TAXABILITY OF NOTICE PAY RECOVERY UNDER GST LAWS – AN ANALYSIS

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1.BACK GROUND:

Contractual agreement / appointment letter usually provides that an employee must serve a notice period upon giving a notice to resign from the employment. Intent of keeping this clause in the agreement / appointment letter is that the employer will have adequate time for making alternative arrangement for the resigned employee. It also provides that resigning employee can pay a certain amount which is known as **"notice pay"** in lieu of his obligation to serve the notice period (may be part or full period). Following are two important issues emerges

- Tax Departments are of the view that, this recovery of notice pay by employers / payment of notice pay by an employee is taxable under erstwhile Service Tax Law and also Goods and Service Tax Laws.
- Besides above many cases employee also claims that the amount paid / recovered by employer as "notice pay" is to be reduced from total salary received during a financial year and balance amount is taxable under income tax act.

As on today sufficient judicial precedents, Circular / clarification by the CBIC are not yet available which could put an end to the controversy / issues of taxability under both Income Tax Act and Goods and Service Tax Act.

This article analysed the provisions of both laws and available jurdiciary decisions on taxability of the "notice pay" in hands of employer and as well as employee.

2.LEGAL FRAMEWORK OF LAW AND JURDICIARY PRONOUNCEMENTS AND ANALYSIS

2.1.Related Provisions under Indian Contract Act

Employment contracts are made under the **Indian Contract Act, 1872**. A contract of employment is a bilateral agreement for the exchange of service and remuneration over a period of time. Like any other valid contract it must satisfy all the essential ingredients viz. offer, acceptance, consideration, competent parties, legal object and free consent etc. Such employment contract in the form of an appointment letter or agreement usually provides for the notice pay recovery.

It is worthwhile to reproduce Sec. 74 of the said Act as under:

> ***"74. Compensation for breach of contract where penalty stipulated for.—1 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."***

Notice pay is nothing but the amount stipulated in the employment contract for breach in serving the stipulated notice period. Since notice pay is a sum mutually agreed by the parties for breach of contract it can be regarded as a consideration flowing from the employment contract itself read with Sec. 74 of the Indian Contract Act, 1872 and not under any other separate contract wherein employer has agreed to refrain from doing any act against the concerned employee. Once notice pay recovery is stipulated in the contract, an

employer can only sue for recovery of such amount but cannot enforce mandatory serving of the notice period. Once it is concluded that an employer cannot enforce mandatory serving of the notice period such employer cannot be said to have refrain from an act of suing the employee for mandatory serving against the notice pay recovery. In such scenario notice pay recovered cannot be said to be a consideration against agreeing to the obligation to refrain from an act, or to tolerate an act

2.2. PROVISIONS RELATED TO RECOVERY OF NOTICE PAY UNDER FINANCE ACT 1994 / SERVICE TAX ACT.

Major amendment made in Service Tax Laws by way of introduction of negative list based taxation with effect from 1st July 2012. All the services were covered under the definition of service and were taxable, except the services listed in Negative list or services exempted vide mega exemption notification.

2.2.1.Section 65B (44) of Finance Act, 1994, definition of *service* reads 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)Xxxx*
>
> *(b)provision of service by an employee to the employer in the course of or in relation to his employment;*

In other words, the service provided by **employee to employer** in course of employment is excluded from service tax levy. However there is no such exclusion or exemption to the services provided by **employer to employee**. The same is also not covered in the exclusion limb of the service definition either and covers declared services in the definition of service, and declared services.

2.2.2. Section 66E (e) of Finance Act 1994 provides that:

> ***'agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act'***

When an employee reigned from service, either adequate notice for such resignation to be served or to pay equivalent salary for the notice period to the company or employer recover the same from his dues. It is pertinent to further examine, whether resigning and leaving employment by without servicing notice / or inadequate notice by which the employer **to tolerate an act or a situation** and payment or recovery of notice pay is liable for service tax.

The Service tax levy is an activity tax under negative list based taxation.. Service tax is leviable on service being **'any activity' for a consideration**. Though the employer is receiving / recovering a consideration, there is no activity done by such employer to the employee in exchange for consideration of notice period recovery. So one can argue that the fundamental premise of 'activity for a consideration' itself is not satisfied, in which case the Service tax levy may not be applicable.

2.2.3. Judiciary Pronouncements / Decisions under Service Tax Act:

2.2.3.1.In case of M/s. QX KPO Services Pvt Ltd vide Order in Appeal no. AHM-EXCUS-001-APP-0107-17-18 dated 29.09.2017, the Commissioner (Appeals) has held that no service tax is payable on notice pay recovery. **The relevant para of the said judgement reads as follows:**

> *9. At the onset, I will discuss the first issue; stating that as per the definition of service as envisaged under Section 65B(44)(b) of the Finance Act, 1994, the activity was carried out by one person to another for a consideration which is tolerating the act of the employees to leave the job without giving notice for the stipulated period and allowing the employees to leave the job. In view of the above, I find that the adjudicating authority has towed to the lines as prescribed in the amendments made in the Act w.e.f. 01.07.2012. in the new system, the word 'service' has been redefined under Section 65B(44) of the* ***Finance Act, 1994****. However, CBEC, in the month of June 2012, had introduced as 'Education Guide' in light of the new system. The said guide clarifies many queries that were supposed to erupt at the time of the amendments made in the Act w.e.f.*

01.07.2012. I would like to quote below a concerned paragraph from the said guide for clarification;

2.9 Provision of service by an employee to the employer is outside the ambit of service

***2.9.1** Are all services provided by an employer to the employee outside the ambit of services?*

No. Only services that are provided by the employee to the employer in the course of employment are outside the ambit of services. Services provided outside ambit of employment for a consideration would be a service. For example, if an employee provides his services on. contract basis to an associate company of the employer, then this would be treated as provision of service.

***2.9.2** Would services provided on contract basis by a person to another be treated as services in the course of employment?*

No. Services provided on contract basis i.e. principal-to-principal basis are not services provided in the course of employment.

***2.9.3** Would amounts received by an employee from the employer on premature termination of contract of employment be chargeable to service tax?*

No. Such amounts paid by the employer to the employee for premature termination of a contract of employment are treatable as amounts paid in relation to services provided by the employee to the employer in the course of employment.

Hence, amounts so paid would not be chargeable to service tax. However, any amount paid for not joining a competing business would be liable to be taxed being paid for providing the service of forbearance to act.

In view of the above, it now very clear that any payment made by either of the party to the other one would not be changeable to service tax. Thus, from the above, conclude that the process of payment made by the employees to the appellants, for termination of job before the completion of the agreed upon period, is not to be treated as a service has any act of consideration for retraining from any act or tolerating any act.

Therefore, I hold that demand of Rs. 86,576/- should be set aside in the interest of justice and the appellants should be given relief from payment of Service Tax along with interest and penalty.

2.2.3.2. In the case of **Gujarat State Fertilizers & Chemicals Ltd Vs Assistant Commissioner, Central Excise & Customs, Service Tax, Division-IV, Anand Commissionerate (Order-in-Appeal No. VAD-EXCUS-003-APP-392/2016-17 dated 20.10.2016),** the Commissioner (Appeals**)** has held that no service tax is leviable on notice pay recovery. But in the said judgement the Commissioner (A) has not given specific finding as to why tax is not payable.

2.2.3.3. In case of **Satya Developers Pvt Ltd, 2017 (3) G.S.T.L. 325 (Del.),** Hon'ble Delhi High Court has held that

"Thus a contract has to be construed by looking at the document as a whole and the meaning of the document has to be what the parties intended to give to the document keeping the background in mind and conclusion that flouts business commonsense must yield unless expressly stated". xxxxx

2.2.3.4.In case of ***Vimal Chand Ghevarchand Jain & Ors.* v. *Ramakant Eknath Jajoo* 2009 (5) SCC 713**, the Supreme Court reiterated the principle of construction of a **commercial contract by looking at the document as a whole and construing it in its entirety.**

2.2.3.5. In a recent decision (in November 2009) of ***M/s. HCL Learning Systems Vs CCE, Noida (Service Tax Appeal no. 70580 of 2018),*** **the Allahabad CESTAT** held that ***when amounts are recovered out of salary already paid, such amounts would not be subject to service tax as salaries are not subject to tax.***

From above decisions of different authorities under law, recovery of notice pay / payment of notice pay is not subject to levy of service tax.

2.3 POSITION OF TAXABILITY OF RECOVERY OF NOTICE PAY UNDER INCOME TAX ACT, 1061

2.3.1. Taxable Income - Section 15 of the Income Tax Act, 1961

It specifies the following kinds of income on which income tax is to be charged:

a. ***any salary due from an employer or a former employer to an assessee in the previous year, whether paid or not***
b. ***any salary paid or allowed to him in the previous year by or on behalf of an employer or a former employer though not due or before it became due to him***
c. ***any arrears of salary paid or allowed to him in the previous year by or on behalf of an employer or a former employer, if not charged to income-tax for any earlier previous year***

Such income is chargeable to income tax under the head 'Salaries'.

2.3.2. As per Section 16 of the Act, the income chargeable under the head "Salaries" shall be computed after making the following deductions:

a. *a deduction in respect of any allowance in the nature of an entertainment allowance specifically granted by an employer to the assessee who is in receipt of a salary from the Government, a sum equal to one fifth of his salary (exclusive of any allowance, benefit or other perquisite) or five thousand rupees, whichever is less*

b. ***a deduction of any sum paid by the assessee on account of a tax on employment within the meaning of Article 276(2) of the Constitution1, leviable by or under any law.***

Hence, salary received by an employee from his employer is subject to income tax as per the provisions of the Act. However when an employer deducts certain amount from his employee's salary if the employee leaves his employment without serving the notice period mentioned in the employment agreement / appointment letter, the issue is whether deductions made from the salary of employee who has not served notice period can be treated as income and subjected to tax.

2.3.3. The fact as well as decisions of **Nandinho Rebello *v.* Deputy Commissioner of Income-tax, Circle-14, Ahmedabad, [2017] 80 taxmann.com 297 (Ahmedabad - Trib.) / [2017] 164 ITD 440 (Ahmedabad-Trib.)** is reproduced below

Facts of the case: The assessee had resigned from two companies without serving notice period and therefore, both the companies deducted a notice pay of INR 1.10 lakh (USD 1716 approx.) and INR 1.66 lakh (USD 2589 approx.) respectively and handed the balance salary to the assesse. Since there was a deduction of INR 2.76 lakhs from his gross salary income, the assesse only showed his net receipt as income while filing his return. However, the income tax authorities denied such deduction on the ground that the Income Tax Act imposes charge when salary becomes due whether paid or not. Therefore, the income tax authorities sought to tax the entire salary due, that is, the salary without deductions. The AO passed an order without deduction of the notice pay recovered by the employer.

The assessee preferred appeal before the ld. CIT(A) who, after considering the submissions of the assessee, sustained the additions made by the Assessing Officer as under:-

> *"4.3 I have considered the order of the AO and the submissions made by the appellant in this regard. Income under the head 'salary' is computed in accordance with Section 15,16 v& 17 of Income-tax Act. As per Section 15, salary income is charged on the due basis whether paid or not.*

Accordingly, the AO has charged the salary to income-tax on due basis. The deduction allowed under the head 'salary' is provided under Section 16, which is as under:

"(ii) a deduction in respect of any allowance in the nature of an entertainment allowance specifically granted by an employer to the assessee who is in receipt of a salary from the Government, a sum equal to one fifth of his salary (exclusive of any allowance, benefit or other perquisite) or five thousand rupees, whichever is less;]

(iii) a deduction of any sum paid by the assessee on account of a tax on employment within the meaning of clause (2) of article 276 of the Constitution, leviable by or under any law.]"

Clearly the deduction made by the employer for the notice period is not provided in Section 16. The appellant's argument of the taxability of real income is not tenable as the doctrine of real income is inapplicable, because Section 15 of the I. T. Act imposes the charge when salary becomes due whether paid or not The deduction of notice period is essentially application of income, after it has become due. The Madras High Court in the case of CIT Vs. P. Natraja Shastri (1976) 104 ITR 295 has held that where remuneration has already accrued to assessee and it was waived, it was rightly brought to tax by the Assessing Officer. The appellant during the hearing has relied upon the decision of Bombay High Court in the case of Ramchandra Dhonde Datar Vs. CIT (1961) 43 ITR 22 (Bom). The above case-law is irrelevant to the fact of the case, as it relates to whether compensation paid by the employer for termination of the employment is taxable. The instant case is allowability of deduction made by the employer for the notice period. Accordingly, the ground of the appellant is dismissed."

Aggrieved, the assessee is now in appeal before this Tribunal.

Para 7. We have heard the ld. Departmental Representative and the perused the material available on record. We find that during the year under consideration the assessee served with Reliance Communication for 39 days for the period 01.04.2009 to 09.05.2009 and received a total salary of Rs.1,64,636/-, out of which Rs.1,10,550/- was recovered as notice pay as per agreement with the employer. Therefore, the assessee declared salary income of Rs.54,086/- after deducting notice pay of Rs.1,10,550/-. Thereafter, the assessee joined in Sistema Shyam Teleservices Ltd where he served for a period from 18.05.2009 to 24.02.2010 and received a total salary of Rs.13,95,880/- out of which Rs.1,66,194/- was deducted as notice pay as per agreement with employer. Therefore, notice pay of total Rs.2,76,744/- was claimed in the return of income as deduction which was recovered from the salary by assessee's previous employers as mentioned above. The Ld. CIT(A) was of the view that no such deduction is available under Section 16 of the Act and the salary income is taxable on due basis or on paid basis. After considering the facts as quoted above, we find that employers have made deduction from the salary which was paid to the assessee during the year under consideration because of leaving the services as per agreement made by the assessee and the respective employer. We find that this is a case of recovery of the salary which is already made to the assessee for which we have not to refer Section 16 of the Act as mentioned by the ld. CIT(A). It is pertinent to note that the assessee has actually received the salary from his previous employers after deducting the notice period as per the job agreement with them. Therefore, in our considered view, the actual salary received by the assessee is only taxable and therefore, we allow this ground of appeal of the assessee.

In view of above provisions of law, judiciary decisions during service tax era (pre GST) period the Notice Pay recovery / or paid by the employee may be concluded as not leviable to service tax and would be deducted for computation of taxable income under Income Tax Act, 1961.

2.4. POSITION OF TAXABILITY OF RECOVERY OF NOTICE PAY UNDER GOODS AND SERVICE TAX ACTS:

The relevant provisions of law are reproduced and analysed below.

2.4.1. Section 7 OF Central Goods and Service Tax Act: Scope of Supply

1. For the purposes of this Act, the expression **"supply" i**ncludes –

(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; and

(c) the activities specified in Schedule I, made or agreed to be made without a consideration;

(d) Omitted vide Notification No. 02/2019-CT dated 29.01.19

1(A) where certain activities or transactions constitute a supply in accordance with the provisions of sub-section (1), they shall be treated either as supply of goods or supply of services as referred to in Schedule II." (amended retrospective effect from 1.7.2017)

2. Notwithstanding anything contained in sub-section (1),—

(a) activities or transactions specified in Schedule III; or

(b) such activities or transactions undertaken by the Central Government, a State Government or any local authority in which they are engaged as public authorities, as may be notified by the Government on the recommendations of the Council, shall be treated neither as a supply of goods nor a supply of services.

3. xxxxxxx

***SCHEDULE III of Section 7 –** Activities or transactions which shall be treated as neither supply of goods nor supply of services.*

1. Services by an employee to the employer in the course of or in relation to his employment.

2.xxxx

From above, it is concluded that the levy under **CGST Act, 2017** is on **"supply"** of goods or services or both. The word "such as" used preceding the words sale, transfer, barter, exchange, etc. indicates that the forms of supply shall be those which are enumerated therein or of similar character but not other dissimilar forms of supply. The expression "such as" indicates the character of the transactions. Furthermore, the CGST (Amendment) Act, 2018 introduced sub section (1A) to Section 7 of the CGST Act, 2017 with retrospective effect 01-07-2017 in place of Section 7 (1)(d), which seeks to levy tax on certain declared "supply" of goods or services referred to in Schedule II of the CGST Act, 2017.

Besides above *Services by an employee to the employer in the course of or in relation to his employment are activities or transactions which shall be treated as neither supply of goods nor supply of services under* ***Schedule III of Section 7 of CGST Act 2017*** .

2.4.2. Clause 5(e) of schedule (II) to Section 7 of CGST Act is reproduced below.

"The following shall be treated as supply of 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;"

Whether any activity or transaction in question can be said to be covered under clause 5(e) of Schedule II to section 7 then it seeks to declare agreeing to the obligation to refrain from an act or tolerate an act or a situation or to do an act, as declared supply of services.

The said clause 5(e) has the following ingredients: –

- one party is under obligation, as agreed, to refrain from an act;
- one party is under obligation, as agreed, to tolerate an act or situation;
- one party is under obligation, as agreed, to do an act; all against consideration

The clause 5(e) treats an act of forbearance (refrain) or tolerating an act or situation where one of the parties is under obligation, as agreed upon, to forbear, refrain or tolerate an act or situation, against consideration.

2.2.3. **Section 2(31)(b) of CGST Act 2017 defines consideration** in relation to supply of goods and services or both and includes the monetary value of any act or forbearance. The word **"Service"** defined under **Section 2(104) of the CGST Act, 2017** means anything other than goods, money and securities. It is pertinent to understand before levy,

(i) whether the receipt or deduction of salary in lieu of notice period by an employee can be said to be consideration for an act of forbearance and

(ii) whether the act of accepting the resignation without contractual period of notice from an employee can be said to be an act of toleration.

The employee opting to resign by paying amount equivalent to month of salary in lieu of notice, has acted in accordance with the contract and that being the case no question of any forbearance or tolerance does arise. Further, as per the agreement, the resignation by the employee is not subject to any acceptance or approval and employee is free to tender his resignation, make payment of notice period salary to leave. Hence, there is neither any activity nor any passive role played by the employer. It must be noted here, that there is no consideration within the meaning of Sec.2(31)(b) of the CGST Act, 2017 flowing from an act of forbearance in as much as there is no breach of contract, as a question of any consideration for forbearance would arise in case of breach of contract.

2.2.4. Applicability of Decisions of Jurdiciary Authority under Finance Act 1994 to GST Regime:

The position of law vis vis the decisions related to Service Tax Regime as well as under Income Tax Act, 1961 have been explained above. Provisions of Section 66E (e) of Finance Act 1994 as well as Clause 5(e) of schedule (II) to Section 7 of CGST Act are the same and in view of similarity, the decisions as explained in detail at para 2.2.3 and 2.3.3. are equally applicable.

3. Conclusions:

So by taking into account the decisions as well as analysis, made in detail as above, it may be concluded that recovery of notice pay from dues of employee / payment of notice pay by the employee who could not serve the notice for the period as per contractual agreement / appointment letter may not attract levy of service tax or goods and service tax. It is also understood that there are much decisions of jurdiciary authorities are not available. However above issue is not free from litigation in view of action of department to levy service tax as well as GST on notice pay recovery during respective period of operation law. It is appropriate time for Department to come out with a Circular clarifying the position of law to avoid litigation and make the law assessee friendly.