dhruva advisors llp

Indirect Tax Alert

Date: July 17, 2020

Dimensions – 74th Edition

Judgment under Pre GST era

Commissioner of Service Tax v. *M/s Repco Home Finance Ltd.* [1]

Issue for Consideration

Can Service tax be levied by banks and non-banking financial companies (collectively referred as "banks") on the foreclosure charges collected for premature termination of loans under the service category of banking and other financial services ("BOFS") as defined under section 65(12) of the Finance Act, 1994 ("FA, 1994")?

Discussion

- The Respondent is engaged in the business of providing housing loans to its customers. The Respondent had collected charges ("foreclosure charges") from its customers for premature termination of loans and had not paid Service tax on such charges. The department had alleged that Service tax was payable on the same under the category of BOFS as per section 65(12) of the FA, 1994.
- The dispute came up before the Tribunal, wherein it was observed that there are conflicting decisions of the Tribunals on the subject matter, pronounced in the case of *Housing and Development Corporation ltd. ("HUDCO") v. Commissioner of Service Tax, Ahmedabad*[2] and *Magma Fincorp Ltd.* v. *Commissioner of Service tax, Kolkata*[3]. Accordingly, the impugned matter was referred to the Larger Bench ("LB") of the Tribunal.
- The LB noted the following contentions of the banks:
  - Foreclosure charges are not towards any 'consideration' for a service provided but to compensate the banks for breach of contract as the borrower unilaterally decides to cut short the period of loan premature, by making the payment before the stipulated time. This act of the borrower is against the interest of banks.
  - The bank, instead of claiming for damages for breach of contract, the amount (i.e. damages) is usually incorporated in the contract to provide a certainty in dealings.

[1] TS-506-CESTAT-2020-ST
[2] 2012 (26) STR 531 (Tri-Ahmd.)
[3] 2016 (4) TMI 21-CESTAT KOLKATA

- Therefore, foreclosure of the loan before the agreed time cannot be said to be a service taxable under BOFS since the foreclosure seeks to end the existing service.

- The LB observed that the department had contended as follows:
  - Foreclosure of loan is a facility available to the borrower at a price in the same way as other facilities are available to the borrower at a price.
  - Such charges are levied over and above the interest charged to the borrower and do not have the character of interest income. They cannot be regarded as penal interest since penal interest is chargeable only in case of default in making the regular payments and not for making payment before the stipulated period.

- The LB after taking into account the conflicting judgments of the Tribunals *(supra)* and of *Small Industries and Development Bank of India ("SIDBI")* v. *CCE, Chandigarh*[4] observed as follows:
  - As per section 66 of the FA, 1994 Service tax is to be levied at a specified rate on the **value of taxable service** referred to in various sub clauses of section 65(105) of the FA, 1994. Further, as per section 67 of the FA, 1994, there has to be a 'consideration' for provision of service. The term 'consideration' is defined in explanation to section 67 to include any amount payable for taxable services provided or any reimbursable expenditure. Also 'consideration' is couched in an inclusive definition.
  - The LB of the Tribunal in the case of *Bhayana Builders Pvt. Ltd.* v. *Commissioner of Service Tax*[5] observed that consideration, whether monetary or otherwise should flow from the service recipient to the service provider and should accrue to the benefit of the latter. Reference was made to the Supreme Court decisions in the case of *Commissioner of Service Tax Etc.* v. *Bhayana Builders Pvt Ltd.*[6] and *Union of India* v. *Intercontinental Consultants and Technocrats Pvt. Ltd.*[7] to understand the meaning of the term 'consideration'.
  - As per a judgment of the European Court of Justice[8] the amount charged has to necessarily be a consideration for the taxable service provided. There is a marked distinction between 'conditions to a contract' and 'consideration for a contract'. A service recipient may be required to fulfil certain conditions in a contract but that would not mean that this value would form part of the value of taxable services that are provided.
  - The term 'include' is used in interpretation clauses to enlarge the meaning of the words or phrases to not only signify their natural import but also things which interpretation clause declares to include. In this regard reliance was placed upon the judgment of *Dilworth* v. *Commissioner of Stamps*[9].
  - Para 2.2 of the Taxation of Services: An Education Guide[10] states that since the definition of consideration is inclusive it would not be out of place to refer to the definition of consideration as given in the Indian Contract Act, 1872.
  - The term 'consideration' as defined under the Indian Contract Act, 1872, states that consideration should flow at the desire of the promisor. The banks are the promisors and the customers are the promisees. The contractual relationship between them is repayment of the loan amount over the period agreed. As premature termination of loan results in loss of future interest income, the banks charge an amount for foreclosure to compensate for the interest income lost. This unilateral act of the borrower results in breach of loan agreement.

[4] 2011 (1) TMI 495 - CESTAT, NEW DELHI
[5] 2013 (32) S.T.R. 49 (Tri - LB)
[6] 2018 (2) TMI 1325 – Supreme Court
[7] 2018 (3) TMI 357 - Supreme Court
[8] *Societe Thermale d'Eugenic-les-Bains* v. *Ministere de v. l'Economie, des Finances et de l'Industrie* [Case-C-277/2005]
[9] 1899 AC 99
[10] TRU Circular dated June 20, 2012

A breach of contract may give rise to a claim for damages.

- Foreclosure charges are not a consideration for performance of lending services but are imposed as a condition of contract to compensate for loss of expectation interest. These charges seek to deter the borrowers from switching over to cheaper available sources of loan as has been held by the Reserve Bank of India vide circular dated June 26, 2012.
- Foreclosure of loan can prompt the promisor to claim damages. Reliance was placed upon the case of *M/s Hotel Vrinda Prakash and another* v. *KSFC and another*[11]. This aspect of damage is known as liquidated damages.
- Foreclosure charge clauses incorporated in the contract are for damages which can be enforced in the event there is a breach of contract to bring certainty. These clauses cannot give rise to any 'consideration'. These clauses come into effect only after the contract comes to end.
- Reference was made to section 74 of the Indian Contract Act, 1872 which comes into play when there is compensation payable for breach of contract, where penalty is stipulated in the contract.
- A penalty is a sum of money so stipulated in terrorem and liquidated damages are a genuine pre-estimate of damages. As per the law in India, there is no qualitative difference between liquidated and unliquidated damages. A genuine pre-estimate of damages is regarded as liquidated damages and is binding as per section 74 of the Indian Contract Act, 1872.
- Foreclosure charges are recovered as compensation for disruption of a service not towards 'lending service'. Processing charges or documentation charges or the like are subject to Service tax because they are essential for the activity of lending and treated as activities 'in relation to lending'. Foreclosure is anti-thesis to lending and cannot be construed to be 'in relation to lending'. The phrase 'in relation to lending' (in section 65(12) of the FA, 1994) cannot be stretched to include in its ambit even activities which terminate the activity. Reliance was placed upon the case of *Standard Chartered Bank* v. *Commissioner of Service Tax, Mumbai-I*[12].
- Foreclosure charges arise upon repudiation of specified terms of contract and intend to compensate the banks. They should not be viewed as 'alternative mode of performance'. Merely because the clause relating to damage is mentioned in the contract would not mean that the party has been given an option to violate the contract. Treating eventuality of foreclosure as an optional performance is not correct.
- The Tribunal in the case of HUDCO *(supra)* had held that there is an element of service involved in considering the request of the borrower for pre-payment of loan, fixing pre-payment of charges, collection and closure of loan. This is not acceptable since the amount of damages is clearly stipulated in the contract and no element of service is rendered by the banks to the borrowers.
- The contract has been broken by the borrowers for which banks are entitled to claim the damages. Foreclosure charges are nothing but damages which are claimed by the banks.
- The amendment in the definition of BOFS by adding "lending" is not relevant at all for determining taxability of foreclosure charges.

Judgment

Foreclosure charges collected by the banks are not leviable to Service tax under the category of BOFS.

Dhruva Comments:

The issue of taxability of foreclosure charges / liquidated damages is a long standing one traversing the three

[11] ILR 2008 KAR 1311
[12] 2015 (40) STR 104 (Tri-LB)

periods: positive list of taxation, negative list of taxation and GST. Whilst the current decision is rendered for the period when Service tax was levied based on specified categories of service, it would be interesting to evaluate whether the decision would continue to hold good under negative list regime and under GST regime.

Whilst this decision is not the last word on the subject since the department is likely to file an appeal against the same, nevertheless the same is welcome. The Tribunal judgment in case of *HUDCO (supra)* is appealed before the Gujarat High Court and remains sub-judice[13].

Judgments under GST era

M/s. Hero Motocorp Ltd. v. Union of India & Ors[14]

Issue for Consideration

Whether plea of promissory estoppel is invokable for reduction in incentives on account of new tax structure.

Discussion

- The Petitioner is engaged in the business of manufacturing of two wheelers in the State of Uttarakhand. Special packages of incentives[15] were announced in the year 2002 for promoting industrial development in the State of Uttarakhand. Under the scheme, new industrial units were provided a 100% Central Excise Duty Exemption for a period of ten years from the date of commencement of commercial production. To give effect to the policy, the Central Government issued a notification[16] ("the exemption notification") providing exemption on certain goods from levy of Excise duty or Additional Excise duty for certain units located in the State of Uttarakhand and Himachal Pradesh for a period of ten years.
- Being eligible for the aforesaid benefit, the Petitioner established a new industrial unit for manufacture of motor vehicles in the State of Uttarakhand. The Petitioner commenced production in the year 2008 and was eligible to avail exemption for ten years, i.e. till 2018.
- However, the exemption notification was withdrawn[17] on introduction of GST w.e.f. July 1, 2017. Recognising the financial hardships faced by the businesses a budgetary support scheme[18] ("BSS") was notified on recommendations of the GST Council ("the Council"). This support scheme provided reimbursements of Central Government's share of the cash component in the CGST and the IGST i.e. 58% of CGST and 29% of IGST.
- Aggrieved, the Petitioner filed a Writ Petition seeking complete exemption by way of reimbursement of CGST and IGST for the residual period in accordance with the exemption notification.
- After considering the facts of the case the Hon'ble High Court observed as follows:
  - The exemption notification granted benefits for a period of ten years to new industrial units and was under the Central Excise Act, 1944 ("the CE Act"). The CE Act stands repealed with the introduction of GST. Furthermore, the entire Indirect tax structure has been overhauled with the introduction of GST.
  - The tax structure prior to introduction of GST did not provide concurrent taxing powers to both the Centre and the States. The taxing powers were clearly delineated in the Union list and State list of the Constitution of India. By insertion of Article 246A of the Constitution of India, both the Parliament and the State Legislature were made competent to concurrently legislate the levy of GST.
  - The Parliament while repealing the earlier legislations, specifically provided that any exemptions or incentives should not be continued as a privilege if such notifications are

[13] Tax Appeal no. 410 of 2012
[14] W.P.(C) 505/2020 (High Court of Delhi, 2 March 2020)
[15] Office Memorandum no. 1(10)/2001-NER dated January 7, 2003 issued by Ministry of Commerce and Industry
[16] Notification No. 50/2003 - Central Excise dated June 10, 2003
[17] Notification No. 21/2017-Central Excise dated July 18, 2017
[18] Notification of Scheme of budgetary support under GST for units located in Uttarakhand etc. dated October 5, 2017 issued by Ministry of commerce and Industry.

rescinded on or after the appointed date. This objective has been enshrined in proviso to section 174(2)(c) of the CGST Act, 2017. Resultantly, various area-based exemption notifications including the exemption notification were withdrawn vide notification no. 21/2017-CE dated July 18, 2017 and the Petitioner lost all the privileges or exemptions enjoyed in the erstwhile regime.

– The Council in its second meeting took up the agenda regarding the treatment of existing tax incentives, wherein the Council reiterated its inability to continue with the exemptions provided. However, it recommended continuity of any existing incentive schemes to be administered by way of a reimbursement mechanism through the budgetary route. In line with the recommendation of the Council, the BSS was framed for eligible units located in certain States including the State of Uttarakhand.
– Under the BSS, eligible units could claim refund of taxes pertaining to the Union's share in the CGST (58%) and IGST (29%). There is a fundamental fallacy in the Petitioner's argument to claim 100% benefit and the Petitioner does not have any vested right to be entitled to budgetary support of the entire CGST and IGST. The policy granting area-based exemption has undergone a complete change and is no longer in force and one cannot selectively concentrate on benefits under policies no longer in force. Furthermore, the GST law also entitles the Petitioner to avail input tax credit ("ITC") of all taxes and cross-utilisation thereof.
– Reliance was placed on the Report of the Task Force dated December 15, 2009 which stated that area-based exemptions create economic distortions and recommended that such exemptions should not continue under the GST framework.
– The Government decided to grandfather the incentives provided to specific industries under the existing industrial policy of the States, or through a scheme of the Government and this resulted in a completely new tax structure known as the GST. The Court rejected the argument of the Petitioner and held that the argument that the policy decision of 2003 should prevail and is enforceable is not correct.
– The 100% exemption under the industrial policy was envisaged under the erstwhile regime and due to the change in structure of taxes the policy can no longer be invoked. Therefore, the exemption notifications issued implementing the said policy also have lost the mandate.
– Mere acknowledgment of difficulties faced, and the consequent introduction of the BSS cannot entitle the Petitioners to insist on grant of entire fiscal benefits originally envisaged. Furthermore, the BSS is not in lieu of the exemptions granted under the previous fiscal incentive schemes. Recognition of hardships faced due to withdrawal of exemption notifications cannot be understood or categorised as an admission of any such right in favour of the Petitioner.
– Moreover, the Petitioner's argument of having a vested right is not tenable as the fiscal benefits promised in return for making investments were privileges granted under the law which is no longer applicable. Rights and obligations under the erstwhile regime cannot stay alive if the entire legislation has undergone a change with introduction of GST.
– The Court observed that the partial tax budgetary support is not irrational or arbitrary in as much as the share of CGST and IGST to the extent of 58% and 29% is based on the recommendations contained in the 14th Finance Commission Report regarding sharing of the Union Tax Revenue. Furthermore, the rationale of providing support to the extent of Central Government's share of the CGST and the IGST is also based on reasoning which cannot be questioned by the Petitioner.
– Placing reliance on Article 279A of the Constitution of India, the Court observed that the Central Government would not only not pocket any tax from the assessee, it would also be out of pocket to the extent the collected tax

devolves upon the States. The States were not bound to take a cut on the tax collected from the assessee under any statute or any equitable principle such as promissory estoppel.

– The Court dismissed the argument of the Petitioner that a revenue sharing mechanism existed even in the erstwhile regime and, therefore, that cannot be the rationale behind the restriction of the budgetary support to the extent of the Central Government share therein. The Court also observed that the revenue sharing mechanism had been recommended by the Finance Commission and the rationale for fixing 58% has a reasonable nexus to the support extended under the BSS.
– The Court distinguished the reliance placed by the Petitioner on judgment in the case of *K. M. Refineries and Infraspace Pvt. Ltd.* v. *The State of Maharashtra and 3 Ors.*[19] wherein the judiciary was dealing with only an executive order, whereas the present case involves withdrawal of exemption by a legislative fiat of the Parliament.
– The Court further emphasised that the issue of invocation of the doctrine of promissory estoppel against a legislative act in light of section 174(2)(c) of the CGST Act, 2017 has been firmly established in a number of judgments. The Court observed that the plea of promissory estoppel cannot be enforced against an act done in accordance with the statutory provisions of law. Reliance was placed upon the Supreme Court decisions in the case of *Shree Sidhbali Steels Ltd. And Others* v. *State of U.P. and Others*[20] and *I.T.C. Bhalachandran Paperboards and Another* v. *Mandal Revenue Officer, A.P. and Others*[21].
– Furthermore, in the absence of any challenge by the Petitioner to the rescission of the exemption notification or to the vires of the proviso to section 174 (2) (c) of the CGST Act, no plea of promissory estoppel is maintainable.
– The language used in the proviso to section 174 (2) (c) is clear and unequivocal and leaves no room for any different interpretation.

Judgment

The Hon'ble High Court dismissed the Writ Petition filed by the Petitioner.

Dhruva Comments:

Doctrine of promissory estoppel does not apply when the act is done in pursuance to statutory provisions of law. The Court highlighted a distinction between the action consequent to an executive order and action pursuant to a legislative fiat of the Parliament.

[19] TS-627-HC-2019(BOM)-VAT
[20] (2011) 3 SCC 193
[21] (1996) 6 SCC 634

ADDRESSES

Mumbai
11th Floor, One IndiaBulls Centre,
Tower 2B, 841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road,
Ahmedabad 380 015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru 560 001
Tel: +91-80-4660 2500

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana 122 002
Tel: +91-124-668 7000

Pune
305, Pride Gateway, Near D-Mart, Baner,
Pune 411 045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal 700016
Tel: +91-33-66371000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #11-05
Singapore 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
U-Bora Tower 2, 11th Floor, Office 1101
Business Bay P.O. Box 127165
Dubai, UAE
Tel: + 971 56 900 5849

KEY CONTACTS

Dinesh Kanabar
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Ritesh Kanodia
ritesh.kanodia@dhruvaadvisors.com

Niraj Bagri
niraj.bagri@dhruvaadvisors.com

Ranjeet Mahtani
ranjeet.mahtani@dhruvaadvisors.com

WTS Dhruva Consultants recognised as **Best Newcomer Firm of the Year 2020 Europe** - International Tax Review

"India Tax Firm of the Year" 2017, 2018, and 2019 - International Tax Review's Asia Tax Awards

"India Tax Disputes and Litigation Firm of the Year" 2018 - International Tax Review's Asia Tax Awards

Dhruva Advisors has been consistently recognised as a **Tier 1 Firm in India for General Corporate Tax** by the International Tax Review's in its World Tax Guide.

Dhruva Advisors has also been consistently recognised as a **Tier 1 Firm in India for its Transfer Pricing practice** in the International Tax Review's Transfer Pricing Guide.

Dhruva Advisors in 2019 for the first time ranked as a **Tier 1 Firm in India for Indirect Taxes** in International Tax Review's Indirect Tax Guide.

Best Newcomer of the Year 2016 - ASIA - International Tax Review's Asia Tax Awards