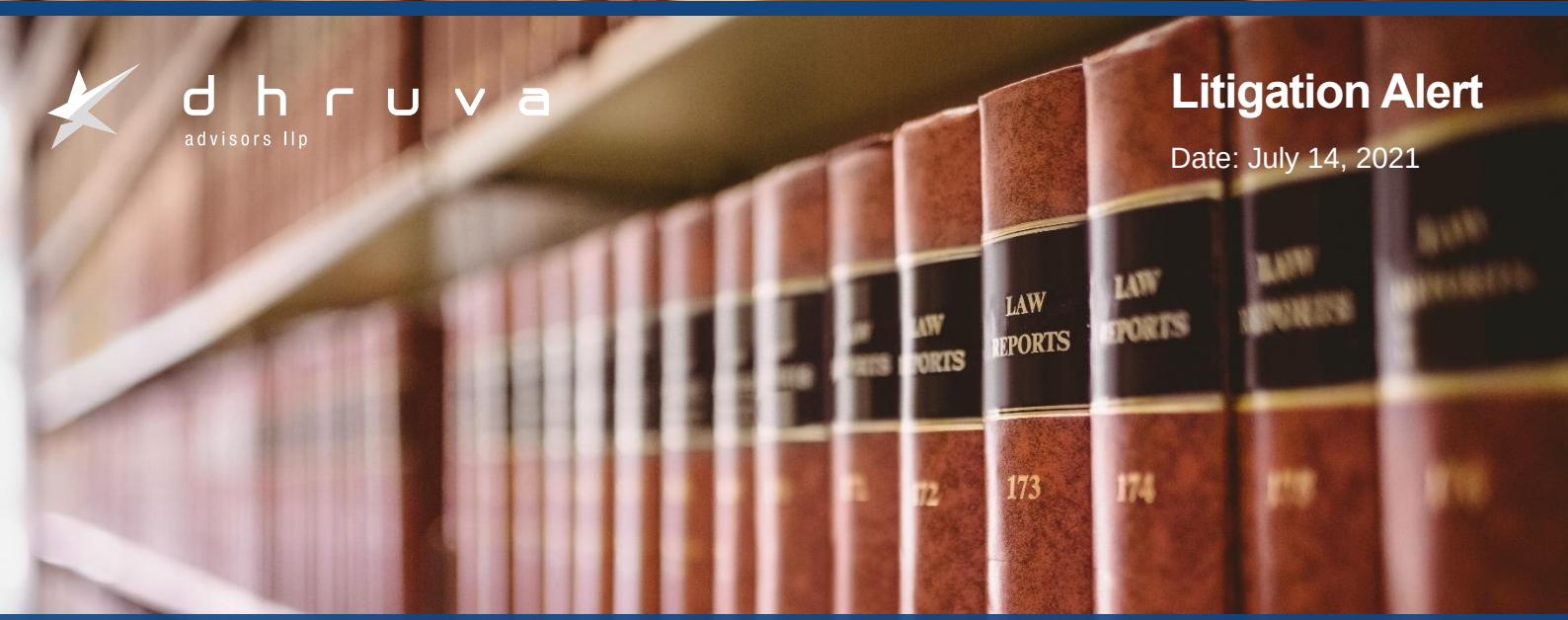

dhruva advisors llp

Litigation Alert

Date: July 14, 2021

Payment of damages not liable to service tax

Ruchi Soya Industries Limited v. Commissioner of Customs, Central GST and Excise, Indore[1]

The Customs, Excise and Service Tax Appellate Tribunal ('CESTAT') Delhi examined the taxability (service tax) of the amount received by the service recipient as payment (compensation) for a service provider's failure to provide quality services, as specified in the agreement.

Facts of the case:

- Ruchi Soya Industries Limited ("the Appellant"), which is engaged in the business of generation of wind energy, purchased and used wind turbine generators to generate wind energy. Operation and maintenance of these wind turbine generators was outsourced to Suzlon Global Services Ltd. ("Suzlon"). Suzlon is the service provider and the Appellant the service recipient in this case.
- According to the agreement between the Appellant and Suzlon, Suzlon would maintain the wind turbine generators in working condition so that they would be available for use by the Appellant. It is further provided in the 'Machine availability clause' ('the said clause') of the agreement that if the availability of the wind turbine generators dropped between 92.5% and 95.5%, then Suzlon would have to compensate the Appellant an amount equal to 3% of the annual operation and maintenance charges for every 1% of shortfall below 95.5% of average machine availability, subject to an overall maximum of 50% of the annual operation and maintenance charges payable by the Appellant.
- As the wind turbine generators broke down and were so unavailable for use by the Appellant - i.e. availability time fell below the criterion set out in the said clause - Suzlon issued a credit note to the Appellant for Rupees one crore and thirty-three lakhs.
- During the course of the service tax audit conducted on the Appellant, for the FY 2015-16 the service tax authorities raised an objection that service tax should be discharged by the Appellant (service recipient) on the amount received from Suzlon. The authorities reasoned this amount is taxable under Section 65B(44) of Finance Act, 1944, ("the Act") as it is a service of *"agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act"*, which is a 'Declared Service' as defined in Section 66(E)(e) of the Act.

[1] TS-301-CESTAT-2021-ST

- The demand in a show cause notice issued to the Appellant was confirmed in the order in original and the issue was brought before the CESTAT. The CESTAT examined whether the machine availability clause of the agreement cast a service tax liability on the service recipient in this case.

Judgement of the CESTAT:

After considering the submissions made by both sides the CESTAT held that the Appellant, in this case, was not liable to pay service tax. The analysis undertaken is as follows:

- It is essential to establish that the basic elements for levy service tax exist, i.e. service provider, service receiver, payment of consideration from the services recipient to the service provider, services etc. In Section 67 of the Act pertaining to valuation, the words "for such service provided" are used, which clearly indicates that there must be an underlying provision of services for which the consideration is charged.

- Reference was made to the Supreme Court decision of *Bhayana Builders and Intercontinental Consultants*[2] to highlight two points: (i) that consideration for the taxable service provided should be from the service recipient to the service provider and (ii) that there is a difference between 'conditions to a contract' and 'considerations for the contract' and that payment made as a condition to contract would not necessarily form a part of taxable value. Basis the judgment of the Supreme Court, it was held that the payment made by Suzlon to the Appellant was a condition of the contract to provide services and maintain the wind turbine generator in way that it is available for use by the Appellant for more than 95.5% of the time. The said clause sets out that the Appellant will not bare losses for Suzlon's failure to provide quality services and in the event that Suzlon does fail to provide a quality service, it should make good the losses borne by the Appellant.

- It was observed by the CESTAT that the payment of compensation should not be construed as the taxable service of "tolerating an act" by the service recipient. Incorporation of penalty clauses is a condition in the contract and the payment pursuant to such a clause is 'condition to the contract'. Thus, reading the agreement as a whole and considering the intent and purpose of the contract is necessary in ascertaining taxability.

- It is opined that when the agreement is read in its entirety it is evident that the machine availability clause is incorporated to ensure that the terms of agreement are not violated and Suzlon does not compromise on the quality of service. Should the quality of service be inadequate, the commercial interests of the Appellant are safeguarded in the form of compensation payable by Suzlon.

- Reference was made to the decision of *South Eastern Coalfields Ltd. v. Commissioner Of Central Excise And Service Tax, Raipur*[3] that recovery of liquidated damage cannot be construed to be payment for any service *per se* as the objective of imposing compensation and providing for it in an agreement is to ensure that the defaulting act is neither undertaken nor repeated, which would indicate that the machine availability clause does not show the Appellant tolerating the default committed by Suzlon.

- The judgement points out that the Appellant does not provide any services to Suzlon, i.e. the alleged services of "tolerating an act", and so the tax liability cannot be placed on the Appellant, who is the service recipient. It is held that *"the amount cannot be called as consideration for the tolerance of service provided and some lacunae thereof nor does it make the appellant the service provider".*

- The tax department's contention that receiving compensation from the service provider is a Declared Service liable to service tax was held to be incorrect after considering the dictionary meaning of the word "tolerate". It was observed that

[2] 2018-VIL-08-SC-ST

[3] 2020-VIL-559-CESTAT-DEL-ST

to qualify as a declared service, first an underlying service has to be established in fact. The order in original that is under challenge is silent on what constitutes a "service" provided by the Appellant to Suzlon and hence, the service tax demand does not survive.

- Relying on the Supreme Court's decision in *Association of Leasing and Financial Service Companies v. Union of India*[4] to conclude that absent a service, there cannot arise liability for service tax.

Dhruva Comments:

The judgement describes the difference between compensation for failure to fulfil an agreed obligation and consideration for provision of services.

Taxation of liquidated damages or penal amounts has been a subject of litigation under both service tax and GST regime. In GST law, Sr. no. 5(e) of Schedule II of the Central Goods and Services Tax Act, 2017, is identically worded as Section 66E(e) of the Act.

Interestingly, several advance rulings under the GST regime have ruled that payment of liquidated damages is liable to tax, without taking into consideration that damages are essentially compensatory in nature and are payable in case of breach of a contract to monetarily place the aggrieved party in the position it would be in if the breach was not committed. Such payment being a condition of contract and not consideration for services has been lost in these advance rulings. The reasoning provided in the judgment will have persuasive value in the GST regime too – clauses for damages / penalty for deficiency or shortcoming in services is a common feature in the commercial world. These advance rulings have also not considered the point that GST is only applicable when there are reciprocal promises and actions.

[4] 2010 (20) STR 417 (SC)

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