THE MAHARASHTRA APPELLATE AUTHORITY FOR ADVANCE RULING FOR GOODS AND SERVICES TAX

(constituted under Section 99 of the Maharashtra Goods and Services Tax Act, 2017)

ORDER NO. MAH/AAAR/SS-RJ/24/2018-19 Date- 14.03.2019

BEFORE THE BENCH OF

(1) Smt. Sungita Sharma, MEMBER

(2) Shri RajivJalota, MEMBER

| | |
|---|---|
| GSTIN Number | 27AABCB1518L1ZS |
| Legal Name of Appellant | Bajaj Finance Limited |
| Registered Address | 3rd Floor, Panchshil Tech Park, Viman Nagar, Pune-411 014. |
| Details of appeal | Appeal No. MAH/GST-AAAR-24/2018-19 dated 14.12.2018against Advance Ruling No. GST-ARA-22/2018-19/B-85 dated 06.08.2018 |
| Jurisdictional Officer | State Tax Officer (VAT-C-707) Pune |

PROCEEDINGS

(under Section 101 of the Central Goods and Services Tax Act, 2017 and the Maharashtra Goods and Services Tax Act, 2017)

At the outset, we would like to make it clear that the provisions of both the CGST Act and the MGST Act are the same except for certain provisions. Therefore, unless a mention is specifically made to such dissimilar provisions, a reference to the CGST Act would also mean a reference to the same provisions under the MGST Act.

The present appeal has been filed under Section 100 of the Central Goods and Services Tax Act, 2017 and the Maharashtra Goods and Services Tax Act, 2017 [hereinafter referred to as "the CGST Act and MGST Act"] by Bajaj Finance Limited(herein after referred to as the "Appellant") against the Advance Ruling No. GST-ARA-22/2018-19/B-85 dated 06.08.2018.

## BRIEF FACTS OF THE CASE

A. The Appellant is a non-banking financial company and is *inter alia* engaged in providing various types of loans to the customers such as auto loans, loans against the property, personal loans, consumer durable goods loans, etc.

B. The Appellant, *inter alia,* enters into agreements with borrowers/customers for providing loans to them. The loan agreements provide for repayment of the outstanding dues/Equated Monthly Installments (EMI) through cheque/ Electronic Clearing System ('ECS')/ National Automated Clearing House ('NACH') or any other electronic or clearing mandate. The illustrative copies of loan agreement entered into between the Appellant and the customers have been enclosed with the Appeal.

C. The installment of a loan is computed taking into consideration the amount of loan, rate of interest, duration for a loan etc. Generally, EMI paid by the customer is a fixed amount paid at a specified date. EMI includes the amount of interest and the principal amount.

D. In case of delay in repayment of EMI by the customers, the Appellant collects penal/default interest (hereinafter referred to as '**penal interest**') as an additional interest for the number of days of delay as per terms of the agreements executed with the customers. The penal interest is calculated at a fixed percentage on the overdue loan amounts of the customer. The percentage of penal interest varies from customer to customer, and generally ranges between 2% to 4% per month depending on the product.The illustrative copies of customer account statement reflecting the penal interest collected by the Appellant have been enclosed with the Appeal. Further, the sample working of the penal interest is also enclosed herewith.

E. The relevant extract of clauses of a sample auto loan agreement in respect of penal interest is reproduced below for ease of reference:

*"I. DEFINITIONS AND ABBREVIATIONS:*

***r. "Penal Charges"** shall mean and include overdue charges on non-payment of installment on the due date.*

*II. TERMS OF THE LOAN:*

*3. The Borrower agrees and confirms that:*

.....

*(iv) BFL is entitled to levy penalty as follows on default:*

***(a) for continuing non-payment of amount due, a penalty not exceeding 3% per month on amount due calculated on pro-rata basis from due date till actually paid as per clause B of the schedule.***

.....

***Schedule forming part of Auto Loan agreement:***

***(B) Penal Charges for bounce up to Rs. 350/- per default / per month & late payment penalty not exceeding 3% on amount due."***

F. The amount of penal interest collected from the customers are accounted by the Appellant in its core accounting platform i.e. SAP under General Ledger Code 60000150.

G. Under the GST law, the Appellant is of the view that penal interest collected from the customer is in the nature of additional interest, and therefore, the same is not subjected to GST levy. However, considering the ambiguity on taxability under the GST law, as an abundant caution, the Appellant had filed an application for Advance Ruling before the Maharashtra Authority for Advance Ruling (hereinafter referred to the '**Ld. AAR**') on 09.05.2018, on the following questions:

*"i) Whether the Penal Interest is to be treated as interest for the purpose of exemption under Sr. No. 27 of Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017, Sr. No. 27 of Maharashtra State Notification No. 12/2017-State Tax (Rate) dated 29.06.2017, and Sr. No. 28 of Notification No. 9/2017-Integrated Tax (Rate) dated 28.06.2017?*

*ii) If the answer to the above is negative, whether the activity of collecting penal interest by the Appellant would amount to a taxable supply under the GST regime?"*

H. The AAR passed the Order No. GST-ARA-21/2018-19/B-24 dated 06.08.2018 (hereinafter referred to as '**impugned order**'), holding that the penal interest charged by the Appellant amounts to supply of services under Sr. No. 5(e) of Schedule II to the CGST Act, and is therefore liable to GST.

I. Aggrieved by the impugned order dated 06.08.2018, the Appellant has filed this appeal, *inter alia,* on the following grounds which are urged without prejudice to each other.

## GROUNDS OF APPEAL

1. **The impugned AAR order is a non-speaking order and is liable to be set aside on this ground alone.**

   (i) Without prejudice to the submissions that the penal interest is an additional interest on loan, such penal interest is liable to be included in the value of main supply under Section 15(2)(d) of the CGST Act, and therefore, any treatment given to the main supply shall be given to the penal interest, and hence, shall be exempt from GST.

   (ii) In any case, the penal interest charged by the Appellant is in the nature of penalty or liquidated damages for breach of contract, which does not amount to consideration for any contract, and therefore, there cannot be any supply of service.

   (iii) Penal interest collected by the Appellant for the breach of contract by the customer, is not covered under the ambit of clause (e) of Entry 5 of Schedule II to the CGST Act. The said clause can be made applicable only when there is an agreement to the obligation to tolerate an act or situation, and the word 'obligation' implies a duty or a liability on the person making the obligation, with a corresponding right to the other person to enforce such obligation. However, in the present case, there is no obligation upon the Appellant to tolerate an act of non-payment or delayed payment by the borrower. The payment of penal interest neither obligates the Appellant not to take any legal action against the borrower, nor the borrower gains any right to sue the Appellant for any legal action taken by the Appellant. Therefore, the penal interest payable by the borrower on breach of its contractual obligation cannot be treated as a payment for any obligation on the Appellant towards the borrower.

(iv) Even internationally, the damages received by way of compensation for termination or breach of a contract are not treated as a supply and therefore not subjected to GST/VAT levy.

2. It is submitted that the above submissions are very crucial to determine whether the penal interest collected by the Appellant is liable to GST. However, the impugned AAR order is completely silent on the above submissions and fails to provide any reasons/observations for not accepting the same.

3. While passing the impugned AAR order, the Ld. AAR was under an obligation to consider each and every submission of the Appellant and record the reasons for acceptance or rejection of every submission of the Appellant, in order to establish the linkage between the facts, and grant sanctity to the order. In this regard, reliance is placed on the following judgements of the Apex Court:

- **State of Orissa v. DhaniramLuhar, (2004) 5 SCC 568**
- **Oryx Fisheries Pvt. Ltd. v. Union of India, 2011 (266) E.LT. 422 (S.C.)**
- **Asstt. Commr., Commercial Tax Department v. Shukla & Brothers, 2010-TIOL-131-SC-CT**
- **Commissioner of CGST & Central Excise v. M/s Development Credit Bank Ltd., 2018-TIOL-2313-HC-MUM-CX**

4. It is an undisputed fact that the Appellant is an NBFC which is engaged in providing various types of loans to the customers such as auto loans, loan against property, personal loan, consumer durable goods loan, etc. Further, it is also undisputed that interest on loans have been kept outside the levy of GST, under Serial No. 27 of the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017. The relevant portion of the said Exemption Notification is reproduced herein below:

| *Sl. No.* | *Chapter, Section, Heading, Group or Service Code (Tariff)* | *Description of Services* | *Rate (per cent.)* | *Condition* |
|---|---|---|---|---|
| *(1)* | *(2)* | *(3)* | *(4)* | *(5)* |

| | | | | |
|---|---|---|---|---|
| *27* | *Heading 9971* | *Services by way of—*<br>*(a) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount*<br>*(other than interest involved in credit card services);* | *Nil* | *Nil* |

5. In view of the above, it is submitted that services of providing loans are exempt, in so far as the consideration of the said services is represented by way of interest. It is therefore submitted that any amount which is charged as interest is not taxable.

6. In the above background, it is important to understand whether the penal interest charged/collected by the Appellant in the present case, qualifies as "interest". The same has been explained in the submissions made herein below.

**Meaning of the term 'interest'**

7. The term 'interest' has been defined under clause (zk) of para 2 of the above said Exemption Notification, which reads as under:

> *"(zk) **"interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred** (including a deposit, claim or other similar right or obligation) but does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised;"*

8. The above definition clearly states that 'interest' means interest payable in any manner in respect of any moneys borrowed or debt incurred. This would not only include the normal interest charged on loan instalments, but also include the interest charged for the delayed payment of such loan instalments.

9. Further, the term 'interest' has been discussed at length by various Courts holding that interest is the return or compensation for the use or retention by one person, of a sum of money belonging to or owed to another.In this regard, reliance is placed on the Supreme Court judgment in the case of **Central Bank of India v. Ravindra, 2002**

(1) SCC 367, wherein the Hon'ble Supreme Court dealing with the nature of 'interest', has held as under:

*"Black's Law Dictionary (7th Edn.) defines "interest" inter alia as the compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use; especially, the amount owed to a lender in return for the use of the borrowed money. According to Stroud's Judicial Dictionary of Words and Phrases (5th Edn.) interest means, inter alia, compensation paid by the borrower to the lender for deprivation of the use of the money. In Secy., Irrigation, Deptt. Govt. of Orissa v. G.C. Roy the Constitution Bench opined that a person deprived of the use of money to which he is legitimately entitled has a right to be compensated for the deprivation, call it by any name. It may be called interest, compensation or damages.....this is the principle of Section 34 of the Civil Procedure Code. In Sham LalNarula (Dr.) v. CIT this Court held that interest is paid for the deprivation of the use of the money. The essence of interest in the opinion of Lord Wright in Riches v. Westminster Bank Ltd. All ER at p. 472 is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had the use of the money, or, conversely, the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for the deprivation; the money due to the creditor was not paid, or in other words, was withheld from him by the debtor after the time when payment should have been made in breach of his legal rights, and interest was a compensation whether the compensation was liquidated under an agreement or statute. A Division Bench of the High Court of Punjab speaking through Tek Chand J. in CIT v. Dr. Sham LalNarula thus articulated the concept of interest (AIR p. 414, para 8).*

*"The words 'interest' and 'compensation' are sometimes used interchangeably and on other occasions they have distinct connotation. **'Interest' in general terms is the return or compensation for the use or retention by one person of a sum of money belonging to or owed to another. In its narrow sense,***

*'interest' is understood to mean the amount which one has contracted to pay for use of borrowed money..... In whatever category 'interest' in a particular case may be put, it is a consideration paid either for the use of money or for forbearance in demanding it after it has fallen due, and thus, it is a charge for the use or forbearance of money. In this sense, it is a compensation allowed by law or fixed by parties, or permitted by custom or usage, for use of money, belonging to another, or for the delay in paying money after it has become payable". It is the appeal against this decision of the Punjab High Court which was dismissed by the Supreme Court in Dr. Sham LalNarula case."*

10. Reliance is also placed on the judgment of the Hon'ble Madras High Court in the case of **EdupugantiPitchayya and Ors. v. GonuguntlaVenkataRanga Row, AIR 1944 (Mad) 243**,whereinthe issue under consideration was whether any amount paid over and above the principal amount could be treated as interest. In this regard, the Hon'ble Madras High Court interpreted the word interest as under:

*".....Halsbury's Laws of England, Vol. 23, Section 253 defines interest as follows:**Interest when considered in relation to money denotes the return or consideration or compensation for the use or retention by one party of a sum of money or other property belonging to another.***

*.....The definition of interest in the English Money-lenders' Act, after excluding certain charges, says:*

***But save as aforesaid, interest includes any amount, by whatsoever name called, in excess of the "principal paid or payable to a money-lender in consideration of or otherwise in respect of a loan.***

*The word interest has a basic meaning of advantage or profit. When used with reference to a loan, interest means the profit or advantage of the creditor which he gets by giving to another the use of his money. If the contract stipulates that for the use of the creditor's money a certain profit shall be payable to the creditor, that profit is interest, by whatever name it is called, or if it is called by no name at all. Applying Act 4 of 1938 to the present*

*contract it is clear that the principal is Rs.2500. The only payment was an open payment of Rs.150 made on 23rd July 1931. The whole of the interest as on 1st October 1937 is cancelled and the creditor is entitled to Rs.2350 with interest at 6.25 per cent per annum from 1st October 1937. The Appellants are entitled to their costs here and in the Court below."*

Similarly, in the case of **V. Srinivasachariar v. ConjeevaramHodgsonpetDharamarakshakaNidhi Limited, 1940 AIR (Mad) 937,** the Hon'ble Madras High Court held as under:

*"3.....I proceed therefore to such an examination and I find that towards the sum of Rs. 1,500 borrowed in February, 1927, a sum of Rs. 1,396-3-3 has been credited as part repayment. The suit is for the balance, namely, Rs. 807-13-2 and the accounts have been closed shortly before the filing of the suit in March, 1932. The result then is that for a debt of Rs. 1,500 incurred in February, 1927, a total sum of Rs. 1,396-3-3 plus Rs. 807-13-2, that is, Rs. 2,204-0-5 has to be repaid and this repayment is related to a period of just over five years. Of this sum, Rs. 1,500 of course represents the principal and the remaining Rs. 704 represents what is claimable in addition to the principal. It is argued for the respondent that this may not be interest in the strict sense of the word because of the provision relating to the monthly payment of subscriptions. But when we probe into the heart of the transaction it seems to me clear that is in all respects analogous to the payment of interest.* ***When money is borrowed and a larger sum is to be repaid the excess over the principal must in my opinion be treated as interest.*** *Therefore, in this matter the sum of Rs. 704 represents the interest charged under the terms of this bond on a debt of Rs. 1,500 for a period of just over five years. Arithmetical calculation will show that this interest represents a rate of slightly more than 9 per cent, per annum. It seems to me therefore that with respect to the present claim as the interest works out at more than 9 per cent, per annum the respondent cannot successfully argue that Section 10(2)(iii) applies."*

11. From the above judgments, it comes out clearly that any consideration received in lieu of money is nothing but interest only. Further, interest when considered in relation to money denotes the return or consideration or compensation for the use or retention by one party of a sum of money or other property belonging to another, and any amount repaid over and above the principal sum of money is interest only.

12. It is relevant to note that the position in the GST regime is similar to the position in the pre-GST regime. Therefore, reference is also made to para 4.14.2 of the Revised Education Guide on Taxation of Services dated 20.06.2012 issued by the CBEC, which describes interest as the time value of money. The relevant portion of the same is reproduced herein below:

> *"**4.14.2 What are the "services by way of extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount"?***
>
> *The negative list entry covers any such service wherein moneys due are allowed to be used or retained on payment of interest or on a discount. The words used are 'deposits, loans or advances' and have to be taken in the generic sense. They would cover any facility by which **an amount of money is lent or allowed to be used or retained on payment of what is commonly called the time value of money which could be in the form of an interest or a discount.** This entry would not cover investments by way of equity or any other manner where the investor is entitled to a share of profit.*
>
> *Illustrations of such services are -*
>
> ♦ .....
>
> ♦ *Providing a loan or overdraft facility or a credit limit facility in consideration for payment of interest.*
>
> ♦ *Mortgages or loans with a collateral security to the extent that the consideration for advancing such loans or advances are represented by way of interest.*
>
> ♦ ....."

13. On conjunctive perusal of the above, it can be understood that "interest" represents the time value of money, and any amount received in lieu of usage or retention by one person of a sum of money belonging to another is nothing but interest only.

14. In the present case, the Appellant is primarily engaged in the business of lending/financing. As a consideration for lending/financing, the Appellant charges interest from the customers at a particular rate, for the period for which such loan is granted. The principal and interest amount on such loan is repaid by the customers by way of equated monthly installments (hereinafter referred to as '**EMI**') over the tenure of loan. Accordingly, while computing the EMI, the Appellant charges and factors pro-rata interest payable on each due date, on the underlying assumption that the customers would not default in payment of the EMI on the due dates. However, in case of any default, the Appellant charges additional interest for the number of days of default. This interest is commonly known as penal/default interest. The sample working of computing the penal interest was enclosed. For ease of reference, the following illustration is made to explain the manner of charging penal interest:

| S. No. | Particulars | Amount |
|---|---|---|
| A | EMI Amount | Rs. 10,000/- |
| B | EMI Due Date | 10th of every month |
| C | Due Date for the month of June 2018 | 10th June 2018 |
| D | Interest factored in EMI upto due date | Rs. 3,000/- |
| E | Actual Date of Payment | 30th June 2018 |
| F | Period of Delay/Default | 20 days |
| G | Penal Interest rate | 2% p.m. |
| **H** | **Penal Interest for the period of delay** (Rs.10000 * 2% * 20/30) | **Rs. 133/-** |

15. The manner of computing Penal Interest, as explained in the above illustration, substantiates that the Penal Interest collected by the Appellant is an additional interest for the delay in payment of loan instalment beyond the due date. It is nothing but the consideration for the usage or retention of money (i.e. overdue loan instalment) by the borrowers for additional time beyond the stipulated time period (i.e. the due date).

16. In other words, Penal Interest reflects the time value of money. To explain further, it is submitted that where the Appellant grants loan to a customer for a specified duration of time, they earn interest on such loan, which represents consideration for use of money for that specified period of time. Similarly, when the customer delays the payment of instalment of loan beyond the due date as provided in the agreement, the Appellant levies additional interest (which is termed as Penal Interest) for use of the money beyond the stipulated period of time by the borrowers. Therefore, penal interest is nothing but interest only.

17. It is further submitted that there is no distinction in law for 'principal interest' and 'penal interest'. The definition of the term 'interest' given in clause (zk) of para 2 of the Exemption Notification covers interest payable in any manner, and therefore, even the penal interest is covered within the scope of 'interest' for the purposes of the GST law, and hence, the same shall be exempt from GST.

18. However, the Ld. AAR in the impugned AAR order has held that the penal interest is not interest on loans. In this regard, the Ld. AAR has recorded a finding that the penal interest has been termed as 'penalty' in the loan agreements entered into by the Appellant.

19. It is submitted in this regard that the additional interest for the period of default has been variedly termed in the loan agreements as 'penal interest' / 'default interest' / 'late payment penalty', however, the same does not change its nature from being 'interest' only. It is a settled principle in law that the nomenclature alone would not determine the nature of transaction. In this regard, reliance is placed on the decision of the Hon'ble Supreme Court in the case of **Moped India Limited reported at 1986 (23) ELT 8 (SC)**, wherein it was held as under:

> *"6. ....Now it is true that this amount allowed to the dealers has been referred to in the agreement as commission but the label given by the*

***parties cannot be determinative because it is, for the court to decide whether the amount is trade discount or not, whatever be the name given to it. ...***"

20. Reliance is also placed on **Hindustan Gas & Industries Ltd. v. CCE, reported at 1991 (54) E.L.T. 383 (Tri.)**, wherein the Hon'ble Tribunal observed as under:

*"14. ... We further observe that it was only because the margins allowed to the agents were considered as commissions, the deductions were disallowed. Where the appellants do not retain the title to the goods and actually sell them, be it to Commission Agents discounts, should be admissible. We have noted the ld. advocate's argument that it is the real substance of the transaction that matters and not the nomenclature given to a particular type of discount."*

21. It is therefore submitted that the mere fact that the additional interest for the period of default has been termed as penalty, will not alter the nature of such transaction.

22. It is further submitted that the amount of overdue loan instalment on default would be 'virtually treated as a new loan transaction under the same contract', and the penal interest so charged on the overdue loan instalment would be treated as interest for such loan amount. In the above illustration, the defaulted loan instalment / EMI of Rs. 10,000/- is, in effect, an additional loan given to the customer, for which penal interest is charged at a specified rate, for the period starting from the date of default till the date of payment of such defaulted EMI, i.e., from 10th June 2018 to 30th June 2018. Hence, in any case, the penal interest charged by the Appellant would be treated as interest only.

23. However, the Ld. AAR in the impugned order held that penal interest cannot be construed as additional interest. In this regard, the Ld. AAR recorded a finding that normally, interest is calculated on the entire tenure of loan given and not on monthly basis, therefore, it cannot be said that the penal interest is for the period of delay not included in the EMI/instalment amount. The Ld. AAR further recorded a finding that rate of interest of loan and the penal interest is different, and in general course of business, the interest charges are fixed at a certain rate, however, the penal interest has been defined in the loan agreement to be "not exceeding 3% per

month". The Ld. AAR further recorded a finding that the penal interest which is termed as additional interest is also levied on the interest component of the EMI.

24. The above findings are based on an incorrect understanding of the facts of the present case. In this regard, it is relevant to note that the Ld. AAR has not disputed that the interest which is factored in EMI fits into the meaning and scope of interest of loans, therefore, the rate at which such interest is payable is not relevant to determine the nature of such transaction. The Ld. AAR has failed to understand the commercial reality of the financial transactions. It is submitted in this regard, that there are many ways of determination of the rate of interest, which includes flat interest rate, reducing balance rate, etc. However, in any case, the interest is, in effect, the consideration for the usage of money for a certain period of time, therefore, even if the interest is computed at flat rate, (i.e. interest for the entire tenure divided by the number of instalments), the same is charged only for the period of usage of money. Further, the rate of interest on loans, amongst other factors, is a matter of negotiation between the lender and the customer, but the same in no manner affects the nature of such interest. For instance, whether a loan is given for 10% flat rate of interest or 15% reducing rate of interest, would not alter the nature of the interest on such loan. Therefore, the Ld. AAR has erred in recording the finding that since interest is computed for the entire period of loan, the penal interest cannot be treated to be the interest for the period of default.

25. It is further submitted that the mere fact that the rate of interest and penal interest is different does not alter the nature of the transaction. It is submitted in this regard that the rate at which penal interest is charged from the customers is a matter of discretion of the lender, and depends on various factors such as the customer credit history, credit worthiness, past payment records, etc. Therefore, the mere difference in the rate of normal interest and penal interest cannot be taken as a factor for distinguishing the nature of interest and penal interest. Further, though the loan agreements entered by the Appellant with customers in certain cases define the penal interest as "not exceeding 3% per month", however, the customer account statements clearly evidence that the penal interest is charged at a fixed rate. Therefore, the findings of the Ld. AAR in this regard are erroneous.

26. It is further submitted that the manner of computing penal interest clearly substantiates that it is nothing but time value of money which is interest only. It is undisputed that penal interest is charged only upon default of payment of the EMI, and it is also undisputed that the same is calculated at a specified rate on the defaulted EMI for the period starting from the date of default till the date of payment of such EMI. Further, such interest for the period beyond the due date is not factored in the EMI and is therefore charged separately as penal interest. These facts clearly establish that the penal interest charged by the Appellant is nothing but an additional interest for the period of delay in making payment of the EMI. Further, the Ld. AAR himself has admitted that penal interest is levied on the interest component of the EMI. This also substantiates that the defaulted EMI (principal and interest) virtually amounts to a new loan, in as much as penal interest is charged on the defaulted EMI (which is inclusive of interest) for the period of default. Hence, the penal interest shall be treated as interest only, and therefore, the above mentioned findings of the Ld. AAR are erroneous and bad in law.

27. In view of the above discussions, it is submitted that Penal Interest collected by the Appellant is additional interest only, therefore, any treatment given to the main consideration, i.e. interest on loans, shall also be equally applicable to the penal interest. Hence, the penal interest shall be exempted from payment of GST under the Exemption Notification.

28. In this regard, reference is also made to **UK VAT Notice 701/49: Finance** issued under the UK VAT law, wherein the charges levied for deferment of payment beyond the time of supply have been treated as consideration for an exempt supply of credit. The relevant portion of the said UK VAT Notice is extracted herein below:

*"**4.5 Deferred payments-**You may allow customers to defer payment but make an extra charge for allowing them to do so. If the charge relates to periods before and up to the time of the supply (see VAT Notice 700: the VAT Guide) it is not a charge for credit, but is further consideration for the supply of the goods or services. Alternatively, where you agree to defer payment beyond the time of supply and make an additional charge for doing so, such a charge will be consideration for an exempt supply of credit."*

29. It is submitted that even internationally, the charges for deferment of payment are treated as consideration for exempt supply of credit. It is submitted that though the foreign case laws are not binding, but they have persuasive value for deciding the matters similar to them. Therefore, the penal interest charged in the present case for deferment of the loan instalment should be treated as a consideration for exempt supply of loan, and hence, shall not be leviable to GST.

**In any case, penal interest is liable to be included in the value of main supply under Section 15(2)(d) of the CGST Act, and therefore, any treatment given to the main supply shall be given to the penal interest, and hence, shall be exempt from GST.**

30. Without prejudice to the above, it is submitted that in view of clause (d) of sub-section (2) of Section 15 of the CGST Act, the penal interest being an interest/penalty for delayed payment of any consideration for a supply would be included in the value of that supply, which is interest. The said provision is extracted herein below for reference:

> *"15. Value of taxable supply.*
>
> .....
>
> *(2) The value of supply shall include——*
>
> .....
>
> *(d) interest or late fee or penalty for delayed payment of any consideration for any supply;"*

31. In view of the above provision, any interest or late fee or penalty charged/levied or collected for delayed payment of any consideration for a supply, shall be includible in the value of the said supply.

32. It is relevant to note that sub-section (2) of Section 15 of the CGST Act is applicable for determination of value of 'any supply', both for taxable as well as exempt supply. Therefore, even if the main supply is exempt by way of any exemption notification, still, the provisions of Section 15(2) shall be applicable to determine the value of such exempt supply. It would be incorrect to say that the provisions of Section 15(2) are not applicable for exempt supplies, in as much as, the valuation of exempt supplies is

equally important as that of taxable supplies, as the quantum of reversal of input tax credit under Section 17(2) of the CGST Act is determined on the basis of the value of exempt supplies. Hence, the provisions of Section 15(2) are applicable to determine the value of exempt supplies as well.

33. In view of Section 15(2)(d) of the Act, the penal interest levied for delayed payment of loan dues/EMI, being an interest/penalty for delayed payment of consideration, is to be included in the value of loans, which is nothing but interest only. Therefore, the penal interest so levied by the Appellant would be treated at par with interest, andany treatment given to the main consideration (i.e. interest) shall also be equally applicable to such amount (i.e. penal interest). Hence, the penal interest would be exempt from GST under Serial No. 27 of the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017.

**In any case, the penal interest charged by the Appellant is in the nature of penalty or liquidated damages for breach of contract, which does not amount to consideration for any contract, and therefore, there cannot be any supply of service.**

34. Without prejudice to the above submissions, in any case, if the penal interest is not treated as interest on loan, then, the same shall be treated either as penalty or as liquidated damages for the default committed by the customers, which is not leviable to tax in GST law.

35. Under the GST regime, the taxable event is the 'supply' of goods or services. The scope of the term 'supply' is provided under Section 7 of the CGST Act, which is reproduced herein below for reference:

*"7. (1) 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."*

36. On perusal of the above provision, it can be seen that clause (a), (b) and (c) define the scope of supply, whereas, clause (d) classifies certain activities specified in Schedule II as supply of goods or supply of services. Clause (a) covers all kinds of supply of goods or services made or agreed to be made for a consideration by a person in the course or furtherance of business. Clause (b) specifically includes import of services for a consideration, whether or not in the course or furtherance of business. Clause (c) expands the scope of supply by including activities specified in Schedule I, made or agreed to be made without consideration.

37. It is therefore submitted that for an activity to be treated as supply under the GST law, it has to be carried out for a consideration, except those activities specified in Schedule I for which consideration is not necessary. In other words, any activity undertaken without consideration, except those activities specified in Schedule I, shall not be treated as 'supply', and accordingly, will not be leviable to GST.

38. It is submitted that the present case of penal interest collected by the Appellant is neither a case of import, nor, is covered in the list of activities specified in Schedule I. Therefore, clause (b) and clause (c) of Section 7(1) of the CGST Act are not applicable in the present case. Further, as submitted above, clause (d) is only for the purpose of determination whether a particular activity is a supply of goods or supply of services. Therefore, it is relevant to first determine whether a particular activity is covered within the scope of clause (a), (b) or (c) of Section 7(1) of the CGST Act. In any case, the penal interest collected by the Appellant is also not covered under clause (d), as explained in detail in the submissions made below.

39. In this background, it is necessary to understand whether the penal interest collected by the Appellant constitute a supply for consideration under clause (a) of Section 7(1). In this regard, it is relevant to refer to the definition of the term 'consideration' given in Section 2(31) the CGST Act as under:

*"(31) "consideration" in relation to the supply of goods or services or both includes—*

*(a) any payment made or to be made, whether in money or otherwise, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government;*

*(b) the monetary value of any act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government:"*

**40.** Since the above definition is an inclusive one, the meaning of the term 'consideration' has to be understood from various external aids, including the natural meaning given in various dictionaries, meaning given to the term in rulings by various forums, etc.

**41.** It is submitted in this regard that the concept of consideration has been derived from the Latin phrase "*quid pro quo*" which means "something in return for something". It is a well settled principle that "where there is no consideration, there is no contract".

**42.** Reference in this regard is also made to the definition of the term 'consideration' provided in Section 2(d) of the Indian Contract Act, 1872, which reads as under:

*"When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise."*

**43.** Furthermore, it is submitted that various dictionaries define the term 'consideration' as follows:

*BLACK'S LAW DICTIONARY*

*Consideration means something which is of value in the eye of law, moving from the plaintiff, either of benefit to the plaintiff or of detriment to the defendant.*

***WEBSTER DICTIONARY***

*Something of value given or done in exchange for something of value given or done by another, in order to make binding contract; inducement for a contract.*

44. From the above discussed meaning of the term 'consideration', it can be said that consideration would necessarily mean "*quid pro quo*", i.e. something in return. It is a benefit which must be bargained for between the parties, and is essential reason for a party entering into a contract. Further, the consideration for an activity must be at the desire of the other person.

45. However, damages for the breach of contract cannot be treated as a consideration for any activity. It is submitted that upon breach of contract, the aggrieved party is entitled to claim compensation for breach of contract. Such compensation is a legal and statutory right provided under Section 73 and 74 of the Indian Contract Act, 1872, and even without any specific clause in the contract for the damages or compensation payable upon the breach of contract, the party suffering such breach has the statutory right to claim damages or compensation from the party who has broken the contract.

46. The provisions of Section 73 and 74 are extracted herein below for reference:

***"73. Compensation for loss or damage caused by breach of contract. –***

*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.*

***74. Compensation for breach of contract where penalty stipulated for. –***

*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.*

*Explanation. – A stipulation for increased interest from the date of default may be a stipulation by way of penalty."*

47. Both, Section 73 and 74, provide for reasonable compensation, but, Section 74 is narrower in scope and limits the compensation to the extent provided for, or stipulated in the contract.

48. It is submitted that the damages in Section 74 may either be in the nature of liquidated damages or penalty. If the sum stipulated in the contract is a genuine pre-estimate of damages likely to flow from the breach, it is called liquidated damages. If it is not a genuine pre-estimate of the loss, but an amount intended to secure performance of the contract, it may be penalty. The question whether a particular stipulation in a contract, is in the nature of penalty has to be determined by the court against the background of various relevant factors, such as the character of the transaction and its special nature.

49. It is relevant to note that the Explanation to Section 74 (supra), clearly states that a stipulation for increased interest from the date of default may be a stipulation by way of penalty.

50. In the present case, the Appellant lends money to the customers with one of the conditions in the loan agreement that the customers shall make timely repayment of loan instalments on the due dates as per the repayment schedule, and in case of any default, the Appellant shall be entitled to charge penal/default interest for the period of default at the specified rate. Therefore, upon default in payment of the instalments, the Appellant shall be entitled to receive damages stipulated in the contract in accordance with Section 74 of the Indian Contract Act, 1872.

51. The Explanation to Section 74 (supra) directly covers the case of penal interest, wherein, higher rate of interest is charged from the customers from the date of default, so as to deter the customers from making such default in future. Therefore, looking from this angle, the penal interest charged by the Appellant may be treated as penalty for the breach of the contract. In any case, if it is held to be not penalty, then, the same shall be treated as liquidated damages.

52. Therefore, in view of the above discussions, it is submitted that the penal interest charged in the present case shall be treated either as penalty or liquidated damages.

53. In fact, the Ld. AAR has also accepted the submissions that the penal interest is in the nature of penalty. Therefore, in this background, it is relevant to understand whether the amounts recovered in the nature of damages or penalty amounts to supply. The same has been explained in the submissions made herein below.

54. It is submitted that payment of liquidated damages or penalty is not a consideration for any supply, as they are merely damages for the breach of contract. It is submitted in this regard that the stipulation for payment of damages upon breach of contract does not constitute a separate contract; it is a part of the original contract only. The payment of damages arises on account of breach of the primary contract, and it would be an incorrect interpretation to say that such payment is a consideration for any other contract.

55. Without prejudice to the submission made in Para B.13 above, in the present case, there is only one contract between the Appellant and the borrower, which is the agreement for loan, for which consideration is payable by the borrower in the form of interest. The penal interest is payable by the borrower, only upon the breach of conditions of the same contract, and therefore, such payment does not constitute a second contract. Therefore, the payment of penal interest by the borrower cannot be treated as a consideration either for the primary contract of loan, or for any other contract.

56. In view of the submissions, it is submitted that the penal interest is merely damages for the breach of contract, and therefore, the same cannot be treated as a consideration. Hence, in the absence of any consideration, the penal interest collected by the Appellant do not amount to a supply under Section 7 of the CGST Act, and therefore, the same shall not be leviable to GST.

57. The Ld. AAR has failed to consider the above submissions, and has proceeded on the presumption that the penal interest is consideration for the toleration of the default committed by the borrowers. However, as explained above, the penal interest is nothing but damages for the breach of contract committed by the borrowers, and such damages do not constitute consideration for any supply. Further, the said breach does not constitute toleration of act, as explained in detail in the submissions made in below.

**Penal interest collected by the Appellant for the breach of contract by the customer, is not covered under the ambit of clause (e) of Entry 5 of Schedule II to the CGST Act.**

58. As submitted above, clause (d) of Section 7(1) of the CGST Act states that the activities specified in Schedule II shall be treated as supply of goods or supply of services. Without prejudice to the above submissions, that the penal interest collected by the Appellant do not amount to consideration for any supply, it is submitted that even such amount does not fall under the ambit of activities specified in Schedule II to the CGST Act.

59. The Ld. AAR in the impugned AAR order has held that the default committed by the borrowers by way of delay in payment of EMI/ installment is being tolerated by the Appellant and is therefore covered under clause (e) of Entry 5 of Schedule II to the CGST Act.

60. For the sake of reference, the above said entry is reproduced herein below:

> *"5. Supply of services*
>
> *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; and"*

61. It is submitted that the Ld. AAR has misinterpreted the above clause to allege that any act of tolerating would fall under the ambit of the said clause. The correct interpretation of the law would be to read the above said clause as under:

(i) agreeing to the obligation to refrain from an act;

(ii) agreeing to the obligation to tolerate an act or situation;

(iii) agreeing to the obligation to do an act.

62. It is submitted that the expression "*agreeing to the obligation*" is a prefix to all the three entries, *viz. 'to refrain from an act', 'to tolerate an act or a situation', and 'to do an act'*. Therefore, to attract the above said clause, there must be an agreement to the obligation in respect of any of the three entries. In other words, the act of tolerance requires the wilful agreement of certain situations wherein the party agrees to suffer or restrain from doing something for some pre-fixed consideration.

63. In the present case, there is no agreement between the Appellant and the borrower to tolerate the default committed by the borrowers. The only agreement between the Appellant and the borrower is in respect of agreement for loan, for which consideration is payable by the borrower in the form of interest. The penal interest is payable by the borrower, only upon the breach of such contract, and therefore, such payment does not constitute a second contract.

64. However, the Ld. AAR has erroneously recorded various findings in the impugned AAR order that the loan agreements entered into by the Appellant with the customers provide that in case of any breach as mentioned in agreement, the Appellant would tolerate the same subject to receipt of consideration in the form of penal interest in return.

65. The above findings of the Ld. AAR are completely erroneous, in as much as none of the clauses in the loan agreements entered into by the Appellant with the customers provide that in case of any breach, the Appellant would tolerate the same subject to receipt of consideration in the form of penal interest in return. As submitted in **the** ground above, the penal interest is only in the nature of liquidated damages or penalty payable by the borrowers for the breach of the terms of the loan agreement. Such penal interest does not amount to consideration for any supply.

66. It is further submitted that the above said clause 5(e) of Schedule II uses the word '*obligation*'. Therefore, it is important to understand the meaning of the said term to give correct interpretation to the entry. The said term has not been defined in the GST law, therefore, reference is being made to the meaning given to it in other Statutes, and its dictionary meaning, as under:

- ***Section 2(a) of the Specific Relief Act, 1963:***

*"Obligation" includes every duty enforceable by law.*

- ***Commentary on Section 2(a) of the Specific Relief Act, 1963, by Pollock &Mulla, at Pg. No. 1837 of Volume II, 14th Edition, reads as under:***

*"Clause (a): Obligation*

*An obligation is a bond or tie, which constrains a person to do or suffer something; it implies a right in another person to which it is correlated, and it restricts the freedom of the obligee with reference to definite acts and forbearances; but in order to be enforceable, it must be an obligation recognised by law; and not merely a moral, social or religious one. An obligation may not be a legal one, where it cannot be reduced to a money value; legal obligation includes every duty enforceable by law so that when a legal duty is imposed on the person in respect to another, the other is invested with a corresponding legal right. This definition is used in its wider juristic sense as covering duties arising ex contractu or ex delicto, and may cover any other enforceable duty under any statute."*

- ***Black's Law Dictionary:***

*"Obligation, (n.)*

***1.A legal or moral duty to do or not do something**. • The word has many wide and varied meanings. It may refer to anything that a person is bound to do or forbear from doing, whether the duty is imposed by law, contract, promise, social relations, courtesy, kindness, or morality.*

***2. A formal, binding agreement or acknowledgement of a liability to pay a certain amount or to do a certain thing for a particular person or set of persons; esp., a duty arising by contract**.*

***3.** Civil law. A legal relationship in which one person, the obligor, is bound to render a performance in favor of another, the obligee."*

- ***Oxford Dictionary:***

*"obligation ► n.*

***1. an act or course of action to which a person is morally or legally bound.*** ■ *the condition of being so bound.*

***2.*** *a debt of gratitude for a service or favour."*

67. In view of the above, it is submitted that the word 'obligation' can be understood to be an act or course of action to which a person is morally or legally bound. It is a bond or tie, which constrains a person to do or suffer something and it implies a right in another person to which it is correlated. As defined in the Specific Relief Act, 1963, 'obligation' includes every duty enforceable by law, so that when a legal duty is imposed on the person in respect to another, the other is invested with a corresponding legal right. Therefore, an obligation comes into existence, only when there is a duty or a liability on the person making the obligation, with a corresponding right to the other person to enforce such obligation.

68. However, in the present case, there is no obligation upon the Appellant to tolerate an act of non-payment or delayed payment by the borrower, in as much as, neither the Appellant has any duty or liability towards the borrower, nor the borrower has any right on the Appellant. The payment of penal interest neither obligates the Appellant not to take any legal action against the borrower, nor the borrower gains any right to sue the Appellant for any legal action taken by the Appellant. On the contrary, the borrower is under the contractual obligation to make timely repayment of the loan to the Appellant, and upon the breach of such obligation, the Appellant is legally entitled to recover damages for such breach and also sue the borrower for such breach.

69. It is further submitted that a sum which is payable in pursuance of a contractual obligation is different from a sum payable on a breach of contractual obligation. Therefore, the penal interest payable by the borrower on breach of its contractual obligation cannot be treated as a payment for any obligation on the Appellant towards the borrower.

70. In view of the above discussion, it is submitted that in the absence of an agreement by the Appellant to any obligation to tolerate an act of non-payment or delayed payment of loan installments by the borrowers, the mere recovery of penal interest

for breach of the contract does not constitute a supply of service by the Appellant to the borrower.

71. It is therefore submitted that the findings of the Ld. AAR that the Appellant has tolerated the act of default of the borrower which falls under clause 5(e) of Schedule II, is based on an incorrect interpretation of the law, without considering the meaning of the expression '*agreeing to an obligation*' used in the said provision.

72. Hence, the impugned AAR order holding that the penal interest is consideration for tolerating by the Appellant is bad in law and is liable to be set aside.

**Even internationally, the damages for breach of contract are not taxed.**

73. It is further submitted that internationally, the damages received by way of compensation for termination or breach of a contract are not treated as a supply and therefore not subjected to GST/VAT levy.

74. In Australian Law, the GST is levied on supply under 'A New Tax System (Goods and Services Tax) Act, 1999'. The term 'supply' is defined under Section 9(10) of the said Act. Clause (g) of sub-section (2) is *parimateria*the provisions of clause (e) of Entry 5 of Schedule II to the CGST Act, which reads as under;

> *"**9-10 Meaning of Supply***
>
> *(1) A supply is any form of supply whatsoever.*
>
> *(2) Without limiting subsection (1), supply includes any of these:*
>
> .....
>
> *(g) an entry into, or release from, an obligation:*
>
> *(i) to do anything; or*
>
> *(ii) to refrain from an act; or*
>
> *(iii) to tolerate an act or situation."*

75. In the above context, reference is made to **GSTR 2001/4**, issued by the Australian Tax Office (ATO), explains the GST treatment of court orders and out-of-court settlements. In the said ruling at Para 73, it has been clarified that the damages are the most common form of remedy arising out of the termination or breach of contract. The damage, loss or injury, being the substance of the dispute, cannot in itself be characterized as a supply made by the aggrieved party. This is because the damage, loss or injury in itself does not constitute a supply under the provision of Australian GST.

76. It is pertinent to bear in mind that the definition of "supply" under the Australian GST legislation includes within its ambit "an obligation to tolerate an act". Thus, when the aforesaid GSTR namely GSTR 2001/4 states that payment of liquidated damages is not towards any supply, it is reasonable to conclude that the GSTR has also considered the clause "an obligation to tolerate an act". In other words, the GSTR impliedly concludes that the acceptance of liquidated damages does not amount to tolerating an act and hence would not fall within the ambit of "supply" for the purposes of GST.

77. Similarly, reference is also made to **GSTR 2003/11**, pertaining to 'payment on early termination of a lease of goods'. It has been clarified therein that a payment received to compensate the lessor for damage or loss flowing from early termination as a result of a default by the lessee is not consideration for a supply, even though the lessor brings the lease to an end by exercising the right to terminate the lease. The Ruling further provides that in such cases, there will be no taxable supply because a payment for genuine damages, which is not consideration for any earlier or current supply, cannot be said to be made in connection with any supply. The lessor merely exercises his right to terminate and the payment is in the nature of damages for the lessee's breach of the lease which gave rise to the lessor's right to terminate. Thus, in the above Ruling issued under Australian GST, it has been clarified that mere payment of an amount under a damages claim is not a 'supply' and hence, GST is not payable on such supplies.

78. Further, reference is made to **GST Determination No. 2005/6** which has been issued to answer the question as to whether a club, association, trade union, society or co-operative (referred to as "association" in the Determination) makes a supply when it imposes a non-statutory fine or penalty on a member for a breach of the association's membership rules. The said GSTD clarifies that there is no supply made by an association when it imposes a fine or penalty on its member for a breach of its membership rules, and the payment of the fine or penalty is therefore not a consideration for a supply and hence not leviable to GST. It has been clarified in the above GSTD that if the true nature of fine or penalty is a punishment and/or to act as

a deterrent, it does not accord with that nature to suggest that there is a supply to the member in return for its payment.

79. Reference is also made to the **New Zealand case S65 (1996) 17 NZTC 7408**, wherein it has been held that an association, in accepting the payment of fine or penalty, does not enter into an obligation with the particular member to tolerate the misconduct, but rather is fulfilling its obligation to all members to enforce the rules. The member does not gain rights additional to those which are already enjoyed by virtue of being a member. That is, upon payment of the fine or penalty, the member continues to enjoy the same rights and privileges and it follows that the association is required to continue to provide the benefits of membership. In this sense, it cannot be said that the association 'makes' a supply where it already has a pre-existing obligation to continue to provide the benefits of membership.

80. Reference is further made to the decision of the European Court of Justice in the case of **SocieteThermale v. Ministere de l'Economie [2007] S.T.I 1866, Celex No. 605J0277**, wherein the issue was whether a sum paid as deposit in a contract related to the supply of hotel services was subject to tax or not. The Court held that where the client exercises the cancellation option available to him and that sum was retained by the hotelier as a fixed cancellation charge paid as compensation for the loss suffered and which has no direct connection with the supply of any service for consideration, it was not subject to tax.

81. Further, in a decision of the Court of Appeal (UK) in case of **M/s.Vehicle Control Services Limited reported at (2013) EWCA Civ 186**, it has been observed that payment in the form of damages/penalty for parking in wrong places/wrong manner is not a consideration for service as the same arises out of breach of contract with the parking manager.

82. In view of the above discussed rulings, the Appellant would like to submit that the very purpose of liquidated damages / penalty is to restitute or make good, the loss incurred by a person because of a default, non-compliance, etc. of the other person. Such liquidated damages/penalty may be in relation to some other supply of service or goods which would have a separate consideration and would be subject to certain terms and conditions between the borrower and the Appellant. When such terms and conditions are not fulfilled, the defaulting party is obligated to make good the

loss by paying liquidated damages. Such liquidated damages/penalty cannot itself become consideration for continuing with the main supply of service/goods by terming the same as towards tolerating the acts of the defaulting party.

83. Thus, liquidated damages/penalty are merely for making good the loss suffered by a contracting party due to breach of terms of the contract by other contracting party. There is no additional benefit given under the main contract of supply of service, in return for the liquidated damages/penalty.

84. The ratio laid down in the above discussed rulings shall be equally applicable for determining the taxability of penal interest in the present case, as the provisions of Entry 5(e) of Schedule II to the CGST Act are similar to the GST/VAT laws of other countries, and the scope of 'supply' in such laws is wide enough to cover an obligation to tolerate an act or situation.

85. Hence, by applying the above rulings, it can be concluded that the penal interest collected by the Appellant in the present case, being penalty/liquidated damages for breach of contract, are not taxable, as the same does not amount to consideration for any supply.

## Personal Hearing

86. A personal Hearing in the matter was conducted on 07.03.2019, wherein Shri Sandeep Sachdeva, Advocate, representative of the Appellant, reiterated their written submissions. Shri HarshalKotale, Dy. Commissioner of State tax, appearing as jurisdictional officer, reiterated the submissions, which had been made earlier before the Advance Ruling Authority.

## Discussion and Findings

87. We have gone through the record, the facts of the case and have also taken on record the written and oral submissions made by the appellant as well as by the department. We have also gone through the impugned order issued by the Advance Ruling Authority, according to which the quantum of penal charges / penalty defined in the loan agreement is being collected by the Appellant for the reason that the customers have delayed the payment of EMI and the Appellant has tolerated the said act of the delay in payment in lieu of such penal charges / penalty, thereby, such act of the

Appellant falls under Sr. No. 5(e) of Schedule II to the CGST Act. According to the said order of the Advance Ruling Authority, the penal / penalty collected by the appellant is also not covered in exemption under Sr. No. 27 of the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017 as it is over and above the interest amount received by the appellant on account of extending deposits, loans, advances in so far as the consideration is represented by way of interest or discount. Thus, the Authority for Advance Ruling held it as a supply as per Sr. No. 5(e) of Schedule II to the CGST Act. The Authority for Advance Ruling also relied on the loan agreements between the Appellant and the customers, which define the penal charges as overdue charges for non-payment on due dates. The definition nowhere mentions that the said charges are additional interest costs to be incurred by the customers. The clauses of the loan agreement show that the Appellant itself is treating the Penal Charges collected by it as "Penalty". The contention of the appellant that the amount of overdue loan installments amounts to a new loan transaction, is also held as fallacious and devoid of merits, as the rate of interest of loan advanced and the rate at which the penal charges are collected on the so called new loan amount (i.e. the defaulted EMI) are different.

88. On perusal of the above, the issue before us, to decide, is whether the penal charges / penalty collected by the Appellant from their borrower customers who have defaulted EMI and delayed the payment of EMI, is for tolerating any act as envisaged under the entry 5 (e) of the schedule II to the CGST Act, 2017, or is in the nature of additional interest, and therefore, covered under the entry 27 of the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017 and not subjected to GST levy.

89. To decide this issue, we have closely examined the copies of the agreements placed before us and we find certain clauses are necessary in order to determine the nature of charges collected by appellant for delay in payment of EMI. The relevant extract of clauses of a sample auto loan agreement in respect of penal charges is reproduced below for ease of reference:

*1. Definitions and abbreviations:*

*e. "Default Interest" means interest levied by BFL from the due date till payment on happening of any event of Default as set out in clause 3 (iv) of this agreement.*

*q. "Penal Charges" mean and include over-due charges on non-payment of installment on the due date.*

*r. ....."*

*3. The Borrower agrees and confirms that:*

*(iv) BFL is entitled to levy penalty as follows on default:*

***(b) for continuing non-payment of amount due, a penalty not exceeding 3% per month on amount due calculated on pro-rata basis from due date till actually paid as per clause B of the schedule.***

*16. In respect of any delayed payments, without prejudice to all other rights of BFL under this agreements:*

*a. BFL shall be entitled to recover a sum described in 'A&B'of the schedule.*

*b. .....*

*SCHEDULE FORMING PART OF AUTO LOAN AGREEMENT*

*A.*

*B. Penal Charges*

*a. Bounce charges .....*

*b. For continuing of non-payment of amount due, a penalty not exceeding 3% per month on amount due calculated on pro-rata basis from due date till actually paid as per clause B of the schedule.*

From the nomenclature adopted by appellant, it is evident that the agreement between appellant and customers has clearly defined the terms therein and the terms 'Default Interest', 'Penal Charges' and 'Bounce Charges' are defined separately and therefore are exclusive of each other. A further reference to the clause 16 and schedule referred therein shows that the appellant recovers the charges for delay in payment of EMI and for continuing of non-payment as a penalty not exceeding 3% per month on amount due calculated on pro-rata basis from due date till date of actual

payment. In clause 3 (iv) of the agreement also the appellant mentioned that he is entitled to recover the penalty as above in the event of default and delay in payment of EMI. Thus, it is evident that although the agreement between appellant and customer has defined separately the terms 'Default Interest', 'Penal Charges' and 'Bounce Charges', but they are exclusive and what appellant recovered or recovers from his customer is only the penalty for delayed payment of EMI under the term 'Penal Charges'. Therefore, we are also of the opinion that the penalty recovered by the appellant does not get covered by the term 'penal interest' as used by the appellant in his grounds of appeal, as *per se*it is not interest but it is penalty / penal charges.

90. Though, it is an undisputed fact that the Appellant is an NBFC which is engaged in providing various types of loans to the customers the interest on loans have been kept outside the levy of GST, under Serial No. 27 of the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017. The above said entry 27 of Notification is reproduced herein below:

| *Sl. No.* | *Chapter, Section, Heading, Group or Service Code (Tariff)* | *Description of Services* | *Rate (per cent.)* | *Condition* |
|---|---|---|---|---|
| *(1)* | *(2)* | *(3)* | *(4)* | *(5)* |
| *27* | *Heading 9971* | *Services by way of—*<br>*(a) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount*<br>*(other than interest involved in credit card services);* | *Nil* | *Nil* |

In view of the above, it is evident that services of providing loans are exempt, in so far as the consideration of the said services is represented by way of interest. The term

'interest' has been defined under clause (zk) of para 2 of the above said Notification, which reads as under:

*"(zk) "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) but does not include any service fee or* ***other charges in respect of the moneys borrowed or debt incurred*** *or in respect of any credit facility which has not been utilised;"*

**91.** We have observed that when the term "means" is used while defining an expression, it gives a restrictive meaning to the expression defined. There is no doubt that the definition is not inclusive of specifically mentioned therein service fees or ***other charges***. The agreed amount payable by the borrower for delay in payment of EMI cannot be characterized as 'interest payable in any manner'. The penalty / penal charges recovered by the appellant for delay in payment of EMI are though in respect of money borrowed by the customers, get covered by the term ***other charges*** used in the said definition. This further proves that the intention of the legislature is to exempt only that '**interest'** which is covered under term 'interest' defined in clause 2 (zk). In view of the above background, the penalty / penal charges charged/collected by the appellant does not qualify as "interest", thereby do not qualify for exemption under entry 27of the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017.

**92.** The appellant while relying on various judgments contended that any consideration received in lieu of or for the use or retention of a sum of money or other property belonging to another is nothing but interest only. And, interest when considered in relation to money denotes the return or consideration or compensation, and any amount repaid over and above the principal sum of money is interest only. In this connection, we are of view that the term 'interest' is defined in the notification and the settled position of law in this regard is that it is open to the Legislature to define words and, if the Legislature has defined it, one cannot go by the **meaning** in common parlance or what may be called as its "natural **meaning**". In case the term has not been defined in the Act, then it can be construed in its common parlance as it is understood. Further, Hon. Apex Court of India in many cases held that different **statutes** may use the same **term** for different purposes. A **term** or a word may be **interpreted** in

the **statute** itself for fulfilling the purport and object mentioned therein whereas in another **statute** it may be **defined** differently. Interpretation of a **term** in one **statute**, however, cannot be done with reference to its definition contained in another. In view of this,the reliance placed by appellant is said to be is misplaced. On the other hand, we have to strictly abide by the **meaning** given to it by the Legislature, as in the present case. The definition provided in clause 2 (zk) of the notification defines **interest** only to mean **interest** *in respect of any moneys borrowed or debt incurred but does not include any* ***other charges in respect of the moneys borrowed or debt incurred.*** Hence, we cannot give it an extended **meaning** as contended by the appellant.

**93.** A perusal of the method of calculation furnished by appellant shows that it is calculated on the entire due amount of EMI, including interest already included therein EMI. But, as claimed the interest cannot be levied on interest, but only penalty can be levied on the interest not paid within the due date prescribed for it. The real substance of the transaction is that the payment of penalty / penal charges is on account of the failure of the customer to adhere to the conditions of repayment of EMI as stipulated in the Agreement. Thus, the nomenclature provided in the agreement is not the only deciding factor to construe it as penalty / penal charges, but the nature of it as defined in agreement is important- the nature being that the appellant is entitled to recover and the borrower agreed to pay it. One of the important test to determine whether the levy is penal in nature is to see whether it is for the non-compliance of provisions and if any criminal liability or prosecution is provided, the levy is surely penal in nature. The said test is surely passed by the penalty / penal charges in the present case as consequences provided therein agreement for non-compliance of it may be prosecution under the Negotiable Instruments Act. Hence, the penalty levied by the appellant cannot be termed as 'additional interest' but are penal charges.

**94.** The Appellant have also relied upon the various overseas rulings, viz. **UK VAT Notice 701/49, GSTR 2001/4, GSTR 2001/4, GSTR 2003/11, GST Determination No. 2005/6,** to substantiate their contention that the charges for deferment of payment are treated as consideration for exempt supply of credit. As regards these international

ruling pronounced in overseas countries, we are of the view that the aforementioned rulings cited by the Appellant are not binding on us. We have interpreted the entire issue on the basis of the provisions laid out in the CGST Act, 2017.

95. The Appellant have, inter-alia, contended on the ground that, in view of clause (d) of sub-section (2) of Section 15 of the CGST Act, any interest or late fee or penalty charged/levied or collected for delayed payment of any consideration for a supply, shall be includible in the value of the said supply. Therefore, the penal charges / penalty so levied by the Appellant would be treated at par with interest, andany treatment given to the main consideration (i.e. interest) shall also be equally applicable to such amount (i.e. penal interest). Hence, the penal interest would be exempt from GST under Serial No. 27 of the Notification No. 12/2017-Central Tax (Rate) dated 28.06.2017. In this regard we are of view that what is exempted vide above notification is the interest as construed under definition provided in the said notification. By abiding to the correct interpretation of term 'interest' as discussed herein above, the penal charges / penalty being not construed as interest, will not qualify for such exemption. The provisions of clause (d) of sub-section (2) of Section 15 of the CGST Act would apply in these cases where interest is not defined separately anywhere else in a specific context. A separate carving out of the word 'interest' in the notification in the context of this case sets it apart from drawing a general meaning from Section 15.

96. Having rejected the above contention of the appellant, the true nature of the issue has to be seen now in the light of the entry 5 (e) of the schedule II to the CGST Act, 2017. Therefore, we will go through the entry 5 (e) of the schedule II to the CGST Act, 2017, which has been reproduced herein under:

*"(e) agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;"*

In the instant case, the Appellant enters into loan agreement with the borrower. On perusal of the sample agreement, it is observed that it contains specific clauses namely 'Events of Defaults' and 'Remedies in case of Defaults'. The relevant portion of these clauses from sample auto loan agreement are reproduced herein below:

*25. Events of Defaults:*

*A default shall be deemed to have been committed if the borrower does not comply with its obligation covenants contained in this agreement, and also if:*

a. *Any default shall have occurred in payment of Monthly Installment or any part thereof and / or in payment of any amount due and payable to BFL in terms of this agreement .....*

*26. Remedies for Default:*

*The following are without prejudice to the other as also to other rights and remedies under law or in enquiry or under this agreement:*

a. *BFL has full right to recall the entire loan and proceed against the borrower.*

b. *In case of default by reason of PDCs, ECS Mandate / ADM / any other electronic or other clearing mandate transaction being dishonored, BFL shall initiate legal proceeding under section 138 of the Negotiable Instrument Act 1881 for dishonor of cheques issued by borrower or under Payment and Settelement System Act, 2007.*

c. *BFL shall be entitled to take possession of the product without prejudice to any other remedy available with BFL .....*

97. From the above referred clause 25 of the agreement it is clear that the default in payment of EMIs is hereby deemed to be default under the provisions of agreement entered between appellant and customers. From the above referred clause 26, on any default or breach of the agreement the remedies available with the appellant are either to recall loan or cancellation of agreement, initiation of legal proceedings under Negotiable Instruments Act or as the case may be under Payments and Settlement Act, taking possession of the product, etc. However, the appellant instead of taking recourse to the remedial provisions in the agreementitself is tolerating the act or the situation of delay in payment of EMI by customers, by imposing / recovering penalty as envisaged under the terms of the agreement. Hence, such an activity of tolerance of situation of delay in payment of EMI is adequately covered in the second expression provided therein above said clause 5 (e) of Schedule II. Such a tolerance of an activity of delay in payment is against the agreed consideration and it is in the form of penal charges / penalty as discussed herein before para 4. It is agreed between appellant and borrower/ customer that in case any delay has occurred, the Appellant is entitled to recover the penal charges /penalty from such defaulting borrowers. Thus, from the

language of the abovementioned clause, it is adequately clear that there is mutual agreement between the Appellant and the borrower. Thus, here it can be said that the Appellant have tolerated an act or situation of default by the borrowers, for which they are recovering some amount in the name of the penal charges / penalty. Hence, such activity of tolerance is against consideration. As regards the contention of the appellant that there is no separate agreement, we are of the view that though there is no separate agreement between the Appellant and the borrower, for the said act of tolerance of the delay by the borrower, there is clear provision laid out at entry 3 (a) of the above discussed agreement, in this regard, in the loan agreement itself which clearly proposes the remedy available for the default by the borrower. Thus, this argument of the Appellant is devoid of any rationale or merit, and hence is not worth considering.

98. The appellant further contended that it is relevant to first determine whether a particular activity of the appellant is covered within the scope of clause (a), (b) or (c) of Section 7(1) of the CGST Act as the Clause (d)only provide to treat said activity as either supply of goods or as the case may be supply of services. The appellant has made this submission with reference to the provisions of scope of supply, the appellant submitted that the clause (a), (b) and (c) of section 7 of CGST Act define the scope of supply, whereas, clause (d) classifies certain activities specified in Schedule II as supply of goods or supply of services. The said section is reproduced herein below:

*"Section 7. (1) 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.*

From above said scheme of scope of supply it is evident that Clause (a) covers all kinds of supply of goods or services made or agreed to be made for a consideration by a person in the course or furtherance of business. The wording provided in Clause (a) start with "all forms of supply such as ...." It means that the form of supplies enlisted there in as an example and it is inclusive of all other than those of enlisted. Clause (b) specifically includes import of services for a consideration, whether or not in the course or furtherance of business. Clause (c) expands the scope of supply by including activities specified in Schedule I, made or agreed to be made without consideration.

**99.** Whereas, Clause (d) of the section 7 (1) of the CGST Act is very clear and provides for inclusion of activities enlisted in Schedule II to be treated as supply of goods or as the case may be supply of services in the scope of supplies. Schedule II of the CGST Act provides the list of activities to be treated as supply of goods or services. The Clause (a) of section 7 (1) covers in its scope all forms of supplies for consideration, irrespective of the fact that such activity is be treated as supply of goods or supply of services by virtue of Clause (d) of said section 7 (1). Clause 5 (e) of the Schedule II of the CGST Act includes the activities to be treated as services and it covers the very activity in the form of expression "to tolerate an act or a situation" and thereby an act of tolerating delay in payment of EMI is brought into ambit of supply by treating it as supply of services. There shall not be confusion in the mind of anyone that legislature intentionally brought this activity of tolerating an act in the scope of supply of services.

**100.** As explained herein above paras the appellant received the consideration and tolerated the act or situation of delay in payment of EMI. In view of these facts the harmonious and purposive interpretation of the above referred Clauses under sub-section (1) of Section 7 of CGST Act is that they are dependent upon the other and conjoint reading of Clause (d) and (a) of the section 7 (1) remove all clouts of doubt and make it absolute clear that such an act of tolerating delay in payment of EMI is nothing but supply as mandated under Section 7 of the CGST Act.

**101.** The Appellant has repeatedly submitted that the penal interest recovered by them from their borrower cannot be considered as consideration, as the same is not received by them for supplying any specific service to the borrowers. It is rather in

nature of damage or compensation for the loss incurred to them on account of the delay by the borrower and the borrower is under the contractual obligation to pay the said amount. As regards this contention of the Appellant, it is opined that as long as the Appellant is tolerating the delay in payment by the borrower, this act of tolerance would be construed as supply of service in terms of the provision of Section 7 (1) (a) of the CGST Act read with the entry 5 (e) of the Schedule II to the CGST Act, 2017. The bounce charges are recovered by the appellant for tolerating the act of delay and it is nothing but consideration. It is clearly from the meaning of the "consideration" provided under Section 2(31) that it includes the impugned charges. The definition is reproduced herein:-

*.."consideration" in relation to the supply of goods or services or both includes—*

*(a) any payment made or to be made, whether in money or otherwise, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government;*

*(b) the monetary value of any act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government:"*

The consideration also includes the monetary value of any act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both. Here, the bounce charges recovered by the Appellant from their borrower can be construed as the monetary value of the act of the tolerance from the side of Appellant in the case of default by the borrower. Thus, this argument of the Appellant is not tenable.

**102.** The appellant has also contended that the clause (e) of Entry 5 of Schedule II to the CGST Act can be made applicable only when there is an agreement to the obligation to tolerate an act or situation, and the word 'obligation' implies a duty or a liability on the person making the obligation, with a corresponding right to the other person to enforce such obligation. However, there is no obligation upon the Appellant to tolerate the act of non-payment or delayed payment by the borrower. The payment

ofpenal interest neither obligates the Appellant not to take any legal action against the borrower, nor the does the borrower gain any right to sue the Appellant for any legal action taken by the Appellant. In this respect the appellant in his grounds of appeal has also submitted that the Ld. AAR has misinterpreted the above clause 5 (e) of Schedule II and interpretation of clause 5 (e) submitted by Appellant in this regard is that it shall be read as under:

(i) agreeing to the obligation to refrain from an act;

(ii) agreeing to the obligation to tolerate an act or situation;

(iii) agreeing to the obligation to do an act.

Being, the expression *"agreeing to the obligation"* is a prefix to all the three entries.

**103.** We believe that the here the appellant has tried to play with words and coined a new theory of interpretation the law. In common parlance the prefix isa group of letters placed before the root or stem of a word or part of a word that is placed at the beginning of another word to change its meaning. By this logic prefix cannot be said as group of words as stated in submission by appellant. However, the construction of the clause 5 (e) of the Schedule II is very clear in regards to separate expressions mentioned therein and separated by semicolon. It is evident from the construction of the said entry that it contains three expressions and that all three expressions namely *"agreeing to the obligation to refrain from an act; or to tolerate an act or a situation; or to do an act"* are separated with semicolon followed by word "or". It shows that semicolon and "or" separates the above said three expressions showing that they are not inextricably connected. Therefore, the theory of interpretation coined out by the appellant by connecting group of words of first expression *"agreeing to obligation"* with rest of two expressions is not the correct legal interpretation.

**104.** The relevant extract of Hon. Supreme Court judgment in the case of PIL of Shri. JayantVerma Vs. Union of India, dated 16/02/2018 related to the expressions separated by semicolon is as under:

*"We are afraid we cannot agree for several reasons.*

*Firstly, purely grammatically, a semicolon separates the two expressions showing that they are not inextricably connected. ..... Entry 5, List III deals with seven completely different subjects, all banded together under Entry 5 and separated by*

*semicolons, making it clear that each subject matter is separate and distinct from what follows each semicolon....."*

The first expression *"agreeing to the obligation to refrain from"* is followed by 'semicolon' and word 'or' itself indicates that the legislature intended to read these expressions separately in a disjunctive manner. This has been discussed by the Hon. High Court of Kerala in case of Mr. Vincent Mathew Vs. LIC of India dated 15/01/2013. The relevant portion of said judgment is as under:

*".....But, what is more relevant and crucial for the purpose of deciding the issue is that each of the earlier clauses viz., (a) to (bbb) ends up with semicolon. It is to be noted that semicolon (;) is a punctuation mark indicating a greater degree of separation than the 'comma' and it is being used to separate parts of a sentence. It is also worthy to note that in addition to semicolon, the conjunction 'or' is also used immediately after semicolon. Thus, the very syntax of the proviso to Rule 44(1) of the Act carrying different clauses would reveal that the punctuation 'semicolon' and the conjunction 'or' are used in between the clauses carrying different eligibility criteria for renewal commission, not without any purpose. In fact, they would indicate that in troth, they form a single sentence carrying different clauses...."*

Therefore, the correct interpretation of expressions separated by "semicolon" followed by word "or" is that they are distinct and carry separate meaning. Thus, the words mentioned in first expression are separate and have limited applicability to the extent of first expression only. The second expression "to tolerate an act or situation" is clearly distinct and separate. In view of this, the group of words "agreeing to the obligation" from first expression of clause 5 (e) mandating for agreement and obligation are not applicable to the expression "to tolerate an act or situation". Hence, it is concluded that the very activity of tolerating act or situation of delay in payment of EMI is covered under clause 5 (e) of the Schedule II without such obligation as contended by the appellant.

**105.** In view of the above observations, we are of the opinion that the penal charges / penalty recovered by the Appellant from their borrowers on account of the delay in payment of EMI byborrowers are adequately covered under clause 5 (e) of the Schedule II of the CGST Act, and will attract GST.

Thus, we pass the following order:

**ORDER**

We do not find any reason to interfere with the ruling pronounced by the Authority for Advance ruling vide their order No. GST-ARA-22/2018-19/B-85 dated 06.08.2018.

(RAJIV JALOTA)
MEMBER

(SUNGITA SHARMA)
MEMBER

Copy to- 1. The Appellant
2. The AAR, Maharashtra
3. The Pr. Chief Commissioner, CGST and C.Ex., Mumbai
4. The Commissioner of State Tax, Maharashtra
5. The Jurisdictional Officer
6. The Web Manager, WWW.GSTCOUNCIL.GOV.IN
7. Office copy.