



GST updates

Taxability of 'Free of Cost' supplies for the purposes of valuation of works contract under Model GST law

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Inclusion of value of Free of Cost (FOC) supply in the value of works contracts and consequent levability of VAT/service tax on such material, has been a highly contentious issue in the

past. This is particularly in scenarios, when, the contractee/customer, supplies cement, steel and other material to the construction contractor on free of cost basis.

Present scenario vis-à-vis free supplies



For the purpose of applicability of VAT on FOC

As far as the issue of applicability of VAT on FOC supply is concerned, this aspect stands settled by the landmark judgement of the Apex Court in the case of **N.M. Goel & Co. vs Sales Tax Officer, Rajnandgaon, [1989-(001)-SCC-0335-SC]** ('N.M. Goel' case) wherein it was held that the transaction would be construed as sale (leviable to sales tax) when the contractee supplied the contractor iron, steel, etc. for the purpose of construction and the cost was deducted from the contract price payable (as the contract price was inclusive of the value of material) to the contractors. Consequently, the above supplies were held to be liable to VAT because the above transaction for supply of material (from the contractee to the contractor) could be viewed as a separate, distinct sale transaction.

Per contra, the above supply of material from the contractee to the contractor is generally viewed as non-taxable from a VAT perspective when the value of such supplies is not deducted in the bill raised by the contractor on the contractee and the contract value does not include the cost of such material. This is also driven by how the contract terms are worded.

For the purpose of applicability of service tax on FOC

Further, as far as levability of service tax on supply of FOC material is concerned, for the period prior to the negative list regime, the Larger Bench of the Tribunal in the case of **Bhayana Builders (P) Ltd., [2013 (32) STR 49 (Tri – LB)]** held that value of goods supplied free of cost by service recipient, not being monetary or non-monetary consideration accruing to the benefit of service provider, would be outside taxable value as defined in Section 67 of the Finance Act, 1994 and thus, not leviable to service tax.

However, in the post negative list regime, total amount liable under works contract was specified to include 'fair market value of all goods and services, supplied in or in relation to execution of works contract, whether or not supplied under same contract or any other contract'. But, it is to be noted that though the above provision says that value of all goods supplied should be included in the value, it fails to set out as to who is the supplier; whether it contemplates the contractee to be the supplier is not clear and the provision to this extent is ambiguous - It can be argued that when the legislature does not specifically provide that supplies made by the recipient are to be included in the value of the service, the same cannot be read into it. Thus, even in the post 2012 regime, it has been a point of argument that the value of free supplies supplied by the contractee is not includable in the assessable value. In fact, this argument can be supplemented by placing reliance on the Notification No. 11/2012 dated 17March 2012 which was in effect for a brief period (3 months) where it specifically provides that free supplies supplied by the recipient shall be included in the value of the service.

For the purpose of applicability of customs/excise duties on FOC

At this juncture, it is pertinent to note that though the issue with respect to inclusion of free supplies persists in the service tax and VAT regimes, the customs law and central excise law specifically provide that the value of free supplies supplied by the buyer shall be includable in the assessable value.

At present, the taxpayers have been structuring their transactions/contracts from a tax optimisation perspective keeping in mind these legal intricacies.

GST Model law and taxability of free supplies – double taxation?

The above ratio laid down in the **N.M. Goel case** does not seem to have been strictly adhered to under the Model GST law which has chosen to follow the central excise and customs valuation provisions and proposes that irrespective of whether the material supplied is actually free of cost or not, the value necessarily needs to be added to determine the taxable base for the construction contractor. In this regard, reliance is placed on Section 15(2)(b) of the proposed Model GST law, which provides for inclusion of value of FOC supply in the transaction value, without any exception. The above relevant section is as follows:

(2) The transaction value under sub-section (1) shall include:

- (a) ...
- (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;

Additionally, under the Model GST law, there are few specified matters (under Schedule I), which are proposed to be treated as supply without consideration, which includes 'supply of goods by a taxable person to another taxable or non-taxable person in the course or furtherance of business'. **Owing to the above, the FOC supply of materials by the customer to the contractor, appears to be liable to be treated as 'supply without consideration' and thus, leviable to GST.**

In light of the above discussion, the FOC supplies which usually do not attract any VAT as on date, appears to be covered under the ambit of GST under the proposed Model GST law **both in the hands of the construction contractor [because of Section 15(2)(b) referred above] and the customer/contractee (because of Schedule 1).**

As a corollary to the above, it needs to be analysed whether a customer undertaking FOC supplies can optimise the GST cost on the said FOC supplies by charging and recovering the same from the contractor who in turn can take credit of the said GST against output GST payable by him/her on his/her construction services. In this regard, Section 16 (c) of the Model GST law should be taken into consideration which specifies that credit shall not be available when goods are acquired by a principal in the execution of a works contract, when such contract results in the construction of immovable property (other than plant and machinery). Thus, it is possible that when FOC materials are supplied by the customer to the contractor, even if the GST leviable on that free supply is recovered by the customer from the contractor, no credit of the said GST will be allowed to the contractor and this GST shall become a transaction cost.

Thus, owing to the foregoing ambiguity in credit availment, the same transaction may be subject to GST twice and this may result in double taxation. Further, since there are two registered taxable persons who would value the free supply independently for paying GST, the valuation for same goods could be different in the hands of different parties. This too is an avoidable and litigation-prone consequence and ought to be avoided.

The foregoing probably is an unintended consequence – nonetheless, this needs to be addressed at the earliest.

This provision for the inclusion of free supplies under Model GST law can be compared to the provision incorporated in the Common System of Value Added Tax for the European Union wherein the Article 73 provides that the taxable amount shall include everything that constitutes consideration obtained or to be obtained by the supplier, in return for the supply, from the customer or a third party, including subsidies directly linked to the price of the supply. Though this provision contemplates that any supply made by the recipient to the supplier shall be included in the taxable amount, it creates an ambiguity as to whether the free supplies shall be regarded as a consideration for the taxable supply.

In contrast, the provision for inclusion of free supplies in the current GST Model law for India appears unambiguous in its interpretation that free supplies shall form part of the taxable value.

Given the above issues, the entire transaction mechanism (where the customer/contractee supplies materials to the construction contractor on free of cost basis) may need to be re-evaluated/re-designed for the GST regime .



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