



## LIQUIDATED DAMAGE – COMPENSATION OR CONSIDERATION

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A] The general rule is that performance of a contract, for discharge of obligations thereto, must be precise and exact. That is, a party performing an obligation under a contract must perform that obligation exactly within the time frame set by the contract and exactly to the standard required by the contract. [Anson (2016) 465]

B] If the obligations of the contract is either not performed within the time frame set by the contract or not performed to the required standard then it results in breach of contract. And as soon as the party is in breach *a new obligation* will arise by *operation of law* – an obligation to pay *damages* to the other party in respect of any loss or damage sustained by that breach. So, every breach of contract entitles the injured party to damages. [Anson (2016) 533]

C] In case of supply of goods and services, apart from the breach of conditions (stipulations which are essential to the main purpose of the contract) of the contract there may be breach of warranties (stipulations which are only collateral to the main purpose of the contract). Breach of conditions is severe in nature and may even lead to repudiation of the contract whereas breach of warranties does not entitle the parties to the contract to repudiate [Sale of Goods Act 1930 Sec 12]. Again, the breach of conditions may be of three types – one with respect to the time, another with respect to the quantity and still other with respect to the quality. Though the quality is rarely compromised the time of delivery and the quantity of the delivery are generally subjected to pragmatic approach ie instead of repudiation of contract compensation in the form of damages for the purchaser and quantum meruit for the supplier of goods and services are usually considered. Damages for delay in delivery are generally predetermined and mentioned in the contract and are known as liquidated damages. Matters of short supply are usually settled through credit notes.

D] Where an obligation arises *not by an agreement* between the parties *but by operation of law* then it is regarded as a relationship resembling that of a contract and is known as quasi-contract. Strictly

speaking, a quasi-contract cannot be called a contract but Indian Contract Act 1872 Chapter V Sec 68 to 72 recognises four such relationships as a contract:

a) Sec 68 says that if a person, incapable of entering into a contract, or any one whom he is legally bound to support, is supplied by another person with necessaries suited to his condition in life, the person who has furnished such supplies is entitled to be reimbursed from the property of such incapable person.

b) Sec 69 says that a person, who is interested in the payment of money which another is bound by law to pay, and who therefore pays it, is entitled to be reimbursed by the other.

c) Sec 70 says that where a person lawfully does anything for another person, or delivers anything to him, not intending to do so gratuitously, and such other person enjoys the benefit thereof, the latter is bound to make compensation to the former in respect of, or to restore, the thing so done or delivered [commonly known as ‘quantum meruit’].

d) Sec 71 says that a person who finds goods belonging to another, and takes them into his custody, is subject to the same responsibility as a bailee.

e) Sec 72 says that a person to whom money has been paid, or anything delivered, by mistake or under coercion, must repay or return it.

E] Indian Contract Act 1872 Chapter VI Sec 73 to 75 deals with the breach of contract and its consequences which are altogether different from Chapter V dealing with quasi-contract.

F] Indian Contract Act 1872 Sec 73 says that 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, or which the 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.

G] Indian Contract Act 1872 Sec 73 further says that when *an obligation resembling those created by contract* (quasi-contract) has been incurred and has not been discharged, any person injured by the failure to discharge it 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. Thus, even in case of breach of quasi-contract the obligation to pay damages arises.

H] Indian Contract Act 1872 Sec 73 explains that in estimating the loss or damage arising from a breach of contract, the means which existed of remedying the inconvenience caused by the non-performance of the contract must be taken into account. It may be noted that difficulty in assessing damages does not disentitle from having an attempt made to assess them, unless they depend on entirely speculative possibilities [Anson (2016) 565]. Such damages, however, shall be compensatory and shall not be penal in nature ie damages for breach of contract are given to compensate for loss suffered by the innocent party and not to punish the contract-breaker. So, punitive or exemplary damages have no place in the law of contract and thus any stipulation in this regard is held as nugatory by English Courts [Anson (2016) 564].

I] But this distinction in the nature of damages ie being compensatory or penalising under English common law has been partially undone by amendment of 1899 in the Indian Contract Act 1872 Sec 74 ie in case of liquidated (predetermined) damages [Mulla (2010) 1677].

J] Indian Contract Act 1872 Sec 74 adds that 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* (such as forfeiture of the sum advanced or the security deposit), 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. This section merely dispenses with proof of actual damage, it does not justify the award of compensation when in consequence of the breach no legal injury at all has resulted [Fateh Chand v Balkishan Das AIR 1963 SC 1405. Again, there may be cases when the liquidated damages cease to be payable such as waiver by the purchaser,

fault of the purchaser resulting in delay, etc. [Markanda (2010) 1156].

K] The parties to a contract, however, generally make provision in the contract for the damages to be paid on a breach of contract. Such provision does not exclude the application of the general rule that damages for breach are intended to compensate for the actual loss sustained by the injured person. Rather it is a genuine attempt to liquidate, that is to say, to reduce to certainty, prospective damages of an uncertain amount [Anson (2016) 598].

L] European legal system accepts that changes of circumstances may justify modifying a contract where to maintain the original contract would produce *intolerable results* incompatible with justice. So the *toleration arises* when the original contract is modified. But English legal system, including India, concerned that modification would undermine certainty and alter the risks allocated by the contract, made provisions for the discharge of a contract only where, after its formation, a change of circumstances makes contractual performance illegal or theoretically impossible [Anson (2016) 497]. Such a situation is provided for by the doctrine of frustration where the parties are discharged of their obligation due to radical change in circumstances [Indian Contract Act 1872 Sec 56].

M] Ind AS 115 issued under the Companies Act 2013 speaks of revenue from contracts with customers wherein rules for the recognition of revenue have been spelt out but it does not talk specifically about liquidated damages. Though the Expert Advisory Committee of the Institute of Chartered Accountants of India has considered the issue on accounting of liquidated damages and has issued an opinion on accounting treatment of liquidated damages on unexecuted portion of the contract but it has dealt the matter from the perspective of suppliers only [Query No.26 disposed of by the Committee on 23 Jan 2014]. It is conspicuously silent over the accounting treatment of liquidated damages from the perspective of purchasers of goods or services who are recovering the liquidated damages for delay in supply.

N] The Supreme Court in CIT Gujarat v Saurashtra Cement Limited (2010) 11 SCC 84, where the damages to the assessee was directly and intimately linked with the procurement of a capital asset which would obviously lead to delay in coming into existence of the profit making apparatus, rather than a receipt in the course of profit earning process, observed that compensation paid for the delay in procurement of capital asset amounted to sterilization of the capital asset of the assessee as

supplier had failed to supply the plant within time as stipulated in the agreement and clause of liquidated damages came into play. Thus the amount of liquidated damages received by the assessee towards compensation for sterilization of the profit earning source, not in the ordinary course of their business, was a capital receipt in the hands of the assessee.

O] Income Tax Act 1961 Sec 2(24) defines income to include: a) Profits and gains; b) Dividend; c) Voluntary contributions received by a trust; d) Perquisite or profit in lieu of salary; e) Any special allowance or benefit other than perquisite; f) City compensatory allowance or dearness allowance; g) Any benefit or perquisite to a director; h) Any benefit or perquisite to a representative assessee ; i) Any sum chargeable under IT Sec 28 (profit and gains from business or profession), 41 (deemed business profit) and 59 (deemed capital gain); j) Capital gains; k) Insurance profit; l) Income of banking of a cooperative society; m) Winning from lottery; n) Employee contribution towards provident fund; o) Amount received under keyman insurance policy; p) Fair market value of inventory; q) Gift of exceeding Rs.50,000; r) Consideration for issue of shares; s) Advance money; t) Compensation on termination of employment or modification of terms of employment; u) Assistance in the form of a subsidy or grant. So we see that definition of income under Income Tax Act 1961 Sec 2(24) is wide enough to include the liquidated damages unless it is against the assets in which case, as per the aforesaid decision of Supreme Court, it will be treated as capital receipt and be kept out of taxable income.

P] Finance Act 1994 Sec 66B is the charging section for service tax which reads thus: There shall be levied a tax (hereinafter referred to as the service tax) at the rate of fourteen 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.

Q] In order to obviate the cloud of doubts over certain services in respect of its amenability to service tax Finance Act 1994 Sec 66E was introduced which declared certain services amenable to service tax through legal fiction. Finance Act 1994 Sec 66E (e) declared '*agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act*' as service amenable to service tax.

R] CGST Act 2017 Sec 9 is the charging section for goods and service tax levied by the central government. The relevant portion for our purpose is

CGST Act 2017 Sec 9 (1) which reads thus: 'Subject to the provisions of sub-section (2), there shall be levied a tax called the central goods and services tax on all intra-State *supplies* of goods or services or both, except on the supply of alcoholic liquor for human consumption, *on the value determined* under section 15 and at such rates, not exceeding twenty per cent, as may be notified by the Government on the recommendations of the Council and collected in such manner as may be prescribed and shall be paid by the taxable person.'

S] Scope of supply has been delineated in CGST Act Sec 7. The relevant portion for our purpose is CGST Act 2017 Sec 7 (1) which reads thus: "For the purposes of this Act, the expression 'supply' includes— (a) all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business; (b) import of services for a consideration whether or not in the course or furtherance of business; (c) the activities specified in Schedule I, made or agreed to be made without a consideration; and (d) the *activities* to be treated as supply of goods or supply of services as referred to in Schedule II."

T] CGST Act 2017 Schedule II lists several activities to be treated as supply of goods or supply of services. The relevant portion for our purpose is CGST Act 2017 Schedule II (5) (e) which reads thus '*agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act*'.

U] So by dint of erstwhile Finance Act 1994 Sec 66E(e) and now CGST Act 2017 Schedule II (5) (e) read with Sec 7 declaring the '*agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act*' as service or supply the erstwhile service tax department and now GST department is of the view that liquidated damages are a consideration for toleration and hence liability for erstwhile service tax and now goods and services tax arises. But this inference suffers from the fallacy of *ignoratio elenchi* (missing the point) in the sense that their conclusion of liquidated damages as a consideration for toleration is not based on any valid premises.

V] Tolerate means 'to allow, so as not to hinder; to permit, as something not wholly approved; to suffer; to endure; to admit'; for instance, *to tolerate* infringement of copyright [Aiyar]. And to get a glimpse of refrain one may refer Indian Contract Act 1872 Sec 27 Exception I which reads thus: 'One who sells the goodwill of a business may agree with the buyer *to refrain* from carrying on a similar business, within specified local limits, so long as the

buyer, or any person deriving title to the goodwill from him, carries on a like business therein, provided that such limits appear to the Court reasonable, regard being had to the nature of the business.' So, refrain simply means to hold back; to abstain [Aiyar].

W] The fallacy is again repeated when the erstwhile service tax department conclude that by declaring any service as declared one the requirement of charging section with respect to agreement is not to be complied. Even if they contend that the obligation of liquidated damages arise by operation of law hence there is a quasi contract then also it is not substantiated by the four express provisions of quasi contract under Indian Contract Act 1872 Chapter V Sec 68 to 72.

X] The contention of the GST department that for levying goods and service tax under Sec 9 the only requirement is of supply, which is defined in Sec 7, and the value, which is determined under Sec 15; and since CGST Act 2017 Schedule II (5) (e) read with Sec 7 declares the obligation to refrain from an act, or to tolerate an act or a situation as supply and Sec 15 determines the sum payable as liquidated damages as the value the liquidated damages are amenable to goods and service tax. Patently this argument appears very plausible but on scrutiny it suffers from the fallacy of hasty generalisation and *ignoratio elenchi*. First, the link between 'the obligation to refrain from an act, or to tolerate an act or a situation' and the breach of contract and compensation thereon is conspicuously absent and being a taxing provision it calls for strict construction, ie unless the liability is clearly written it cannot be levied. Second, had it been the intention of the legislature then it had clearly expressed such as CGST Act 2017 Sec 15(2)(d) wherein interest or late fee or *penalty for delayed payment* of any consideration of any supply is to be included into the value of supply. Third, adjustment in consideration will result into novation of contract, which requires agreement on the part of purchaser and supplier else the doctrine of failure will apply. Fourth, CGST Act 2017 Sec 15(1) expressly provides that where the supplier and recipient of the supply are not related the price will be the sole *consideration* for the supply which clearly signifies the presence of an express agreement and not the obligation which arises by operation of law as is the case with the obligation to pay damages in case of breach. Fifth, in case of breach of contract enabling the obligation for damages there is *failure to perform an act* rather than an *act of tolerating*. Sixth, the breach of condition may give rise to the right of repudiation as well as claiming of damages and by opting claim of damages only the purchaser is not

refraining or tolerating the repudiation rather it is the commercial expediency because in both the cases the supplier has got its right of payment for supplies made by it under the doctrine of quantum meruit [Indian Contract Act 1872 Sec 70]. Seventh, by treating the liquidated damages as consideration in case of capital equipments will require accounting of such consideration as other income instead of adjustment with value of the asset; which will be a contradiction to the ruling propounded in (2010) 11 SCC 84. Eighth, adding goods and service tax on the value of liquidated damages will cause the amount to go beyond the predetermined amount which will be a violation of Indian Contract Act 1872 Sec 74 for time being because the supplier will get the input tax credit at a later date.

Y] If the liquidated damage is to be treated as consideration then the requirement of agreement and quasi-contract need to be statutorily relaxed as well as toleration as provision of services need to be statutorily recognised.

Z] Hence, for the time being the liquidated damage is to be treated as compensation and should be kept outside the purview of declared services. Apart from the legality this measure will be appropriate for the reason that the intention of the agreeing party is for delivery without delay; had they intended the delay they would have sought an extended delivery period.

AA] In view of above discussion, it is respectfully submitted that the ruling given by Maharashtra Authority for Advance Ruling under GST [No.GST-ARA-15/2017-18/B-30 dated 8 May 2018]] and approval of the same by the Maharashtra Appellate Authority for Advance Ruling [MAH/AAAR/SS-RJ/09/2018-19 dated 11 Sep 2018] in re Maharashtra State Power Generation Co. Ltd. reported in (2018) 70 GST 411 that liquidated damages are considerations liable to be taxed under GST need to be reviewed at the earliest to give succour to already bleeding public sector undertakings who are mainly affected by this innovation.