate submitted that non-existence of nexus can be demonstrated with the help of rulings from HM Revenue and Customs, HMRC Internal Manual, VATSCO5910 in which various illustrative examples were given as to what will fall within the ambit of supply of service and what will not?:-

> *"The test of whether there is the necessary direct link between a supply and the consideration will already have been satisfied as regards a VAT-registered business's normal income from a supply. Thus, the question will be, why isn't other income it has received in connection with that supply also within the scope of VAT? To illustrate this point, as the Court of Appeal commented in paragraph*

*31 in Esporta Ltd v Revenue and Customs [2014] EWCA Civ 155 (https://www.bailii.org/ew/cases/EWCA/Civ/2014/155.html):*

*"I cannot see how, as a matter of principle, and looking at the contract at the time it was made, the default provisions in the contract should affect the underlying analysis of the services that are to be provided in consideration for the fees. The default provisions are just that - steps that are taken when, unexpectedly, the member fails to comply with his payment obligations. They would not be expected to change the nature of the services that are to be supplied in consideration of the payments the member has agreed to make."*

*Historically, HMRC took the view that payments described as compensation were typically outside the scope of VAT. One authority for this was the CJEU case of Société thermale d'Eugénie-les-Bains (C-277/05)*

*(http://curia.europa.eu/juris/document/document.jsf?docid=62752&mode=req&pageIndex=1&dir=&occ=first&part=1&text=&doclang=EN&cid=15243477). In the very particular circumstances of that case, the Court concluded that the deposit received by the hotel was not a part payment for the accommodation, and when a customer cancelled a booking, it was to be treated as outside the scope of VAT as it was compensation rather than consideration for a supply. In March 2019, they updated their guidance on deposits following later CJEU authorities, where the court found that similar payments were consideration- see VATSC05822(https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc05822).*

*More recent case law further indicates that some payments described as compensation or damages are nevertheless actually consideration for supplies.*

*(emphasis supplied)*

*In MEO-C295/17*

*(http://curia.europa.eu/juris/document/document.jsf?text=&docid=207965&pageIndex=0&doclang=en&mode=Ist &dir=&occ=first&part=1&cid=6571625) the CJEU found that the fact that payments may be categorised as contractual penalties or compensation under national law was irrelevant to the question of*

*whether there was a supply for consideration. In (#)Vodafone Portugal-C43/19 (http://curia.europa.eu/juris/document/document.jsf?text=&docid=227304&pageIndex=0&doclang=EN&mode=re q&dir=&occ=first&part=1&cid=4352595) the Court confirmed that position saying:*

*"In the context of an economic approach, an operator determines the price for its service and monthly instalments, having regard to the costs of that service and the minimum contractual commitment period... ...the amount payable in the event of early termination must be considered an integral part of the price which the customer committed to paying for the provider to fulfil its contractual obligations."*

*For a payment to be consideration for a supply there needs to be reciprocity between the supplier and the customer. The supplier agrees to provide a service which the customer benefits from. An example of where the necessary reciprocity was absent is the case of Mohr v Finanzamt Bad Segeberg (Case C-215/94)*

*(http://curia.europa.eu/juris/showPdf.jsf;jsessionid=D451703720B37933A819A0A76F7AA07E?text=&docid=99932&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=6712595). In this case, the German and Italian Governments argued that there was a clear and direct link between payments made by state authorities to farmers to cease milk production. The court ruled that the payments were outside the scope of VAT. This was because the authorities were paying out money for a wider good. They did not directly benefit from the action taken by the farmer and so did not consume any service. The necessary reciprocity between the supplier and customer did not exist. There was therefore no supply, and so there was no consideration liable to VAT.*

*In Vodafone Portugal - C43/19(http://curia europa.eu/juris/document/document.jsf?text=&docid=227304&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=4352595), the test for whether a payment is consideration for a supply was summarised as follows -.*

*"31. A supply of services is carried out 'for consideration',..., only if there is a legal relationship between the provider of the service and the recipient pursuant*

*to which there is reciprocal performance, the remuneration received by the provider of the service constituting the actual consideration for an identifiable service supplied to the recipient. That is the case if there is a direct link between the service supplied and the consideration received (judgment of 22 November 2018, MEO Serviços de Comunicações e Multimédia, C 295/17, EU:C:2018:942, paragraph 39 and the case-law cited).*

*32. As regards the direct link between the service supplied to the recipient and the consideration actually received, the Court has held that the consideration for the price paid at the time of the signing of a contract for the supply of a service is formed by the right derived by the customer to benefit from the fulfilment of the obligations arising from that contract, irrespective of whether the customer uses that right. Thus, that supply is made by the supplier of services when it places the customer in a position to benefit from the supply, so that the existence of the above mentioned direct link is not affected by the fact that the customer does not avail himself or herself of that right (see, to that effect, judgment of 22 November 2018, MEO- Serviços de Comunicações e Multimédia, C295/17, EU:C:2018:942, paragraph 40 and the case-law cited)."*

*It is therefore essential that there is a direct link between the consideration and the supply. Where this is the case, the supplier will normally have clearly agreed to do something for the customer in return for a payment. It may occasionally be the case that where an agreement does not explicitly allow a customer to do something, the economic reality of the transaction is such that agreement to supply something is nevertheless effectively there. This may be when a similar amount is paid for the hire of something when it is kept beyond the agreed term to that paid for the agreed hire period. In the Tribunal case JG Leigh t/a Moor Lane Video, it was found that the economic reality was that the penalty charged for late return was an additional fee for hire.*

*Similarly, if a car is hired for a period of a week and is due to be returned by, say 9am on a Monday but is not in fact returned until 5pm on the following Tuesday, a charge for late return will normally be made. Such charges are* *generally designed to both deter the person hiring the car from bringing it back late and to compensate the hire company for the additional use.*

*The charge will be subject to VAT as it is for the supply of the car, and the customer is aware that an additional charge will be made and how much that charge will be or how the charge will be calculated. Although the use goes beyond that which is agreed with the customer at the outset of the contract, it is an additional hire fee similar to that in JG Leigh t/a Moor Lane Video.*

*If the customer were to write off the car and the supplier charges a fee for doing so, this will not be further consideration for the hire of the car. The supplier does not agree that the customer can write the car off, and this is not something one would normally expect as part of the supply. The contract may envisage the possibility that the car will be written off and provide for a fee to be paid should that eventuality arise, but this is not further consideration for the supply as the necessary reciprocity does not exist.*

*Another potentially difficult area are dilapidation payments which occur in the land and property sector. These vary in the way they are provided for but broadly they exist to ensure landlords are not out of pocket if buildings are not returned in the agreed condition at the end of a lease. Our policy continues to be that these are normally outside the scope of VAT, see VAT Notice 742 Land and Property (https://www.gov.uk/guidance/vat-on-land-and-property-notice-742#other-land-transactions).*

*Again, the question that needs to be addressed is whether the payment is sufficiently linked to the supply of the lease to be regarded as further consideration for it. The service being supplied is the grant of an interest in the premises by way of a lease. It is the lease which creates the obligation to make such dilapidation payments. The obligation to make a dilapidation payment is not inevitable, rather the lease creates an obligation to return the property in the agreed state and it is the default on this obligation that gives rise to the requirement to make dilapidation payment.*

*The tenant takes on a package of rights and obligations when entering the lease, one of which is to return the building in the agreed state. The rent will normally reflect those rights and obligations. If the tenant does not fulfil its obligation to return the building in the required state, it is required to make a further payment so the landlord can restore the building to the agreed condition, and it is in effect a re-imbursement of the cost of goods and services that the landlord faces incurring. It is arguable that this therefore represents additional consideration for the supply of the lease. If the obligation to return the building in the agreed state was not there, it is probable that the rent would be set higher to allow the landlord to cover the costs of rectifying the building at the end of the contract.*

*On the other hand, if the tenant had exceeded the wear and tear that might reasonably be expected during the period of the lease, or even undertaken unapproved alterations, the dilapidation payment would be to rectify damage rather than for use of the premises and would be beyond what the landlord agreed the tenant could use the premises for. The link between payment and supply would therefore be broken. Although the payment arguably covers the landlord's expenses in meeting the tenant's obligation under the lease, it may be difficult to establish that the rent has been set with that in mind. It may be that the rent in reality reflects what the market will bear and would not be increased if the dilapidation clauses were removed from the lease. In that case the dilapidation payment would be made to put right damage and there would not be sufficient link between the payment and the service(s) the landlord had agreed to provide under the lease. It would not therefore be further consideration for the lease.*

*Our policy having weighed these factors is not to treat dilapidation payments as further consideration for the supply of a lease. We might depart from that view if in individual cases we found evidence of value shifting from rent to dilapidation payment to avoid accounting for VAT.*

*Another example of a situation in which additional fees may be charged is parking. If the fee is for the additional use of the parking space, it is further consideration for the supply of parking. HMRC's policy position is that where a* *fine is substantial and punitive and is designed to deter a breach of the terms and conditions of parking it will be outside the scope of VAT as the reciprocity needed to link it to the supply is lacking. If on the other hand it is effectively an additional charge for occupying a space, then it would be a standard rated supply. The level of the fee for breaching the parking terms in comparison to the standard parking fee may be indicative of which category a particular fine would be in."*

10.2 He particularly pointed out that when government gives a mandate to the farmers to not to produce milk more than 7 liter per cow to get allowance /compensation from the government, then even though this amounts to tolerating an Act from the government but no nexus between consideration received by the farmers from the government and service provided to the government can be made out as to what is paid by the government was in pursuance of a public policy of not allowing the milk prices to get depressed through excess supply. So, this is the case where tolerating of an act exists but there is no nexus of activity carried out, being for consideration. He pointed out that the liquidated damages which are ascertained a-prori at the time of entering into contract through prior agreement but will come into effect only on breach of the contract and will not get covered under the phrase of 66E(e) and what can get covered in the scope of the phrase are non-compete obligations like blocking of Senior Advocate by a strong litigant or consideration or other blocking contracts whereby, through agreements amounts are paid for not carrying out business in particular area or in a particular line of profession for some years entered into with apprentices or for contracts in which IPRs are compromised by inventors in favour of employers during course of employment for any inventors carried out and IPRs like patent, Trademark etc. received during the period of employment. A release from suing for infringement between a company who transfers commercial usage of a patent to someone else. Such right to sue for infringement being part of transfer amount can also be considered as getting covered under the context. Toleration of a tunnel passing from particular piece of land by the owner or electricity poles/ line passing through owner's land for consideration, can also come within the phrase of 'agreeing the obligation to refrain from an act, or to tolerate an act or a situation'. Money retained for aborted flights through a prior agreement can also be considered within the scope of the phrase of Section 66E(e). He pointed out that though the phrase 'agreeing to obligation' is exclusive to Indian Law and Indian context only. The phrase 'limits scope' as is appearing in British and European Union Law as well in Australian Tex Jurisdiction, as the obligation is required to be agreed in advance. He pointed out that from the scope of ruling VATSCO05910 dated 10th April, 2016 of HM Revenue and Customs following examples emerge, which can be considered as covered under Indian Law subject to the scope of Phrase "agreeing to an obligation" which as per his submission limits the scope of succeeding phrase. And that a cancelled booking of Hotel which was not part payment for the accommodation was compensation rather than "consideration" for a supply and therefore same was not consideration for a supply. Any ex-gratia payments made by the government citizens will not fall within the scope of supply making service for consideration.

10.3 He also pointed out that excess hire charges paid for keeping any video on hire beyond the agreed hire period was in fact additional fee for hire and such penal charges were for consideration. As both parties are aware that usage of hire beyond the stipulated period will be on additional charge and they also know how much the charge will be and how it will be calculated. Such charges will fall within the scope of such deemed levy. He also pointed out that the customer who has to ride the car and the supplier charges for doing so, will be further consideration for hire of the car, as this is not a normal activity expected as part of the supply. Therefore, in such eventuality, it cannot be consideration for the supply as necessary reciprocity does not exist. He thus pointed out that the reciprocity test and consideration as existing at the time of entering into contract, are the determinative tests which decide whether a service is deemed service or not? It is also pointed out that a slight variation in circumstances can give rise to new facts, which can lead to there being no service for consideration and can take the service /supply out of the ambit of "deemed service or supply".

10.4 Coming to the scope of the damages and why they do not form part of the "consideration", he with the help of various authoritative texts submitted the following proposition: -

(1). Even if a contract does not explicitly provide for damages, the party that breaches the contract is still liable to pay damages for the said breach. To support his argument, he relied on Pollock & Mulla Indian Contract Act and Specific Relief Act 7th Edition, 1944 to bring out the scope of penalty and liquidated damages as provided in Section 73 of the Contract Act:-

> *"Penalty and liquidated damages. This section boldly cuts the most troublesome knot in the Common Law doctrine of damages. By the Common Law, parties may name a penal sum as due and payable on a breach of contract, that sum being, according to the true intention of the parties, only a maximum of damages. In that case the real damages, and no more, are recoverable. On the other hand, they may by consent assess a fixed measure of damages, liquidated damages as they are called, to avoid the difficulty that must often be found in setting a pecuniary value on obligations not referable, on the face of them, to any commercial standard. So far this looks very well. The trouble is that even now the Courts have not arrived at clear or certain rules for deciding to which of these two classes a given stipulation for a penal or seemingly penal sum belongs. The only thing that is quite certain is that the use of the words "penalty" or "liquidated damages" is not decisive; and that even the addition of negative words purporting to exclude the other alternative, for example "as liquidated damages and not as a penalty" (k), will not make it so. Two causes appear to have conspired to produce this anomalous result: a well-meant but perhaps not wholly well-informed endeavour to imitate the equitable doctrine of giving relief against forfeiture (l), and, reinforcing this, a logical or arithmetical repugnance of the Common Law (perhaps connected with the canonical prohibition of usury (m)) to admit that a greater sum of money can ever be due for the breach of an obligation to pay a smaller one. "That a very large sum should become immediately payable in consequence of the non-payment of a very small sum, and that the former should not be considered as a penalty,*

*appears to be a contradiction in terms" (n). Accordingly a conventional larger sum agreed upon as payable in the event of failure to pay a smaller sum, or in such an event among others, is treated as penal only. Further, it is understood that "where a sum is made payable by a contract to secure performance of several stipulations the damages for the breach of which respectively must be substantially different that sum is prima facie to be regarded as a penalty, and not as liquidated damages" (o). The truth is that here, as in some other branches of the law, what once was a rule of policy overriding the intention of the parties has been turned into an artificial and more or less arbitrary rule of construction. The nearest approximation to a general test yet arrived at is that so-called liquidated damages will not be recoverable in full when the Court thinks this would be extravagant or unconscionable, having regard to the circumstances of the particular case (p). But it is quite needless to enter in this place upon the somewhat confusing application of the resulting distinctions, for the manifest purpose of the present section is to get rid of all these questions by carrying out the tendency of the English authorities to its full consequences (q).*

*There may, again, be a conventional sum which is neither damages nor penalty, but, as it has been called a " liquidated satisfaction" (r) the agreed price of liberty to do or omit something. In such a case there is merely a conditional or alternative promise which, if not open to any other objection, will take effect according to its terms.*

*It has been held by a Full Bench of the High Court of Allahabad that the section applies to a compromise decree and that it is open to a Court executing such a decree to go behind it if it contains a stipulation which is by way of penalty (s).*

*The original section has been amended by the Indian Contract Act Amendment Act, 1899. The italicised words indicate the portion newly added in the section. Illustrations (d), (e), (f) and (g) as given below, were also inserted by the same Act. The marginal note 10 the section has also been altered, it originally stood thus: Title to compensation for breach of contract in which a sum is named as payable in case of breach" (t). There is no doubt that, as the section originally stood, it was intended to do away with the dis-tinction between a penalty and liquidated damages (u). The sole object of the section appears to have been to provide for the class of cases to which Kemble v. Farren (v) belongs, and in which the distinction between 'liquidated damages' and 'penalty' has given rise to so much difference of opinion in the English Courts" (w). The amended section does not apply to covenants in a lease of which the breach involves forfeiture (x).*

***Illustrations***

*(d)* ***A****. gives* ***B****. a bond for the repayment of Rs. 1,000 with interest nt 12 per cent. at the end of six months, with a stipulation that in case of default, interest*

*shall be payable at the rate of 75 per cent. from the date of default. This is a stipulation by way of penalty, and **B**. is only entitled to recover from **A**. such compensation as the Court considers reasonable.*

*(e) **A**., who owes money to **B**., a money-leader, undertakes to repay him by delivering to him 10 maunds of grain on a certain date, and stipulates that, in the event of his not delivering the stipulated amount by the stipulated date, he shall be liable to deliver 20 maunds. This is a stipulation by way of penalty, and B. is only entitled to reasonable compensation in case of breach.*

*(f) **A**. undertakes to repay **B**. a loan of Rs. 1,000 by five equal monthly instalments, with a stipulation that, in default of payment of any instalment, the whole shall become due. The stipulation is not by way of penalty, and the contract may be enforced according to its terms.*

*(g) **A**. borrows Rs. 100 from **B**. and gives him a bond for Rs. 200, payable by five yearly instalments of Rs. 40, with a stipulation that in default of payment of any instalment, the whole shall become due. This is a stipulation by way of penalty."*

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*(k) In Kemble v. Farren (1829) 6 Bing. 141; 31 R.R. 366, a sum expressly declared by the parties to be "liquidated and ascertained da-mages, and not a penalty or penal sum or in the nature thereof," was held to be a penalty.*
*(l) See per Jessel M.R., Wallis v. Smith (1882) 1 Ch.D. 243, 256.*
*(m) It must be remembered that in the Middle Ages, and even later, usury meant not taking exorbitant interest, but taking interest at all.*
*(n) Kemble v. Farren (1829) 6 Bing. 141, at p. 148.*
*(o) A. L. Smith L.J., Wilson v Love [1896] 1 Q.B. 626, 631*
*(p) Clydebank Engineering Co. v. Castaneda [1905] A.C. 5 (an appeal from Scotland, but the Scottish law does not differ on this point from the English); Webster v. Bosanquet [1912] A.C. 394 (Jud. Comm. from Ceylon). See Mahadeoprasad V. Siemens (India) Ltd. (1934) 60 Cal 1379; 149 I.C. 858; A.I.R. 1934 Cal. 285.*
*(q) That this is now fully settled, see Panna Singh v. Arjan Singh, 33 C.W.N. 949; 117 I. C. 485; A. I.R. 1929 P.C. 179; (1929) All. L. J. 791; Mahadeoprasad v. Siemens (India) Ltd. (1933) 60 Cal. 1379; 149 I.C. 858; A.I.R. 1934 Cal. 285.*
*(r) See Lord Elphinstone γ. Monkland Iron and Coal Co. (1886) 11 App. Ca. 332, at p. 347.*
*(s) Mohiuddin v. Kashmiro Bihi (1933) 55 All. 334; 142 I.C. 419; A.I.R. 1933 All, 252, overruling a contrary decision of the same Court: Raghunandan Prasad v. Ghulani Ala-ud-din Beg (1924) 46 All. 571; 79 I. C. 916; Subbayya v. Pedayya (1937) 169 I.C. 345; A.I.R. 1937 Mad. 234.*
*(t) The first paragraphia of the section stood as follows before amendment: "When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named."*
*(u) Mackintosh v. Crow (1883) 9 Cal. 689, at p. 692, per Wilson J.; Vengideswara Putter v. Chatu Achen (1881) 3 Mad. 224, 228; The Brahmaputra Tea Co, Ltd. v. Scarth (1885) 11 Cal. 545, 550; Deno Nali v. Nibaran Chandra (1899) 27 Cal. 421, 423; Nait Ram v. Shib Dat (1882) 5 All. 238, 241; Dilbar Sarkar v. Joysri Kurmi (1898) 3 C. W.N. 43, 45. It is said to be a common error to suppose the operation of this section to be confined to unreasonable agreements, as obviously it is not: Jagannath v. Vish-11 A.I.R. 1927 Nag. 284; 96 Γ.C. 382.*
*(v) (1829) 6 Bing. 141.*
*(w) Per Sargent C.J. in Umar-khan v. Salekhan (1892) 17 Bom. 106, 111.*
*(x) Krishna Shetti v. Gilbert Pinto (1919) 42 Mad. 654:50 I.C. 898.*

(2). It was the argument of the Learned Senior Counsel that in case of breach of contract, the Law will take over, even if, the contract has provided a remedy or not. Elucidating the scope of Section 73, He submitted as follows:-

***"Principle of the Section***

*This section is declaratory of the Common Law as to damages.*

*The law imposes an obligation or implies the terms that upon breach of a contract, damages must be paid; that is also provided in plain terms by the section. The party 'does not enter into a kind of second contract to pay damages', and 'an agreement to pay damages does not form part of the contract';" and the theory of an auxiliary contract to pay special damages is no longer prevalent, that as to damages which could not be foreseen without information of special circumstances, notice of any such circumstances at the time of entering into the contract would not suffice to make the defendant liable, but there must be in effect, if not in terms, an undertaking to answer for resulting special damages.*

***Existence of a Valid Contract***

*In a suit to enforce a contract, it is necessary to ascertain its exact terms, so as to determine its breach. Where the contract is not concluded, no action for its breach or for damages will lie. The paragraph does not apply to cases where the contract is for any reason void, or illegal. A plaintiff cannot claim damages being the loss of income derived from business or transactions, which are unlawful. The fact that a contract is contingent, does not affect the measure of damages; they are assessed in the usual manner. Where the contract is varied, damages are to be assessed to put the plaintiff in the same position as if the varied contract had been carried out. Damages have been awarded on the principles of contract law where lease was not registered."*

***Breach of Contract***

*The section applies only where a contract has been broken; and breach of contract must be proved before setting about the question of damages. Whether there is a breach cannot be decided by a party; it must be adjudicated, and must be proved. No damages can be awarded by the court without coming to any conclusion about breach, merely on the ground that the defendant has been profited by the contract.*

*Thus, a toll contractor who suffered loss in his revenue by reason of the discontinuance of the traffic, owing to plague regulations made by Government consequent upon the outbreak of plague in the locality, has no cause of action against the Government to recover damages for breach of contract. There was* *no breach of contract involved in making regulations. Where the tenderer did not deposit the earnest money and the contracted sum as stipulated for in a contract for purchase of goods from the Food Corporation, it was held that he was liable to pay the storage charges, and could not blame the Corporation for non-delivery of the goods. A trade union was under a contractual obligation to a paid-up member in relation to legal assistance if the secretary was reasonably satisfied that member should take legal action. It was then necessary for a member to show, in an action for breach of contract, that he had lost a right of action with reasonable prospect of success. If there was no such prospect, there would be no breach of contractual duty. The claim for timber cut by a contractor before the contract (a lease to fell timber) was illegally terminated, did not arise from breach, but de hors the cancellation.*

*In the case of an alternative contract, giving the right to a party to perform the contract or to pay damages, the party having the right to select must make the selection within reasonable time, and give notice of his having made the election to the opposite party. The cause of action to claim damages, in such a case would arise only when the choice not to sell has been made. Damages have been awarded to an employee for the employer's failure to carry out his undertaking to promote an employee to a post of responsibility." In a contract for sale of manganese ore, the quality of the ore was an essential condition of sale. For the purpose of determining the quality of the ore, the parties nominated two analysts, one of each party. Analysis by both the analysts was held to be an essential condition. Where on the refusal of the buyers' analyst to analyse, the sellers intimated their willingness to get the samples, analysed by a particular analyst and if the buyers did not agree, the analysis by their analyst would become final and the offer was rejected by the buyers, the rejection by the buyers was held" to be justified as it was not in accordance with the terms of the contract to have the analysis done by any other analyst."*

(3). On liquidated damages, he pointed out that in UK, such liquidated damages are pre-determined and are awarded and accepted as such in case of breach of contract. Same in the jurisdiction of UK cannot be disallowed for difficulty in quantification as to what is the quantum of loss suffered and what is the quantum of penalty involved in the case of liquidated damages as both if agreed and contracted for in advance can be enforced. However, Indian courts have treated liquidated damages as a maximum amount as has been contracted by the party within the scope of which Indian courts have exercised jurisdiction to understand what is the quantum of penalty and what is quantum of actual loss, to reduce the amount of penalty if it is found unreasonable. He relied upon Pollock & Mulla Indian Contract and Specific Relief Act, 14th Edition as below:-

> *"Whether the sum named is liquidated damages, or the amount agreed to be paid in performance of the contract, is a matter of construction. In Tejendro Narain Singh, Bakai Singh, the defendant executed, a kabuliat by which he agreed to pay rent at rates of eight annas, four annas, and two annas per bigha for a period of seven years, and if he cultivated the land on expiry of the term without executing a fresh kabuliat, to pay rent at a uniform rate of Rs 4/- per bigha. The defendant continued to hold the land after expiry of the said period without executing a fresh kabuliat, and the plaintiff sued for arrears of rent at the rate of Rs 4/-. It was held that the stipulation for higher rate of rent was in the nature of a penalty, and the court allowed rent at the former rates. Justice Rampini gave a dissenting judgment holding that s. 74 did not apply, as the suit was not brought on the allegation that a contract had been broken, but was one to recover arrears of rent at rate at which the defendant agreed to pay on his failure to execute a fresh kabutiat. He further held that the rate of rent mentioned in the kabuliat was not named as the amount to be paid in case of a breach of the contract." However, a stipulation by a tenant that if he failed to deliver at a specified time forty mudis of rice by way of rent, and to pay Government revenue and interest due on a mortgage, he would deliver five mudis more of rice, was held to be liquidated damages."*
>
> ***As Payable in Case of 'Such Breach'***
>
> *The question of whether the sum specified in the contract is so payable arises only when the payment is stipulated as payable upon breach, and upon 'such' breach. Thus, to attract the provisions of s. 74, it is not necessary that the entire contract should come to an end; the breach of each term thereof can be visualised in advance and taken care of by providing an adequate clause for liquidated damages so that the parties to the contract can proceed to work out the contract in future and settle the question of damages that have accrued on the basis of the rate that has been put as a pre-estimate at the commencement of the contract. A party can impose liquidated damages only if the other party has committed breach, and the fact of breach must be adjudicated by the court or arbitrator.*
>
> *A hirer of a car under a hire-purchase agreement found himself unable to pay the instalments, after having paid the initial deposit. He wrote to the owner to that effect and enclosed the keys, the log book and gave its location. The owner took possession of the car and sued for enforcement of the agreement as to instalments. The Court of Appeal held the letter was not an exercise of option to determine the agreement, and in the absence of consensual termination of*

*the agreement, the owner must be taken to have terminated the agreement, and it would be entitled to only one installment. There should be no penalty without a breach of contract.*

*A sum which is liable to fluctuate according to extraneous circumstances is not liquidated damages. Damages which are not a direct result of the breach or of any act of the defendant, or are not within the contemplation of the parties, cannot be recovered under this section.*

***Difficulty in Assessment***

*The fact that a precise pre-estimate of damages is difficult strengthens the presumption that the agreed sum is a genuine attempt to estimate the damages to avoid the difficulties of a trial. A good example of such a stipulation is where a lump sum is fixed for breach of a covenant, not to compete loss resulting from such breach is always uncertain in amount and difficult to prove. It has been stated:*

> *The mere fact that the damages for a breach would be very difficult to assess does not mean that the agreed sum cannot be liquidated damages. On the contrary, this is precisely the situation in which the parties may reasonably wish to agree on the sum payable for breach.*

*Where it is difficult to assess the compensation arising from breach, the amount stipulated by the parties can be awarded if it is genuine pre-estimate as the measure of reasonable compensation."*

***Liquidated and Unliquidated Damages***

*So far as the law in India is concerned, there is no qualitative difference in the nature of liquidated and unliquidated damages, as s. 74 eliminates the somewhat elaborate refinement made under the Common Law between stipulations providing for payment of liquidated damages and stipulations in the nature of penalty, which under the Common law is stipulation in terrorem and a genuine pre-estimate of damages is regarded as liquidated damages, and is binding.*

*A claim for liquidated damages stands on the same footing as a claim for unliquidated damages, and a party in breach of contract does not incure eo instanti pecuniary liability, nor does the injured parry become entitled to claim a debt.*

*Where the parties have provided for compensation in express terms, the right to claim unliquidated damages to that extent is necessarily excluded. In Chunilal V. Mehta Vs. Century Spinning and Mfg. Co. Ltd.," it has been stated:*

> *Where parties name in a contract reduced to writing a sum of money to be paid as liquidated damages they must be deemed to exclude the right to claim unascertained sum of money as damages. The right to claim liquidated*

*damages is enforceable under s. 74 of the Contract Act and where such a right is found to exist, no question of ascertaining damages really arises. Where the parties have deliberately specified the amount of liquidated damages, there can be no presumption that they at the same time, intended to allow the party who has suffered by the breach to give a go-by to the sum specified and claim instead a sum of money which was not ascertained or ascertainable at the date of the breach.*

*To the extent, the specific breach is not covered by the provision of liquidated damages, unliquidated damages can be awarded.*

***Sections 73 and 74***

*This section does not overlap s. 73. This section applies when there is a sum named in the contract as the amount paid in case of breach of contract, or the contract contains any other stipulation by way of penalty.*

*In Shiva Jute Baling Limited v. Hindley & Co. Ltd., an agreement for supply for 500 bales of jute between an Indian company and a British company contained a clause for payment of 'liquidated damages' for default at the difference between the contract rate and rate on the day following the default plus 10 sh per ton, and also a provision for arbitration in accordance with the byelaws of London Jute Association. On disputes having arisen, the arbitrators in London gave an award for liquidated damages as given in the agreement, i.e. the difference in rates plus 10 s per ton. The Supreme Court held that the stipulation was valid as also the award. Both Sections 73 and 74 provide for reasonable compensation, but section 74 contemplates that the maximum reasonable compensation may be the amount which may be named in the contract, but not more, even though according to section. 73, the amount of compensation may exceed the sum named.*

***Penalty***

*The essence of a penalty is a payment of money stipulated as in terrorem of the offending party, the essence of liquidated damages is a genuine covenanted pre-estimate of damages. The expression 'penalty is an elastic term with many different shades of meaning, but it always involves an idea of punishment. It means: "I promise to pay so much money if I break certain terms of the contract." It is 'a sum of money that is manifestly intended to be in excess of the amount which would fully compensate the other side in consequence of the breach of the primary obligation. It implies a main contract and a subsidiary contract providing for some more drastic consequences (viz. to pay something more than the debtor would be liable to pay under the primary contract) and in event of the breach of the original and main contract. If what is contemplated in the agreement to be paid or forfeited in case of its breach is of the nature of* *penalty even if it be earnest money, s. 74 comes into operation; else s. 73 would not be applicable. Penalty clauses are described to be in effect exclusion of damages clauses in reverse.*

*Provisions of incentive payments viz., extra payment for early completion of work, or for an increased price etc. are not in the nature of penalty, nor concessions in payment if made in time."*

(4). To emphasize on the scope of various rulings in Australian jurisdiction, learned Senior Advocate relied on Australian GSTR Ruling 2001/4 about the scope of supply specially for National Compensation Scheme for farmers and limiting the production for purpose of claiming compensation:-

***"What is a 'supply'?***

*22. Essentially, a supply is something which passes from one entity to another. The supply may be one of particular goods, services or something else.*

*23. 'Supply' is defined in subsection 9-10(1) as 'any form of supply whatsoever'. In UK, the term 'supply' has been held to take its ordinary and natural meaning, being 'to furnish or to serve'. Similarly, the definition of 'supply' in the Macquarie Dictionary is 'to furnish or provide (something wanting or requisite: to supply electricity to a community)'. The term refers to things passing from one party to another.*

*24. Without limiting these general meanings, subsection 9-10(2) provides a non-exhaustive list of activities or occurrences that are included within the meaning of supply. The list is as follows:*

*(a) a supply of goods;*

*(b) a supply of services;*

*(c) a provision of advice or information;*

*(d) a grant, assignment, or surrender of real property;*

*(e) a creation, grant, transfer, assignment or surrender of any right;*

*(f) a financial supply;*

*(g) an entry into, or release from an obligation:*

*(i) to do anything; or*

*(ii) to refrain from an act; or*

*(iii) to tolerate an act or situation;*

*(h) any combination of any 2 or more of the matters referred to in paragraphs (a) to (g).*

*25. Subsection 9-10(2) refers to two aspects of a supply; the thing which passes, such as goods, services, a right or obligation; and the means by which it passes, such as its provision, creation, grant, assignment, surrender or release.*

*Supplies of rights and obligations in other jurisdictions*

*26. In other jurisdictions, supply is also broadly defined, by first defining the term 'goods' and then treating services as anything that is not goods. For example, in the Sixth VAT Directive of the European Council ('the Sixth Directive'), a supply of services is defined as 'any transaction which does not constitute a supply of goods', and the term includes 'obligations to refrain from an act or to tolerate an act or situation'.*

*27. In the UK, 'supply' includes all forms of supply, but not anything done otherwise than for a consideration. Anything which is not a supply of goods but is done for a consideration (including the granting, assignment or surrender of any right) is a supply of services.*

*28. In Canada, supply is defined to mean 'the provision of property or a service in any manner, including sale, transfer, barter, exchange, license, rental, lease, gift or disposition'. A right or interest of any kind and a chose in action are included within the definition of 'property'.*

*29. In New Zealand, GST is imposed on supplies of goods and services. 'Services' is defined as 'anything which is not goods or money'. The term 'supply' is defined as 'all forms of supply', and the succeeding subsections of the New Zealand legislation specify particular rules relating to supplies of goods or services.*

*30. The Australian GST Act deals with 'supply' in a similar but not identical way, to these overseas jurisdictions. Therefore, while there is useful guidance to be obtained from an analysis of relevant overseas court decisions, some caution must also be exercised.*

*Transactions which are supplies of rights or obligations*

*31. It has been found in overseas cases that surrender of a right or entering into an obligation does not, without more, constitute a supply of services. This is despite the term 'services' being defined to include them.*

*32. For example, in the Court of Justice of the European Community (ECJ) case Landboden-Agrardienste GmbH & Co. KG v. Finanzamt Calau [1998] BVC 70, the issue was whether the 'supply of services', within the meaning given by the Sixth Directive, extended to an undertaking given by a farmer to reduce its harvest of a potato crop. The undertaking appeared to constitute 'an obligation to refrain from an act' and so fits within the definition of a 'service' in terms of the Sixth Directive. However, the Court ruled:*

*'an undertaking given by a farmer under a national compensation scheme not to harvest at least 20% of his potato crop does not constitute a supply of services for the purposes of [the Sixth] Directive.'*

*33. In the opinion of Advocate General Jacobs, it did not amount to a service. He commented that:*

*'any payment, except perhaps a gift, will have conditions attached to it whose performance might, by creative use of language, be described as a service.'*

*34. Mohr v. Finanzamt Bad Segeberg [1996] BVC 293 was another ECJ case in which such a finding was made. In this case, an undertaking by a farmer to refrain from milk production was found not to constitute a supply within the meaning of the Sixth Directive.*

*35. In Landboden, it was held that for an undertaking to be covered by the common system of VAT, it must imply consumption, and that by undertaking to reduce production, the farmer did not provide either services to an identifiable consumer, or some benefit capable of being a cost component of another person in the commercial chain.*

*36. Under the GST Act, there will be no GST on a supply unless it is a 'taxable supply'. It is the concept of a 'supply' itself that is the entry point into the GST system. As supply 'is defined broadly and is intended to encompass supplies as widely as possible', we consider that the undertaking to reduce production as dealt with by Landboden would be a 'supply' under paragraph 9-10(2)(g). Whether the supply would be a taxable supply would then depend on the requirements of section 9-5 being met in relation to that supply."*

(5). He further relied on Australian GSTR Ruling 2006/2 on security for the performance of an obligation. The relevant portion of the ruling is as follows:-

***"Ruling and Explanation***

***The Purpose of Division 99***

*13. Subsection 99-5(1) prevents a security deposit from being treated as consideration for a supply until such time that the deposit is either forfeited because of a failure to perform the secured obligation or applied as all or part of the consideration for a supply.*

*14. Under subsection 99-10(1), the GST payable on a taxable supply for which the consideration is a security deposit is attributable to the tax period in which the security deposit is forfeited or applied as all or part of the consideration for a supply. The EM5 contemplates at least two types of security deposit arrangements to which this Division applies.*

*15. One type of arrangement involves a contract for the purchase of real property, goods or services (a 'purchase contract'), where the recipient pays a deposit to secure their obligations under the contract.*

*16. The other type of arrangement in which a security deposit may be paid involves a contract for the hire of goods6, where the supplier requires a deposit (or bond) to be paid to secure the payment of periodic rental instalments and/or the return of the goods on time and in good condition. In this Ruling, we will refer to lease, rent, hire-only and bailment arrangements as 'hire arrangements'.*

*17. Under either arrangement, the failure to perform the secured obligation risks forfeiture of the deposit.*

***Characteristics of a 'security deposit' under Division 99***

*18. To fall within the provisions of Division 99, the amount received by the supplier must be a 'deposit'.*

*19. The term 'deposit' is not defined in the GST Act. However, judicial decisions have indicated that the term 'deposit' has a particular meaning in a commercial context.*

*19A. In Federal Commissioner of Taxation v. Reliance Carpet Co Pty Ltd [2008] HCA 22; 2008 ATC 20-028; 68 ATR 158 (Reliance Carpet) the High Court noted at paragraphs 22 to 27 of the decision that the term 'deposit' had several aspects. These aspects include that a deposit: could be counted towards the payment of the purchase price; be brought into account in assessment of damages; be a token provided by the purchaser as 'an earnest to bind the bargain'; and provide a form of security for performance by the purchaser.*

*20. For a payment to be considered a 'security deposit' for the purposes of Division 99, it should have the following characteristics:*

*• be held as a security for the performance of an obligation: see paragraphs 21 to 30;*

*• the contract, conduct and intent of the parties to the contract must be consistent with the payment being a security deposit: see paragraphs 31 to 50;*

*• be at risk of forfeiture upon failure to perform the obligation: see paragraphs 51 to 64; and*

*• be a reasonable amount:8 see paragraphs 65 to 108.*

***Held as security***

*21. For Division 99 to apply, the deposit must be 'held' as security for the performance of an obligation. However, the GST Act does not explain the concept of a deposit that is 'held'.*

*22. A deposit is 'held' when it is paid to a person in the capacity of stakeholder. Normally, in commercial situations, the supplier will be the holder of the security deposit. It makes no difference who holds the deposit, provided it is 'held' for the benefit of the supplier to secure the recipient's obligations.*

*23. An amount ceases to be a security deposit when that amount is applied as consideration, or forfeited, regardless of whether it is held by the supplier or a third party at that time. However, there are occasions where a deposit may be released without it being considered to be applied.*

*24. The accounting treatment may be evidence that a deposit has been either forfeited or applied as consideration for a supply. For example, a deposit that is recognised as revenue because it is no longer refundable is indicative of a deposit that is no longer held as security because it has been applied as consideration for a supply.*

*Example 1: Deposit held by a stakeholder*

*25. Dale enters into a contract to purchase an apartment from Wayne. By mutual agreement with Wayne, Dale pays a forfeitable deposit to a third party, Tim, to hold on trust awaiting settlement. Tim is not paid any fees or commission from this deposit until it is either applied at settlement or is forfeited upon a breach of contract by Dale.*

*26. The deposit is a security deposit for the purposes of Division 99. The deposit is held by Tim as a stakeholder for the benefit of Wayne until it is applied at settlement.*

***Performance of an obligation***

*27. A security deposit is held to secure, or to act as a guarantee, for the performance of the recipient's obligations under a contract. The nature of the obligations is usually dependent upon the intentions of the parties, as evidenced by the terms and conditions (express or implied) of a contract and the conduct of the parties.*

*28. In a purchase contract, the supplier ordinarily seeks to secure, by way of a security deposit, the recipient's obligations to complete the contract and pay the contracted purchase price. Upon the recipient performing its obligations, the supplier is obliged either to apply the deposit for the recipient's benefit, usually by applying it towards the total purchase price of the supply, or by returning it to the recipient.*

*29. However, if the recipient fails to perform their obligations, then the security deposit is at risk of forfeiture.*

*30. Under a hire arrangement, the recipient's secured obligations are typically satisfied by returning the hired goods in a satisfactory condition at the agreed time and paying any additional or outstanding hire fees. The supplier either* *returns the deposit upon the return of the goods, or keeps all or part of the deposit if the goods are not returned, returned late, or returned damaged.*

***Deposit and part payment***

*31. In analysing contracts, the courts have commonly described a deposit as an 'earnest' that is paid 'to bind the bargain'. A payment made as an earnest has been said to be 'a portion of something, given or done in advance as a pledge of the remainder'. This can be distinguished from paying the first instalment of the total price in a purchase contract, which is to be paid over a period of time, that is, an initial instalment payment, or a part payment.*

*32. In Howe v. Smith17 (Howe), Fry, LJ described a deposit in the following terms:*

*It is not merely a part payment, but is then also an earnest to bind the bargain so entered into, and creates by the fear of its forfeiture a motive in the payer to perform the rest of the contract.*

*33. This view has been adopted by the Commissioner in Goods and Services Tax Ruling GSTR 2000/28,19 in relation to standard land contracts. In that Ruling, the Commissioner takes the view that:*

*A deposit paid under a standard land contract serves a number of purposes. If the contract goes through to completion, the deposit goes against the purchase price. But its initial purpose is as security for the performance of the contract.*

*34. A payment that is not intended to act as an earnest to ensure the contract is completed is not a security deposit.*

*Example 2: Part payment is not a security deposit*

*35. Laura purchases electrical equipment from a retailer for $550. The retailer tells Laura that if she enters into an instalment plan where she makes an initial instalment payment of $100, and agrees to pay the balance in a month's time, she can take the equipment home that day. The payment does not act to secure the performance of any obligation and is not at risk of forfeiture.*

*36. The $100 that Laura pays is not a security deposit for the purposes of Division 99. It is a part payment of the agreed purchase price.*

***The deposit must be a deposit in more than name only***

*37. The fact that a certain payment is labelled a 'deposit' does not make it a security deposit at law. Whether a particular payment is a security deposit is a question of fact, determined by looking at the terms of the contract and the intention of the parties to the contract.*

*38. For example, in the automotive recycling industry, recipient may be required to pay what is referred to as a 'core deposit' to purchase a reconditioned part.*

*The core deposit is returned to the recipient when the recipient gives the worn part to the reconditioned parts supplier.*

*39. The core deposit, although labelled a deposit, is not a security deposit that is held to guarantee that the recipient will complete the purchase of the reconditioned part. The purchase of the reconditioned part is considered to be a separate contract to that of the supply of the worn part. There are two separate supplies. In this case, the core deposit acts as an inducement for the recipient to supply, separately, the worn part to the reconditioned parts supplier. In return the supplier refunds the core deposit to the recipient upon receipt of the worn part.*

***Pre-contract deposits are not security deposits***

*40. A pre-contract deposit may be paid by a potential recipient to demonstrate the potential recipient's keen interest in entering into a purchase contract or hire arrangement. Because there is no contract the 'pre-contract deposit' is held on trust for a specified purpose but remains the beneficial property of the potential recipient.*

*41. A so called 'deposit' may also be paid by a potential recipient under an agreement, prior to entering into a purchase contract or hire agreement, in return for rights of pre-emption, or for a covenant.*

*42. In the circumstances described in paragraphs 40 and 41, even though these payments are often called deposits, the Commissioner does not regard them as security deposits for the purposes of Division 99. Neither payment has the characteristics of a security deposit as outlined in this Ruling.*

*43. The pre-contract deposit referred to in paragraph 40 is not a security deposit because it remains the property of the potential recipient. At the time of payment it is not paid in respect of a supply that is to occur between the parties. It is not subject to forfeiture, and does not secure any contractual obligations between the parties, because, at the time of payment, none are in existence.*

*44. However, this type of pre-contract deposit may later become all or part of a security deposit if a purchase contract or hire arrangement is entered into. As explained by Aickin J in Brien v. Dwyer:*

*It appears clear in principle that if payment were made in advance of the formation of the written contract, it would be held by the estate agent for the purchaser until the contract was signed by both parties or separate parts exchanged: Sorrell v. Finch [1977] AC 728. Upon exchange of parts or contemporaneous signatures it would become 'the deposit' and as such would be held by the estate agents in accordance with the terms of the contract.*

*45. The 'deposit' referred to in paragraph 41 is not a deposit at all but may be consideration for a separate supply under a pre-emption or covenant* *agreement. The 'deposit' is not a security deposit as it is not paid to act as earnest to secure any obligations between the parties but rather is paid for the pre-emption or covenant rights.*

*Example 3: Pre-contract deposit not a security deposit*

*46. Hajar wants to buy real property. She approaches the real estate agent who suggests she pays $10,000 as a good faith gesture before approaching the owner.*

*47. No contract is entered into for the purchase of the property when this payment is made and the supplier is free to enter contracts with other parties or otherwise deal with the property. It is agreed between Hajar and the agent that the payment will form the initial deposit if a contract is entered into. It is also agreed that, until a contract is entered into, the pre-contract deposit remains Hajar's property and she can withdraw it at any time.*

*48. Hajar's pre-contract deposit is not a security deposit for the purposes of Division 99. If a contract for sale is entered into, and the pre-contract deposit becomes a deposit to secure Hajar's obligations under that contract, it becomes a security deposit for the purposes of Division 99.*

*Example 4: Consideration for a covenant not a security deposit*

*49. William needs to lease business premises but is unable to sign a lease agreement until his business plan is approved by his financier. He approaches the owner of suitable premises who agrees not to lease the property to anyone else for one week provided William pays $550.*

*50. The payment of $550 is not a security deposit for the purposes of Division 99. It is consideration for the taxable supply of a covenant or undertaking of not leasing the property to anyone else.*

***Forfeiture***

*Deposit subject to forfeiture*

*51. A fundamental requirement of a security deposit is that the parties to a contract clearly understand at its commencement, either through an express term, or by implication, that the deposit may be forfeited if the recipient fails to perform the secured contractual obligations.24 It is necessary, in the Commissioner's view, that there be a mutual intention by the contracting parties to make the deposit subject to forfeiture. If this intention is not present, the deposit is not a security deposit.*

*52. The important consideration is the intention or understanding between the parties to the contract at its commencement. Therefore, if, at the time that the deposit was paid it was intended and clearly understood that the deposit was subject to forfeiture upon the failure of the recipient to perform their obligations, the deposit is a security deposit.*

*53. If this clear understanding exists between the parties at the commencement of the contract, it is not relevant whether the forfeiture is actually enforced by the supplier upon the breach of some term or condition.*

*Deposit not subject to forfeiture*

*54. Even though a contract may state that the deposit is subject to forfeiture, the parties to the contract may have an understanding at the time the contract was entered into that the forfeiture will not be enforced. The understanding may be reached through additional bargaining at the time of entry into the contract, or through the previous conduct of the parties. If such an understanding can be discerned having regard to these and other factors, the deposit is not a security deposit.*

*55. It is necessary to examine the terms and conditions of the contract, in particular, the forfeiture clause, and the intention of the parties at the time of entering into the contract, to determine whether the deposit is subject to forfeiture.*

*56. Although many standard contracts contain forfeiture clauses, to maintain good customer relations, commercial practice may be to not enforce forfeiture of the security deposit. This may indicate that there is no real intention, at the time of entry into the contract, that the deposit is genuinely forfeitable if the recipient fails to perform their contractual obligations.*

*57. Where forfeiture is a term or condition of the contract, the Commissioner will accept, prima facie, that the deposit is at risk.*

*However, if the commercial practice is made known to the recipient at the time of entry into the contract, this may lead to the conclusion that the parties have openly bargained to remove the forfeiture clause.*

*Example 5: Forfeiture clause varied through understanding between parties – deposit not a security deposit*

*58. Nick is a purchasing officer with a firm specialising in office refurbishment. He buys office equipment from Customised Office Systems (Customised) but frequently cancels orders at short notice due to changes in project specifications and designs.*

*59. For each project, Nick enters into a contract to purchase the project equipment and pays a security deposit.*

*60. Although Customised has a forfeiture clause in its standard contracts, Nick, historically, has had all deposits refunded on cancelled orders. Nick considers that he is a valued customer and has an understanding, through previous discussions with staff, of the store's commercial practice to refund deposits to valued customers.*

*61. Since Nick and the supplier have an understanding that deposits are not subject to forfeiture, the deposit paid by Nick is not a security deposit for the purposes of Division.*

*Example 6: Forfeiture clause removed from contract – deposit not a security deposit*

*62. European Cars Pacifica (Pacifica) enters into a standard contract to sell a luxury motor vehicle to Joseph. Joseph pays a deposit of 10% of the purchase price. The standard contract contains a forfeiture clause.*

*63. Joseph specifically questions the forfeiture clause and requests that it be removed from the contract. Pacifica agrees.*

*64. As the contract has been varied to exclude the possibility of forfeiture, the deposit paid by Joseph is not a security deposit to which Division 99 applies.*

***A deposit must be reasonable***

*65. For a deposit to be a security deposit for the purposes of Division 99, the amount of the deposit must be reasonable. If the amount is set too high, the courts exercising equitable jurisdiction will not regard the amount paid as a deposit."*

(6). He also relied upon Australian GSTR Ruling 2009/3 about the scope of leviablity of tax on cancellation fees. The relevant portion of the ruling is reproduced below: -

***"Ruling***

*17. In considering the GST consequences of a cancellation fee, the main issues are whether a 'supply' has been made and whether the supply is 'for consideration'. A supply can be for consideration if the consideration is 'in connection with' the supply.*

*Supplies for which cancellation fees may be consideration*

*18. A supply for which a cancellation fee may be consideration can be:*

- *the intended supply (see paragraphs 21 to 22 of this Ruling); or*
- *a different supply, which may include one or more of the following supplies:*

*-the provision of obligations, rights, goods, services or other things in facilitating the intended supply up to the time of cancellation or no show, even though the intended supply is ultimately not made ( facilitation supply - see paragraphs 23 to 38 of this Ruling);*

*-different goods, services or other things related to the intended supply (see paragraphs 39 to 43 of this Ruling);*

*-services relating to the cancellation of an arrangement, for example, administrative services to give effect to the cancellation ( cancellation supply - see paragraphs 44 to 50 of this Ruling); or*

*-a release from an obligation to do anything, refrain from an act or tolerate an act or situation ( release supply - see paragraphs 51 to 61 of this Ruling).*

*19. It is a question of fact whether the intended supply or a different supply is made.*

*20. If a cancellation fee is consideration for a supply, the supply will be a taxable supply if it meets all the other requirements in section 9-5.*

*Cancellation fees as consideration for the intended supply*

*21. In some circumstances, a supplier may make the intended supply even though the customer fails to take advantage of that supply. Alternatively, a customer may be unable to cancel the intended supply. If there is a no show or a term of the arrangement prevents the customer from cancelling, the Commissioner considers that the intended supply would still be made.*

*22. If the intended supply is made but the customer does not avail themselves of it through a no show, any payment for the intended supply remains consideration for that supply. Also, a cancellation fee is consideration for the intended supply if it represents payment for work done by a supplier in making the intended supply.*

*Cancellation fees as consideration for a different supply*

*Facilitation supply*

*23. If an intended supply is cancelled or there is a no show, the supplier may still have made a supply. All the things the supplier does to put itself in a position to make the intended supply, that is, to facilitate that supply, is a supply.*

*24. Examples of things done to facilitate the intended supply may include:*

- *the supplier entering into obligations, and providing corresponding rights to the customer to receive another supply, usually the intended supply, (for example, a right to receive a supply of travel);[8]*
- *making an appropriate booking or reservation or providing a ticket;*
- *making available facilities for the use of the customer, for example, a seat at a venue to watch a performance or event;*
- *arranging for the provision of goods or services to enable the supplier to perform their obligations under the arrangement, including paying deposits or other amounts to secure those goods or services;*
- *allocating the services of particular personnel and/or appropriating equipment or goods for use in making the intended supply; and*
- *providing administrative services in facilitating the intended supply.*

*25. If the intended supply is made - the services or tasks that constitute a facilitation supply either form part of the intended supply, or are a separate supply to the intended supply. If the facilitation supply is a separate supply, that supply may not be a taxable supply because the consideration provided by the customer is not connected with the facilitation supply but is instead connected with the intended supply.*

*26. If the intended supply does not proceed because of a cancellation or no show, a facilitation supply is still made to the customer. Any cancellation fee payable by the customer may be consideration for this facilitation supply, which is a different supply to the intended supply.*

*26A. An example of this is Commissioner of Taxation v. Qantas Airways Ltd (Qantas), in which the High Court considered whether payments received by Qantas Airways Ltd from prospective passengers for flights booked but not taken constituted consideration for a taxable supply. After looking at the specific terms and conditions of carriage, the High Court held (4:1):*

*The Qantas conditions and the Jetstar conditions did not provide an unconditional promise to carry the passenger and baggage on a particular flight. They supplied something less than that. This was at least a promise to use best endeavours to carry the passenger and baggage, having regard to the circumstances of the business operations of the airline. This was a 'taxable supply' for which the consideration, being the fare, was received.*

*27. If the actual supply made upon a cancellation or no show is different from the intended supply, the GST status of the actual supply must be analysed against provisions in the GST Act to determine whether it is taxable, GST-free or input taxed.*

*28. For example, if a facilitation supply is within one of the following provisions of the GST Act, that supply would be GST-free:*

- *paragraph 9-30(1)(b), which provides that a supply is GST-free if it is a supply of a right to receive a supply that would be GST-free under either Division 38 or under a provision of another Act;*
- *paragraph 38-85(b), which provides that a supply is GST-free if it is a supply of administrative services directly related to the supply of a GST-free education course, but only if the services are supplied by the supplier of the course;*
- *item 4 of the table in subsection 38-190(1), which provides that the supply of certain rights covered by that item is GST-free;*
- *item 7 of the table in subsection 38-355(1), which provides that the supply of arranging certain kinds of international transport of passengers, goods or insurance is GST-free; and*
- *section 38-360, which provides that a supply is GST-free if the supplier makes the supply in the course of carrying on an enterprise as a travel agent*

*and the supply consists of arranging for the making of a supply, the effective use or enjoyment of which is to take place outside Australia.*

*29. Similarly, a right to receive an input taxed supply is itself an input taxed supply under paragraph 9-30(2)(b).*

*30. The Commissioner considers that paragraphs 9-30(1)(b) and 9-30(2)(b) would apply to make a facilitation supply GST-free or input taxed if the facilitation supply includes a right for the customer to receive the intended supply, and the intended supply would have been GST-free or input taxed, respectively. The Commissioner does not consider that this view is affected by the mere fact the relevant rights might be conditional. Further, the Commissioner considers that the right is the dominant part of the facilitation supply. For example, a supply of residential premises is an input taxed supply under Division 40. Therefore, a facilitation supply which includes a right to receive a supply of residential premises would also be input taxed.*

*31. In other cases, the absence of a specific provision in the GST Act that provides GST-free or input taxed treatment for a facilitation supply made in relation to an intended supply that would be GST-free or input taxed may mean that the facilitation supply is a taxable supply if the intended supply does not proceed.*

*Example 1: supply of facilitation services - GST-free supply*

*32. Abra Cadabra Training School (Abra Cadabra) provides a GST-free English language course for overseas students. The course runs for six months. Che Zhuan applies for enrolment in the course, which is accepted by Abra Cadabra.*

*33. Abra Cadabra makes a supply of facilitation services to Che Zhuan in providing him with details of the course and course materials, setting up an enrolment file, advising the Department of Immigration and Citizenship of the enrolment to facilitate Che Zhuan's student visa application, arranging for Che Zhuan's accommodation and informing the various lecturers and tutors of Che Zhuan's enrolment. These facilitation services are directly related to the supply of the GST-free English language course.*

*34. Under the terms of the enrolment, Abra Cadabra advises Che Zhuan that the course fee of $2,000 is to be paid three weeks prior to the start of the course and if Che Zhuan cancels his enrolment before the start of the course a cancellation fee of $250 will be charged. Once the course is commenced there is no refund. Che Zhuan pays the fee of $2,000.*

*35. Instead of starting the course, Che Zhuan decides to go to the US to learn English. He advises Abra Cadabra that he will not be attending the course. Abra Cadabra retains $250 as a cancellation fee and refunds $1,750 to Che Zhuan.*

*36. The $250 retained by Abra Cadabra is consideration for the supply of facilitation services directly related to the supply of the GST-free education course by Abra Cadabra. This supply is GST-free under paragraph 38-85(b).*

*Example 2: supply of education course - GST-free supply*

*37. Following on from Example 1, Che Zhuan attends the first three months of the course but due to an illness in the family returns home. Che Zhuan does not attend the remainder of the course.*

*38. Although Che Zhuan does not attend part of the course, a supply of the course is still made by Abra Cadabra. The fact that Che Zhuan does not attend for the remainder of the course does not change this. The supply is a GST-free supply of the education course for which the $2,000 fee is consideration.*

*Different goods, services or other things related to the intended supply*

*39. A customer may cancel an intended supply after the supplier has purchased materials or performed work to enable that supply to be made. The terms of the arrangement may, in these circumstances, provide for the charging of a cancellation fee to pay the supplier for the supplies made or work done.*

*40. If the intended supply is cancelled, the supplier cannot make that supply as originally contemplated but may nevertheless make a different supply, for example, where a supplier provides the customer with work in progress if the intended supply is cancelled. This is a different supply to the intended supply. A cancellation fee may be consideration for that different supply.*

*Example 3: cancellation fee for a different supply - different goods or services*

*41. In July, Ken, an unregistered customer, orders a custom built shed from Wallaby Worksheds for a GST inclusive price of $1,100. Wallaby Worksheds, which has monthly tax periods and accounts on an accruals basis, invoices Ken but does not require any payment until the shed is erected. The agreement provides for the payment of a cancellation fee of 50% of the price if Ken cancels the order. Wallaby Worksheds designs the shed to Ken's specifications and acquires materials for constructing the shed.*

*42. In August, Ken cancels the order as he no longer needs the shed. Ken refuses to pay the cancellation fee unless Wallaby Worksheds agrees to supply the materials, the plans and specifications for the shed. Wallaby Worksheds agrees to this. The cancellation fee is consideration for this different supply as the intended supply, being the supply of the shed, is not made.*

*43. The GST consequences for Wallaby Worksheds are as follows:*

- *as Wallaby Worksheds has attributed the GST payable on $1,100 to the July tax period, it has a decreasing adjustment of $100 attributable to the August tax period being the period in which it becomes aware of the adjustment (the tax period in which the order is cancelled); and*

- *the cancellation fee of $550 is consideration for the new supply of materials, the plans and specifications. This supply, which is a taxable supply, is different from the intended supply of the custom built shed. The GST payable of $50 on this supply is attributed under the basic rules in Division 29 to the August tax period.*

*Cancellation supply*

*44. Services provided by a supplier to give effect to the cancellation of an arrangement constitute a cancellation supply. A cancellation supply may include administrative services provided in unwinding an arrangement or making refunds. The fee for these services is commonly a flat fee which may be referred to as a cancellation fee, administration fee, change fee or service fee. This fee is consideration for the supply of these services.*

*45. It does not matter whether the fee is charged separately or taken out of deposits or other monies already paid. The GST treatment is not affected by how the cancellation fee is paid.*

*Example 4: cancellation fee as consideration for a cancellation supply*

*46. White Hills Enterprises Ltd (White Hills) operates a ski lodge in Australia and takes bookings for ski holiday packages. The terms and conditions as set out on its website and in its brochures state that a booking fee of $55 is charged when a booking is made and if a booking is cancelled, a cancellation fee of $33 applies for services provided in giving effect to the cancellation. Services provided to give effect to a cancellation include arranging for the reimbursement of the balance of amounts paid, informing ski instructors of the cancellation and altering various other arrangements.*

*47. In December, Wati books and pays $605 (including the booking fee) for a ski holiday in mid September the following year. However, in early September, Wati cancels her booking. White Hills charges a cancellation fee of $33 and refunds $517 (that is, $605 less the booking fee of $55 and the cancellation fee of $33).*

*48. The cancellation fee is consideration for the supply of services to give effect to the cancellation. The supply is a taxable supply.*

*49. As White Hills accounts for GST on a monthly basis, it accounts for the GST payable on $605 in the tax period ending 31 December.*

*50. When Wati cancels her booking, White Hills has a decreasing adjustment of $50 (being the GST payable on the $550 Wati paid for the holiday, that is, $605 less $55). In addition, White Hills needs to account for the GST payable of $3 on the taxable cancellation supply. The decreasing adjustment and the GST payable on the taxable cancellation supply are attributable to the tax period* *ending 30 September in the following year, that is, when Wati cancels her booking.*

*Release supply*

*51. A customer who has entered into a contract may not wish to, or may be unable to complete the contract. A term in the original contract may grant to the customer the right to terminate the contract upon payment of a cancellation fee in these circumstances.*

*52. Alternatively, the parties to the contract may enter into another contract under which one party (usually the supplier) upon payment of a cancellation fee agrees to release the other party (usually the customer) from performing the latter's obligations under the original contract.*

*53. An example of a clause that provides for a release from the performance of the customer's obligations under the contract is:*

*If you no longer wish to continue this contract, you have the right to terminate it at any time by calling our customer service hotline. However, if you terminate this contract after the end of the cooling-off period and before the end of your contract term, you must pay us a cancellation fee.*

*54. In the circumstances outlined in paragraph 53 of this Ruling, the customer may terminate the agreement pursuant to a right set out in the terms of the arrangement. The termination is not a breach of the contract. The customer exercises their contractual right, for which they agree to pay a cancellation fee as consideration.*

*55. Without limiting subsection 9-10(1), a supply includes the supply of services, the creation or surrender of any right and the release from an obligation under paragraphs 9-10(2)(b), 9-10(2)(e) and 9-10(2)(g) respectively. In the context of the broad definition of supply, and having regard to the things included as supplies as set out in subsection 9-10(2), the Commissioner's view is that, if it is not consideration for any other supply, a cancellation fee may be consideration for the creation or surrender of rights and/or a release supply that occurs when an arrangement is cancelled, and/or a combination of these supplies under paragraph 9-10(2)(h).*

*56. The GST status of the release supply is not determined by the GST status of the intended supply.*

*57. The Commissioner's view outlined in paragraph 55 of this Ruling is different from a situation where a termination or cancellation payment changes the consideration for the supply.*

*58. If the termination payment or cancellation fee has a sufficient nexus with an earlier supply, the fee may change the consideration for the earlier supply but is not consideration for a release supply. The change in consideration gives* *rise to an adjustment event in relation to the earlier supply. For example, this may occur where an agreement for progressive and periodic supplies has been terminated because the making of the supply has already commenced or the supply has been made. This is different from the scenarios addressed in this Ruling where the intended supply has not been made at the time of release.*

*Example 5: release supply*

*59. Trust Mee Enterprises Ltd (Trust Mee), a property management company, enters into a management agreement with Children's Reward Investment Bank (CRIB). Under the management agreement, Trust Mee will manage a commercial property owned by CRIB for 10 years. The agreement allows either party to negotiate with the other party to release them from their obligation under the agreement.*

*60. Three years into the contract, CRIB wishes to terminate the management agreement. After a long negotiation, the parties enter into a separate agreement, under which Trust Mee and CRIB agree to terminate the original management agreement upon payment of $1 million by CRIB to Trust Mee.*

*61. The separate agreement provides CRIB with a right to terminate the original management agreement. In entering into the separate agreement, Trust Mee agrees to release CRIB from its obligations under the terms and conditions of the original management agreement. Trust Mee makes a release supply for which the payment of $1 million is consideration. The release supply is a taxable supply.*

*Cancellation fees as damages, penalties or compensation*

*62. It has been suggested by a number of commentators that when an intended supply is cancelled, no supply is made on cancellation. It is stated that, a cancellation fee cannot be consideration for the intended supply, nor consideration for a different supply, but is an amount of damages (in the form of liquidated damages), a penalty or compensation.*

*63. It has also been suggested that any activities or things that the Commissioner considers to be a facilitation supply as discussed in paragraphs 23 to 38 of this Ruling are merely business inputs or in-house activities of the supplier and are not supplies made to a customer. It is said that this is the case as the inputs or activities are not provided to the customer nor do they confer an advantage or benefit on the customer. Therefore, any cancellation fee is in the nature of damages, a penalty or compensation. These inputs and activities are, therefore, said not to fall within the meaning of 'supply' for GST purposes.*

*64. The Commissioner does not accept the views outlined at paragraphs 62 and 63 of this Ruling. The fact that an amount paid in relation to a cancelled arrangement might be described as 'damages', a 'penalty' or 'compensation' does not mean that the amount is not thereby consideration for a supply. An* *amount can have both the character of damages, a penalty or compensation and also be consideration in connection with a supply.*

*65. Regardless of whether an amount paid or payable is damages as properly understood (whether it is paid or payable under a liquidated or agreed damages clause or otherwise), the fundamental question to be answered in an Australian GST context is whether the amount is consideration for a supply. The classification of an amount as consideration for a supply or as damages is to be made in accordance with Goods and Services Tax Ruling GSTR 2001/4 Goods and services tax: GST consequences of court orders and out-of-court settlements.*

*66. GSTR 2001/4 sets out the Commissioner's views on when damages are, and are not, consideration for a supply. The Commissioner takes the view that payments that are called 'damages' resulting from court orders and out-of-court settlements need to be examined to establish whether the payment relates to a supply.*

*67. Whether an amount described as damages would be regarded as consideration for a supply is determined having regard to all relevant factors. For example, the cancellation fee would be consideration if, having regard to industry practices and conventions, it is accepted as a normal incidence of business that the amount represents consideration for a supply associated with the cancellation.*

*Example 6: consideration for a supply*

*68. Joe purchases a television set from Clearvision Electronics by instalments. Joe is not satisfied with the quality of the television set and refuses to pay the balance outstanding. Clearvision sues Joe and is successful. The court orders Joe to make full payment of the balance outstanding.*

*69. The amount paid by Joe in accordance with the court order is consideration for the supply of the television set.*

*Example 7: damages for injury*

*70. Charmaine is contracted by Shifty and Co to carry out maintenance work on a newly constructed commercial building. In carrying out this work, Charmaine is injured by falling masonry. She sues Shifty and Co. and is awarded damages of $100,000.*

*71. The $100,000 awarded to Charmaine is not consideration for any supply as Charmaine has not supplied anything to Shifty and Co for this amount. The amount represents compensation for injuries sustained and is not consideration for any work carried out under the maintenance contract.*

*Cancellation fees that are neither consideration for a supply nor damages, penalties or compensation*

*72. In a very limited number of cases, the facts of a case may establish that a customer made an ex-gratia payment, for example, a payment with the expectation of maintaining a good relationship with the supplier in circumstances where the supplier is not obliged to do, or has not done, anything in connection with the payment.*

*73. In the Commissioner's view, the payment made in these circumstances does not constitute consideration for a supply as there is no connection between the ex-gratia payment and any supply.*

*Adjustment events upon cancellations*

*74. Prior to the cancellation of an intended supply, the supplier may have attributed the GST payable on the supply to the tax period in which part of the consideration is paid or when an invoice is issued. Conversely, the customer may have attributed the input tax credit on the acquisition on a similar basis.*

*75. The cancellation of an intended supply may give rise to an adjustment event. Subsection 19-10(1) states that an adjustment event is any event which has the effect of:*

*•cancelling a supply or an acquisition;*

*•changing the consideration for a supply or an acquisition; or*

*•causing a supply or acquisition to become, or stop being, a taxable supply or creditable acquisition.*

*76. If an intended supply is cancelled, a supplier may have accounted for too much GST for that supply, or a customer may have accounted for too much input tax credit for a creditable acquisition. If this is the case, the supplier or the customer may have an adjustment. Any decreasing adjustment for the supplier, or increasing adjustment for the customer upon cancellation of an intended supply is attributed to the tax period in which the supplier or the customer becomes aware of the adjustment. This will normally be the tax period in which the cancellation occurs.*

*76A. If a supplier does not fully reimburse a customer, or only reimburses part of the GST paid for a cancelled supply, any decreasing adjustment as a result of the cancelled supply, or corresponding increasing adjustment for the customer, is reduced to the extent the GST amount is not reimbursed. This ensures that the supplier does not get a windfall gain.*

*Example 7A: decreasing adjustment reduced for amount not reimbursed*

*76B. Sue Sand orders and pays for a new laptop from Dan Office Supplies Pty Ltd for $1,100 which includes GST payable of $100. Dan Office Supplies despatches the order to the distributor and accounts for the GST of $100 in the tax period ending 31 March.*

*76C. The laptop arrives but Dan Office Supplies is unable to contact Sue for collection. After several attempts over a three month period, Dan Office Supplies cancels the supply and includes the laptop as part of its sales stock in June. Dan Office Supplies has a decreasing adjustment of $100 for the tax period ending 30 June, but the amount is reduced to nil as Dan Office Supplies does not reimburse Sue for any of the GST she had previously paid.*

*76D. When an intended supply is cancelled and the supplier makes a facilitation or cancellation supply that forms part of the cancelled supply, an adjustment only arises if there is a change in consideration. That is, the supplier has accounted for too much GST or the recipient has overclaimed input tax credits in a previous tax period.*

*76E. If the facilitation or cancellation supply forms a separate supply, the supplier must make a decreasing adjustment to account for the cancelled supply and account for the GST on the separate taxable facilitation or cancellation supply in the appropriate tax period. If applicable, the recipient must also account for the corresponding increasing adjustment and claim the input tax credit for the separate taxable acquisition in the appropriate tax period.*

*Example 7B: cancellation supply as a separate supply*

*76F. Using the facts of the last example, Dan Office Supplies manages to contact Sue in June. Sue changed her mind and requests a refund. Dan Office Supplies agrees to the refund less a cancellation fee of $55. Under its returns and cancellation policy, a cancellation fee of $55 applies to cancellation of merchandise specifically ordered by a customer.*

*76G. In the June tax period, Dan Office Supplies has a decreasing adjustment of $100. It must also account for the GST of $5 on the taxable cancellation supply.*

*Security deposits as cancellation fees*

*77. Special rules in Division 99 provide that a deposit held as security for the performance of an obligation (security deposit) is not treated as consideration for a supply unless the security deposit is forfeited because of a failure to perform the obligation, or it is applied as all or part of the consideration for a supply.*

*78. A contract may provide for the forfeiture of a security deposit if a customer cancels the contract. In these cases, under Division 99, the security deposit is treated as consideration for a supply when the deposit is forfeited.*

*79. In Federal Commissioner of Taxation v. Reliance Carpet Co Pty Ltd (Reliance Carpet), the High Court accepted the finding by the Administrative Appeals Tribunal that upon entry into the contract the taxpayer had entered into an obligation to do the things it was bound to do under the contract. The High Court* *also found that, in that case, the supply had been made by the taxpayer before the forfeiture of the security deposit. Further, the High Court accepted that the supply was made in advance of the failure by the purchaser in performance of the terms of the contract which led to the forfeiture of the security deposit to the taxpayer.*

*80. The High Court found that the security deposit was consideration for the supply, as the connection between the payment of the security deposit and the entry into the contract could be 'readily seen' in the circumstances of the case.*

*81. Although the decision in Reliance Carpet was made in the context of a formal contract for the sale of land, the Commissioner considers the position to be no different where a security deposit is forfeited under the terms of a cancellation clause in other arrangements. Upon entry into a contract involving the doing of things, the supplier enters into an obligation to do certain things (a paragraph 9-10(2)(g) supply).*

*82. Alternatively, the supplier:*

*•provides services or things to facilitate the intended supply (facilitation supply), which may include the entry into obligations by the parties and the creation and granting of rights by the supplier; or*

*•agrees to release the customer from the performance of their obligations under the terms of the agreement or arrangement (release supply).*

*83. Upon the cancellation of the intended supply, the forfeited security deposit can be consideration for one or more of these supplies or another supply. The supply may be taxable, GST-free or input-taxed.*

*84. If the security deposit is forfeited under the terms of a cancellation fee clause, that deposit is treated as consideration for a supply under subsection 99-5(1), when it is forfeited.*

*Example 8: security deposit as cancellation fee - overseas package tour*

*85. On 20 February 2009, Cyrus Travel and Tours (Cyrus) arranges a package tour for David for travel to the USA in July 2009. The arrangements include air travel to and from the USA, accommodation and car hire in a number of cities. Cyrus checks the availability of airline seats, accommodation and car hire, the cost of each and makes all the necessary bookings. Upon confirmation of all the bookings at the time they are made, and in accordance with the requirements of Cyrus, David pays a security deposit of 10%. Cyrus requires payment of the balance 30 days before the date of departure.*

*86. Under the terms of its arrangement with the overseas hotel, Cyrus is required to pay a security deposit to the hotel. Cyrus is also liable to pay a cancellation fee to the hotel if there is a cancellation within 10 days of the intended stay.*

*87. The contract between Cyrus and David has a cancellation clause in the following terms:*

*Deposits, Final Payments, Cancellations and Refunds*

*(a) You must pay a deposit equal to 10% of the total cost at the time of booking your tour. If you cancel your booking prior to your final payment you will pay a cancellation fee equal to the amount of the deposit you have paid.*

*(b) You must pay the balance of your tour cost 30 days before the date of your travel. If you cancel your booking after your final payment you will pay a cancellation fee as follows:*

*For cancellations made:*

*•15 to 30 days before date of travel: 40% of the total cost;*

*•7 to 14 days before date of travel: 60% of the total cost; and*

*•Within 7 days of the date of travel: 100% of the total cost.*

*88. Due to a serious illness in his family, David cancels his travel 35 days before the date of travel and incurs a cancellation fee equal to the amount of his security deposit.*

*89. The security deposit was held by Cyrus as security for the performance by David of his obligations (principally to pay the purchase price). Division 99 applies to the security deposit. When the deposit is forfeited, it is treated as consideration for a supply. The supply (which is a facilitation supply) consists of arranging for the making of supplies, the effective use or enjoyment of which is to take place outside Australia. This supply is made regardless of whether or not the travel takes place. This supply is GST-free under subsection 38-355(1) (item 7) and section 38-360.*

*Explanation*

*Is there a supply for consideration?*

*90. The starting point for determining the GST consequences of a cancellation fee is to see whether a supply is made, and if one is, whether the cancellation fee is connected with the making of that supply such that it is consideration for that supply.*

*91. For there to be a supply for consideration, as required by paragraph 9-5(a), three main requirements must be met:*

*• the supplier must make a supply;*

*• there must be a payment;[30] and*

*• there must be a sufficient nexus between the supply and the payment such that the payment constitutes consideration for the supply."*

11. Further, Liberty was afforded to both the sides to make further submissions, if any, within a week's time. The respondent availing the opportunity made further submission on 30th December, 2025 whereas learned AR availed opportunity on 05.01.2026. The Senior Advocate for the appellant made following submissions:-

**<u>The additional amount received by the Respondent – (Assessee) is nothing but additional consideration received for goods manufactured and sold and exported outside India</u>**

A.1 The Respondent submits that additional amount received by them is nothing but additional consideration received for the goods manufactured, sold and exported outside India. They received additional amount in case the buyer has not purchased the agreed quantity of the goods in a particular quarter. They submit that the said additional amount so received would be covered under Section 4 of the Central Excise Act, 1944 as value of the excisable goods. The only relationship between the Respondent and the overseas buyer of the goods is goods manufactured and sold. Since the goods are manufactured and exported, no additional central excise duty is also payable on the additional amount received by the Respondent.

A.2 It is further submitted that the Central Excise Authorities have not initiated any proceedings against them for demanding any central excise duty on receipt of such additional amount. Therefore, demand raised in the present case under the service tax law is not sustainable at all. They rely on CBIC Circular dated 10.11.2014 wherein it is clarified that such additional amount received by the assessee would be treated as part of the value for the purposes of central excise duty. The relevant part of the said Circular is extracted below:

> *5. In view of the same, it is clarified that:*
>
> *(a) In the months where there is a supply of gas, all elements of consideration such as, price of gas at decimated rate per unit of gas and FFC (fixed facility charges) would be added to determine the assessable value for payment of central excise duty. In those months where MTOP (minimum take*

*or pay) is charged, the same shall be added to FFC to determine assessable value.*

*(b) FFC paid for the months when there was no supply of gases is to be added in the price of gas supplied in the subsequent month, in addition to the price arrived for that month as per (a) above.*

*(c) if FFC Is paid for months during reach no gas was supplied and there is no subsequent supply of gas, then FFC paid for months for which there was no supply of gases is to be added to the price of gases supplied in earlier month by way of raising a supplementary invoice in addition to the prices arrived for that month as per (a) above.*

*(d) Where the gases so supplied are used by another assessee as inputs, admissibility of CENVAT Credit of duty paid on gases as reflected in the invoice for all situations covered in Para (a), (b) & (c) above, would be decided in accordance with provisions of CENVAT Credit Rules, 2004.*

A.3 In view of the above, the Respondents – assessee submit that no demand of service tax can survive in the facts of the present case.

**Idle capacity compensation received by the Respondent - assessee would not be classifiable as service itself and therefore, not taxable**

B.1 The definition of service as per Section 65B(44) is as under:

***"service" means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include—***

*(a) an activity which constitutes merely,—*

***(i) a transfer of title in goods or immovable property, by way of sale, gift or in any other manner; or***

*(ii) such transfer, delivery or supply of any goods which is deemed to be a sale within the meaning of clause (29A) of Article 366 of the Constitution, or*

*(iii) a transaction in money or actionable claim;*

*(b) a provision of service by an employee to the employer in the course of or in relation to his employment;*

*(c) fees taken in any Court or tribunal established under any law for the time being in force.*

B.2 It can be seen from the above that mere transfer of title in the goods is not considered as service. The only relationship the Respondent is having with the overseas buyer is supply of goods. They have merely supplied the goods and transferred the title in the goods to the overseas buyer and therefore, it will get excluded from the definition of service itself.

B.3 The only activity carried out by the Respondent is to manufacture goods for the overseas buyer and therefore, they have not provided any service to anyone. As per the provisions of negative list as mentioned in Section 66D of the Finance Act, 1994 (reproduced below);

> ***SECTION [66D. Negative list of services.*** *— The negative list shall comprise of the following services, namely :—*
>
> *(f) services by way of carrying out any process amounting to manufacture or production of goods excluding alcoholic liquor for human consumption;"*

The additional amount received for manufacture, sale and export of goods for the overseas buyer would not be classifiable as service. The demand of service tax is not sustainable on this ground as well and the appeal filed by the revenue authorities is liable to be dismissed on this ground.

**Once the services are covered under Rule 3 of Place of Provision of Services Rules, 2012 then the issue whether it is service or declared service becomes irrelevant. In any case, amount received by them not for any services related to immovable property**

C.1 Rule 3 of POPS Rules, 2012 is extracted below:

> ***RULE 3. Place of provision generally.*** *— The place of provision of a service shall be the location of the recipient of service :*
>
> ***Provided*** *that in case [of services other than online information and database access or retrieval services, where] the location of the service receiver is not available in the ordinary course of business, the place of provision shall be the location of the provider of service.*

Once the services are falling within the coverage of Rule 3 of Place of Provision of Service (POPS) Rules, 2012, then issue whether it is service or declared service becomes irrelevant as the same will be treated as export of services in the present case as the recipient of the services is situated outside India.

C.2 As per the contention of the department, the activity of the Respondent falls under Rule 5 of the POPS Rules, 2012 as the services are in relation to plant & machinery of the Respondent and therefore, in connection with immovable property and since the immovable property is situated in India, the place of supply would be in India.

C.3 The discussion whether the amount received by them is additional consideration for the goods or consideration for the services becomes relevant only if the services fall under Rule 5 of the POPS Rules, 2012. The relevant portion of Rule 5 of the POPS Rules, 2012 dealing with services related to immovable property is reproduced below:

> ***Place of provision of services relating to immovable property.***
>
> ***5.*** *The place of provision of services* ***<u>provided directly in relation to an immovable property,</u>*** *including services provided in this regard by experts and estate agents, provision of hotel accommodation by a hotel, inn, guest house, club or campsite, by whatever, name called, grant of rights to use immovable property, services for carrying out or co-ordination of construction work, including architects or interior decorators, shall be the place where the immovable property is located or intended to be located.*

C.4 The scope and coverage of the services related to immovable property was explained by CBEC in the Education Guide 2012 as under:

> *5.5.2 What are the criteria to determine if a service is 'directly in relation to' immovable property located in taxable territory?*
>
> *Generally, the following criteria will be used to determine if a service is in respect of immovable property located in the taxable territory*
>
> *(i) The service consists of lease, or a right of use, occupation, enjoyment or exploitation of an immovable property;*
>
> *(ii) the service is physically performed or agreed to be performed on an immovable property (e.g. maintenance) or property to come into existence (e.g. construction);*
>
> *(iii) the direct object of the service is the immovable property in the sense that the service enhances the value of the property, affects the nature of the property, relates to preparing the property for development or redevelopment or the environment within the limits of the property (e.g. engineering, architectural services, surveying and sub-dividing, management services, security services etc);*
>
> *(iv) the purpose of the service is:*

*(a) the transfer or conveyance of the property or the proposed transfer or conveyance of the property (e.g., real estate services in relation to the actual or proposed acquisition, lease or rental of property, legal services rendered to the owner or beneficiary or potential owner or beneficiary of property as a result of a will or testament);*

*(b) the determination of the title to the property.*

*There must be more than a mere indirect or incidental connection between a service provided in relation to an immovable property, and the underlying immovable property. For example, a legal firm's general opinion with respect to the capital gains tax liability arising from the sale of a commercial property in India is basically advice on taxation legislation in general even though it relates to the subject of an immovable property. This will not be treated as a service in respect of the immovable property.*

C.5 They submit that Rule 5 of the POPS Rules, 2012 cannot apply in the facts of the present case. The services must be directly in connection with the immovable property and it should be renting of immovable property. Therefore, there are two legs, first the services should be directly in relation to immovable property and secondly, it should be granting the rights to use the immovable property. "Renting" is legal term and no contract has been entered in to for renting of immovable property services by the Respondent in the present case.

C.6 They submit that both the tests are not applicable in the facts of the present case as the alleged services are not in direct relation to the immovable property and they have not entered in to any contract for letting the use of their plant and machinery to anyone. The Ld. Commissioner has rightly relied on the Education Guide, 2012 and reached to the conclusion that the services are not in relation to (direct or indirect) immovable property and therefore, demand of service tax is not sustainable in the present case.

**<u>In any case the activity will not fall within the provisions of Section 66E(e) of the Finance Act, 1994</u>**

D.1 The idle capacity compensation received by them would not fall within the definition of "service" as defined in Section 65B(44) of the Finance Act,

1994. As per this section, *"service" means* *<u>any activity carried out by a person for another</u>* *for consideration, and includes a declared service, but shall not include—.* Therefore, there should be an activity carried out by one person for another and that too for consideration.

D.2 Section 66E(e) was inserted in statutory provisions because what is taxable under the Service tax law is activity carried out. It means that some activity is carried out and it refers to some positive act of doing something for consideration. There can be doubt that one refrains or abstains from doing something may not be covered by the term "activity carried out". Secondly, if there is guarantee like insurance contract, maintenance contract, someone can say that positive activity is carried out.

D.3 Section 66E(e) of the Finance Act, 1994 relating to the declared service-

> ***66E.*** *The following shall constitute declared services, namely:—*
>
> *(e)* ***<u>agreeing to the obligation</u>*** *to refrain from an act, or to tolerate an act or a situation, or to do an act;*

The charging section under Section 66B read with declared services signifies that there should be an agreement between the service provider and service recipient for provision of services.

D.4 The statutory provision is a long sentence and correct way to interpret the same is that:

(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

The above proposition is clarified by CBIC also vide Circular No. 214 dated 28.02.2023 as under:

> *"An issue has arisen on the levy of service tax on liquidated damages arising out of breach of contract, forfeiture of salary or payment of bond amount in the event of the employee leaving the employment before the minimum agreed*

*period and similar other issues arising out of clause (e) of section 66E of the Finance Act, 1994. Reference has also been invited to Circular No. 178/10/2022-GST, dated 3rd August, 2022 regarding applicability of GST on liquidated damages, compensation and penalty arising out of breach of contract or other provisions of law, and its applicability to service tax related issues.*

***2.** It may be seen that "Agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act" is a Declared Service as per clause (e) of section 66E of the Finance Act, 1994. A service conceived in an agreement where one person agrees to an obligation to refrain from an act or to tolerate an act or to do an act, would be a 'declared service' under section 66E, read with section 65B(44) and would be leviable to service tax.*

***3.** The description of the declared service in question, namely, agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act is similar in GST. "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 of the CGST Act, 2017.*

***4.** As can be seen, the said expression has three limbs: —*

| | | |
|---|---|---|
| *(i)* | | *Agreeing to the obligation to refrain from an act,* |
| *(ii)* | | *Agreeing to the obligation to tolerate an act or a situation,* |
| *(iii)* | | *Agreeing to the obligation to do an act. Service of agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act is nothing but a contractual agreement. A contract to do something or to abstain from doing something cannot be said to have taken place unless there are two parties, one of which expressly or impliedly agrees to do or abstain from doing something and the other agrees to pay consideration to the first party for doing or abstaining from such an act. Such contractual arrangement must be an independent arrangement in its own right. There must be a necessary and sufficient nexus between the supply (i.e. agreement to do or to abstain from doing something) and the consideration.* |

***5.** The issue also came up in the CESTAT in Appeal No. ST/ 50080 of 2019 in the case of M/s Dy. GM (Finance) Bharat Heavy Electricals Ltd in which the hon'ble Tribunal relied on the judgement of divisional bench in case of M/s South Eastern Coal Fields Ltd Vs. CCE Raipur {2021(55) G.S.T.L 549(Tri-Del)}. Board has decided not to file appeal against the CESTAT order ST/A/50879/2022-CU[DB], dated 20.09.2022 in this case and also against Order A/85713/2022, dated 12-8-2022 in case of M/s Western Coalfields Ltd. Further, Board has decided not to pursue the Civil Appeals filed before the*

*Apex Court in M/s South Eastern Coalfields Ltd. supra (CA No. 2372/2021), M/s Paradip Port Trust (Dy. No. 24419/2022, dated 8-8-2022), and M/s Neyveli Lignite Corporation Ltd. (CA No. 0051-0053/2022) on this ground.*

***6.** In view of above, it is clarified that the activities contemplated under section 66E i.e. when one party agrees to refrain from an act, or to tolerate an act or a situation, or to do an act, are the activities where the agreement specifically refers to such an activity and there is a flow of consideration for this activity. Field formations are advised that while taxability in each case shall depend on facts of the case, the guidelines discussed above and jurisprudence that has evolved over time, may be followed in determining whether service tax on an activity or transaction needs to be levied treating it as service by way of agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act. Contents of Circular No. 178/10/2022-GST, dated 3rd August, 2022, may also be referred to in this regard."*

D.5 In GST, Schedule II of the CGST Act, 2017 has identical provision. For ease of reference, Paragraph 5 – Supply of Services Clause (e) states as under:

| | | |
|---|---|---|
| *(e)* | | *agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;* |

D.6 Even in context of GST, CBIC vide Circular 178 dated 03.08.2022 has clarified as under:

***2.** "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 of CGST Act if the same constitutes a "supply" within the meaning of the Act. The said expression has following three limbs: -*

*a.* *Agreeing to the obligation to refrain from an act — Example of activities that would be covered by this part of the expression would include non-compete agreements, where one party agrees not to compete with the other party in a product, service or geographical area against a consideration paid by the other party.*

*Another example of such activities would be a builder refraining from constructing more than a certain number of floors, even though permitted to do so by the municipal authorities, against a compensation paid by the* *neighbouring housing project, which wants to protect its sunlight, or an industrial unit refraining from manufacturing activity during certain hours against an agreed compensation paid by a neighbouring school, which wants to avoid noise during those hours.*

*b.* *Agreeing to the obligation to tolerate an act or a situation — This would include activities such a shopkeeper allowing a hawker to operate from the common pavement in front of his shop against a monthly payment by the hawker, or an RWA tolerating the use of loud speakers for early morning prayers by a school located in the colony subject to the school paying an agreed sum to the RWA as compensation.*

*c.* *Agreeing to the obligation to do an act — This would include the case where an industrial unit agrees to install equipment for zero emission/discharge at the behest of the RWA of a neighbouring residential complex against a consideration paid by such RWA, even though the emission/discharge from the industrial unit was within permissible limits and there was no legal obligation upon the individual unit to do so.*

***3.*** *The description "agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act" was intended to cover services such as described above. However, over the years doubts have persisted regarding various transactions being classified under the said description.*

*3.1. Some of the important examples of such cases are Service Tax/GST demands on –*

*i.* *Liquidated damages paid for breach of contract;*

*ii.* *Compensation given to previous allottees of coal blocks for cancellation of their licenses pursuant to Supreme Court Order;*

*iii.* *Cheque dishonour fine/penalty charged by a power distribution company from the customers;*

*iv.* *Penalty paid by a mining company to State Government for unaccounted stock of river bed material;*

*v.* *Bond amount recovered from an employee leaving the employment before the agreed period;*

*vi.* *Late payment charges collected by any service provider for late payment of bills;*

*vii.* *Fixed charges collected by a power generating company from State Electricity Boards (SEBs) or by SEBs/DISCOMs from individual customer for supply of electricity;*

*viii.* *Cancellation charges recovered by railways for cancellation of tickets, etc.*

*In some of these cases, tax authorities have initiated investigation and in some advance ruling authorities have upheld taxability.*

***4.*** *In Service Tax law, 'Service' was defined as any activity carried out by a person for another for consideration. As discussed in service tax education guide, the concept 'activity for a consideration' involves an element of contractual relationship wherein the person doing an activity does so at the desire of the person for whom the activity is done in exchange for a consideration. An activity done without such a relationship i.e., without the express or implied contractual reciprocity of a consideration would not be an 'activity for consideration'. The element of contractual relationship, where one supplies goods or services at the desire or another, is an essential element of supply.*

***5.*** *The description of the declared service in question, namely, agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act in para 5 (e) of Schedule II of CGST Act is strikingly similar to the definition of contract in the Contract Act, 1872. The Contract Act defines 'Contract' as a set of promises, forming consideration for each other. 'Promise' has been defined as willingness of the 'promisor' to do or to abstain from doing anything. 'Consideration' has been defined in the Contract Act as what the 'promisee' does or abstains from doing for the promises made to him.*

***6.*** *This goes to show that the service of agreeing to the obligation to refrain from an act or to tolerate an act or a situation, or to do an act is nothing but a contractual agreement. A contract to do something or to abstain from doing something cannot be said to have taken place unless there are two parties, one of which expressly or impliedly agrees to do or abstain from doing something and the other agrees to pay consideration to the first party for doing or abstaining from such an act. There must be a necessary and sufficient nexus between the supply (i.e. agreement to do or to abstain from doing something) and the consideration.*

*6.1 A perusal of the entry at serial 5(e) of Schedule II would reveal that it comprises the aforementioned three different sets of activities viz. (a) the obligation to refrain from an act, (b) obligation to tolerate an act or a situation and (c) obligation to do an act. All the three activities must be under an "agreement" or a "contract" (whether express or implied) to fall within the ambit of the said entry. In other words, one of the parties to such agreement/contract (the first party) must be under a contractual obligation to either (a) refrain from an act, or (b) to tolerate an act or a situation or (c) to do an act. Further some "consideration" must flow in return from the other party to this contract/agreement (the second party) to the first party for such (a) refraining or (b) tolerating or (c) doing. Such contractual arrangement* *must be an independent arrangement in its own right. Such arrangement or agreement can take the form of an independent stand- alone contract or may form part of another contract. Thus, a person (the first person) can be said to be making a supply by way of refraining from doing something or tolerating some act or situation to another person (the second person) if the first person was under an obligation to do so and then performed accordingly.*

D.7 This can also be explained by way of an example. There is difference between agreement to sell and actual sale. Agreeing to sell is merely a formation to sale. The sale will be completed only when transfer of property in the goods is accomplished. The difference between the two is if one agrees to sell and does not actually sell thereafter, the buyer can sue for damages for not supplying the goods as agreed for. The buyer cannot ask for sale/ delivery of goods. Even Section 54 of the Transfer of Property Act states that agreeing to sale does not confer title. The agreement to sale is merely a promise and if that is breached, then no title passes on to the buyer. If the legislation wants to levy tax on agreement to provide services, for example insurance contracts, then in case of insurance of contract for one year if no claim is lodged by the insured then it can be argued that there is no service provided by the insurance company. To plug those type of transactions, Section 66E(e) of the Finance Act, 1994 becomes relevant. Further, the section requires positive act on the part of the service provider to do some activity. In the facts of the present case, since there is no agreement between the Respondent and the recipient of goods situated in foreign country to tolerate any act or to refrain from any act or obligation to do an act, it is not covered within the scope of declared services i.e. Section 66E(e) of the Finance Act, 1994.

**<u>The scope of declared services in India is narrower then other tax jurisdictions</u>**

E.1 The legislation to tax declared services in India is significantly different than other tax jurisdictions. From the language employed in India for taxation of such services, the legislature has consciously used the words "Agreeing to the obligation". This makes the Indian law narrower than laws in other tax jurisdiction. This can be explained as follows.

E.2 The 2nd European Council Directive (on harmonisation of legislation of Member States of European Union) issued on 11.04.1967 vide Point No. 9 to the Annexure to the said Directives clarified as under:

> *9. Regarding Article 6(1)*
>
> *The definition of Provision of services given in the paragraph involves classification of inter alia the following as a provision of services:*

- *the assignment of intangible property;*
- ***<u>the carrying out of an obligation to refrain from doing something;</u>***
- *the carrying out of a service rendered by order of a public authority*
- *the carrying out of work on goods if such work is not considered as a supply within the meaning of Article 5(2)(d) and (e) as, for example current maintenance work, the laundering of linen etc.;*

E.3 The 6th Council Directive on harmonisation of the laws of the Member States for levy of VAT dated 17.05.1977 clarified as under:

> *Article 6*
>
> *Supply of Services*
>
> *1. Supply of services shall mean any transaction which does not constitute a supply of goods within the meaning of Article 5.*
>
> *Such transaction may include inter alia:*

- *Assignment of intangible property whether or not it is the subject of a document establishing title*
- ***<u>obligations to refrain from an act or to tolerate an act or a situation</u>***
- *the performances of a services in pursuance of an order made by or in the name of a public authority or in pursuance of the law*

E.4 Again, 2006 Council Directive on the common system of value added tax dated 28.11.2006 clarified as under:

> *Article 25*
>
> *Supply of services may consist, inter alia in one of the following transactions:*
>
> *(a) The assignment of intangible property whether or not the subject of a document establishing title;*

***(b) the obligation to refrain from an act or to tolerate an act or a situation;***

*(c) the performance of a services in pursuance of an order made by or in the name of a public authority or in pursuance of the law.*

E.5 Similarly, in Australia, in A New Tax System (Goods & Services Tax) Act, 1999 – Section 9.10 it is provided as under:

*(2)(g) an entry into, or release from and obligation:*
*(i) to do anything: or*
*(ii) To refrain from an act: or*
*(iii) To tolerate and act or a situation*

E.6 It can be observed from the above and in comparison, with the law in India, it is imperative to be taxable that the activity is done **"agreeing to obligation**" which signifies that there is an agreement or consensus for doing that activity between the supplier and the recipient. A doubt can arise whether prefix "agreeing to obligation" is common for all or only "agreeing to" is common prefix for all the situations mentioned in Section 66E(e) of the Finance Act, 1994. In India, language employed is "agreeing to obligation", therefore, there should be an agreement and also obligation as prefix for all the situation envisaged in Section 66E(e) of the Finance Act, 1994.

**Law of obligation is wider than law of contract**

E.7 There can be obligation outside the contract. The obligations which are arising outside the contract are outside the scope of Section 66E(e) of the Finance Act, 1994 for the reason that the law in India covers only those transactions which are agreed to be performed as per Indian Contract Law. The Law of obligation is wider than law of contract. For this proposition, a leading commentary of Salmond on Jurisprudence at Para 121 can be referred to wherein it is explained as under:

"*121. The nature of obligations*

*Obligation in its popular sense is merely a synonym for duty. It's legal sense derived from Roman law, differs from these in several aspects. In the first place obligations are nearly one class of duties, namely those which are the correlatives of right in personam. An obligation is the vinculum juris, or a bond of legal necessity, which binds together 2 or more determinate individuals. It includes for example the nutty to pay a debt to perform a contract, or to pay damages for a Todd but not the duty to refrain from interference with the person, property, or a reputation of others. Secondly, the term obligation is in law the name, not merely of the duty, but also of the correlative right. It denotes the legal relation or vinculum juris in its entirety including the right of the one party no less than the liability of the other. Looked at that point of view of the person entitled an obligation is a right; looked at from the point of view of the person bound, it is a duty. We may say either that the creditor acquires, owns, or a transverse and obligation or that the data has incurred or been released from one. Thirdly and lastly, all obligations pertain to the sphere of a proprietary rights. They form part of the estate of him who is entitled to them. Rights which relate to a person's status, such as those created by marriage are not obligations, even though they are rights in personam. An obligation therefore, may be defined as a proprietary right in personam what a duty which corresponds to such a right."*

E.8 In the facts of the present case, there is no agreement with Respondent and the recipient of the goods to have idle capacity and therefore, the sum received by them cannot be taxed under the realms of Section 66E(e) of the Finance Act, 1994. Even Circular 178 dated 03.08.2022 supports their views. Para 7 of which clarifies as under:

***Agreement to do or refrain from an act should not be presumed to exist***

***7.*** *There has to be an express or implied agreement; oral or written, to do or abstain from doing something against payment of consideration for doing or abstaining from such act, for a taxable supply to exist. An agreement to do an act or abstain from doing an act or to tolerate an act or a situation cannot be imagined or presumed to exist just because there is a flow of money from one party to another. Unless there is an express or implied promise by the recipient of money to agree to do or abstain from doing something in return for the money paid to him, it cannot be assumed that such payment was for doing an act or for refraining from an act or for tolerating an act or situation. Payments such as liquidated damages for breach of contract, penalties under the mining act for excess stock found with the mining company, forfeiture of salary or payment of amount as per the employment bond for leaving the employment before the minimum agreed period, penalty for cheque dishonour etc. are not* *a consideration for tolerating an act or situation. They are rather amounts recovered for not tolerating an act or situation and to deter such acts; such amounts are for preventing breach of contract or non-performance and are thus mere 'events' in a contract. Further, such amounts do not constitute payment (or consideration) for tolerating an act, because there cannot be any contract: (a) for breach thereof, or (b) for holding more stock than permitted under the mining contract, or (c) for leaving the employment before the agreed minimum period or (d) for doing something leading to the dishonour of a cheque. As has already been stated, unless payment has been made for an independent activity of tolerating an act under an independent arrangement entered into for such activity of tolerating an act, , such payments will not constitute 'consideration' and hence such activities will not constitute "supply" within the meaning of the Act. Taxability of these transactions is discussed in greater detail in the following paragraphs.*

**<u>"Consideration" is taxable under service tax. When a contract is broken, the suffering party will be entitled to "damages". Damages are not consideration and therefore not taxable in service tax</u>**

F.1 An activity carried out for consideration is chargeable to service tax. Even Section 67 (dealing with valuation of services) also states that what is taxable is "gross amount charged" for the services rendered. Therefore, when one party breaches the contract, the suffering party will be entitled to the damages which are not consideration for any services. Reference can be made to Para 2.2 & 2.3 of the Education Guide, 2012 wherein it is clarified as under:

***2.2 Consideration***

*2.2.1 The phrase 'consideration' has not been defined in the Act. What is, therefore, the meaning of 'consideration'? As per Explanation (a) to section 67 of the Act "consideration" includes any amount that is payable for the taxable services provided or to be provided.*

*<u>Since this definition is inclusive it will not be out of place to refer to the definition of 'consideration' as given in section 2 (d) of the Indian Contract Act, 1872 as follows-</u>*

*<u>"When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise"</u>*

*In simple terms, 'consideration' means everything received or recoverable in return for a provision of service which includes monetary payment and any consideration of non- monetary nature or deferred consideration as well as recharges between establishments located in a non-taxable territory on one hand and taxable territory on the other hand.*

***2.3 Activity for a consideration***

*The concept 'activity for a consideration' involves an element of contractual relationship wherein the person doing an activity does so at the desire of the person for whom the activity is done in exchange for a consideration. An activity done without such a relationship i.e. without the express or implied contractual reciprocity of a consideration would not be an 'activity for consideration' even though such an activity may lead to accrual of gains to the person carrying out the activity.*

*Thus an award received in consideration for contribution over a life time or even a singular achievement carried out independently or without reciprocity to the amount to be received will not comprise an activity for consideration.*

*There can be many activities without consideration. An artist performing on a street does an activity without consideration even though passersby may drop some coins in his bowl kept after feeling either rejoiced or merely out of compassion. They are, however, under no obligation to pay any amount for listening to him nor have they engaged him for his services. On the other hand if the same person is called to perform on payment of an amount of money then the performance becomes an activity for a consideration.*

*Provisions of free tourism information, access to free channels on TV and a large number of governmental activities for citizens are some of the examples of activities without consideration.*

*Similarly there could be cases of payments without an activity though they cannot be put in words as being "consideration without an activity". Consideration itself pre-supposes a certain level of reciprocity. Thus grant of pocket money, a gift or reward (which has not been given in terms of reciprocity), amount paid as alimony for divorce would be examples in this category. However a reward given for an activity performed explicitly on the understanding that the winner will receive the specified amount in reciprocity for a service to be rendered by the winner would be a consideration for such service. Thus amount paid in cases where people at large are invited to contribute to open software development (e.g. Linux) and getting an amount if their contribution is finally accepted will be examples of activities for consideration.*

F.2 The term "consideration" is not defined in the Finance Act, 1994. However, Section 67 dealing with valuation of services refers to term "consideration" in Explanation appended to that Section. This term is used in expansive manner and therefore, reference can be made to Section 2(d) of the Indian Contract Act, 1872 which defines consideration.

F.3 "Consideration" means something receivable in return for an activity carried out. Any activity done without reciprocal consideration would not fall within the definition of service also.

**Even if a contract does not explicitly provide for damages, the party that breaches the contract is still liable to pay the damages for the said breach. If there is no breach of the contract, there cannot be damages**

G.1 There are three aspects which require consideration in this discussion:

(a) Consideration means discharge of obligation under the contract. For example, when the buyer pays price for purchase of goods, he is discharging his obligation under the contract and can be treated as consideration.

(b) Amount paid should be damages for the breach of the contract. If there is no breach of the contract, the question of damages cannot be there.

(c) Even when there is breach of the contract, the breach is prospective and does not affect the past performance of the contract

G.2 Few examples can be referred to here:

Example -1 Where seller of a business agrees that for another 5 years he will not compete in the same business and he receives a non-compete fees.

Example – 2 Where the producer of the milk agrees to not to produce the milk beyond certain levels and he gets amount for such activity.

There can be question whether these amounts will fall within the coverage of Section 66E(e) of the Finance Act, 1994 or not.

**The provisions of Indian Contract Act, 1872 are relevant**

G.3 Section 73 of the Indian Contract Act, 1872 has inbuilt provision for compensation for loss or damage caused by breach of contract. For a valid contract, there should be an offer, an acceptance by the parties and agreed consideration for the performance of the contract. In case of receipt of compensation for breach of the contract, there is no offer, no acceptance and there cannot be consideration. Reference can be made to leading commentary on Indian Contract Act, 1872 by **Pollock & Mulla – 14th Edition** wherein Section 73 explains as under:

> ***S.73. Compensation for loss or damage caused by breach of contract –***
>
> *when a contract has been broken, the party who suffers by such breach is entitled to receive from the party who has broken the contract compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach which parties knew when they made the contract, to be likely to result from the breach of it.*
>
> *Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach.*
>
> *Compensation for failure to discharge obligation resembling those created by contract –*
>
> *When an obligation resembling those created by contract has been incurred and has not been discharged, any person injured by the failure to discharge is entitled to receive the same compensation from the party in default as if such person had contracted to discharge it and had broken his contract.*
>
> *Explanation. - In estimating the loss or damage arising from a breach of a contract, the means which existed of remedying the inconvenience caused by the non-performance of the contract must be taken into account.*

G.4 Section 73 of the Indian Contract Act, 1872 itself gives illustration which are relevant for the present matter are explained and discussed hereunder:

> (a) ***A*** *contracts to sell and deliver 50 maunds of saltpetre to* ***B,*** *at a certain price to be paid on delivery.* ***A*** *breaks his promise.* ***B*** *is entitled to receive from* ***A****, by way of compensation, the sum, if any, by which the contract price falls short of the price for which* ***B*** *might have obtained 50 maunds of saltpetre of like quality at the time when the saltpetre ought to have been delivered.*

G.5 The above can be explained by way of example. B enters in to contract for purchase of goods at say Rs.100/-. However, A does not deliver the goods and B is forced to purchase the same goods at Rs.120/- from open market. In the present case, the money is charged by the buyer from the seller. There is breach by the seller and the buyer is receiving the money from the seller. In the present case, B is entitled to receive Rs.20/- as damages for breach of the contract. There cannot be any supply of services from the buyer to the seller even though the buyer is receiving the money from the seller.

G.6 The illustration (c) to Section 73 of the Indian Contract Act, 1872 is also relevant:

> *(c)* ***A*** *contracts to buy of* ***B****, at a stated price, 50 maunds of rice, no time being fixed for delivery.* ***A*** *afterwards informs* ***B*** *that he will not accept the rice if tendered to him.* ***B*** *is entitled to receive from* ***A****, by way of compensation, the amount, if any, by which the contract price exceeds that which* ***B*** *can obtain for the rice at the time when* ***A*** *informs* ***B*** *that he will not accept it.*

G.7 The above can be explained as follows. A is the purchaser and B is the seller. A informs the seller not to supply the goods. In that case, B the seller entitled to receive compensation from the purchaser A. Let's say the agreement to purchase the goods was at Rs.100. However, on the date when A intimates B not to supply the goods, the market price of the goods is Rs.80. The B seller is entitled to compensation of Rs.20 from the purchaser A in this case.

G.8 The illustration (d) to Section 73 of the Indian Contract Act, 1872 is also relevant:

> *(d) A contracts to buy B's ship for 60,000 rupees, but breaks his promise. A must pay to B, by way of compensation, the excess, if any, of the contract price over the price which B can obtain for the ship at the time of the breach of promise.*

G.9 The illustration (f) to Section 73 of the Indian Contract Act, 1872 is also relevant:

*(f) A contracts to repair B's house in a certain manner, and receives payment in advance. A repairs the house, but not according to contract. B is entitled to recover from A the cost of making the repairs conform to the contract.*

G.10 The illustration (m) to Section 73 of the Indian Contract Act, 1872 is also relevant:

*(m) A sells certain merchandise to B, warranting it to be of a particular quality, and B, in reliance upon this warranty, sells it to C with a similar warranty. The goods prove to be not according to the warranty, and B becomes liable to pay C a sum of money by way of compensation. B is entitled to be reimbursed this sum by A.*

In all the above illustrations, it can be noticed that compensation received is never recognized as consideration of the contract.

G.11 The Respondent wishes to refer to commentary on Indian Contract Act, 1872 by **Pollock & Mulla – 14th Edition** wherein in Section 73, it is explained as under:

*Damages as a remedy for breach of contract*

*Damages for breach of contract committed by the defendant are a compensation to the plaintiff for the damage, loss or injury he has suffered through that breach. An action for damage is always available as a matter of right when a contract has been broken as against the relief of specific performance which lies in the discretion of the court.*

***Express Provisions in the Contract for Reliefs***

*The parties to a contract can create, for themselves, special rights and obligations such as providing for themselves the measure of damages for breach. If the parties themselves fix the value of their right, that amount is a proper measure of damages. Section 62 of the Sale of Goods Act, 1930 is statutory recognition of this right, under which it is open to parties to a sale of goods to provide their own measure of damages in cases of breach of contract.*

The above, shows that as per the choice of the parties, the contract itself can have the remedy for breach of the contract. However, that itself will not make the compensation for breach of the contract as consideration of the contract.

G.12 Further, the below Paragraph enunciates the principle of Section 73 of the Indian Contract Act, 1872 as under:

> ***<u>Principle of the Section 73</u>***
>
> *This section is declaratory of the Common Law as to damages.*
>
> *The law imposes an obligation or implies the terms that upon breach of a contract, damages must be paid; that is also provided in plain terms by the section. The party 'does not enter into a kind of second contract to pay damages', and 'an agreement to pay damages does not form part of the contract'; and the theory of an auxiliary contract to pay special damages is no longer prevalent, that as to damages which could not be foreseen without information of special circumstances, notice of any such circumstances at the time of entering into the contract would not suffice to make the defendant liable, but there must be in effect, if not in terms, an undertaking to answer for resulting special damages*

The above can be explained by way of an example. Suppose on breach of contract between seller A and buyer B, the seller A has to pay compensation to buyer B. Both the parties agree to pay compensation as per their agreed terms and are not entering in to a separate contract for compensation. The liability to pay damages flows from the Contract Act itself and not from the contract between the parties.

G.13 The below Paragraph enunciates the principle of Section 73 of the Indian Contract Act, 1872 so far as breach of contract is concerned as under:

> *<u>Breach of contract</u>*
>
> *This section applies only where a contract has been broken and breach of a contract must be proved before setting about the question of damages. <u>Whether there is a breach cannot be decided by a party and it must be adjudicated and must be proved.</u> No damages can be awarded by the court without coming to any conclusion about breach merely on the ground that the defendant has been profited by the contract.*

The said commentary further explains as under:

> *In the case of an alternative contract, giving the right to a party to perform the contract or to pay damages, the party having the right to select must make the selection within reasonable time, and give notice of his having made the selection to the opposite party. The cause of action to claim damages, in such a case would arise only when the choice not to sell has been made. Damages have been awarded to an employee for the employer's failure to carry out his undertaking to promote an employee to a post of responsibility. In a contract for sale of Manganese ore, the quality of the ore was an essential condition of sale. For the purpose of determining the quality of the ore, the parties nominated two analysts, one of each party. Analysis by both the analysts was held to be an essential condition. Where on refusal of the buyers' analyst to analyse, the sellers intimated their willingness to get the samples analysed by a particular analyst and if the buyers did not agree, the analysis by their analyst would become final and the offer was rejected by the buyers, the rejection by the buyers was held to be justified as it was not in accordance with the terms of the contract to have the analysis done by any other analyst.*

Thus, even if the contract itself provides for alternative contract for performance of the contract or to pay damages, the performance of the contract is still damages only.

G.14 The said commentary further explains the ***nature of remedy of damages*** as under:

> *"It is the fundamental principle of damages for breach of contract that these are awarded to place the injured party in the same position in which he would have been, had he not sustained the injury of which he complains. Hence, the damages must be commensurate with the injury sustained.*
>
> *<u>Where a contract is broken by one party, contract is discharged, and the obligations under the contract come to an end;</u> a new obligation arises for payment of damages. Thus, in Mishra Bandhu Karyalaya v. Shivratanlal Koshalf A, an assignee of an author, had a publishing agreement with P. P failed to render accounts of royalties, which breach was held to entitle A to treat the contract as at an end. A remedy thereafter lay not in claiming royalty in respect of infringing copies, but in damages, which were the loss of business profits."*
>
> *(emphasis supplied)*

From the above Para, it becomes clear that once the contract is broken, future performance of the contract need not be necessary. A new obligation to pay damages arises under the Indian Contract Act itself and not from the contract.

G.15 The said commentary further explains the liquidated damages and unliquidated damages as under:

> *<u>Liquidated and Unliquidated Damages</u>*
>
> *Damages are said to be liquidated when they have been agreed and fixed by the parties. It is the sum which the parties have agreed by contract as payable on default of one of them. Section 74 applies to these damages. In all other cases, the court quantifies or assesses the damages or loss such damages are unliquidated. It is possible that the parties fix an amount as a liquidated damages for a specific type of breach only, then the party suffering from other type of breach may sue for unliquidated damages arising from such breach.*
>
> *Where, under the terms of the contract, it was stipulated that if the goods were not supplied before the date fixed, the purchaser had a right to claim damages at the rate agreed and if they were not delivered within 7 days of the date fixed, then the purchaser was entitled to cancel the contract and encash the bank guarantee but the goods were delivered within the extended time it was held that the purchaser was entitled to claim damages only at the rate agreed and the clause relating to confiscation of bank guarantee could not be invoked since the contract was not cancelled.*

G.16 For the time of assessment of the damages, it is explained as under:

> *"Under a contract for the sale of goods, the measure of damages upon a breach by the buyer is the difference between the contract price, and the market price at the date of the breach. The date of breach is the material date; a seller who holds on after the buyer's default can recover no further loss, nor is he liable to allow for improvement due to later change in the market price. Nor can the seller claim damages with reference to the higher rate at which his buyer, after having repudiated the contract, procured the goods from another seller."*

The above can be explained in the following way. Let's say the price of the goods in the market is Rs.100. The Seller A agreed to supply the goods to buyer B at Rs.120. Now, the buyer B refuses to purchase the goods and for that breach of the contract, Seller A charges Rs.20 to buyer B as damages. The buyer and seller do not enter in to separate contract for damages as there is a breach of the contract. As, there is no supply of goods and therefore, Rs.20 cannot be considered as consideration for any supply.

G.17 Section 74 of the Indian Contract Act, 1872 as reproduced below, deals with Compensation for breach of contract where penalty is stipulated for.

> "*S. 74 Compensation for breach of contract where penalty is stipulated for.*
>
> *When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.*
>
> *Explanation - a stipulation for increased interest from the date of default may be a stipulation by way of penalty.*
>
> *Exception. - When any person enters into any bail bond, recognizance or other instrument of the same nature, or under the provisions of any law or under the orders of the central government or of any state government, gives any bond for the performance of any public duty or act in which the public are interested, he shall be liable upon breach of the condition of any such instrument to pay the whole sum mentioned therein.*
>
> *Explanation. - A person who enters into contract with government does not necessarily thereby undertakes any public duty or promise to do an act in which the public are interested."*

G.18 Reference can be made to commentary on Section 74 of the Indian Contract Act, 1872 by Pollock & Mulla (14th Edition). It is explained as under:

> "*The Principle*
>
> *The parties to a contract may agree at the time of contracting that, in the event of a breach, the party in default shall pay a stipulated sum of money to the other, or may agree that in the event of breach by one party any amount paid by him to the other shall be forfeited. This sum is a genuine pre-estimate of damages likely to flow from the breach. It is called 'liquidity damages. If it is not a genuine pre estimate of the loss but an amount intended to secure performance of the contract, it may be a penalty.*
>
> *Liquidated damages*

*Liquidated damages mean a sum which the parties have by the contract assessed as a damage is to be paid whatever may be the actual damage. A fixed figure of damages which is not assessed for all circumstances, but is graduated to correspond with passage of time between the making of a contract and end of its breach is a proper estimate of the damages to be anticipated from the breach, is called liquidated damages.*

*Sum is named*

*Damages may be liquidated by parties in their contract by naming the specific amount or by fixing the rate or by stating a method of calculation. It may be a lump sum or a fixed sum with reference to time or periods of time. It may be left for calculations. They may name a sum as payable for breach of the entire contract, or for a breach of a particular term only. Parties may also fix different amounts for breach of different terms of their contract.*

*As payable in case of "such breach"*

*Question of whether the sum specified in the contract is so payable arises only when the payment is stipulated as a payable upon breach and upon 'such' breach. Thus, to attract the provisions of section 74, it is not necessary that the entire contract should come to an end, breach of each term thereof can be visualised in advance and taken care of by providing an adequate clause for liquidated damages so that the parties to the contract can proceed to workout the contract in future and settle the question of damage that have accrued on the basis of the rate that has been put as a pre estimate at the commencement of the contract. A party can impose liquidated damages only if the other party has a committed breach and the fact of breach must be adjudicated by the court or arbitrator.*

G.19 The above can be summarized as follows:

(i) Section 73 of the Indian Contract Act, 1872 can be applied in case of breach. The existence of any remedy under the contract itself is not necessary in case of breach.

(ii) When the obligation cast on any party to the contract is breached, the suffering party is entitled to compensation by virtue of Section 73 of the Indian Contract Act, 1872 and that is not recognized as "consideration" of the contract.

(iii) Section 73 will apply only in cases where there is breach of the terms of the contract.

(iv) When the amount of compensation is ascertained, it is termed as liquidated damages. So far as the law in India is concerned, there is no qualitative difference in the nature of liquidated damages and unliquidated damages.

(v) Section 73 and Section 74 of the Indian Contract Act, 1872 do not overlap each other.

**References to other leading commentaries on the subject**

H.1 In the commentary on Law of Contract, by G. C. Cheshire, 7th Edition, it is explained as under:

*Consequences of anticipatory breach*

*In the event of "anticipatory breach", the innocent party has an option; he may either accept the repudiation and enforce the appropriate remedy at once or he may ignore the repudiation and wait until the time for performance arrives. The essential point is that such a repudiation constitutes violation of the contract in omnibus and entitles the other party if he is so minded to sue immediately for its breach.*

H.2 On the "effect of breach", it is explained as under:

*A breach of contract, no matter what form it may take, always entitles the innocent party to maintain an action for damages; but if it is of a sufficiently serious nature, it entitles him not only to recover damages in respect of the present and any past breaches, but also to treat himself as free from further liability.*

H.3 It explains on the rights of the party who accepts the discharge as under:

*"First, He is relieved from further liability to perform his obligations and he may fortify his position in this respect by taking proceedings for the recission of the contract.*

*Secondly, he may sue for recovery of damages, a remedy which is considered as length in the next section stop*

> *Thirdly, instead of showing for the recovery of damages, he may claim on a quantum meruit for the value of the work that he has already done. If for example, he has agreed to render personal services for a sum payable upon completion of these promise, he may recover remuneration for services already rendered up to the time when the contract is discharged. If he adopts these course, his claim is quasi contractual in nature."*

H.4 The above can be explained by way of an example. For example, if a builder is delaying the construction, the purchaser may say that since there is delay in construction, he no longer needs any services or he may say that he will deduct some amount from the payment to be made to the builder. Therefore, for the breach of the contract by one party, another party may sue for the breach or treat the contract as cancelled.

H.5 On the issue of Principle of property transferred by defaulting party not returnable, it is explained as under:

> *"Though a party may exercise his right to treat the contract as at an end as regards obligations de future, it remains alive for the purpose of vindicating rights already acquired under it on either side.*
>
> *Rights and obligations which have occurred prior to recission remain and the contract also remains for the purpose of giving effect to them. It follows in principle therefore that the defaulting party cannot recover property which he has already transferred to the other party in accordance with the terms of the contract."*

H.6 The above can be explained as follows. Let's say, Seller A has agreed to supply 10 units of goods to Buyer B and A has already supplied 6 units of goods to Buyer B, but, not able to supply the remaining 4 units on time. In that case if Buyer B sues seller A for performance of the contract and seller A agrees to pay compensation then, so far as value of 6 units is concerned, it will be treated as value of the supply only.

H.7 The difference between liquidated damages and penalty is explained as under:

*"The parties to a contract may agree beforehand what sum shall be payable by way of damage in the event of breach. For example, a builder agreed that he will pay US$5 a day for every day then if the building remains unfinished after the contractual date for completion, a sum fixed in this manner falls into one of two classes.*

*First, it may be a genuine pre estimate of the loss that will be caused to one party if the contract is broken by the other. In this case, it is called **liquidated damages** and it constitutes the amount, no more and no less than the plaintiff is entitled to recover in the event of breach without being required to prove actual damage. Thus, Liquidated damages means the sum which the parties have by the contract assessed as the damage to be paid whatever may be the actual damage.*

*Secondly it may be in the nature of a threat held over the other party in terrorism a security to the promise that the contract will be performed. A sum of this nature is called a **penalty**, and it has long been subject to equitable jurisdiction. Courts of Equity have taken the view that since the penalty is designed as a mere security for the performance of the contract, the promise is a sufficiently compensated by being indemnified for his actual loss and that he acts unconscionably if it demands a sum which, though certainly fixed by agreement may well be disproportionate to the injury. The rule, therefore, is that a plaintiff who brings an action for the enforcement of a penalty can recover compensation only for the damage that he has in fact suffered. He is not entitled to recover the sum stated in the contract if he has not in fact suffered so much loss.*

*A penalty covers but does not assess the damage. Where, however, this is stipulated sum does not compensate for the actual loss suffered the plaintiff may either sue on the penalty clause in which case he cannot recover more than the stipulated sum; or he may sue for breach of a contract and recover damage in full. There is no such option in the case of liquidated damages."*

H.8 Similarly, in another leading commentary of Anson's Law of Contract, (24th Edition) it is explained as under:

*"If one of two parties to a contract breaks the obligation which the contract imposes, a new obligation will in every case arise that is right of action conferred upon the party injured by the breach. Besides this, there are circumstances under which the breach not only gives rise to a right of action but we will also discharge the injured party from such performance as may still be due from him.*

*If the injured party allows or accepts the repudiation, this discharges all contractual obligations on his part which have not already been performed. At the same time the primary obligations of the party in default to perform any of the promises made by him in the contract and the remaining unperformed are likewise discharged. However in the case of the party in default in place of the primary obligations imposed by the contract there arise secondary obligations to pay damages for the breach.*

*The effect, therefore, of an accepted repudiation is to bring the contract to an end and to discharge both parties from further performance of the primary obligations contained in the contract, although, else will be seen, it will still be necessary to refer to those primary obligations in assessing the extent of the secondary obligations for example the major of damage is, new from the party in default.*

***Remedies of breach of contract***

*These remedies fall under three heads;*

*1 every breach of contract entitles the injured party to damages for the loss he has suffered.*

*2 if the injured party when the breach occurs has already done part though not all of what he was bound to do under the contract, he may be entitled to claim the value of what he has done. In that case, he is said to sue upon quantum meruit.*

***Damages***

*except in the case of a debt, the repayment of which may be specifically not forced at common law, the common law remedy for breach of a contractual promise is that of damages.*

***Assessment of Damages by the parties***

*The parties to a contract not infrequently assess the damages at which the rate of breach of a contract by one or both of them and introduce their assessment into the terms of the contract. By so doing, however, they do not exclude the application of the rule that damages for breach are intended to compensate the plaintiff for his actual loss and it is a question of the proper construction of the contract to decide whether a sum fixed in this way however the parties may have described it is a panel duty in which case it cannot be recovered or a genuine attempt to liquidate that is to say to reduce to certainty prospective damages of an uncertain amount in which case the sum will be recoverable.*

*In construing the terms of penalty and liquidated damages when inserted in a contract, the courts will not be bound by the phraseology used, for equity looks* *to the intent rather than to the form. The party may call the sum specified "liquidated damages" if they wish but if the court finds it to be a penalty, it will be treated as such. Conversely if the parties have described the sum fixed as a penalty but it turns out to be a genuine pre estimate of the loss, it will be treated as a liquidated damages with the result that the injured party cannot disregard it and sue for the actual loss.*

***Quantum Meruit***

*If our law where scientifically arranged, it would probably regard the rules about quantum merit claims which we are about to consider merely as rules for the assessment of damages in a special case. But these rules have come down to us from a time when there were certain procedural advantages in framing an action in quantum meruit rather than as damages for breach of contract and though these advantages have now disappeared, the distinction still remains. Quantum meruit is still a remedy which is alternative to rather than a form of, damages.*

*The case for which it provides is where the party injured by a breach of a contract has at the time when the breach occurs done part but not all of that which he is bound to do under the contract and is seeking to recompensed for the value of what he has done.*

*Suppose, by the terms of a contract A is to do a certain piece of work for B for a lump sum, payable on its completion. B repudiates the contract when A has done part of the work.*

*It is clear that if for whatever reason A fails to complete the work as stipulated, he cannot demand any remuneration for it under the contract. But it would be most unjust if the law provided him with no remedy when failure is due to B's breach. In such a case, whatever the contract may say, if what A has done can be estimated at the money value the law ought to give him some redress and so it does; it says that he may claim quantum meruit, the reasonable value of the work done. If a man agrees to deliver me 100 quarters of corn, and after I have received 12 quarters, I decline taking anymore, he is at all events entitled to recover against me the value of 12 that I have received.*

*The right to claim quantum meruit does not arise out of the contract as the right to damage does; it is a right conferred outside the contract by the law as a quasi contractual right therefore and not a contractual one and it would be more correct to describe it as an incident of rather than the remedy for the breach of a contract. Breach of a contract is only one of several occasions which give rise to quantum meruit claims and that such claims are sometimes quasi contractual as here but that sometimes they are genuinely contractual.*

*First, a quantum meruit claim is only available if the original contract has been discharged. The contract must have been broken by the defendant in such a* *way as to entitle the plaintiff according to the principles discussed in Chapter XV, to regard himself as discharged from any further performance and he must have elected to do so. If the contract is still as it is said open he cannot use the quantum meruit remedy but must rely on his remedy in damages.*

*Secondly the claim must be brought by the party not in default. The party who breaks the contract even though he may have partially performed some part of his obligation is not entitled to a quantum meruit for the work which he has done.*

*If these requirements are satisfied, the party who has absolutely refused to perform, or who has rendered himself incapable of performing his part of the contract puts it in the power of the other party either to sue for a breach of it, or to reset the contract and sue on a quantum meruit for the work actually done. If the injured party chooses the latter remedy, the law proceeds on a principle of assessment which differs from that which it applies in assessing damages for breach of contract. For where is the purpose of damages is to place the injured party as nearly as may be, in the position which he would have been in if the other party had performed the contract. The purpose of quantum meruit is to recompense him for the value of the work which he has done that is to restore him to the position which he would have been in if the contract had never been made. In other words, damages are compensatory, and quantum meruit is restitutory, and, as Lord Porter pointed out in Heyman Vs. Darwin Ltd. the sum which the injured party is entitled to recover may differ accordingly, as it is assessed on a one or the other of these two principles. If we take the example previously cited and suppose that A is to be paid $1200 on completion of the work, should he claim damages, he will receive $1200 less any saving on labour and materials, which is the sum which he would have received had B performed the contract. But if we ask for quantum meruit, he is asking to be paid the reasonable value of his work which, in a simple case like the present would probably be less than the contractual sum. There might, however, be some special circumstances which would show that the contractual sum was an underestimate of the real value of the work, and that it was worth more than had been there provided for. In such a situation A might well find it to be more profitable issue for quantum merit than to claim damages.*

**References to relevant circulars/ guidelines issued in foreign tax jurisdictions**

I.1 Any sum received whether it is consideration of the contract or compensation/ damages for the breach of the contract is governed by similar provisions in India and other tax jurisdictions like Europe, UK and Australia.

References can be made to ascertain whether the sum received is consideration for any services or not.

**HMRC Guideline – VATSC05910 – Consideration: Compensation and liquidated damages that are consideration: When are compensation payments consideration for a supply**

*Historically, HMRC took the view that payments described as compensation were typically outside the scope of VAT. One authority for this was the CJEU case of Société thermale d'Eugénie-les-Bains (C-277/05)http://curia.europa.eu/juris/document/document.jsf?docid=62752&mode=req&pageIndex=1&dir=&occ=first&part=1&text=&doclang=EN&cid=15243477). In the very particular circumstances of that case, the Court concluded that the deposit received by the hotel was not a part payment for the accommodation, and when a customer cancelled a booking, it was to be treated as outside the scope of VAT as it was compensation rather than consideration for a supply. In March 2019 we updated our guidance on deposits following later CJEU authorities, where the court found that similar payments were consideration – see VATSC05822 (https://www.gov.uk/hmrc-internal-manuals/vat-supply-andconsideration/vatsc05822).*

*Whether Payment is for a VAT supply depends on whether anything is being done in a return for a consideration. Where a party agrees to do something in return for a fee there is a supply. How that fee is described does not affect whether there is a supply for VAT. What matters is whether something is done and if there is a direct link between what is done and the payment received and the reciprocity between the supplier and the customer.*

*For payment to be consideration for a supply, there needs to be reciprocity between the supplier and the customer. The supplier agrees to provide a service which the customer benefits from. An example of where the necessary reciprocity was absent is the case of Mohr V Finanzamt Bad Segeberg (Case C-215/94). In this case, the German and Italian governments argued that there was a clear and direct link between payments made by state authorities to farmers to cease milk production. The court ruled that the payments were outside the scope of VAT. This was because the authorities were paying out money for a wider good. They did not directly benefit from the action taken by the farmer and so did not consume any service. The necessary reciprocity between the supplier and customer did not exist. There was therefore no supply and so, there was no consideration liable to VAT.*

*It is therefore essential that there is a direct link between the consideration and the supply. Where this is the case, the supplier will normally have clearly agreed to do something for the customer in return for a payment. It may occasionally be the case that where an agreement does not explicitly allow a customer to do something, the economic reality of the transaction is such that agreement to supply something is nevertheless effectively there. This may be when a similar amount is paid for the higher of something when it is kept beyond the agreed term to that we paid for the agreed higher. In the tribunal case JG Leigh t/a Moor Lane Video. It was found that the economic reality was that the penalty charged for a late return was an additional fee for hire.*

*Similarly, if a car is hired for a period of one week and is due to be returned by, say 9:00 AM on Monday but is not in fact returned until 5:00 PM on the following Tuesday, a charge for a late return will* *normally be made. Such charges are generally designed to both deter the person hiring the car from bringing it back late and to compensate the Hier company for the additional use. The charge will be subject to VAT as it's for the supply of the car, and the customer is aware that an additional charge will be made and how much that charge will be or how the charge will be calculated. Although the use goes beyond that period which is agreed with the customer at the outset of the contract, it is an additional hire fee similar to that in JG Leigh t/a Moor Lane Video.*

*If the customer were to write off the car and the supplier charges fee for doing so, this will not be further consideration for the hire of the car. The supplier does not agree that the customer can write the car off and this is not something one would normally expect as part of the supply. The contract may envisage the possibility that the car will be written off and provide for a fee to be paid should that eventuality arise but this is not further consideration for the supply as a necessary reciprocity does not exist.*

*The tenant takes on a package of rights and obligations when entering the lease, one of which is to return the building in the agreed state. The rent will normally reflect those rights and obligations. If the tenant does not fulfil its obligation to return the building in the required state, it is required to make a further payment so the landlord can restore the building to the agreed condition, and it is in effect a re-imbursement of the cost of goods and services that the landlord faces incurring. It is arguable that this therefore represents additional consideration for the supply of the lease. If the obligation to return the building in the agreed state was not there, it is probable that the rent would be set higher to allow the landlord to cover the costs of rectifying the building at the end of the contract.*

*On the other hand, if the tenant had exceeded the wear and tear that might reasonably be expected during the period of the lease, or even undertaken unapproved alterations, the dilapidation payment would be to rectify damage rather than for use of the premises and would be beyond what the landlord agreed the tenant could use the premises for. The link between payment and supply would therefore be broken. Although the payment arguably covers the landlord's expenses in meeting the tenant's obligation under the lease, it may be difficult to establish that the rent has been set with that in mind. It may be that the rent in reality reflects what the market will bear and would not be increased if the dilapidation clauses were removed from the lease. In that case the dilapidation payment would be made to put right damage and there would not be sufficient link between the payment and the service(s) the landlord had agreed to provide under the lease. It would not therefore be further consideration for the lease.*

*Another example of a situation in which additional fees may be charged is parking. If the fee is for the additional use of the parking space it is further consideration for the supply of parking. HMRC's policy position is that where a fine is substantial and punitive and is designed to deter a breach of the terms and conditions of parking it will be outside the scope of VAT as the reciprocity needed to link it to the supply is lacking. If on the other hand, it is effectively an additional charge for occupying a space, then it would be a standard rated supply. The level of the fee for breaching the parking terms in comparison to the standard parking fee may be indicative of which category a particular fine would be in.*

I.2 The principle that emerges from the above is that many times it may be difficult to ascertain or differentiate between compensation and consideration. However, if there is direct link or reciprocity between the amount paid and the beneficial activity carried out, then it will be consideration of supply.

I.3 Further reference can be made to HMRC guideline on VAT Supply and Consideration on early termination of contracts.

**HMRC Guideline – VATSC05920 – Consideration: Compensation and liquidated damages that are consideration: Compensation Payments: Early termination of contracts**

> *HMRC's Policy is to treat payments arising out of early contract termination as a further consideration for the contracted supply where the payments are linked to that supply which will normally be the case. Businesses must account for VAT on these fees if the supply is taxable at the same rate of VAT as the supply. This applies in cases where the original contract allows for such a termination as well as when a separate agreement is reached.*
>
> *This is supported by the CJEU decision in MEO C295/17, which was concerned with the treatment of early termination fees within the contracts for telecommunication services. The court held that the fact that there is a clause in the contract requiring the customer to pay an amount equivalent to the remaining fees, means the supplier is receiving further consideration for the original supply. The fact that the customer is no longer making use of that supply is not relevant if the supplier is made the service available.*
>
> *The more recent case of Vodafone Portugal – C-43/19 endorsed that view, even where the amount payable is not equal to the amount that would have been due had the contract been fulfilled. The court said "Article 2(1)€ of Council Directive 2006/112/EC of 28 November 2006 relating to the common system of value added tax must be interpreted to mean that amounts received by an economic operator in the event of early termination for reasons specific to the customer of a service contract requiring compliance with a tie-in period in exchange for granting that customer advantageous commercial conditions, must be considered to constitute the remuneration for a supply of services for consideration within the meaning of that provision.*
>
> *Early termination payments are also consideration for a supply when there is no pre existing right to terminate in the original contract. The VAT tribunal judgement in Lloyds Bank plc supports this. Lloyds sought an early termination of a lease it held on a property. The lease did not provide for such early cancellation. Tribunal found that there had been a supply by the landlord of granting and exercising an option to terminate the lease in a return for Lloyds making a payment and vacating the premises. As was found by ECJ in Lubbock Fine C-63/92 where a lease is surrendered the liability of that supply will be exempt unless the tenant has opted to tax the property.*
>
> *Where the payments exceed the cost to the supplier of making the supply broadly equivalent to what the customer would have paid had the contract run as envisaged, they are consideration for the supply.*

*Thus, payments that arise from a contract which is broken due to a cause attributable to the customer, being charged to cover the cost to the supplier of making the supply available, or equivalent to what would have been charged for the supply had it gone ahead as intended will be further consideration for that supply.*

I.4 The principle that emerges from the above is that if any sum is received by the supplier on default of the customer and the amount received is equivalent to the supply, if made available by the supplier, then it can be considered as consideration of the supply.

I.5 Further reference can be made to HMRC guideline on VAT Supply and Consideration on early termination of contracts.

**HMRC Guideline – VATSC05930 – Consideration: Compensation and liquidated damages that are consideration: Liquidated damages**

*Agreements that allow for early termination will invariably include related clauses that provide a formula for payment of compensation in the event of such termination. These amounts are generally expressed as being compensation for loss of earnings and are often referred as a liquidated damage. In the light of MEO and Vodafone Portugal, this need to be considered carefully to determine whether they are consideration for supplies.*

*Although the payments are partly designed to compensate they are made as a result of events provided for under the contract. They are therefore part of the agreement and if they form cost to the supplier of making the supply available or equate to what would have been charged for the supply if it had run as expected, they may be further consideration for the supply. Agreements for movable goods commonly include clauses that allow lessees to terminate early but to pay liquidated damages as a result. Examples of these are vehicle finance leases that customers can cancel after an initial period of hire but, if so doing, must pay a termination fee to cover the loss of future rents. HMRC's previous guidance suggested that these were outside the scope of VAT but under an agreement with the leasing industry, allowed lessors to treat lease terminations as a taxable supplies if they so wished. The CJEU judgements in Vodafone Portugal and MEO make clear that such payments are taxable and must be treated as such.*

*Where a supplier makes a supply available to a customer, but they do not avail themselves of all or part of that supply, and the supplier charges a payment to compensate them for having made the supply available that will normally be further consideration for that supply. That is the case even if it is described as damages (see VATSC09520).*

*If a customer uses less of a supply than they contracted and does not pay the amount agreed for the supply in the contract, but is instead charged another fee to compensate the supplier for loss of earnings, this will normally be consideration for the original supply however it is described, as that is the economic reality if the supplier has made the supply available. If however that fee is at a level such that it is clearly punitive and is designed to prevent breach rather than to compensate for lost income, then the link between that payment* *and the supply is not sufficient to regard it as additional consideration, and it will be outside the scope of VAT. Operational colleagues will need to apply their judgment to the facts of their case and should seek assistance if necessary via a Technical Advice Request.*

*Where a supplier breaches the terms of a contract, rather than the customer doing so, then they may reduce the price they charge for the supply, as what is being supplied has been altered. This will result in less VAT being charged if the supply is taxable. If the adjustment is made retrospectively, the supplier must adjust the VAT they have accounted for under VAT Regulation 38. Price adjustment in these circumstances are common practice and if the customer is asked to pay less it is likely that in economic reality the price has been reduced to reflect the lower value of what was actually provided. If the price is not adjusted, but the supplier agrees to pay liquidated damages to compensate the customer for the actual loss suffered as a result of the breach, the payment will be outside the scope of VAT. This might happen where the knock-on effect of the supplier not fulfilling the supply as originally agreed result in substantive costs to the customer for which they seek recompense. The payment may bear little relation to what was provided and if this is the case, the payment will not be sufficiently linked to the supply to be treated as reduced consideration.*

**Australian Tax Guidelines – Taxability of sum received on out of court settlement**

J.1 There may be consequences or liability to pay GST on the sum received resulting from court orders and out of court settlements. Whether a sum received resulting from court orders and out of court settlements is consideration for any taxable supply or not is explained by GSTR 2001/4 issued by the Australian Taxation Office.

*1. This Ruling considers the goods and services tax (GST) consequences resulting from court orders and out-of-court settlements. It explains how a payment (or act or forbearance) that is made in compliance with a court order or out-of-court settlement should be treated for the purposes of A New Tax System (Goods and Services Tax) Act 1999 (the GST Act).*

*7. This Ruling analyses the concept of supply and the nexus that must exist between payment and supply in order to establish the relationship of a 'supply for consideration'. As explained later in the ruling, a payment will not necessarily be consideration for a supply.*

*8. The ruling begins by analysing the concept of 'supply'. It does this by examining the statutory definition of the term in section 9-10, and comparing this definition with the meaning the term has in overseas jurisdictions, namely the United Kingdom, New Zealand and Canada. Similarities and differences are highlighted. This analysis is found at paragraphs 22 to 73.*

*9. The Ruling then analyses the critical 'nexus' requirement that must be satisfied to establish the 'supply for consideration' relationship. This analysis is found at paragraphs 80 to 99.*

*32. For example, in the Court of Justice of the European Community (ECJ) case Landboden-Agrardienste GmbH & Co. KG v. Finanzamt Calau [1998] BVC 70, the issue was whether the 'supply of services', within the meaning given by the Sixth Directive, extended to an undertaking given by a farmer to reduce its harvest of a potato crop[F15]. The undertaking appeared to constitute 'an obligation to refrain from an act' and so fits within the definition of a 'service' in terms of the Sixth Directive. However, the Court ruled:*

*'an undertaking given by a farmer under a national compensation scheme not to harvest at least 20% of his potato crop does not constitute a supply of services for the purposes of [the Sixth] Directive.'[F16]*

*33. In the opinion of Advocate General Jacobs, it did not amount to a service. He commented that:*

*'any payment, except perhaps a gift, will have conditions attached to it whose performance might, by creative use of language, be described as a service.'[F17]*

*34. Mohr v. Finanzamt Bad Segeberg [1996] BVC 293 was another ECJ case in which such a finding was made. In this case, an undertaking by a farmer to refrain from milk production was found not to constitute a supply within the meaning of the Sixth Directive.*

*35. In Landboden, it was held that for an undertaking to be covered by the common system of VAT, it must imply consumption[F18], and that by undertaking to reduce production, the farmer did not provide either services to an identifiable consumer, or some benefit capable of being a cost component of another person in the commercial chain.[F19]*

*36. Under the GST Act, there will be no GST on a supply unless it is a 'taxable supply'. It is the concept of a 'supply' itself that is the entry point into the GST system. As supply 'is defined broadly and is intended to encompass supplies as widely as possible'[F20], we consider that the undertaking to reduce production as dealt with by Landboden would be a 'supply' under paragraph 9-10(2)(g). Whether the supply would be a taxable supply would then depend on the requirements of section 9-5 being met in relation to that supply.*

*Example - Earlier supply*

*47. Widget Company supplies toys to a retailer. A dispute between the parties over payment for the toys is subsequently resolved through an out-of-court settlement, with the retailer paying all monies owed. The supply of the toys, that is the subject of the dispute, is an earlier supply because it occurred before the dispute arose.*

*Current supply*

*48. A new supply may be created by the terms of the settlement. In this Ruling, such a supply is referred to as a 'current supply'.*

*Example - Current supply*

*49. A dispute arises over a claim by Beaut Enterprises Ptv. Ltd that Plagiariser Pty Ltd is using their trade name. Negotiations between the parties follow, resulting in Beaut entering into an agreement with Plagiariser that allows Plagiariser to use its trade name in the future. This would constitute the supply of a right under the agreement between Beaut and Plagiariser that amounts to a 'current' supply.*

*Where the subject of a claim is not a supply*

*71. Disputes often arise over incidents that do not relate to a supply. Examples of such cases are claims for damages arising out of property damage,* *negligence causing loss of profits, wrongful use of trade name, breach of copyright, termination or breach of contract or personal injury.*

*72. When such a dispute arises, the aggrieved party will often assert its right to an appropriate remedy. Depending on the facts of each dispute a number of remedies may be pursued by the aggrieved party in order to ensure adequate compensation. Some of these remedies may be mutually exclusive but it is still open to the aggrieved party to plead them as separate heads of claim until such time as the matter is resolved by a court or through negotiation.*[F37]

*73. The most common form of remedy is a claim for damages arising out of the termination or breach of a contract or for some wrong or injury suffered. This damage, loss or injury, being the substance of the dispute, cannot in itself be characterised as a supply made by the aggrieved party. This is because the damage, loss, or injury, in itself does not constitute a supply under section 9-10 of the GST Act.*

*Example - payment for an earlier supply-*

*102. In the Widget Company example at paragraph 47, the out-of-court settlement reached with the retailer provides for the retailer to make payment in full to Widget for the toys. The supply of the toys is an earlier supply and there is a sufficient nexus between it and the payment. The payment is consideration for that supply.*

*103. A payment made under a court order or out-of-court settlement may also result in an effective reduction in the price of an earlier supply, perhaps to nil. Where this happens, an adjustment event may be required (refer paragraphs 126 to 136 on GST consequences).*

*Example - reduction in the price of an earlier supply*

*104. The retailer paid Widget Company the full price for the toys, but subsequently discovered they were cheaper toys than it believed it was purchasing. The dispute was settled with Widget agreeing that the price charged was excessive for the toys. The terms of the settlement provided for Widget to pay back to the retailer an amount that reflects the price difference between the two products. The payment will be a reduction in the consideration for the supply.*

*Damages*

*110. With a dispute over a damages claim, the subject of the dispute does not constitute a supply made by the aggrieved party. If a payment made under a court order is wholly in respect of such a claim, the payment will not be consideration for a supply.*[F62]

*111. If a payment is made under an out-of-court settlement to resolve a damages claim and there is no earlier or current supply, the payment will be treated as payment of the damages claim and will not be consideration for a supply at all, regardless of whether there is an identifiable discontinuance supply under the settlement.*

*Example - payment of damages*

*112. Bluey's Waste Removal contracts for a three month period with the local Council to collect waste from specified sites in a particular area and remove it to the Council's rubbish tip. Subsequently, one of Bluey's trucks has its suspension badly damaged on the tip site while delivering a load of rubbish in accordance with the contract. An obstacle, which should have been removed by Council staff, was the cause of this damage.*

*113. Bluey takes legal action to recover $50,000, being the cost to repair the truck and the loss of productive time caused by the truck being off the road. Subsequently, Bluey and the Council settle the dispute, with the Council paying Bluey $37,000 and Bluey agreeing to proceed no further with the action.*

*114. No part of the $37,000 paid by the Council to Bluey is consideration for a supply.'*

*Example - apportionment where no earlier supply*

*120. Triple dot, an Australian based provider of music services on the internet, is sued by Ozy Rockers, a local rock group, for infringement of copyright in relation to its material. The infringement relates to similarities between the website signature tune and the music and lyrics of one of the band's top forty hit tunes. The infringement occurred at the time the website first appeared in October 2000. Since then Triple dot has achieved unparalleled success in attracting 'surfers' to the site.*

*121. Ozy Rockers is seeking damages for the infringement in the order of $50,000. Prior to the matter being considered by the courts Ozy Rockers and Triple dot enter into negotiations in an attempt to resolve the dispute. During the discussions, a settlement is reached which provides that Triple dot will make a one off payment of $200,000 to Ozy Rockers. The payment is for the past infringement and the ongoing right for Triple dot to use the signature tune.*

*122. Apportionment is necessary for the correct GST consequences to attach to the supply of the ongoing right to use the copyright. A reasonable approach is required for calculating the necessary apportionment. In the absence of any further information, it may be reasonable to apportion $50,000 to damages for the breach of contract (which would not attract GST) and $150,000 to the use of the copyright (a taxable supply). An alternative basis for apportionment may be to use industry standards to calculate copyright fees.*

## **Australian Tax Guidelines – Taxability of sum received as cancellation fees**

K.1 There could be consequences of GST liability on payments made when an arrangement under which a particular supply was intended to be made, does not proceed in the manner originally contemplated. In such an event, the suffering party receives cancellation fees. The guidelines issued by Australian Taxation Office vide GSTR 2009/3 explains the taxability of such cancellation fees.

*8. The failure to proceed with an arrangement under which an intended supply was to be made may involve:*

- *the customer notifying the supplier that they are cancelling before the time of the intended supply. In this Ruling, this is referred to as a ' **cancellation** ';*

- *the customer failing to take advantage of the arrangement by not showing up at the time of the intended supply, for example, failing to show up for an appointment or hotel reservation. In this Ruling, this is referred to as a ' **no show** '; or*
- *the customer failing to show up at the time of the intended supply under the arrangement but showing up after that time. In this Ruling, this is referred to as a ' **late show** '.*

Facilitation supply

*23. If an intended supply is cancelled or there is a no show, the supplier may still have made a supply. All the things the supplier does to put itself in a position to make the intended supply, that is, to facilitate that supply, is a supply.*

*24. Examples of things done to facilitate the intended supply may include:*
*• the supplier entering into obligations, and providing corresponding rights to the customer to receive another supply, usually the intended supply, (for example, a right to receive a supply of travel);*[8]
*• making an appropriate booking or reservation or providing a ticket;*
*• making available facilities for the use of the customer, for example, a seat at a venue to watch a performance or event;*
*• arranging for the provision of goods or services to enable the supplier to perform their obligations under the arrangement, including paying deposits or other amounts to secure those goods or services;*
*• allocating the services of particular personnel and/or appropriating equipment or goods for use in making the intended supply; and*
*• providing administrative services in facilitating the intended supply.*

*25. If the intended supply is made - the services or tasks that constitute a facilitation supply either form part of the intended supply, or are a separate supply to the intended supply. If the facilitation supply is a separate supply, that supply may not be a taxable supply because the consideration provided by the customer is not connected with the facilitation supply but is instead connected with the intended supply.*

*26. If the intended supply does not proceed because of a cancellation or no show, a facilitation supply is still made to the customer. Any cancellation fee payable by the customer may be consideration for this facilitation supply, which is a different supply to the intended supply.*

*26A. An example of this is Commissioner of Taxation v. Qantas Airways Ltd (Qantas), in which the High Court considered whether payments received*

*by Qantas Airways Ltd from prospective passengers for flights booked but not taken constituted consideration for a taxable supply. After looking at the specific terms and conditions of carriage, the High Court held (4:1):*
*The Qantas conditions and the Jetstar conditions did not provide an unconditional promise to carry the passenger and baggage on a particular flight. They supplied something less than that. This was at least a promise to use best endeavours to carry the passenger and baggage, having regard to the circumstances of the business operations of the airline. This was a 'taxable supply' for which the consideration, being the fare, was received.*

*27. If the actual supply made upon a cancellation or no show is different from the intended supply, the GST status of the actual supply must be analysed against provisions in the GST Act to determine whether it is taxable, GST-free or input taxed.*

*Cancellation supply*

*44. Services provided by a supplier to give effect to the cancellation of an arrangement constitute a cancellation supply.*[11] *A cancellation supply may include administrative services provided in unwinding an arrangement or making refunds. The fee for these services is commonly a flat fee which may be referred to as a cancellation fee, administration fee, change fee or service fee. This fee is consideration for the supply of these services.*

*Release supply*

*51. A customer who has entered into a contract may not wish to, or may be unable to complete the contract. A term in the original contract may grant to the customer the right to terminate the contract upon payment of a cancellation fee in these circumstances.*

*52. Alternatively, the parties to the contract may enter into another contract under which one party (usually the supplier) upon payment of a cancellation fee agrees to release the other party (usually the customer) from performing the latter's obligations under the original contract.*

*53. An example of a clause that provides for a release from the performance of the customer's obligations under the contract is:*
*If you no longer wish to continue this contract, you have the right to terminate it at any time by calling our customer service hotline. However, if you terminate this contract after the end of the cooling-off period and before the end of your contract term, you must pay us a cancellation fee.*

*54. In the circumstances outlined in paragraph 53 of this Ruling, the customer may terminate the agreement pursuant to a right set out in the terms of the arrangement. The termination is not a breach of the contract. The customer exercises their contractual right, for which they agree to pay a cancellation fee as consideration.*

***Security deposits as cancellation fees***

*77. Special rules in Division 99 provide that a deposit held as security for the performance of an obligation (security deposit) is not treated as consideration for a supply unless the security deposit is forfeited because of a failure to perform the obligation, or it is applied as all or part of the consideration for a supply.*

*78. A contract may provide for the forfeiture of a security deposit if a customer cancels the contract. In these cases, under Division 99, the security deposit is treated as consideration for a supply when the deposit is forfeited.*

*79. In Federal Commissioner of Taxation v. Reliance Carpet Co Pty Ltd (Reliance Carpet), the High Court accepted the finding by the Administrative Appeals Tribunal that upon entry into the contract the taxpayer had entered into an obligation to do the things it was bound to do under the contract. The High Court also found that, in that case, the supply had been made by the taxpayer before the forfeiture of the security deposit. Further, the High Court accepted that the supply was made in advance of the failure by the purchaser in performance of the terms of the contract which led to the forfeiture of the security deposit to the taxpayer.*

*80. The High Court found that the security deposit was consideration for the supply, as the connection between the payment of the security deposit and the entry into the contract could be 'readily seen' in the circumstances of the case.*

12 Subsequent to the hearing dated 16.12.2025, Service Tax Appeal No. E/12085/2018, as per directions of the Bench, Learned AR also made his final submissions on 05.01.2026 thereby responding to the submissions of the Advocate as below:-

12.1 During discussions on Section 66E[e] of the Finance Act, 1994, one of the points emphasized by the Learned Advocate was that the definition of Section 66E[e] differs from contemporary laws in other countries as it starts with the word '*agreeing to' [ the obligation to refrain from an act, or to tolerate* *an act or situation, or to do an act* ] indicating that there must be an agreement in the matter. In this case, there is an agreement between the Respondent and their parent company M/s. Lanxess Deutschland GmbH, Germany (LXD), which is part of the Appeal. Another aspect very vehemently emphasized by Sr. Advocate was that whenever there is a breach of agreement, the question of damages suffered, whether liquidated or not, arises, which can be in the form of consideration or compensation or penalty. In this case, there is no breach of the agreement because primarily, the agreement is for maintaining, holding the availability and use of the Respondent's capacity to manufacture the products for LXD at it's factory. Thus, the agreement has two components namely (i) maintaining and holding available the use of the manufacturing capacity for LXD and (ii) manufacturing the products for LXD. The major distinguishing factor between this agreement and any other agreement, is that in this agreement, remuneration consisted of two parts (i) Manufacturing Fee and (ii) an Idle Cost Compensation (if any).

Thus, the Respondent and LXD had agreed to a fair and adequate compensation for the functions performed, assets employed and risks assumed under this Agreement. The consideration encompassed in the agreement covered both Manufacturing Fee as well as Idle Cost Compensation and therefore, amount paid as Idle Cost Compensation is not any additional damages, but a part of the remuneration agreed upon by the Respondent and LXD. Thus, Idle Cost Compensation is a part of the performance or scope of the Agreement/Contract and it is not a penalty for any breach of the contract. LXD has sought control over the manufacturing capacity of the Respondent through this Agreement. For tolerating LXD's act of controlling the Respondent's manufacturing capacity, LXD agreed to (i) off take the products manufactured in the Respondent's factory and (ii) pay to the Respondent the agreed remuneration.

12.2 The other important factor in this case is that the Respondent themselves have declared in their invoice that the gross value charged therein to LXD is in respect of "Declared Service" in terms of clause (e) of Section 66E of the Finance Act, 1994. Copy of one such invoice is reproduced below:-

LANXESS
Energizing Chemistry

Kldn Attn : Mr. Patrick Zepf

Bill to: LANXESS Deutschland GmbH
Room T.E09.093
Kennedyplatz 1
50569 Köln, Germany

Invoice
LIPL/DRST/14-15/EX/JHG-001

Date : 31.03.2015

| PARTICULARS | AMOUNT USD |
|---|---|
| **Nature of services :** Compensation receivable towards underutilization of installed production capacity of LPT plant at Jhagadia factory for the period FY 2014-15 as per Annexure attached. **Declared Service :** In terms of Clause (e) of Section 66 E of the Finance Act,1994, as amended. | 3,636,464 |
| USD Thirty Six Lakhs Thirty Six Thousand Four Hundred Sixty Four Only | 3,636,464 |
| Conversion rate of 1 USD = Rs.62. Ps 4975 Value in INR : Twenty Two Crore Seventy Two Lac Sixty Nine - Thousand Nine Hundred Two Only Service tax payable . Export of service. Permanent Account No. . AACCB3880A Service Tax Regn. No : AACCB3880AST001 | |

LANXESS India Private Limited
Registered Office .
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infoindia@lanxess.com
www.lanxess.in
CIN : U24119MH2004PTC158377

LANXESS India Private Limited

Authorised Signatory

N.B. Please remit the above amount to Deutsche Bank, Kodak House , D.N. Road , Fort , Mumbai - 400 001. **Account Number : 0538397-00-0**

The Adjudicating Authority in para 16 of his order has also considered the issue of whether the idle cost compensation received by respondent by respondent towards underutilization of installed production capacity of

Jhagadia factory and classified by them as 'Declared Service' would qualify as 'export of service' in terms of Place of Provision of Services Rules, 2012? The Respondent has not in any manner denied the above declaration made by them in their invoices.

12.3 The remuneration specified in the agreement consists of the Manufacturing Fee to be paid on per unit basis of the product delivered by the Respondent and Idle Cost Compensation based on unutilized manufacturing capacity during the relevant period, which has no relation with the export of goods. The Idle Cost Compensation is paid by LXD to the respondent towards non/underutilization of plant & machinery (which is an immovable property), as the right to use the manufacturing capacity of the Respondent's factory has been dedicated/reserved for LXD. LXD enjoys an advantage, through this agreement, of having a control over the manufacturing capacity of the Respondent's factory. The Respondent in turn, for agreeing to the obligation to tolerate the control of LXD over the Respondent's manufacturing capacity, is adequately compensated in terms of Manufacturing Fee and the Idle Cost Compensation, both of which together cover remuneration payable by LXD to the Respondent. Thus, there is a direct nexus between toleration by the Respondent and remuneration received from LXD in the from of Idle cost compensation. Thus, the Respondent received remuneration towards the Declared Service under Section 66E(e) of the Finance Act, 1994, provided to LXD in terms of the agreement.

12.4 The Agreement contains all the definitions to clearly define the scope of the Agreement. The manufacturing capacity of any factory is directly linked with the plant and machinery installed therein. The Idle Cost Compensation indicated mentioned in the Agreement is therefore directly linked with utilization of Plant and machinery of the Respondent's factory. The Plant & Machinery being an immovable property as per Section 3(26) of the General Clauses Act, 1897, the declared service under Section 66E(e) of the Finance

Act, 1994, provided by the Respondent to LXD would be covered under Rule 5 of the Place of Provision of Services Rules, 2012, instead of Rule 3, which is the general rule. If there is a dispute in determination of place of provision between more than one rule, Rule 14 categorically states that the later rule will prevail, and thus, Rule 5 will prevail over Rule 3.

12.5 The Respondent's contention that they consider payment towards Export of Service, also needs to satisfy the conditions laid down under Rule 6A of the Service Tax Rules, 1994, wherein clause (f) of sub-rule (1) states that the provision of any service provided or agreed to be provided shall be treated as export of service when the provider of service and recipient of service are not merely establishments of a distinct person in accordance with item (b) of Explanation 3 of Clause (44) of Section 65B of the Finance Act, 1994. As the relationship between the Respondent and LXD does not satisfy this condition, the said payment, cannot be termed as payment towards Export of Service.

12.6 In the case of M/s. Hyundai Motor India Pvt. Ltd. reported at 2024(5) TMI 1339 – CESTAT Chennai, an issue came up for decision was whether Service tax demand is sustainable for the period after 01.07.2012 on the consideration received by the appellant for Extended Warranty Service (EWS)? The Tribunal at para 8.4 of the Order dt.27.05.2024, observed that '*It is to be seen that while offering extended warranty services, the appellant does not render any actual repair work of the vehicle. The consideration (upfront charges) is received for offering to repair the vehicle in the event of happening of a requirement to repair the vehicle in future. It is more like assurance given to a customer*.' Hon'ble Tribunal concludes at para 8.8 in this words – '*We have no quarrel that when actual repair work is done, the activity would fall under WCS as defined under Section 65B(54). However, in the present case, it is only a promise to do the repair and consideration is not for the actual repair*.' The facts in the current case are also similar. If the remuneration received by the respondent was for the goods exported, then there was no question of demanding any Excise duty or Service Tax, as the same is considered as Export of Goods. However, the Agreement clearly says that the remuneration is to maintain, hold available and use the capacity to manufacture the products for LXD. The Idle Cost Compensation alongwith Manufacturing Fee, as per the Agreement is an assurance against the manufacturing capacity kept in hold for LXD by the Respondent. The manufacturing capacity of any factory including the Respondent's factory, is directly linked with the Plant and Machinery installed therein which is immovable property as per Section 3(26) of the General Clauses Act, 1897. Thus, the Declared service under Section 66E(e) of the Finance Act, 1994, provided by the Respondent to LXD would be covered under Rule 5 and not under general Rule 3 of the Place of Provision of Services Rules, 2012.

12.7 During hearing in the matter, learned Senior Advocate, stressed on the phrase 'agreeing to the obligation' in Section 66E(e), which perhaps was not visible in other contemporary laws worldwide. This phrase has two limbs one there should be an obligation and second, there should be an agreement. Both the limbs are satisfied in the present case as there is an obligation on the part of the respondent to hold their production capacity for LXD and also a formal agreement between both LXD as well as the Respondent. The agreement is not for any purchase or sale of goods but for this particular obligation. Even if LXD does not buy a single product from the Respondent during a particular period, LXD is bound to remunerate the Respondent for holding their manufacturing capacity for them. There is no breach of agreement which encompasses consideration in the form of Manufacturing Fee and/or Idle Cost Compensation for holding the manufacturing capacity of the respondent. Both the parties have reached an agreement on holding the manufacturing capacity of the Respondent in lieu of consideration and have devised a system for implementation of the consideration part of the agreement. As such, the

Agreement between LXD and the Respondent satisfies the major limb of Section 66E(e) regarding 'agreeing to the obligation'.

12.8 During the last hearing, two compilations on this aspect pertaining to laws similar to Section 66E(e) of the Finance Act, 1994, from the European Union Laws and Australian Laws. He drew attention of the Bench towards major reference points from the European Union Laws. The Court of Justice of the European Union (CJEU) has given various judgements clarifying as to when such obligations for refrain/tolerate/do type supplies become taxable supply for consideration. One such decision dt. 03.09.2015 by the CJEU is in the case of Asparuhovo Lake Investment Company where the issue was whether supply of service covers cases involving subscription contracts for Consulting Services where a supplier with qualified personnel available for consulting services agrees to be on call for the customer throughout the period of Contract and has agreed not to enter into similar contracts with competitors of the customer. The CJEU held that supply of services includes subscription contracts for supply of consulting services under which the supplier has agreed to be available to the customer during the term of the contract. He also referred to another major judgement by CJEU on 11.06.2020 in the case of Vodafone Portugal was rendering e-commerce services under a contract with an agreed upon minimum contract period (tie-in period). In this case, when a customer terminates contract before end of tie-in period, he had to pay a termination fee (pre-determined cost) to Vodafone Portugal. Vodafone considered this amount outside the scope of VAT taking it as compensation or loss of income. The CJEU decided that such termination fees were subject to VAT for reason that the termination fees (i) have been pre-agreed upon and (ii) equal a certain statutory cost base. According to CJEU, the method of determining the amount payable by the customer is immaterial and what is important is that the payment is set in the terms and conditions of the contract between the supplier and the customer. They said that regular monthly payment by the customer is a part of the contractual consideration payable by the customer to the supplier, as are any early termination charges. The amount payable in the event of early termination must be considered as an integral part of the price which the customer committed to pay to the supplier to fulfil the contractual obligations. The European Union law thus clearly emphasizes that if the liquidated damages are a part of performance of the Contract, then it would be a taxable service.

12.9 He also invited attention of the Bench to similar decisions under Australian GST laws. In the case of MBI Properties, they had purchased reversionary interest in residential apartments that were already subject to existing lease with a tenant (MML). The central question was whether MBI Properties, by acquiring the reversion and becoming obliged to observe the lease covenants, made a supply to the tenant. The High Court explicitly recognized that the tenant's enjoyment of the premises is something being tolerated by the landlord, and that this toleration constitutes a supply. By acquiring the reversionary interest and assuming the landlord's obligations under the lease, MBI Properties entered in to an obligation to tolerate the tenant's occupation and use of the premises. As regards whether there was a price for the supply of toleration, the High Court rejected the contention of MBI that the rent paid by the tenant to the landlord was exclusively consideration for the original grant of lease and not for the subsequent supply by MBI Properties for toleration or permission to occupy. The High Court held that the rent payable by the tenants was in part, the price for MBI Properties supply of observing and continuing to observe the covenant of quiet enjoyment. The High Court's judgement in MBI Properties acknowledged the conceptual complexity of treating passive toleration as a supply.

12.10 In the case of the Respondent, Learned AR submits that there is no passive toleration involved. It is an active toleration as encompassed in the agreement entered upon by both LXD and the Respondent, with inbuilt remuneration package involving two components – Manufacturing Fee & Idle Cost Compensation, which is very much a part of the agreement. The toleration and the consideration are not for non-supply or defective supply of products, but for holding the manufacturing capacity consisting of the Plant & Machinery of the Respondent exclusively for LXD for the contracted period. Thus, LXD was obliged under the Agreement to pay the Respondent a fixed sum (comprising either the Manufacturing Fee or the Idle Cost Compensation or partly both) for holding the manufacturing capacity of the Plant & Machinery of the Respondent's factory at Jhagadia exclusively for LXD. The plant and Machinery being an immovable property as per Section 3(26) of the General Clauses Act, 1897, the Declared service under Section 66E(e) of the Finance Act, 1994, provided by the Respondent to LXD would be covered under Rule 5 of the Place of Provision of Services Rules, 2012, which is specially earmarked for services related to immovable property, instead of Rule 3, which is the general rule of the Place of Provision of Services Rules, 2012. Accordingly, consideration received from LXD for supply of Service by the Respondent being a Declared Service, would be liable to service tax.

**Findings**

13. At the outset, we appreciate contribution by both sides in making detailed submissions relevant to the factual matrix of the case, as well as on the proposition as to what gets included or excluded in the scope of declared services in terms of Clause (e) of section 66E of the Finance Act, 1994. Their submissions coupled with analysis is expected to bring about clarity to both- the litigants as well as the departmental officers, as to what gets included within the scope of declared services. The period involved in this show cause notice is from 20.12.2013 to 2015-16. The issues involved are as follows:-

1) Whether "compensation" paid by German holding company to its Indian entity under the impugned agreement for underutilization of installed capacity is taxable service falling in the ambit of "declared service" under clause (e) of 66E of the Finance Act, 1994?

2) Whether the alleged service, if it is within the scope of declared service, can be considered as export of service under the Place of Provision of Services Rules, 2012.

3) Whether the Indian Unit and German entity are or are not merely establishments of distinct persons as per explanation 3 of Clause 44 of the Section 65B.

14. We take up the first issue in detail as the existence of service or declared service alone can bring taxability in picture and the latter issue of Place of Provision of Service Rules is secondary and depends upon whether the service exists or not?

14.1 We have considered rival submissions made before us, with the department pitching that the invoices issued by the respondent clearly indicate that the service included is a declared service and therefore, on the basis of such document alone, it gets established and same can be taken as admission by the respondent that they knew it was taxable and the taxability as a declared service existed and therefore, the only issue which has survived is in relation to place of provision of services. On the other hand, respondent have vigorously attacked that service was provided within the scope of "deemed service" on the basis of elaborate arguments which have been duly put forth with the support of case laws by either side to assert their respective positions. It was initially observed by the Bench that most of the decisions cited by either side, only go to indicate as to what is not a "declared service" and how the specific services indicated in the decisions were not in the nature of declared service so as to fall within the phrase of clause (e) of Section 66E i.e. 'agreeing to the obligation to refrain from an act, or to tolerate an act or situation, or to do an act'. This Bench rather than opting to pronounce on the issue of why the impugned sum paid/compensation was/was not within the ambit of "declared service", which has so far been the approach in most of the decisions on the subject, including various clarifications issued by the CBIC, when juxtaposed to what can be included in the phrase of Section 66E(e) of Finance Act, 1994, and how the fiscal legislations have understood it in various tax jurisdictions. Most of the decisions cited as have been briefly discussed as a part of the submissions observe and indicate that something which is given as compensation for breach, whether being damages or liquidated damages or penalty cannot be considered as providing consideration and therefore, cannot be part of the services as defined in Section 65B(44) of the Finance Act, 1994 which reads as follows:-

> *"service" means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include…………"*

14.2 From the above definition, it is clear that levy of service tax which is a levy on provision of service can arise only from an activity which is carried out by a person for another for consideration. If this is so, then for being a "service" there has to be quid pro quo by the service seeker to the service provider for the service provided. In the second limb of the term 'service' as defined above, following has been provided after the coma (,) "and includes the declared service". Thus, the inclusion clause seems to be expanding the scope of service by including declared service within its domain. We are of the view that the service thus can include any activity carried by a person for another for consideration and can also include a "declared service". From the first limb of the definition as has been phrased by the legislature, it is clear that expression "for consideration" qualifies even the declared service and therefore, consideration must exist even if the service falls within the extended scope i.e. "declared service" defined in Section 66E(e)(ibid). From the above analysis, it becomes clear that "agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act" equally requires consideration. The term "consideration" has not been defined in the Finance Act, 1994 and therefore, for its meaning definition elsewhere can be looked for. We find that Indian Contract Act, 1872 which is of vintage of more than 150 years, is well established in most commonwealth jurisdictions and had its genesis in the common law. Therefore, it is safe to seek and rely on the definition of consideration as is available in Section 2(d) of the Indian Contract Act, 1872 which reads as follows:-

> *"**Section 2(d):** When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise"*

14.3 It is thus clear that to be an "act" for valid consideration under the contract law, the consideration should have moved firstly at the desire of the promisor and then from the promisee side, some act or abstinence should be done and it is only such act or abstinence or promise which is called "consideration" for the promise. It is thus clear that "damages" including "liquidated damages" are not done at the desire of the promisor, but normally are outcomes of accidental acts or undesired actions not done deliberately, which lead to a situation where damages become available as remedy to the party, which has suffered any loss due to such undesired action on the part of second party. Therefore, damages are a consequence of breach and not part of consideration for promise. The breach in turn is relatable to an inactivity or such activity, which was not envisaged in the due course of performance of the contract, but is a result of some supervening developments. The basis of various judgments quoted by the respondent which treat breach and consequent damages as not being "consideration" holds good and is the test for determining as to whether there is element of consideration or element of service or consequently liability of service tax, in such situations. We, therefore, first of all pronounce that damages or liquidated damaged as well as penalties even if they are provided for in the contract but are consequence of an undesired act or an unanticipated situation, cannot be considered as "service" because of lack of element of consideration which is essential both for "service" as well as "declared service". We, therefore, are not at variance with all the case laws quoted above, by the respondent, which hold as ratio that damages and liquidated damages arising out of breach of contract cannot be considered as part of service, as a general proposition.

14.4 Before, we specifically deal with the factual matrix of the case and as to what will happen in situations where restraint is paid for and is outcome of agreeing to the obligation and what are the situations, which can envisage coverage of different type of activities within the scope of "deemed service" as put forth in the provision of Section 66E(e) of the Finance Act, 1994, we would like to understand the scope of "restraint" or "refrain" from an act as has also now been clarified by GST CBIC Circular No. 178/2022 dated 03.08.2022 which though given under the concept of "deemed supply" as per schedule II of CGST Act, 2017 can apply mutatis mutandis for "declared service" in the Finance Act, 1994 also. Therefore, we try to lay down by way of illustrative examples, as to what is supposed to and what gets included within the scope of "declared service" or what is not included. The list is only illustrative and can be at variance in varied factual circumstances.

**<u>What gets included?</u>**

- Non-compete agreements. When one party agrees not to compete with the other party in a product, service or geographical area against the consideration paid by the other party. It is made clear that such obligation can exist *ab initio* when agreement is entered into or even such agreement to refrain can be taken at any time before the first contract ends. Sometimes, it may cause difficulties to cull out as to how much is the amount for non-compete clause and how much is for the normal service, unless it is specifically mentioned in the contracts but a consideration for non-compete clause will be taxable is not doubted.
- Payments received for refraining from enforcing easements like some sun light by a house owner of already existing house, or industrial unit refraining from manufacturing activities during certain hours against

compensation paid by a neighbouring school to avoid noise can be considered, as such activity of refrain.

- Agreeing to the obligation or tolerate an act or a situation can include activities such as shopkeeper allowing a hawker to operate from the common pavement in front of his shop for some monthly payment by the hawker, or a shopping mall management allowing shopping counters to operate in common areas to the entrance hall or contracts for such stalls allowed after making payments to mall management. Agreeing to the obligation to do an act would include the cases where an industrial unit agrees to install zero emission equipment at the behest of RWA of neighboring residential complex against a consideration paid by such RWA, even though there was no legal obligation upon the industrial unit, to do so.
- Blocking of Advocates of repute by corporate entities for not appearing from the opposite side in a litigation and to remain engaged by them.
- The reward received for an activity performed explicitly with the understanding that the winner will receive this specified amount on reciprocity or a service to be rendered by the winner would be consideration for the service and therefore, will be a deemed service. For example, contribution to open software development or an AI project if the project is finally accepted is an example of such activity carried out for consideration or a lawyer receiving remuneration (as is allowed in U.K.) from the win in a litigation.
- Delayed hire charges or usage of any hire asset over or beyond the stipulated period, even if, at the higher rate. The notion which emerges is that sometimes, it may be difficult to differentiate between compensation and consideration. However, there is a direct link or reciprocity between the amount paid and the beneficiary activity carried out then it is consideration for supply. HMRC Guideline, VATSCO5910 (ibid) refers.

- Early termination charges for hire contracts or early loan repayment charges made by banks though may appear to be a form of liquidated damages or compensation but is still consideration (as per VATSC05930 supra).
- Cancellation charges for no Show in a theater or a late show or facilitation supply i.e. if an intended supply is cancelled or there is no show and the supplier has still made the supply as he has prepared himself for supply and thus, initiated supply is also a supply as per guideline of Australian Taxation Office vide GSTR 2009/3 and the cancellation fees appropriated for administrative services provided in initiated supply and in an arrangement of making refunds and flat fee charge thereof shall also be consideration for supply of the services. Therefore, cancellation fees can also be taxable depending upon the facts in each case. Same can apply to security deposits as well.

**What is not included**?

- Damages or liquidated damages paid for breach of contract clearly established to be for breach.
- Bond amount recovered from an employee leaving employment before the agreed period as it was basically a compensation agreement not enforced by one of the parties but was eventually an outcome of breach of contract or its terms.
- Compensation received by previous allottees of coal blocks for cancellation of their licenses pursuant to any Supreme Court order as such amount was within the nature of compensation for breach of contract of allotment already done.
- Cheque dishonour fine /penalty charge by Power Distribution Company from the customers as the same is in the nature of fine/penalty depending upon contract, with the rider that the cheque will be duly

honored and such fine/penalty being in the nature of compensation for breach.

- Late payment charges collected by any service provider for late payment of debts, as the same are in the nature of compensation for not making payment in time and therefore committing the breach. Fixed charges collected by power generating company from the state boards or by discoms from individual customer for supply of electricity, as this amounts to breach of an agreement with the minimum power consumption every month made available to be consumed.
- Cancellation charges recovered by railways for cancellation of tickets for breach of contract for not undertaking the journey for which they were booked.
- Compensation for excess cost incurred for replacement of goods which were to be supplied but could not be supplied. Therefore, the excess price over the contract price for replacement cost is treated to be still within the scope of breach of service.
- Liquidated damages over and above the contracted price as mentioned in the contract to the extent, they are reasonable in Indian situation cannot be considered as consideration for any supply or non-supply but is by way of prefixed compensation for breach of contract and therefore, outside the scope of service tax.
- Amounts received consequent upon court settlements on the basis of claim for damages are not taxable as there is no supply or consideration or nexus existing.

14.5 After making out of list the what is broadly covered and what is not covered in the ambit of Section 66E(e) which is for consideration, we proceed to examine the factual matrix of the present case. The relevant portion of the agreement in the present dispute is as follows:-

***Definitions***

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|---|---|
| ***AGREEMENT*** | *shall mean this agreement including it's Annexes, Schedules and Appendices and any amendment made thereto from time to time* |
| ***CAPACITY*** | *shall mean the technically available (based on the nameplate capacity) production capacity for PRODUCTS at the SITE during any one financial year of LIPI* |
| ***GENERAL ADMINISTRATION AND OTHER COST*** | *shall include general administration overheads, lab expenses and other operating expenses incurred in connection with the manufacturing of PRODUCTS.* |
| ***IDLE CAPACITY*** | *shall mean the CAPACITY unutilised/remained idle during the relevant financial year of LIPL.* |
| ***IDLE COST COMPENSATION*** | *shall be compensation towards the fixed manufacturing cost allocated to the IDLE CAPACITY and shall have the meaning ascribed to it in § 2 (1) d below.* |
| ***IMPROVEMENTS*** | *shall mean any results, developments and inventions, whether patentable or not, which are achieved by any of the Parties with regard to the manufacture of PRODUCTS during the term on this AGREEMENT.* |
| ***INPUT MATERIALS*** | *shall mean all input materials (incl. raw, auxiliary and process materials) and all packaging needed for the manufacture, filling, packaging, labelling, safe and secure storage and shipment of PRODUCTS* |
| ***INSTRUCTIONS*** | *shall mean the proprietary know-how and information of LXID (including inter alia all experiences, physical data, specifications for products and Input materials, control methods, analytical techniques, safety practices and techniques for evaluation and testing of finished products) provided by LXD to LIPI from time to time for the manufacture of PRODUCTS and for their filling, packaging, labelling, safe and secure storage and shipment.* |
| ***MANUFACTURING FEE*** | *shall have the meaning ascribed to it in §2 (1) a. below.* |

| | |
|---|---|
| ***MARK -UP*** | *shall be a factor applied to the cost of INPUT MATERIALS, PRODUCTION COST, SELLING EXPENSES GERNERAL, ADMINISTRATION EXPENSES, OTHER COSTS to arrive at the MANUFACTURING FEF AND to the fixed manufacturing cost allocated to the IDLE CAPACITY to arrive at the IDLE COST COMPENSATION so as to ensure that LIPL receives a fair and adequate compensation for the function performed, assets employed and risks assumed under this Agreement that meets arm's length principles. Unless amended by the PARTIES mutual written agreement, the MARK-UP shall be equal to 7.5%* |
| ***PRODUCTION COST*** | *shall include the fixed and variable manufacturing cost.* |
| ***PRODUCTS*** | *shall mean the products as listed in Appendix I to be manufactured by LIPL on basis of the INSTRUCTIONS and as amended from time to time in accordance with § 4 (2).* |
| ***SELLING EXPENSES*** | *shall include freight, stock keeping and packaging cost, other selling expenses incurred in connection with the manufacturing of PRODUCTS* |
| ***SITE*** | *shall mean the part of LIPL production site in Jhagadia dedicated to the LANXESS Business Unit LPI* |
| ***SPECIFICATIONS*** | *shall mean the limits for certain key characteristics of PRODUCTS and the methods to test for those key characteristics as well as the packaging details as provided to LIPL by LXD from time to time and in accordance with § 4 (2) below.* |
| ***ARM'S LENGTH CONSIDERATION*** | *shall mean the consideration which is applied or proposed to be applied in remunerating for same or similar Contract manufacturing services as contemplated in this Agreement under conditions that are made or imposed between the Parties in their commercial or financial relations which do not differ from those which would be made between independent enterprises under similar circumstances.* |

### *§1 Scope of AGREEMENT and Supply of PRODUCTS*

*(1) LIPL agrees to maintain, hold available and use the CAPACITY to manufacture the PRODUCTS for LXD at its SITE in Jhagadia in accordance with the INSTRUCTIONS and the SPECIFICATIONS and LXD agrees to off-take the PRODUCTS and pay to LIPI the agreed remuneration pursuant to cl. 2 of this AGREEMENT.*

*(2) LXD shall provide LIPL with a non-binding forecast of the PRODUCTS to be produced within the upcoming calendar year (identity of PRODUCTS, volumes, timing, budgeted costs etc.). Thereafter, LXD shall issue a weekly instruction on the production programme for the respective upcoming week which shall become binding on LIPL unless LIPL objects to the instruction within reasonable time for substantial reasons.*

*(3) LXD shall ensure that LIPL receives all INSTRUCTIONS and SPECIFICATIOS necessary to manufacture, fill, pack, store and ship the ordered volumes of PRODUCTS in a timely manner.*

*(4) LIPL shall inform LXD if there are unexpected circumstances or impacts. Especially LIPL shall inform LXD if there are indications that budgeted costs will be extended*

*(5) All INPUT MATERIALS needed for the manufacture of PRODUCTS shall be purchased by LIPL. However, any change by L.IPL of any supplier of INPUT MATERIALS is subject to prior approval by LXD. which approval shall not be unreasonably withheld.*

### *§2 Remuneration*

*(1) LXD shall remunerate LIPL's manufacturing activities to be rendered under this AGREEMENT by paying a MANUFACTURING FEE and an IDLE COST COMPENSATION (if any), whereby*

*a. The MANUFACTURING FEE shall be paid per unit of PRODUCT delivered to LXD and shall cover cost of INPUT MATERIALS, PRODUCTION COST, SELLING EXPENSES, GENERAL, ADMINISTRATION AND OTHER COST plus the MARK UP*

*b. Before the beginning of each quarter, the PARTIES shall mutually determine the MANUFACTURING FEE to be invoiced by LIPI upon delivery per unit of PRODUCT. The said MANUFACTURING FEE shall remain applicable until replaced by a revised MANUFACTURING FEE.*

*c. At the end of each quarter, LIPL shall determine in its equitable discretion whether the MANUFACTURING FEE determined in accordance with $2 (1) b. has covered all actual cost positions as set out in Appendix 2, including the MARK-UP, taking the ARM'S LENGTH CONSIDERATIONS into account. The excess/shortfall, if any. (i.e. the difference between the MANUFACTURING FEE already invoiced during the relevant quarter and the actual cost plus MARK-UP) shall be adjusted within 60 days from the end of each quarter.*

*d. <u>At the end of each quarter, LIPI shall determine the IDLE COST COMPENSATION based on the cost of IDLE CAPACITY plus MARK UP and shall invoice to LXD within 60 days from the end of each quarter.</u>*

*(emphasis supplied)*

*e. When calculating the IDLE COST COMPENSATION, any costs and/or frustration of cost being a direct consequence of a force majeure event pursuant to §3 (2) below or of a culpable conduct of LIPL shall be disregarded.*

*(2) The total remuneration and compensation to be paid by LXD to LIPL in accordance with the preceding § 2 (1) is designed to leave LIPL with a fair and adequate compensation for the functions performed, assets employed and risks assumed under this AGREEMENT that meets arm's length principles. Accordingly, this § 2 and, in particular, the factor to be applied as MARK-UP shall be reviewed by the PARTIES each year*

*(3) Taxes: The MANUFACTURING FEE under this Agreement unless otherwise stated, would be exclusive of all taxes, including national and local sales, use or value added taxes, goods and services tax, consumption tax, customs duties, withholding taxes or similar charges, apart from Corporate Income Taxes, falling due on the remuneration under this Agreement, if applicable. LIPL shall take all reasonable efforts to reduce all kind of taxes as far as possible*

*(4) Payment terms. LIPL shall raise invoices in USD and shall be settled by LXD in the same currency. All invoices shall be due within 60 (Sixty) days from the date of invoice. If there is any change in the payment terms between the parties, the same shall be mutually agreed and documented in writing, which in effect would form part of this agreement.*

*(5) LXD shall have the right to inspect LIPL's records and books of accounts regarding actual PRODUCTION COSTS incurred by LIPL. Any underpayment or overpayment revealed by an audit shall be paid to the other Party within thirty (30) days after the receipt of the audit results."*

14.6 From the above, it is clear that the issue in hand has its genesis in the terms of contract, which by the department were considered to be in the nature of consideration for providing pre-decided manufacturing capacity and in the event of same not having been fully utilized, the consideration as per the contract was liable to be paid which as per the department was taxable. Whereas on the basis of same terms of the contract, the respondent emphasizes with the support of rulings, that the same was by way of, for idle capacity and thus compensation of breach of contract and therefore not taxable. We have gone through the terms of the contract as well as various rulings to consider if the ideal capacity compensation towards the fix manufacturing cost, can be considered as consideration. The fact is that respondent relying upon the promise made by its parent company in Germany, has created such capacity. In fact, there has been no breach or discharge of agreement and idle capacity as remuneration is duly invoiced and agreement allowed to continue from quarter to quarter. This distinguishes it from a contract breached, as breach leads to discharge of a contract and requirement for entering into a fresh contract arises.

14.7 Here, the principle is not of compensation for damages as the capacity installation was under taken by the respondent at the behest of its parent company in Germany, over the promise. Therefore, conceptually it was a consideration as the act was done as per desire of the promiser. Therefore, even as per Section 2(d) of the Contract Act,1872, such act of creation of stipulated capacity is very much consideration for the promise. The remuneration clause of the agreement at page 47(clause-II) provides as follows:-

> *"(2) The total remuneration and compensation to be paid by LXD to LIPL in accordance with the preceding § 2 (1) is designed to leave LIPL with a fair and adequate compensation for the functions performed, assets employed and risks assumed under this AGREEMENT that meets arm's length principles. Accordingly, this § 2 and, in particular, the factor to be applied as MARK-UP shall be reviewed by the PARTIES each year."*

Thus, it is clear that the compensation paid is also termed as part of the remuneration which, *inter alia*, is for the function performed, capacity earmarked and risk assumed under the agreement that meets nexus principle. It is therefore clear that term "compensation for so termed unutilized capacity" was part of the remuneration and was for consideration of respondent acting on behalf of their principal/client. Department has also sought to rely on the invoices as are appearing at page No. 6 of the show cause notice, which indicate that the respondent issued invoices to its Germany party by treating the nature of service as declared service and compensation as being towards underutilized installed production capacity. There is no breach of agreement, nor there is discharge from future obligations of either party.

14.8 Learned Senior Advocate has also, inter alia, emphasized that the legislature in Indian context has limited the scope for deemed supply or declared services because by putting the phrase "agreeing to the obligation", which makes Indian law narrow than the laws in other tax Jurisdictions. We are not particularly impressed with the argument, as we find, the second European Council Director issued on 11.04.1967 at point No. 9 ibid specifically mentions (the carrying out an obligation to refrain from doing something). Similarly, quoted Council directive on European laws, of the members states for levy of VAT dated 17.05.1977 also had the phrase as also is contained in 2006 Council Directive of the common system of value added Tax dated 28.11.2006 in Article 25, the phrase "obligation to refrain from an act, or to tolerate an act or situation". Similarly, in Australian New Tax System of Goods and Service Tax Act, 1999, Section 9.10 "entering into or release from an obligation" has been mentioned. We are therefore, not convinced with the meaning assigned by the learned Senior Counsel that in Indian context, the meaning is rather narrow and restricted. We find that the phrase "agreeing to an obligation" exists in most of the cited legislations, with different syntax but this makes no difference to the scope of the obligations. We have by way of example taken that an obligation as in the nature of non-compete clause can be undertaken at any time and not necessarily at the time when initial obligation was undertaken. For example, a service contract may not initially provide for a non-compete clause but an obligation may be undertaken for consideration at the time of exiting the service contract. Again, every agreement or promise involves some obligation or the other on part of either promisor or promisee, and therefore "agreeing to an obligation" cannot be construed as anything more than an obligation being undertaken by promisor or promise and does not expand or restrict scope of the phrase that follows "agreeing to the obligation".

14.9 We find that in the case of KN Food Industries Pvt limited Vs. Commissioner of CGST and Central Excise, Kanpur reported in 2020 (38) GSTL 60 (Tri.-Ahd.) ex-gratia charges or non-capacity utilization were to protect the party from financial damage/injury. The same were not fixed before hand and such ex-gratia charges were made by the principal and not intended events and did not emanate from any obligation on part of any of the parties to tolerate an act or a situation. The same, as is clear from para 4, were for uncertain circumstances and consequences and were clearly in the nature of compensation to make up for possible damage and for breach as the case may be, by way of payment of liquidated damages provided by contract as a remedy, if breach or loss eventually occurs. Same therefore were in the nature of ex-gratia charges if the delivery of the project got delayed or any other terms of the contract got breached. Such payment as is clear from para 4 of the decision which is reproduced below, was clearly for breach of contract due to unforeseen circumstances: -

> ***"4.*** *After hearing both the sides duly represented by Shri H.P. Kanade, Learned Advocate appearing for the appellant and Shri Shiv Pratap Singh, Learned AR appearing for the Revenue, we find that the short issue required to be decided in the present appeal is as to whether the receipt of ex-gratia job charges amount by the appellant amounts to providing any services so as to attract the Service Tax on the same. We find that appellant is admittedly manufacturing confectionaries for and on behalf of the M/s. Parle and is clearing the same upon payment of Central Excise duty on the basis of MRP declared by M/s. Parle. It is only in situation when the appellant's capacity, as*

*a manufacturer, is not being fully utilized by M/s. Parle, their claim of ex-gratia charges arises so as to compensate them from the financial damage/injury. As such, <u>ex-gratia amount is not fixed and is mutually decided between the two, based upon the terms and conditions of the agreement and is in the nature of compensation in case of low/less utilization of the production capacity of the assessee.</u>*

*(emphasis supplied)*

*The Lower Authorities have invoked the provision of Section 66E(e) of the Act which relates to definition of declared services. The same is to the effect that "(e) agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act". Provisions of Section 65B(44) of the Act refers to the process amounting to manufacture or production of goods on which the duty is leviable under Section 3 of the Central Excise Act, 1944 as on service. However no Service Tax is leviable on such services, as the same is covered under the negative list. Further, agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act is a declared service on which the Service Tax is leviable under Section 66B of the Act.*

*In the present case apart from manufacturing and receiving the cost of the same, the appellants were also receiving the compensation charges under the head ex-gratia job charges. The same are not covered by any of the acts as described under Section 66E(e) of the Finance Act, 1994. The said sub-clause proceeds to state various active and passive actions or reactions which are declared to be a service namely; to refrain from an act, or to tolerate an act or a situation, or to do an act. As such for invocation of the said clause, there has to be first a concurrence to assume an obligation to refrain from an act or tolerate an act etc. which are clearly absent in the present case. In the instant case, <u>if the delivery of project gets delayed, or any other terms of the contract gets breached, which were expected to cause some damage or loss to the appellant,</u> the contract itself provided for compensation to make good the possible damages owning to delay, or breach, as the case may be, by way of payment of liquidated damages by the contractor to the appellant. As such, the contracts provide for an eventuality which was uncertain and also corresponding consequence or remedy if that eventuality occurs. As such the present ex-gratia charges made by M/s. Parle to the appellant were towards making good the damages, losses or injuries arising from "unintended" events and did not emanate from any obligation on the part of any of the parties to tolerate an act or a situation and cannot be considered to be the payments for any services." (emphasis supplied)*

In this case, there is already an existing obligation as capacity has been created or earmarked at the behest of the principal by the respondent. Situation and the terms are therefore distinguishable.

The subtle difference between "Remuneration" and "Compensation" needs to be observed as is generally assigned in legal jurisprudence: While Compensation is generally to make good a loss, injury or inconvenience, or deprivation, and is often remedial to put a person in a position, it would have been, but for the loss. Remuneration in contrast is a contractual or statutory entitlement arising from performance.

"Remuneration is earned, whereas Compensation is awarded."

14.10 We also find that learned AR has correctly put forth extra territorial rulings to buttress this point in his submission dated 05.01.2026. Howsoever, worded a "remuneration" remains only a remuneration and is consideration for the contract till the time it is earned without breach which is by unanticipated event and till contract is not discharged. Discharge of contract alone leads to damages. In present case, contract is running for years as was envisaged at the time of entering and was never treated as breached or discharged by either party.

14.11 In South Eastern Coalfields Ltd. vs. Commr. of C. Ex. & ST Raipur reported at 2022(12) TMI 912 CESTAT New Delhi, the matter pertained to breach of contract for non-lifting the quantity of coal. Therefore, there was a breach of terms and conditions for which compensation was paid and the same was held as damages and therefore not liable to service tax.

In this case, the respondent has done something in pursuance of the contract and earmarked capacity in the factory and it was agreed beforehand that remuneration will include an element of unutilized capacity as part of overall remuneration. The possibility of variance in quantum of remuneration cannot be equated with an uncertainty of an event leading to consequence of damages. Remuneration was only made dependent on the quantum of unutilized capacity, and therefore as per the definition of Section 2(d) of Indian Contract Act, there was definitely a consideration and also the capacity was created at the behest of the promiser that is the "Principal" in Germany. Thus here, the principle and situation are different from the cited case as consideration existed and situation was pre-envisaged, only quantum of remuneration was worked out later. Besides, it is the respondent who, in the documentary evidence produced before us, had indicated it to be declared service. All the ingredients emphasized by learned Senior Counsel are present in the instant situation. There is:

(i) an obligation undertaken by service provider to earmark a particular capacity at the disposal of service seeker.

(ii) The service seeker is indicating the obligation to pay, if there is some capacity, which remains unutilized.

(iii) Both are aware of such obligation on the part of each other.

(iv) the respective obligations exist, even without a breach unlike clauses of "damages" and "liquidated damages" and are part of consideration as remuneration.

Only the remuneration can be variable, as per terms worked out. From the submissions made by the Respondent-Assessee, it clearly flows that for damages to be involved, there has to be breach with in scope of Section 73 of Indian Contract Act,1972, and breach is generally adjudicated by a court and not decided by party. If a situation is envisaged in the terms of contract, then such a situation being inbuilt in terms of contract cannot lead to or considered as a breach of contract. Further, as the learned Senior Advocate has pointed out that, where contract is broken by one party, contract is discharged, and only then new obligation of damages arises. Not like in the instant case, where same contract continues to subsist for years. Clearly, thus it is a case of pre-determined remuneration and not of compensation post breach of a contract, despite both expressions "remuneration" and "compensation" having been opted to be used.

14.12 We are further fortified in our views as we find that in the mark-up clause, apart from various cost elements like input materials, production cost, and overheads like selling expenses, general administration expenses, other costs to arrive at the manufacturing fees and to the fixed manufacturing cost has also been allocated to the Idle capacity to arrive at the so termed "Idle cost compensation" so as to ensure that LIPL receives a fair and adequate compensation (emphasis supplied) for the functions performed, assets employed and risks assumed under the agreement. In the scope of agreement, it has also been provided that LIPL shall hold available and use capacity to manufacture the products for LXD at its site in accordance with the instructions and the specifications and LXD agrees to off take the products and pay to LIPL the agreed remuneration pursuant to the agreement. It is also mentioned in the remuneration clause as follows:-

> *"(2) The total remuneration and compensation to be paid by LXD to LIPL in accordance with the preceding § 2 (1) is designed to leave LIPL with a fair and adequate compensation for the functions performed, assets employed and risks assumed under this AGREEMENT that meets arm's length principles. Accordingly, this § 2 and, in particular, the factor to be applied as MARK-UP shall be reviewed by the PARTIES each year."*

It is thus clear that an ear marked capacity is required to be placed at the disposal of LXD by LIPL and remuneration of LIPL will include a manufacturing fees plus idle cost compensation which has been pre-conceived in case there is unutilized capacity out of capacity to be maintained, as directed by LXD to LIPL. We find that this situation is different from liquidated damages as the agreement itself envisages that in all probability there will be some idle capacity with LIPL which has to be held at the disposal of LXD, in case it so desires to utilize it. In case payment is allowed, no party considers the contract as discharged and the same continues in next quarter on same terms. It is natural that every manufacturing business has some installed capacity which is normally higher than the utilized capacity to overcome the uncertainty of the business environment. Idle capacity is a reality in every manufacturing business. Therefore, LXD has also desired to keep it and to pay for it in case their production program so requires. This is clearly distinguishable from liquidated damages as in that case, arising of the event for which liquidated damages for breach are paid, itself is uncertain. In any manufacturing activity, "idle capacity" stands on a different footing and is a commitment for an obligation undertaken by both parties, at the time of entering into agreement, by which one party will hold capacity in manufacturing assets as per the direction of the other and any less capacity utilization shall be paid for on the basis of fixed cost and other cost elements. On one side, there is an obligation to keep a particular capacity available and on the other side, there is an undertaking to provide remuneration, albeit, both for utilized capacity as well as capacity that could not be utilized and kept idle. The whole arrangement therefore, clearly falls within the parameter of the description given for "deemed service" in the specific facts of this matter. Simply using word "compensation", does not in the present context means it is compensation for some "damages" but is very much a payment already agreed at the time of entering into an agreement for an event which was highly probable to occur and was well-known to both the parties. The consideration has already been concurred by both the parties, variating quantum over a period of time does not make it "compensation for damages", as vehemently argued by learned Senior Advocate. As per Australian Taxation office GSTR 2009/3 cancellation charges, fees appropriated for administrative services provided in initiated supply and in arrangement of making refunds of flat fee, charge etc. have been considered as consideration for supply of the services. The scope, therefore, in any case is being accepted by even a Foreign Tax Jurisdiction. In view of the foregoing discussion, we find that in the instant case, and going by the terms of the agreement what has been essentially provided is a "declared service" and has to be treated as such. Simply, the use of expression "compensation" cannot prevent a close scrutiny of the terms of contract and nature of the same, or whether the same was a consideration for agreeing to an obligation to do or not to do an act. After going through the whole gamut of various clauses in the agreement, it is clear that 'what has been provided for', is very much within the parameters of "declared service" as per definition of Section 66E(e) of Finance Act, 1994.

15. Now this brings us to the second issue that if there was a supply of "declared service", as we have held, whether what has been provided for and the activities carried out are in the nature of export or, are in the nature of services provided in India relating to plant and machinery and therefore, immovable property or not? In this context, it is useful to go through the detailed discussion, which has been undertaken by the learned Commissioner in the impugned order with relevant portion of the findings in this regard being as follows: -

***"Provision w.e.f. 01/07/2012***

> ***Section 66B, the charging section reads as under****:*
> *"66B. There shall be levied a tax (hereinafter referred to as the service tax) at the rate of twelve percent on the value of all services, other than those services specified in the negative list, provided or agreed to be provided in the taxable territory by one person to another and collected in such manner as may be prescribed"*

*The defining features of Section 66B are:*
*(i) Concept of services specified in Negative List;*
*(ii) Notion of Taxable Territory':*

*It can be safely inferred that to attract levy of Service Tax, a service which is not specified in the negative list should be provided in the taxable territory. To sort out the issue of levy of Service Tax in this case, the definition of taxable territory is required to be looked into which is provided under Section 65B (52) and Section 64.*
*"****Section 65B (52)*** *"taxable territory" means the territory to which the provisions of this Chapter apply.*

***SECTION 64. Extent, commencement and application****: -*
*(1) This Chapter extends to the whole of India except the State of Jammu and Kashmir.*

*(2) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.*
*(3) It shall apply to taxable services provided on or after the commencement of this Chapter."*

*Further, Section 66C guides us as to how to determine whether a service is provided in the taxable territory.*

> ***SECTION 66C. Determination of place of provision of service.***
> *(1) The Central Government may, having regard to the nature and description of various services, by rules made in this regard, determine the place where such services are provided or deemed to have been provided or agreed to be provided or deemed to have been agreed to be provided.*
> *(2) Any rule made under sub-section (1) shall not be invalid merely on the ground that either the service provider or the service receiver or both are located at a place being outside the taxable territory."*

*The Place of Provision of Services (POPS) Rules, 2012 are framed by the Central Government in pursuance of Section 66C and are notified vide Notification No. 28/2012-ST dated 01.07.2012. These rules apply for determining the place of provision of service which in turn would depend upon the (1) location of service provider or (ii) location of service receiver or (iii) place of performance of service.*

*I have examined Rules serially from 4 to 12 and noticed that Rules make specific provision in respect of specified services. So in case of services specified in Rule 4 to 12, the place of provision will be determined as per the respective rules and in the case of any other service, the Rule 3 will apply.*

*The Department has alleged in the show cause notice that idle cost compensation paid by LXD is on account of underutilization of fixed establishment of plant and machinery. The plant as such is an immovable property in terms of Rule 3 of the General Clauses Act. 1987 and therefore, the agreement is in the nature of grant of right to use the immovable property. As per the provisions of Rule 5 of the POPS Rules, 2012, the place of provision of service will be where the immovable property is located or intended to be located which in the present case is the assesse's factory premises. The provisions of Rule 5 ibid are reproduced herein below:*

***Rule-5 Place of provision of services relating to immovable property** - The place of provision of services provided directly in relation to an immovable property, including services provided in this regard by experts and estate agents, provision of hotel accommodation by a hotel, inn, guest house, club or campsite, by whatever, name called, grant of rights to use immovable property,* *services for carrying out or coordination of construction work, including architects or interior decorators, shall be the place where the immovable property is located or intended to be located*

*On going through Rule 5 of the POPS Rules, it is observed that the place of provision will be the location of immovable property when any services provided are directly in relation to immovable property including services provided in this regard by experts and estate agents, provision of hotel accommodation by a hotel, inn, guest house, club or campsite, by whatever, name called, grant of rights to use immovable property, services for carrying out or co-ordination of construction work, including architects or interior decorators.*

*The department has alleged in the show cause notice that the place of provision of service for claim of idle cost compensation falls under Rule 5 of the POPS Rules, 2012 as idle cost compensation were paid towards underutilization of fixed establishment of plant and machinery and the plant as such is an immovable property in terms of Rule 3 of the General Clauses Act, 1987. It has also alleged that agreement is in the nature of grant of right to use the immovable property.*

*I find that there are two main ingredients of Rule 5 of the POPS Rules, 2012,:-*

*(i) As per the definition, scope of immovable property includes land and building and benefits arising out of land;*

*(ii) The services should be directly in relation to immovable property.*

*The scope of Rule 5 of the POPS Rules is clarified in CBEC Education Guide, the relevant portion of which is extracted below:*

***"5.5 Rule 5-Location of Immovable Property***

*In the case of a service that is 'directly in relation to immovable property', <u>the place of provision is where the immovable property (land or building) is located</u>, irrespective of where the provider or receiver is located (emphasis supplied)*

***5.5.1 What is "immovable property"?***

*"Immovable Property has not been defined in the Finance Act, 1994. However, in terms of Section 4 of the General Clauses Act, 1897, the definition of immovable property provided in sub-section 3 (26) of the General Clauses Act will apply, which states as under:*

*"Immovable Property" shall include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth."*

*It may be noted that the definition is inclusive and thus properties such as buildings and fixed structures on land would be covered by the definition of immovable property. The property must be attached to some part of earth even if underwater.*

***5.5.2 What are the criteria to determine if a service is 'directly in relation to immovable property located in taxable territory?***

*Generally, the following criteria will be used to determine if a service is in respect of immovable property located in the taxable territory:*

*(i)<u>the service consists of lease, or a right of use, occupation, enjoyment or exploitation of an immovable property:</u>*

*(emphasis supplied)*

*(ii) the service is physically performed or agreed to be performed on an immovable property (e.g. maintenance) or property to come into existence (e.g. construction);*

*(iii) the direct object of the service is the immovable property in the sense that the service enhances the value of the property, affects the nature of the property, relates to preparing the property for development or redevelopment or the environment within the limits of the property (e.g. engineering, architectural services, surveying and sub dividing, management services, security services etc);*

*(iv) the purpose of the service is:*

*(a) the transfer or conveyance of the property or the proposed transfer or conveyance of the property (e.g., real estate services in relation to the actual or proposed acquisition, lease or rental of property, legal services rendered to the owner or beneficiary or potential owner or beneficiary of property as a result of a will or testament);*

*(b) the determination of the title to the property.*

*There must be more than indirect or incidental connection between a service provided in relation to an immovable property, and the underlying immovable property. For example, a legal firm's general opinion with respect to the capital gains tax liability arising from the sale of a commercial property in India is basically advice on taxation legislation in general even though it relates to the subject of an immovable property. This will not be treated as a service in respect of the immovable property.*

***5.5.3 Examples of land-related services***

*(i) Services supplied in the course of construction, reconstruction, alteration, demolition, repair or maintenance (including painting and decorating) of any building or civil engineering work;*

*(ii) Renting of immovable property:*

*(iii) Services of real estate agents, auctioneers, architects, engineers and similar experts or professional people, relating to land, buildings or civil engineering works. This includes the management, survey or valuation of property by a solicitor, surveyor or loss adjuster.*

*(iv) Services connected with oil/gas/mineral exploration or exploitation relating to specific sites of land or the seabed*

*(v)The surveying (such as seismic, geological or geomagnetic) of land or seabed*

*(vi) Legal services such as dealing with applications for planning permission.*

*(vii) Packages of property management services which may include rent collection, arranging repairs and the maintenance of financial accounts.*

*(viii) The supply of hotel accommodation or warehouse space.*

***5.5.4 What if a service is not directly related to immovable property?***

*The place of provision of services rule applies only to services which relate directly to specific sites of land or property. In other words, the immovable property must be clearly identifiable to be the one from where, or in respect of which, a service is being provided. Thus, there needs to be a very close link or association between the service and the immovable property. Needless to say, this rule does not apply if provision of service has only an indirect connection with the immovable property, or if the service is only an incidental component of a more comprehensive supply of services.*

*For example, the services of an architect contracted to design the landscaping of a particular resort hotel in Goa would be land-related. However, if an interior decorator is engaged by a retail chain to design a common decor for all its stores in India, this service would not be land-related. The default rule Le. Rule 3 will apply in this case.*

***5.5.5 Examples of services which are not land-related***

*(i) Repair and maintenance of machinery which is not permanently installed. This is a service related to goods.*

*(ii) Advice or information relating to land prices or property markets because they do not relate to specific sites.*

*(i) Land or Real Estate Feasibility studies, say in respect of the investment potential of a developing suburb, since this service does not relate to a specific property or site.*

*(iv) Services of a Tax Return Preparer in simply calculating a tax return from figures provided by a business in respect of rental income from commercial property.*
*(v) Services of an agent who arranges finance for the purchase of a property."*

*From the reading of the aforesaid explanation given in Education guide, the understanding and intention of the Legislature with respect to Rule 5 is that the said rule is invokable only when place of provision is with respect to identifiable location of land or building. Immovable property has not been defined in the Finance Act, 1994. Reliance is placed on the definition of immovable property as mentioned under Section 3(26) of the General Clause Act, 1897 which clarifies that the fixed structures on land would be covered by the definition of immovable property and the property must be attached to some part of earth even if underwater.*

*I find that it is not disputed that fixed plant and machinery is an immovable property in terms of Rule 3(26) of the General Clause Act, 1897. It is also explicitly clear that the services should be 'directly in relation to' immovable property and should have a very close link or association with the immovable property to apply Rule 5 to determine place of provision of service.*

*I find that a very restricted scope is covered under the ambit of Rule 5 of the POPS Rules and in case, provision of service has only an indirect connection with the immovable property, or if the service is only an incidental component of a more comprehensive supply of services, Rule 5 of the POPS Rules, is not invokable. It is clear that Rule 5 can be invoked only in case of service provided directly in relation to immovable property which is further extended to few activities such as grant of right to use the immovable property.*

*Further, the instant case needs to be tested to identify whether Rule 5 can be made applicable in the facts of present case. To understand the scope of activity performed by the noticee, it is important to understand the terms of the manufacturing agreement entered into between LXD and the noticee which is for activity of manufacture to be undertaken by the noticee for LXD and accordingly, remuneration is paid per unit of the product delivered to LXD. The manufacturing cost of per unit of the product includes the cost of input materials, production cost, selling expenses, general administration, other cost plus the mark up. The said agreement also provides the clause of remuneration in terms of idle cost compensation in case of losses suffered by the noticee due to underutilization of the plant production capacity which is also determinative by accounting the manufacturing cost of product sold to the LXD.*

*The department alleges that idle cost compensation is basically towards grant of rights to use immovable property, i.e. grant of right to use the plant and machinery. This allegation is not correct as there is no direct connection with immovable property and has only an indirect connection with the immovable property as evident from the content of the contract manufacturing agreement entered between the LXD and the noticee.*

*I find that the remuneration received by the noticee is for short lifting of goods from the LXD and otherwise, under the said agreement, the main activity constitutes transfer of title in goods by way of sale. It cannot be said that the remuneration or idle cost compensation received by the noticee is towards the grant of right to use plant and machinery. I find that the compensation is accounted towards the idle capacity of the plant and not towards grant of right to use the immovable property. The notice has failed to establish on the basis of any documentary evidence that the noticee were compensated based on the grant of right to use the plant and machinery. The compensation received from LXD is neither for provision of service directly related to immovable property nor for grant of rights to use immovable property, i.e. plant and machinery.*

*As per the agreement, consideration was for the idle capacity of the plant due to short purchase of goods by LXD and not towards grant of right to use plant and machinery. Hence, I find that Rule 5 of the POPS Rule does not apply if a provision of service has only an indirect connection with the immovable property, or if the service is only an incidental component of a more comprehensive supply of services. In the present case, the idle cost compensation arrived at is dependent on the fixed cost i.e. cost of plant and machinery, volume variance which includes unabsorbed fixed costs like salary, wages, repairs & maintenance etc. Therefore, it can clearly be concluded that the compensation amount is not in direct relation to immovable property by means of grant of right to use plant and machinery. It is dependent only on the fixed cost actually incurred by the noticee.*

*I find that the department has alleged in the show cause notice that the agreement between the noticee and LXD is of contract manufacturing using the plant and machinery of the noticee and the same being an immovable property, the said service is in or in relation to the immovable property and Rule 5 of the Place of Provision of Service Rules, 2012 shall apply instead of general Rule 3 for determination of place of provision, in light of Rule 14 of the POPS, Rules, 2012, is not sustainable.*

*The place of provision for declared services provided by the noticee is rightly as per terms of Rule 3 of the POPS Rules as per which place of provision of service shall be the location of service receiver. The principal effect of Rule 3 is that (a)* *where the location of receiver of a service is in the taxable territory, such service will be deemed to be provided in the taxable territory and service tax will be payable; (b) if the receiver of service is located outside the laxable territory, no service tax will be payable on the said service. In the present case, since the service recipient, i.e. M/s. Lanxess Deutschland GmbH, Kennedyplatz 1, 50569 Cologne, Germany is located in Germany which is not in the taxable territory, the services provided by the noticee are outside the taxable territory*

*Furthermore, service provider (Lanxess India Pvt Ltd) is engaged by the service recipient (LXD- located outside taxable territory) in terms of a contract with a promise to reimburse idle cost compensation to the service provider. The terms of the contract and remuneration are already noted and discussed in the above paras.*

*Location of service recipient is defined under Rule 2(i) of POPS Rules, 2012 as extracted below:*
*"(i) "location of the service receiver" means.*
*(a), where the recipient of service has obtained a single registration, whether centralized or otherwise, the premises for which such registration has been obtained;*
*(b) where the recipient of service is not covered under sub-clause (a):*
*(i) the location of his business establishment, or*
*(ii) where services are used at a place other than the business establishment, that is to say, a fixed establishment elsewhere, the location of such establishment, or*
*(iii) where services are used at more than one establishment, whether business or fixed, the establishment most directly concerned with the use of the service, and*
*(iv) in the absence of such places, the usual place of residence of the recipient of service.*
*Explanation 1:-. For the purposes of clauses (h) and (i), "usual place of residence in case of a body corporate means the place where it is incorporated or otherwise legally constituted.*
*Explanation 2:-. For the purpose of clause (i), in the case of telecommunication service, the usual place of residence shall be the billing address."*
*Thus, where the service recipient has obtained a single registration, the premises for which single registration is taken shall be the location of service recipient. For a case where service recipient has not taken registration, the place of provision shall be the location of his business establishment*
*The term business establishment has been explained in Education Guide of CBEC as under:-*

*"5.2.5 What is the meaning of "business establishment"?*

*Business establishment' is the place where essential decisions concerning the general management of the business are adopted, and where the functions of its central administration are carried out. This could be the head office, or a factory, or a workshop, or shop/ retail outlet. Most significantly, there is only one business establishment that a service provider or receiver can have."*

*After reading above provisions harmoniously, following facts are emerge-*

*a. The service recipient is LXD, Germany.*
*b. It is neither located in India nor registered with Service Tax.*
*c. LXD is incorporated outside India with its Head Office also outside India and is thus a business establishment outside the taxable territory.*

*Therefore, Section 66B would apply and no Service Tax would be chargeable on the service provided by noticee as their services are provided outside taxable territory. This view is also supported by Advance Ruling authority in Tandus Flooring India Private Limited Vs. Commissioner of Service Tax, 2014 (33) STR 33 (AAR).*

*For determining whether these services can be treated as Export of Services, the conditions of Rule 6A of Service Tax Rules, 1994 needs to be visited, which are as under:-*

*"RULE [6A. Export of services. (1) The provision of any service provided or agreed to be provided shall be treated as export of service when,-*

*(a) the provider of service is located in the taxable territory,*
*(b) the recipient of service is located outside India,*
*(c) the service is not a service specified in the section 66D of the Act,*
*(d) the place of provision of the service is outside India,*
*(e) the payment for such service has been received by the provider of service in convertible foreign exchange, and*
*(f) the provider of service and recipient of service are not merely establishments of a distinct person in accordance with item (b) of Explanation 3 of clause (44) of section 65B of the Act.*

*The conditions for determining export of services vis-à-vis the present case can be tabulated as under:-*

| *Condition of Rule 6A of Service Tax Rules, 1994* | *Compliance by the Noticees* |
|---|---|
| *(a) The provider of service is located in taxable territory* | *The Noticees are provider of service and they are located in taxable territory.* |

| | |
|---|---|
| *(b) The recipient of service is located outside India* | *As per service agreement, service receipeint LXD is an entity registered and located in Germany.* |
| *(c) The service is not a specified services in Section 66D of the Finance Act, 1994.* | *In the present case, the services provided by the Noticee is in the nature of declared service which are not specified under Section 66D of the Finance Act, 1994* |
| *(d) The place of provision of service is outside India* | *The Noticee has established by the above submissions that the place of provision of service is outside India.* |
| *(e) the payment for such service has been received by the provider of service in convertible foreign exchange* | *It is undisputed fact that the Noticee has received consideration for the declared service in convertible foreign currency* |
| *(f) the provider of service and recipient of service are not merely establishments of a distinct person in accordance with item (b) of Explanation 2 of clause (44) of section 65B of the Act.* | *In the present case, service provider and the service recipient are two separate legal entities.* |

*The noticee in their defence has also stated that without prejudice to all allegations if proved correct as alleged in the notice, there can be no element of service. The department has alleged in the show cause notice that the arrangement between the noticee and LXD is of contract manufacturing using the plant and machinery of LPT plant of the noticee is without appreciating the terms of the contract and intent of the parties while entering into the contract The levy of service tax is a contractual based levy. The contract entered between the noticee and LXD is for manufacture and sale of goods. The terms of the contract never mentioned grant of right to use the plant and machinery. The idle cost compensation was not dependent on right to use plant and machinery but due to short purchase of goods by LXD which was dependent on the sale cost of manufactured goods. The understanding of the department to account the compensation received by the noticee for provisions of service in terms of Rule 5 of the POPS Rules is not sustainable. The agreement is clearly towards sale of manufactured goods and not for provision of any kind of service, whatsoever. I completely agree with the above contention also. Thus, I find that M/s. Lanxess India Pvt Ltd were not required to pay Service Tax for the period from 2012-13 (from July, 2012) to 2015-16."*

15.1 The inapplicability of constraint in item (b) of explanation 3 of clause (44) of Section 65B of the Finance Act, 1994 has correctly been analyzed by the Adjudicating Authority by holding that export to German Entity by Indian Entity is possible as both are distinct incorporated entities - one in non-taxable territory and the other in taxable territory of India. We uphold his analysis as above and hold that conditions of export have been duly complied with. From elaborate discussion made available by the learned Adjudicating authority in his order which has been challenged before us by the department, we find that he has reached a conclusion that service provided cannot be considered to be in relation to immovable property for the reasoning adopted by him. We have already held that the same is a "declared service". We find that the Place of Provision of Services Rules, 2012 as a general rule, provides that it is the location of the recipient of service, which is "to be treated as place of service". It is not doubted that the recipient of service in the instant case is located in Germany which is not in taxable territory. We already have held in detail as to why the service involved is "deemed service" and the same therefore is not a supply of immovable property service. We find that "declared service" is a service which is a species of its own, created and defined by the statute as a legal fiction. It is therefore, not covered by clauses 2(i) (b) (i),(ii),(iii) of POPS Rules, 2012 (ibid)but in clause (iv) of the Rule 2(i)(b), nor can the services in the nature of "declared Services" be placed in different category of "immovable property service" and therefore can only be within the ambit of Rule 5 (ibid) of Place of Provision of Services Rules. In absence of a dedicated provision for "declared service" and its placement in POPS Rules, 2012, the residuary and general rule emanating from "destination principle" of location of service recipient, applies. Same therefore in the instant case cannot be considered to have been supplied in relation to "immovable property" in India nor is it a manufacturing service rendered abroad, as held by Learned Commissioner. We, therefore agree with the conclusion drawn by Commissioner in impugned order, but with a different reasoning as above.

Therefore, Rule 3 of Place of Provision of Services Rules, 2012 that provides that the place of provision of service shall be the place of service receiver comes into place. The payment as per obligation undertaken to allocate a particular capacity level for the parent company cannot be taken to be an agreement for usage of immovable property. We are unable to imagine a situation where but for the definition of "declared service" being made available to us, we could have held that the service was of immovable property, in any case. The reasoning adopted by the learned Commissioner about why the remuneration received for non-utilized capacity cannot be treated as usage of immovable property is well founded and deserves to be accepted by us in conclusion arrived at, but for reason that service is "deemed service" and not for any other reason given by him. "Deemed Service" is a species of service segregated from all other services, as it exists only by operation of a deemed legal fiction.

15.2 Therefore, while we agree on the basis of documentary evidence of invoice as well as analysis done by us that the service is "declared service" in terms of Section 66E(e) of the Finance Act, 1994 and we decide the first issue in favour of Revenue. We are unable to convince ourselves that the place of provision of service is not the place of recipient of service and therefore, same is nothing but export of service. In view of the foregoing, we hold that the Place of Provision of Service is outside India as unutilized capacity service (which is a "declared service") is received in terms of benefit by the service recipient at its own location. Same is therefore within the ambit of export of services and it is accordingly answered that the "declared services" of the nature impugned before us are provided outside India at the location of the recipient. We are neither called upon nor are deciding the question as to whether the respondent has charged and collected service tax as per invoice from German Entity or not, for such exports.

16. We, therefore, while holding that there is a “declared service” involved in the factual matrix of the case, also hold that the “declared service” has been exported to the place of service recipient. Appeal therefore cannot be allowed on second issue. Same is accordingly dismissed.

(*Order Pronounced in the open court on 26.02.2026*)

**(SOMESH ARORA)**
**MEMBER (JUDICIAL)**

**(SATENDRA VIKRAM SINGH)**
**MEMBER (TECHNICAL)**

Raksha