

Delayed payment charges, penal interest and cheque bounce charges not leviable to service tax – CESTAT

17 August 2023



Summary

The Customs, Excise & Service Tax Appellate Tribunal (CESTAT) Mumbai Bench has held that the charges levied for a delay in the payment of EMLs, including penal interest and cheque bounce charges recovered in case of bouncing of repayment/dishonour of a cheque, are not a part of consideration, and therefore, not leviable to service tax. The CESTAT observed that the transaction of levy of additional/penal interest or penalty imposed for the dishonour of a cheque is not for tolerating the act or situation but is penal in nature and thus is not towards consideration for any service. Therefore, the Tribunal allowed the appeal filed and has set aside the order passed by the Commissioner confirming the demand of service tax, along with interest and penalty on the recovery of penal interest and cheque bounce charges.

Facts of the case:

- M/s. Bajaj Finance Limited ('the appellant') is a non-banking financial company (NBFC) engaged in the business of providing finances to borrowers.
- The appellant had entered into agreements for providing loans and collected various charges, such as processing fees, documentation fees, logging fees etc., and had paid service tax on such charges.
- The terms and conditions of the agreement provided to collect 'penal interest' as an additional interest in case of a delay in the payment of dues and 'bounce charges' on account of dishonour of a cheque/ECS or any other electronic or clearing mandate.
- The department conducted an audit and examined the agreements and identified that the 'penal interest' is a part of consideration and is to be treated as a 'service of tolerating the act of delay/default by borrowers'.
- Therefore, a show cause notice was issued, alleging recovery of service tax on such charges collected, which was confirmed by the commissioner.

- Aggrieved by the same, the appellant had filed an appeal before the Tribunal.

Appellant's contentions:

- The appellant submitted that it was under the bonafide belief that the 'penal interest and bounce charges' were additional interest, penalty or liquidated damages or compensation for the breach of the terms and conditions of the agreement, therefore, these were exempt from service tax.
- The petitioner also mentioned that the failure of the payment of dues at the specified time amounts to breach of the contract and the compensation for the breach is not a consideration for any service.
- The appellant also submitted that there was only one agreement for the disbursement of the loan for which consideration was payable in the form of interest, and this agreement was for the performance of the contract and not for its breach.
- The appellant contended that it is a settled position of law that damages/penalty/compensation for a breach of contract is not consideration

for any service, and thus, is not leviable to service tax.

- The appellant referred to the master circular issued by the RBI, wherein, it was stated that interest should be charged on loans and advances. The circular also provides to levy penal interest for default in repayment, and so, there was no extra consideration that flows in such payments made on account of penal interest delayed payment charges.
- The appellant also referred to Notification No.24/ 2012 - S.T. inter alia, which provided that the value of any taxable service does not include interest on delayed payment of any consideration for the provision of services or sale of property, whether 'movable' or 'immovable' and contended that it provides that the government had excluded the interest on delayed payment from the scope of the payment of service tax.

Revenue's contentions:

- The department clarified that the penal interest/bounce charges are not part of the EMI of the loan amount or principal loan amount, and these are extra amounts imposed by the appellants as penal interest/bounce charges.
- The department submitted that the following remedies were available with the appellant, either to recall loan or cancellation of agreement, initiation of legal proceedings under the Negotiable Instruments Act, 1881, taking possession of the product, etc., but the appellant did not obtain a recourse to these remedies.
- The department submitted that the intention of both the parties was to avoid litigation by paying a pre-

determined sum to the lender on the breach of contract by the borrower.

- Therefore, the department contended that 'penal charges and bounce charges' are in nature of consideration, and such a default/delay/non-payment/dishonour of payment instrument was tolerated by the appellant, and it was a declared service of 'agreeing to tolerate an act or a situation'.

CESTAT Mumbai observations and ruling (Service Tax Appeal No. 90043 of 2018, vide order dated 7 August 2023):

- **Penal interest is not chargeable to tax:** The CESTAT referred to a recent circular issued by the board under the GST regime (Circular No. 102/21/2019-GST dated), wherein, it has been clarified that the transaction of levy of additional/penal interest does not fall within the ambit of Entry 5(e) of Schedule II of the Central Goods and Services Tax Act, 2017 (CGST Act), as this levy of additional/penal interest satisfies the definition of 'interest' as contained in Notification No.12/2017-Central Tax (Rate), and hence, it is exempt from tax.
- **Penal charges are not covered under the ambit of declared services:** The CESTAT referred to the decision in the case of M/s. South-eastern Coalfields Ltd., wherein, it was held that it is not a sustainable view to consider penalty amount, forfeiture of earnest money deposit and liquidated damages as consideration for tolerating an act.
- **Compensation received is not 'synonymous' to 'tolerating of an act':** The CESTAT referred to the decision of the Supreme Court, wherein, it was held that in a breach of contract, one party tolerates an act or situation is not correct and also

emphasised 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 that is taxable, and there is a marked distinction between 'conditions to a contract' and 'considerations for the contract'.

- **Penalty on dishonour of cheque deters and discourages such actions:** The Tribunal referred to

Circular No.178/10/2022 and Circular No.214/1/2023-Service Tax, wherein, it was clarified that a cheque dishonour, fine or penalty is not a consideration for any service, therefore, it is not taxable. The fine or penalty imposed for the dishonour of a cheque is not for tolerating the act or situation, but it is for penalising and thereby deterring and discouraging such an act or situation.

Our comments

The taxability of recovery of penal interest and cheque bounce charges has been one of the contentious issues under the erstwhile service tax laws, as well as GST laws. Considering the contradictory rulings on the issue and concerns raised by the businesses, the board issued a circular categorically clarifying that the fine or penalty that the bank imposes, for delayed payment or dishonour of a cheque, is a penalty imposed not for tolerating the act or situation but for penalising, and thereby deterring and discouraging such an act or situation. Therefore, the recovery of such amounts is not a consideration for the service of agreeing to tolerate an act or a situation. Such transactions of levy of additional/penal interest does not fall within the ambit of Entry 5(e) of Schedule II of the CGST Act.

Even in the appellant's own case, the Maharashtra Authority for Advance Rulings (AAR) had held that the amount collected towards cheque bounce charges amounts to the supply of service. However, the Appellate Authority for Advance Ruling (AAAR) has reversed the AAR's ruling and held that the additional/penal interest recovered by the applicant from its customers against the delayed payment of monthly instalments of the load extended to such customers, would be exempt from GST.

The present ruling is in line with the above rulings and circulars, and shall set precedence in similar matters.

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