

Inter Unit Transactions & Netting of Consideration – Legal Issues

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There is a never-ending appetite to seek Advance Rulings in GST despite the fact that most of the rulings are in favour of the Revenue. While the AAR ruling in GST is not a precedent and is binding only on the applicant, the attention bestowed on such rulings creates unwarranted panic in the business and professional community.

ITC for inter-unit transactions

A classic example is the recent ruling of the Tamil Nadu AAR in Sanghvi Movers Ltd. [TS-614-AAR-2019-NT] to the effect that input tax credit is not available for the branch office which received cranes from the head office in Maharashtra on the ground that the branch office does not pay the full consideration but the same is being netted off against the receivables by the branch from the head office.

In the said case, in terms of an MoU between SML Maharashtra and SML Tamil Nadu, the Maharashtra unit agreed to provide crane components to the branch office on hire charges. Originally, SML Maharashtra had approached the Maharashtra AAR who had given the ruling that movement of crane from one registered office to another registered office for further supply on hire charges to customer would be a taxable supply. However, on the question of eligibility to claim ITC, the Maharashtra AAR expressed the view that SML Maharashtra is not the proper person to raise the question.

SML Tamil Nadu, therefore sought the ruling of the Tamil Nadu AAR with reference to ITC eligibility. The AAR noticed that in terms of the MoU, the lease/hire charges payable by SML Tamil Nadu to SML Maharashtra is to be netted off receivable and payable in the books of accounts and is considered as deemed payment. It was observed that even though SML Maharashtra raised invoices on SML Tamil Nadu at 90% of the underlying billing by SML Tamil Nadu to its customers, the full amount is not being paid since the same is being netted off against the receivable by SML Tamil Nadu for the upkeep charges which SML Maharashtra has to pay to SML Tamil Nadu as per the MoU.

Applicability of proviso to Rule 37



The applicant relied upon the proviso to Rule 37 which provides that value of supplies made without consideration as specified in Schedule-I shall be deemed to have been paid for the purposes of the second proviso to Section 16(2) and hence the condition of payment within 180 days is not applicable to the applicant.

The AAR ruled that the said proviso would apply only when the supplies are "made without consideration". Since there is a consideration to be paid by SML Tamil Nadu to SML Maharashtra and also specified in the invoices, the proviso to Rule 37 is not applicable. Accordingly, it was ruled that the applicant cannot claim full ITC since they would be required to reverse such ITC as per the second proviso to Section 16(2).

Design flaws in GST

This ruling is a classic example of consequences that flow when the statute makes certain assumptions which run contrary to business and the concept of consideration. There was a design flaw in the legislation itself when, Section 7(1)(c) considered activities specified in Schedule – I made or agreed to be made without a consideration as a supply. In the pre- GST scenario, movement of goods between the head office and branch was an exempt transaction which distorted the input credit mechanism. IGST was imposed on such transactions in order to ensure that the flow of credit is not disturbed. Applying the same rationale for services was a recipe for chaos. The problem was further compounded by over- emphasizing the valuation aspect when the whole objective was tax- neutrality. Having created the concept of 'open market value', exceptions had to be created to address practical problems.

Para 2, Schedule – I, CGST Act covers supply of goods or services or both between the related persons or between distinct persons as specified in Section 25 and Schedule covers activities to be treated as supply even if made without consideration.

Macro-level legal questions

- (i) Whether it is permissible for the Parliament to declare certain activities as a supply even if made without consideration when consideration is critical for taxability and whether the same can be done without using the tool of a deeming fiction?
- (ii) Can mere activities be identified as a supply through Section 7 when Article 246A of the Constitution confers the power to make laws with reference to GST where there is a supply of goods or services or both?
- (iii) Whether consideration is an important component for levy of tax when the charging provisions seeks to tax supplies and not removals?
- (iv) When the charging provision is linked with value under Section 15 which refers to price paid or payable, can it be said that there is a price paid or payable in a transaction between distinct persons?
- (v) Whether Rule 28 can be considered as valid when there is no delegated power to value Schedule I transactions between distinct persons, given the fact that Section 15(1) only covers



related parties?

The Supreme Court in the case of *Govind Saran Ganga Saran Vs. Commissioner of Sales tax (1985) 60 STC 1*, has held that the components which enter into the concept of a tax is well known. The <u>first</u> is the character of the imposition known by its nature which prescribes the taxable event attracting the levy; <u>second</u> is a clear indication of the person on whom the levy is imposed and who is obliged to pay the tax; the <u>third</u> is the rate at which the tax is imposed and <u>fourth is the measure or value</u> to which the rate will be applied for computing the tax liability. If these components are not clearly and definitely ascertainable, it is difficult to say that the levy exists in point of law. Any uncertainty or vagueness in the legislative scheme, defining any of those components of the levy will be fatal to its validity. It remains to be seen as to whether the tests laid down are met in the context of Section 7(1)(c) and distinct persons.

The debate around cost allocation; recovery of salary; inter-unit billing for shared services; impact of AAAR rulings will pale into significance if the test laid down by the Supreme Court is not met.

Micro-level issues

If the AAR was of the view that the proviso to Rule 37 providing for a concept of deemed payment is not applicable as there is a consideration between distinct persons, then, Section 7(1)(c), Schedule – I itself should not have become applicable.

If the AAR was of the view that as per the agreement there was a consideration, legally, it cannot have a character of consideration since primarily it does not meet the requirement of a contract under Section 10 of the Contract Act, 1872 which requires competent contracting 'parties.' The head office and branch of the same company cannot meet the requirements of Section 10.

If the AAR is of the view that the second proviso should be read with the first proviso to Rule 28, then the ruling does not appreciate the distinction between the two provisos. The first one deals with goods and the second one covers both goods and services and further, the second proviso also introduces a deeming fiction. The whole object of invoice value being accepted as open market value was based on the principle of tax neutrality and hence the reference to full Input Tax Credit in the hands of the recipient.

Last but not the least, netting of is a well-known accounting concept and should have been accepted as a form of payment. The Supreme Court in the case of *Kanchanganga Sea Foods* (2010) 325 ITR 540 has recognized that payments in kind would also attract TDS under Section 195 of the Income Tax Act, 1961. Further, in the case of *JB Boda & Co. Pvt. Ltd. vs. CBDT* (1997) 223 ITR 271, the Supreme Court has held that a two-way traffic is unnecessary. To insist on a formal remittance first and thereafter to receive a commission from the foreign re-insurer will be an empty formality and a meaningless ritual, on the facts of the case.