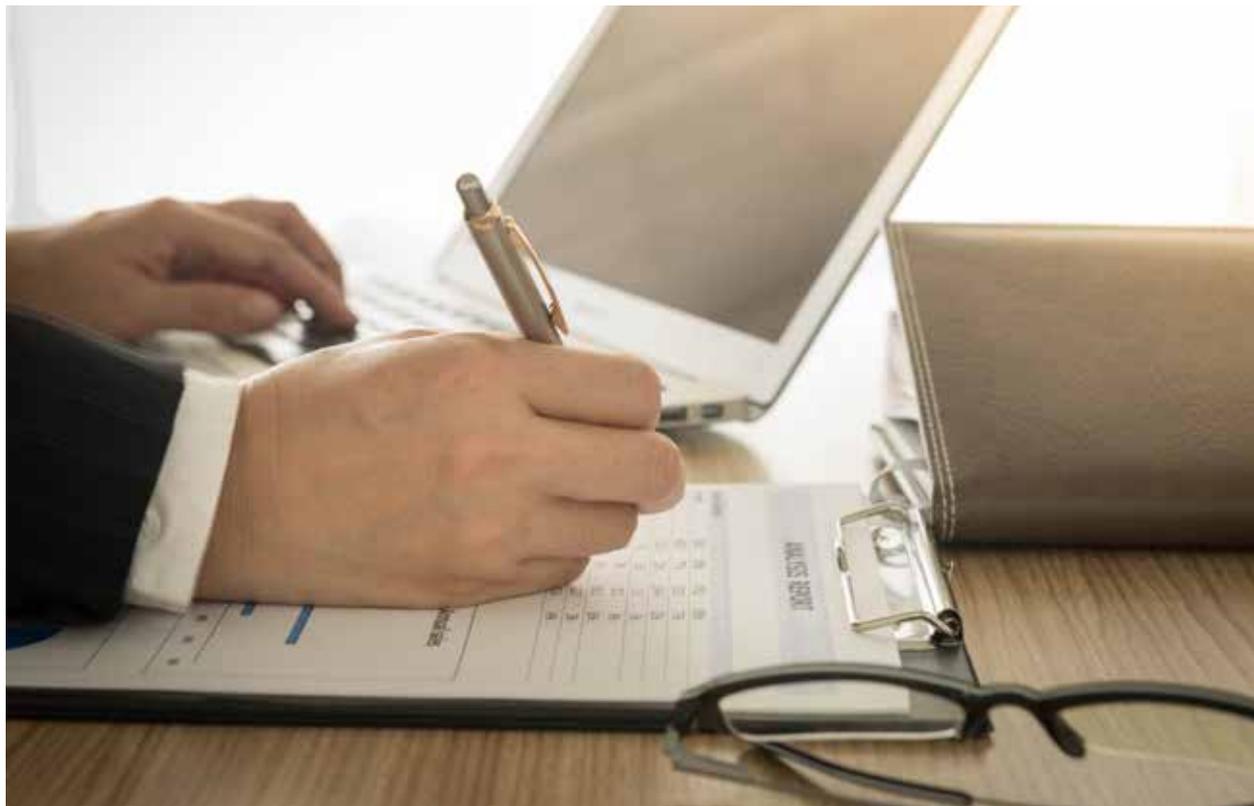


## Taxability of Free Supplies by the Contractee under GST Law



*In a historic day for the Republic of India, The Constitution (One Hundred and First amendment) Bill, 2016 was passed by the Rajya Sabha on the 3<sup>rd</sup> of August, 2016 with the Lok Sabha approving the amendments on the 8<sup>th</sup> of August, 2016. One month later, almost 18 states have approved the same in their State Assemblies, crossing the required threshold of 16. With this being done, and only the presidential assent remaining, it is virtually certain that Goods and Service Tax (hereinafter referred to as "GST") may be implemented in India for the Fiscal Year 2016-17 with the Government setting a "Target Date" of 1<sup>st</sup> April 2017 for GST Roll Out. Is this target realistic? In the very words of our Hon'ble Finance Minister Shri Arun Jaitley-it is better to have a Target than not have any. So with the impending onset of GST, it is prudent that the economy wakes up to the concept of GST. The Model Law on GST has been notified by the Government for Public Comments, and hence, this would be the proper time to go in and study the Model Law, and in general prepare ourselves as to how the same will impact existing Issues in Indirect Tax Law. Read on...*



**CA. M. Saravana Prabhu**

(The author is a member of the Institute. He can be reached at [msaravanaprabhu@outlook.com](mailto:msaravanaprabhu@outlook.com))

### **1. Inclusion of Free Supply of materials provided by Contractee-Service Tax**

1.1 One of the pressing issues that existed in erstwhile Indirect Tax Legislation is the inclusion of Materials supplied by the Contractee/Buyer to the Contractor/Supplier, for execution of Works/Manufacture of Items.

These are often referred to in trade parlance as Free of Cost (FOC) Supplies.

1.2 **Let us take an Example:** Imagine a Contract for Erection and Installation of Pipes by a Contractor for a network of Storage Tanks of a Large Corporation dealing in Petroleum and Petroleum Products. Usually, these Pipes and valves are provided by the Principal Contractor without any sale price/Sales Invoice. Their exact nature, type, chemical composition, tensile strength, which influences the determination of value such items are also neither known nor disclosed to the Service Provider/Contractor. **By any stretch of imagination, such value of pipes cannot be included in the Value of the Service more precisely "Works Contract Service".**

1.3 However, the Department known for its counter-intuitive thinking usually contends that Materials are supplied by the Contractee as part of the impugned contract, is to be included in Gross Amount Charged for levy of Service Tax treating the same as "Non-monetary consideration" and hence, includible in value under Section 67(ii) of Chapter V the Finance Act, 1994.

1.4 The argument that such FOC Supplies are includible in the Gross Amount Charged is augmented by the following decisions in favour of the revenue-

- *Simplex Infrastructure Limited vs. Commissioner of Service Tax 2011 (21) S.T.R. 11 (Cal.)*
- *Jaihind Projects Ltd vs. CST Ahmedabad (2010 18 STR 650 (Tri - LB))*
- *VPR Mining Infrastructure Pvt Ltd vs. CCE Hyderabad (2011 (23) STR 279 (Tri - Ban))*

However, the above cases have been overruled and are not valid precedents based on the foregoing discussions.

1.5 That Free Supply of Materials by the Service Receiver cannot be included in the Gross Amount Charged, as has been held in the following cases-

- *Inox Air Products Ltd. [2012 (28) S.T.R. 570 (Bom.)]*
- *Larsen & Toubro Ltd., Chennai vs. Union of India-2007 (7) S.T.R. 123 (Mad.)*
- *Era Infra Engineering Ltd. vs. Union of India—2008 (11) S.T.R. 3 (Del.)*

**One month later, almost 18 states have approved the same in their State Assemblies, crossing the required threshold of 16. With this being done, and only the presidential assent remaining, it is virtually certain that Goods and Service Tax may be implemented in India for the Fiscal Year 2016-17 with the Government setting a "Target Date" of 1<sup>st</sup> April 2017 for GST Roll Out .**

- *NM Goel and Co vs. STC (1989) 72 STC 368,*
- *Karyapalak Engineer vs. Rajasthan Taxation Board (2004) 136 STC 641*

1.6 More recently, the Larger Bench of the Tribunal has in the case of *BHAYANA BUILDERS (P) LTD. vs. COMMISSIONER OF SERVICE TAX, DELHI (2013 (32) S.T.R. 49 (Tri. - LB)* in a similar situation had held that "Free supplies", incorporated into construction (cement or steel for instance), even on extravagant inference, **would not constitute non-monetary consideration remitted by service recipient to service provider for providing service, particularly since no part of goods and materials so supplied accrues to or is retained by service provider.** Wherever monetary consideration is charged for providing taxable service and no non-monetary consideration forms part of agreement between parties, the value of taxable service would in such case be gross amount charged by service provider and paid by service recipient. **Hence, contrary conclusion in *Jaihind Projects Ltd. [2010 (18) S.T.R. 650 (Tribunal)] found to be incorrect, proceeding on flawed interpretation of Section 67 ibid.***

1.7 It is to be noted that the decision in the case of *Bhayana Builders (P) Ltd.* has been ruled by a Larger Bench of the Tribunal and has **directly overruled the case of *Jaihind Projects Ltd.***

1.8 Further, the Tribunal in the case of *Dholu Construction and Projects Limited 2013 (32) S.T.R. 245 (Tri. - Del.)* has held that the case of *VPR Mining Infrastructure Pvt. Ltd. vs. CCE, Hyderabad reported in 2011 (23) S.T.R. 279 (Tri.-Bang) relied on by the Department was a stay order whereas the Bombay High Court's decision (Inox Air Products Ltd. [2012 (28) S.T.R. 570 (Bom.)]-Refer Para 1.5*

*above) is a final order, and would be a better precedent.* The same argument also holds good in the case of Simplex Infrastructure Limited vs. Commissioner of Service Tax 2011 (21) S.T.R. 11 (Cal.) which is also an order dealing with Stay of Demand and not a final order.

- 1.9 The above discussions, in the works Contract may not be very relevant post 7.7.2009 post the introduction of the Explanation to Rule 3(1) of the Works Contract (Composition Scheme for payment of Service Tax) Rules, 2007 which specifically includes such FOC Supplies. However, such inclusion can be made for all contracts commencing after that date and not for the contracts which have commenced preceding that date as clearly mentioned in *Proviso* to the said Explanation. This view is fortified by the Department Cir. No 150/1/2012-ST dated 08.02.2012. ***However this would be the case only for Works Contract. For other Contracts, an argument may still be taken that FOC supplies may not be includible in the Gross Amount Charged in light of the Ratio Decidendi of the precedents as earlier discussed.***

## 2. Inclusion of Free Supply of materials provided by Contractee-Excise/VAT/ Customs Law

- 2.1 As regards the applicability of VAT on Free supplies by the Buyer, the issue stands settled by the judgment of the Supreme Court in the case of *N. M. Goel & Co. vs. Sales Tax Officer (1989) 72 STC 368* wherein it was held that such Free Supply would be construed as Sale liable to Sales Tax/VAT when the Contractee supplied the contactor iron, steel, etc. for the purpose of construction and the cost was deducted from the contract price payable which was inclusive of the value of material.
- 2.2 Based on the ratio of the above decision, a view is generally taken that when such free supply of material from the Contractee to the contactor ***when the contract value does not include the cost of such material and where no adjustment is made from the Contractee's account on account of the same, would not be includible*** in the value. Hence, presently, contracts are structured keeping the above in mind to avoid VAT on the same.

- 2.3 The Customs Law Rule 10(1) of Customs Valuation (Determination of Value of Imported Goods) Rules, 2007 specifically provides that-

*"(b) The value, apportioned as appropriate, of the following goods and services where supplied directly or indirectly by the buyer free of charge or at reduced cost for use in connection with the production and sale for export of imported goods, to the extent that such value has not been included in the price actually paid or payable, namely-*

- (i) *Materials, components, parts and similar items incorporated in the imported goods;*
- (ii) *Tools, dies, moulds and similar items used in the production of the Imported goods;*
- (iii) *Materials consumed in the production of the imported goods;"*

The above would squarely cover the impugned situation. Similarly, the Central excise law based on Sec.4, Rule 6 (similar to Rule 10(1) above) and interpretations, argument may be taken that the value of free supplies supplied by the buyer shall be includable in the Assessable Value.

## 3. GST Model law on free supplies

- 3.1 Attention is invited to Sec. 15(2) of the Model GST law which reads as follows -  
*"(2) The transaction value under sub-section (1) shall include (emphasis supplied):...*  
*(b) The value, apportioned as appropriate, of such goods and/or services as are supplied directly or indirectly by the recipient of the supply free of charge or at reduced cost for use in connection with the supply of goods and/or services being valued, to the extent that such value has not been included in the price actually paid or payable;..."*
- 3.2 Thus, based on the above, the FOC supplies which usually may not attract any VAT/Service Tax presently, ***appears to be taxable under the proposed Model GST law***, the same being based more on the Customs Valuation Provisions.
- 3.3 Further, based on Schedule I, Item 5 which specifies "Supply of goods and/or services by a taxable person to another taxable or nontaxable person in the course or furtherance of

business" as one of the items "treated as Supply without Consideration" one may also take a view that such Free Supply by the Contractee may also be treated as Supply and be taxable in the hands of the Contractee.

3.4 However, considering Input Tax Credit (ITC) may be available on the Tax paid by the Contractor/Contractee on the above, the whole exercise may end up becoming revenue neutral to both Parties, the takeaway being Procedural Compliance relating to raising invoice by the Contractee on Such free supplies and the Contractor also including the same for valuation of his outward supply (How both parties are going to Value such Free Supplies whether the same value to be adopted by both parties or whether valuation is to be done independently is another issue that may arise).

3.5 Further, one major impact may be that considering the amount of such free supplies which may be very high, and sometimes exceeding the value of the Contract itself by many multiples, the same may lead to a huge Working Capital nightmare for all parties involved, since tax on the same have to be paid first at the time of invoice, however payment for the same may be settled after several months. **Example:** Let us take the same example as discussed in Para 1-Imagine a huge Company like Indian Oil Corporation supplying Pipes, for installation work. Should the value of such Free Pipes worth Crores supplied be included in the value of the Installation Service which may be merely a Few Lakhs?!!

3.6 The biggest impact however may arise, where Input Tax Credit is restricted in certain Contracts like Construction Contract (Refer Sec. 16(c) relating to eligibility to ITC), the above may result also in double/multiple taxation depending the number of parties involved in the Contract (a sub-contract being involved for example), and could result in huge cost increase

**Further, every assessee should sensitise its vendors, customers and stake holders in general so that they are made aware of the above implications well in advance, and be prepared to take necessary corrective actions if required.**

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in such contract due to the Cascading Effect of Tax.

#### 4. Conclusion

Considering the manifold implications discussed in the above provisions, it would be wise for all stake-holders to represent to the Government, to incorporate suitable provisions in the Act, to avoid unnecessary litigation in the future. Further every assessee should sensitise its vendors, customers and stake holders in general so that they are made aware of the above implications well in advance, and be prepared to take necessary corrective actions if required. On a concluding note, where clarity seemed to have emerged in existing law after so much jurisprudence on the issue, especially in Service Tax (as discussed in Para 1), the GST law has now chosen to take re-course to Customs Provisions to tax Free Supplies merely because the stricter and more regressive (more so than any other reason). The same is the case with many other issues under GST Law. When GST Law was in its inception stage (and to some extent it still is), it was generally believed that it would be more assessee-friendly and would bring down litigation. Going by the above discussion, the same seems to have been merely wishful thinking! ■