TAXABILITY OF NOTICE PERIOD RECOVERY

The terms of contract between an employer and employee are generally laid down in the appointment letter issued to the employee by the employer. Typically, the appointment letter also has a clause regrading serving of notice period or payment of an agreed sum by the employee for waiving the notice period.

The issue for consideration is whether such payment made by the employee to the employer for waiver of the notice period constitutes a supply under the GST law. Under the GST law, the taxable event is 'supply' as opposed to sale, manufacture or rendition of service under the erstwhile VAT, Excise and Service tax law. Once a transaction or activity is covered within the meaning of the term 'supply' then the liability to pay GST arises. Section 7 of the Central Goods and Services Tax (CGST) Act, 2017 defines the expression 'supply' in an inclusive manner as under:

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, license, 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, and
(c) The activities specified in Schedule I, made or agreed to be made without a consideration

(1A) Where certain activities or transactions constitute a supply in accordance with the provisions of sub-section (1), they shall be treated either as supply of goods or supply of services as referred to in Schedule II.

(2) Notwithstanding anything contained in sub-section (1),—

(*a*) activities or transactions specified in Schedule III; or
(*b*) such activities or transactions undertaken by the Central Government, a State Government or any local authority in which they are engaged as public authorities, as may be notified[39a] by the Government on the recommendations of the Council,

shall be treated neither as a supply of goods nor a supply of services.

Schedule II of the CGST Act lists down activities or transactions which would be treated as supply of goods or services as per the said Schedule. Clause No. 5 of the said Schedule gives a list of activities which is treated as supply of services. Sub-clause (e) of clause 5 provides for an entry to be a service which is- "agreeing to the obligation to refrain from an act, or to tolerate or a situation or to do an act".

Based on the above entry in Schedule II the GST authorities contend that the employer is 'tolerating the act' of the employee wherein the employee is not serving the notice period but has agreed to pay the stipulated sum to the employer by way of a deduction from his salary.

In a very recent ruling in the matter of **M/s. Amneal Pharmaceuticals Pvt. Ltd. (Advance Ruling No. GUJ/GAAR/R/51/2020, dated July 30, 2020)** the AAR has held that notice pay recovery is a supply and is subject to GST.

The argument put forth by the GST authorities and upheld by the AAR does not seem to be correct as notice pay is nothing, but the amount stipulated in the employment contract for breach in serving the stipulated notice period. Since notice pay is a sum mutually agreed by the parties for breach of contract it can be regarded as a consideration flowing from the employment contract itself read with section 74 of the Indian Contract Act, 1872 and not under any other separate contract wherein the employer has agreed to refrain from doing any act against the concerned employee.

It should be noted that the notice pay recovery is stipulated in the contract and the employer can only sue for recovery of such amount but cannot enforce mandatory serving of the notice period. Once it is concluded that an employer cannot enforce mandatory serving of the notice period such employer cannot be said to have refrained from an act of suing the employee for mandatory serving against the notice pay recovery. Notice pay recovery is nothing but a deduction from the salary payable to the resigning employee and it is not a separate consideration flowing from any independent contract. Hence it should not be taxed under clause (e) of clause 5 of Schedule II of the CGST Act.

It would not be worthwhile to examine the legal position laid down by the Hon'ble Ahmedabad Tribunal in the case of Nandinho Rebello Vs. DCIT (2017) 80 Taxmann.com 297 (Ahmedabad). In the said case, the appellant had claimed deduction of notice pay recovered by employer from his salary income. The Department denied the deduction of the ground that the same is not allowed under the head 'salary' since salary is charged on due basis and permissible deduction stipulated u/s 16(2) does not contain notice pay recovery. The Hon'ble Tribunal held as under –

> *"Therefore, notice pay of total Rs. 2,76,744/- was claimed in the return of income as deduction which was recovered from the salary by assessee's previous employers as mentioned above. The ld. CIT(A) was of the view that no such deduction is available under section 16 of the Act and the salary income is taxable on due basis or on paid basis. After considering the facts as quoted above, we find that employers have made deduction from the salary which was paid to the assessee during the year under consideration because of leaving the services as per agreement made by the assessee and the respective employer. We find that this is a case of recovery of the salary which is already made to the assessee for which we have not to refer to section 16 of the Act as mentioned by the ld. CIT(A). it is*

pertinent to note that the assessee has actually received the salary from his previous employers after deducting the notice period as per the job agreement with them. Therefore, in our considered view, the actual salary received by the assessee is only taxable and therefore, we allow this ground of appeal of the assessee."

The approach under the two statutes is contradictory. The contention of the GST tax authorities is that notice pay recovery is not a reduction in salary but another form of supply flowing from the employer to the employee and is thus subject to GST under clause 5(e) of Second Schedule to the Act. Whereas, on the other hand, the ITAT has held that recovery of the notice period is a reduction in the salary. The correct legal position thus seems to be as that followed by the ITAT that the notice pay recovery is nothing but deduction from salary and therefore it should not constitute a separate item of supply under the GST law.

The Government should step in and take a step so as to clarify this issue through the GST council such that litigation at least on this aspect can be avoided.