The issue of applicability of Service tax on foreclosure charges collected by banks and non - banking financial companies ('NBFCs') on premature termination of loans has been a matter of contention with divergent opinions amongst various division benches of Ahmedabad[1] and Kolkata[2].

Recently, the Larger Bench of Customs, Excise and Service Tax Appellate Tribunal ('CESTAT') Chennai[3], upheld that foreclosure charges shall not be leviable to Service tax.

The principles of this judgement shall have a wide reaching implication on interpretation of service provision, i.e., agreeing to the obligation to tolerate an act introduced in the negative list and continuing in the Goods and Services Tax (GST) regime. It would also be a relevant guide to determine the nature of amount received as compensation for premature termination of services.

Background

- The assessee provides housing loan to customers and was registered for service tax under the category of 'banking and other financial services'. The definition of 'banking and other financial services' was amended to include 'lending' with effect from 10 September 2004.

- For the period from October 2004 to June 2007, the foreclosure charges where shown as miscellaneous income in the books of accounts and no service tax was paid on such charges. Subsequently, Revenue issued a show cause notice demanding service tax alongwith interest and penalty for the period prior to the negative list under service tax regime.

Tribunal's Ruling

- The Tribunal held that loan foreclosure charges collected by banks and NBFC shall not be subject to Service tax

Consideration for Service

- Service tax would be leviable only when an activity is considered to be a service and such service classifies as a 'taxable service' defined in section 65(105) of the Act. There has to be a 'consideration' for the provision of a service.

- Thus, only an amount that is payable for the taxable service can be considered as consideration.

- Reliance was placed in the case of *Bhayana Builders (P) Ltd*[4] of the Delhi Tribunal, that:

[1] 2012 (26) STR 531 (Tribunal-Ahmedabad)
[2] 2016 (4) TMI 21-CESTAT Kolkata
[3] TS -506 CESTAT 2020-ST
[4] 2013 (32) S.T.R. 49 (Tri.-LB)

- Consideration, whether monetary or otherwise, should have flown or should flow from the service recipient to the service provider and should accrue to the benefit of the latter.
- Reference was made to Australian GST Rules which make a categorical distinction between conditions to a contract and consideration. The said rules provide that certain conditions contained in the contract cannot be seen in the light of consideration for the contract. Merely because the service recipient has to fulfil such conditions would not mean that this value would form part of the value of the taxable services that are provided.

- The Supreme Court[5] , while deciding the appeal filed by the Revenue in the above case (Bhayana Builders), observed that any amount charged which has no nexus with the taxable service and is not a consideration for the service provided, does not become part of the value which is taxable.

- The above rationale was reiterated by the apex court in the case of *Intercontinental Consultants and Technocrafts*[6], wherein it was held that the valuation of service *cannot be anything more or less than the consideration paid as quid pro quo for rendering such a service.*

- Reference was also made to the judgement of the European Court of Justice in the case of *Societe Thermale d'Eugenic-les-Bains*[7]*:*

  - The question was whether the deposit amount, retained by the hotelier due to cancellation by a client, could be regarded as consideration for the supply of reservation service and hence be subjected to VAT or the deposit amount was to be treated as a fixed compensation for cancellation and not subjected to VAT.
  - The Court observed that since the obligation to make a reservation had arisen from the contract for accommodation and not from the payment of a deposit, there is no direct connection between the service rendered and the consideration received. Such compensation does not constitute the fee for a service and forms no part of the taxable amount for VAT purposes.
  - Parties may make contractual provisions applicable in the event of non-performance, for compensation or penalty.

- Thus, there is a marked distinction between conditions to a contract and considerations for the contract. Further, reference was made to the definition of consideration as provided in section 2(d) of the Indian Contract Act, 1872 ('Contract Act'). As per the definition in the Contract Act, consideration should flow at the desire of the promisor. Thus, if the consideration is not at the desire of the promisor, it ceases to be a consideration.

- The banks would not desire pre-mature termination of the loan as it is in their interest that the loan runs the entire agreed tenure. As premature termination of a loan results in loss of future interest income, the banks charge an amount for foreclosure of loan to compensate for the loss in interest income.[8]

Breach of Contract

- A customer on initiating foreclosure of loan, results in a breach of one of the essential terms of the loan agreement (i.e., period of loan) and such breach may give rise to a claim for damages. This amounts to a unilateral act of the customer in repudiating the contract.

[5] 2018 (2) TMI 1325
[6] 2018 (10) GSTL 401 (SC)
[7] C-277/2005
[8] ILR 2008 KAR 1311

- The foreclosure charges, therefore, are not a consideration for performance of lending services but are imposed as a condition of the contract to compensate for the loss of identified interest, on pre-mature termination of the contract.

Damages (Liquidated) received for breach of Contract

- Damages can be determined by Courts or they can also be incorporated in the loan agreements and other commercial contracts so as to ensure certainty in dealings and also serve as a deterrent measure. This aspect of damage is known as liquidated damages. The clauses relating to damages for foreclosure of loan do not and cannot give rise to any consideration. They come into effect only after the contract comes to an end.

- Section 74 of the Contract Act deals with compensation for breach of contract where penalty is stipulated for. The section would be applicable only in cases where the eventuality of damage and the quantification for damages is specified in the agreement.

- To attract the provisions of section 74, it is not necessary that the entire contract should come to an end.[9]

- Contract Act, eliminates the refinement between stipulations governing payment of liquidated damages and stipulations in the nature of penalty. A penalty is a sum of money so stipulated in terrorem and liquidated damages are a genuine pre-estimate of damages.

- Therefore, Tribunal observed that foreclosure charges are recovered as compensation for disruption of a service and not towards 'lending' services.

- Foreclosure charges cannot be viewed as an alternate mode of performance since they arise upon repudiation of the contractual terms, whereas alternate mode of performance still contemplates performance. Thus, merely because the clause relating to damage is featuring in a contract, it would be incorrect to conclude that the party has been given an option to violate the contract.

- The amount of damages is clearly stipulated in the contract and no element of service is sought to have been rendered by the banks to borrowers. Thus, foreclosure charges collected by the banks and non-banking financial companies on premature termination of loans are not leviable to service tax under 'banking and other financial services'.

Comments

There has been much ambiguity on the taxability of payments towards damages for breach of contract, liquidated damages, notice pay recovery, etc., in the pre-GST and the GST regime. As the ruling pertains to the period prior to July 2012, it would be relevant to examine the applicability of this ruling in the negative list and GST regime in light of the declared service provision.

[9] AIR 1985 Bom 186