

Indirect Tax Alert

5 January 2021



Service tax demand on liquidated damages set aside by the Tribunal

Issues for consideration before the Tribunal¹

The point of dispute before the Tribunal was whether service tax could be demanded under Section 66E(e) of the erstwhile Chapter V of the Finance Act, 1994 ('service tax law') i.e., toleration of an act, in respect of the following:

- Liquidated damages from the suppliers of materials for breach of the terms and conditions of the contract.
- Compensation/penalty from the contractors for breach of the terms and conditions of the contract.
- Compensation/penalty from the buyers of coal on the short-lifted/un-lifted quantity of coal and non-compliance of the terms and conditions of

the coal supply agreement, including forfeiture of earnest money deposit/security deposit.

Tribunal Ruling

The Tribunal held that that the penalty amount, forfeiture of earnest money deposit and liquidated damages received by the assessee cannot be construed as a consideration for tolerating an act leviable to service tax under Section 66E(e) of the service tax law. Accordingly, the demand of service tax was set aside.

Following are some of the key observations made by the Tribunal:

- '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

¹ M/s. South Eastern Coalfields Ltd. vs Commissioner of Central Excise and Service Tax Office of the Principal Commissioner [Service Tax Appeal No. 50567 of 2019]

consideration for the taxable service provided under the service tax law.

- Any amount charged which has no nexus with the taxable service and is not a consideration for the service provided does not become part of the value which is taxable.
- It should also be remembered that there is a 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.
- There has to be a flow of consideration in the agreement from one person to another when one person agrees to the obligation to refrain from an act, or to tolerate an act, or a situation, or to do an act.
- 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 activities, that are contemplated under section 66E(e) of the service tax law, 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.

- The conclusion drawn by the Department that compensation received is synonymous with 'tolerating' is not correct.

Aurtus comments

- The ruling has analysed in detail and distinguished what is 'conditions to a contract' and 'consideration for the contract'.
- The conditions to a contract would not necessarily mean that a person had tolerated an act to qualify as service under the service tax law.
- This ruling would help the assessee in respect of the ongoing litigation with regard to the demand of service tax made on the liquidated damages and other activities which the revenue authorities view it to be 'toleration of an act'.
- The Tribunal has delivered the favourable ruling after considering the agreement/ contract entered into by the assessee which re-emphasize the importance of the manner in which the agreement/contract is drafted, from an indirect tax perspective.