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What's New

News Flash

Delhi bench of CESTAT holds that cancellation fee paid on termination of agreement, cannot be treated as 'consideration' for a taxable service

Recently, the Delhi bench of the Customs, Excise and Service Tax Appellate Tribunal (CESTAT)[1], held that cancellation fee paid in pursuance of an agreement being terminated to compensate for certain losses cannot be attributed to the provision of a service.

Facts

- The appellant had entered into a 'Technical Collaboration Agreement' (Technical Agreement) with its overseas Group Company (Group Company) to receive technical and proprietary information for manufacturing new models of cars in India. Subsequently, the parties also entered into a 'Model Agreement' (Model Agreement) for the launch of new model of cars in India.
- Owing to the unviability of sales of high-end petrol cars due to the increasing sales of diesel cars, it was decided not to launch the new model of a particular car in India, and accordingly, the Model Agreement was terminated by a 'Model Termination Agreement' (Termination Agreement).
- As per the Termination Agreement, the appellant was required to pay a certain amount to its Group Company as compensation towards all costs, expenses and non-cancellable commitments. Accordingly, an invoice was raised with the description 'Support Service Fee'.
- The service tax authorities alleged that the compensation/ termination fee payments constituted 'consideration' towards supply of 'consulting engineer services' and that the appellant was liable to pay service tax under reverse charge.

Appellant's contentions

- Once the agreement for receipt of services was terminated, any amount paid towards the reimbursement of costs would only be in the nature of a cancellation fee.
- As the Technical Agreement was terminated even before the designs, drawings, etc., were completed and supplied to the appellant, the Group Company could not even begin providing consulting engineer services to the appellant.
- The amount paid to the Group Company was in the nature of reimbursement of expenses, which cannot be subjected to service tax.
- No advice, consultancy or technical assistance was provided to the appellant, and thus, the services would not qualify as 'consulting engineer services'.

Revenue's contentions

- Under the Termination Agreement, the appellant agreed to compensate the Group Company for the amount towards the commencement of the volume production and the word 'towards' means 'in the direction of' denoting that the compensation was directed towards the commencement of volume production.
- The agreements or the invoice do not use the term 'reimbursement', and compensation was different from reimbursement, as compensation is typically for a 'service', while reimbursement may not be for a service.

- The Termination Agreement cannot undo the technical information already provided and shared by the Group Company from 2010 to 2012.

CESTAT's ruling

The CESTAT held that the cancellation fee paid by the appellant on termination of the agreement was not towards any 'consideration' for a taxable service, and therefore, not liable to service tax. The CESTAT's ruling is based on the following rationale:

- While the service tax authorities had assumed that consulting engineering services were rendered, they had not examined the kind of technical assistance actually provided by the Group Company to the appellant, to constitute 'consulting engineering services' and make the services liable to service tax.
- The decision to launch the new car model was terminated before any information/ advice/ drawing could be shared with the appellant, and therefore, the appellant had not received any service.
- The amount paid by the appellant was 'cancellation fee' and not towards the first instalment. Even the invoice does not mention that the payment was towards the first instalment.
- Reliance was also placed on a few other rulings[2] in the context of termination of agreements, which have held that no identifiable service can be attributed for payments made, if an agreement was terminated, as the consideration was to make good the loss.

PwC comments

The above decision discusses the taxability with regard to the non-existence of an identifiable service and is in line with some recent decisions on the taxability of liquidated damages, forfeiture payments, etc. The decision has specifically examined the contractual arrangement, linkage of payments to the termination agreement and the underlying intention of the parties to determine the nature of the transaction. While the decision pertains to the pre-negative list regime of service tax, the rationale that payments made in pursuance of a termination agreement cannot be attributed to a 'service', would be relevant for transactions pertaining to the negative list of service/ GST regime.

[1] Service Tax Appeal No. 51888 of 2015

[2] Ford India Private Limited *v.* Commissioner, LTU, Chennai [2018 (1) TMI 1219-Cestat Chennai] and Lemon Tree Hotel *v.* Commissioner, GST, Central Excise & Custom [2019 (7) TMI 767-Cestat New Delhi]

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