

GST on free supplies by customers

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Introduction:

It is common practice prevailing in many industries that certain materials are provided by the customer to the manufacturer or contractor. This is done for various business or economic reasons. For example, moulds, jigs and dies etc., are provided by the Original Equipment Manufacturers (OEM) to a component manufacturer in the automobile industry. Similarly, the client would be supplying the diesel and explosives to the mining contractor. Likewise, the recipient would be providing the steel and cement to the contractor in the construction contracts. In this article, an attempt is made to explain the relevant legal provisions and applicability of GST on such free supplies made by the recipient to the supplier.

Position during Pre-GST regime:

The value of the free supplies required to be included in the taxable value. This position is almost settled in all indirect taxes like Central Excise, VAT. However, the applicability may differ (either time or law) as there were several disputes, amendments and court decisions on this subject for very long time.

Position under GST:

GST is levied at a specified rate on the value determined under section 15 of CGST Act, 2017 (similar provisions are existed in all state SGST laws and made applicable for IGST). To determine whether free supplies are to be includible in the taxable value or not, the primary question to be answered is whether price agreed in the contract (wherein the price of free supplies is not factored) would constitute the '*consideration*' at first instance and thereby to construe the same as '*sole consideration*' and accordingly the provisions of section 15, *ibid qua* Transaction value can be adopted.

Section 2(31) defines consideration which reads as follows:
"consideration" in relation to the supply of goods or services or both includes–

- a. *any payment made or to be made, whether in money or otherwise, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government;*
- b. *the monetary value of any act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government:*

Provided that a deposit given in respect of the supply of goods or services or both shall not be considered as payment made for such supply unless the supplier applies such deposit as consideration for the said supply.”

In absence of means part of the expression "consideration" as it only gives the inclusive definition, it is pertinent to know what is meant by the said expression. In this connection, reference can be made to the decision of Hon'ble Apex court in the case of *Ku. Sonia Bhatia vs. State of U.P. and Others* AIR 1981 SC 1274 wherein after considering the expression in the Contract Act and referring to Black's Law Dictionary, other dictionaries, English judgments and Corpus Juris Secundum, the Hon'ble Supreme Court held that *“inescapable conclusion that follows is that consideration means a reasonable equivalent for other valuable benefit passed on by the promisor to the promisee or by the transfer of to the transferee.”* The rationale of this decision was discussed & applied even in the context of service tax [*Bhayana Builders Pvt. Ltd. v. Commissioner — 2013 (32) S.T.R. 49 (Tribunal-LB)*]. A similar view was expressed under Central Excise law by the Hon'ble Supreme court in case of *Commissioner v. Fiat India Pvt. Ltd. — 2012 (283) E.L.T. 161 (S.C.) (Para 58)*.

Thus, any consideration whether monetary or otherwise should have flown or should flow from the payer to the payee and should accrue to the benefit of the later. The holistic reading of the definition given under GST (extracted supra) also gives similar meaning as explained by the Hon'ble supreme court.

The above theory remains unchanged and does not get affected even after applying the inclusive part of the 'consideration' definition as it attempts to cover the payments/acts done in response to the supply but nowhere

overrides the above-stated principle that such payment/act should accrue to the benefit of the supplier. Going by this analogy, it can be said that “free supplies” would not constitute a consideration remitted by the recipient to the supplier, more so when the no part of the free supplies accrues to or is retained by the supplier.

Further, the wordings of section 15(2)(b) of CGST Act, 2017 also does not make the ‘free supplies’ as taxable value as it mandates the liability of the supplier at first instance (contractual obligation to procure cement & steels in the above-stated example), which is completely missing in the context of ‘free supplies’. However, in a case wherein it was initially agreed that supplier would incur the entire cost but the same was actually incurred by the recipient and adjusted in the payment, the value of ‘free supplies’ may have to be includible and liable for GST.

Position under old laws Vs GST:

In old indirect taxes (Central Excise, VAT, service tax etc.,) the taxable events are restrictive in the gamut of entire supply chain and governed by the different laws and of course by the different Governments (Centre or State). For instance, the Central Excise can be levied only at the stage of ‘manufacture’, VAT only at the time of ‘sale’. Because of this restrictive application and in order to avoid the revenue leakage, the old laws attempted to tax the ‘free supplies’.

However, as GST is levied on the common taxable event known as ‘supply’ across the entire supply chain and leviable at all stages and the tax charged by the supplier is anyway available as input tax credit (ITC) to the recipient (except when the ITC is specifically restricted or recipient engaged in exempted supplies or unregistered etc.,). Thus, there is very less chance for revenue leakage.

For instance, assume 5 components are to be assembled in order to manufacture a mobile phone. Out of 5 components required, 2 components are agreed to be provided by the recipient at free of cost and supplier is

required to purchase the rest 3 components and manufacture the mobile. Central Excise being leviable on the very specific activity of **‘manufacture’**. Hence, the cost that is to be incurred for manufacturing has to be included in the taxable value (i.e. price of 2 components supplied free of cost). The person who is actually incurring the cost is the irrelevant i.e. supplier or receiver. However, under GST, the taxable event is **‘supply’** which is a broader term than manufacture and includes all types of transfers. Hence, in determining the taxable value, the significance shifts to ‘contractual obligation or business transaction’ from *‘a targeted event of manufacture’*.

Hence, the rationale of the old laws attempts to tax the free supplies would not hold water under GST and may run against the objective of GST to avoid ‘cascading effect’.

The above conclusion that ‘free supplies’ are not liable to be includible for payment of GST is fortified from the fact that unlike old laws (Central Excise for instance) there is no specific provision that specifies for the inclusion of ‘free supplies’ value and also the fact that model GST law contained the specific provision for inclusion of the same but was omitted in the final law.

Recent clarification from Government:

Very recently Government has issued a circular no. 47/21/2018 - GST dated 08.06.2018 clarifying that the value of free supplies need not be added to the value of supply. The relevant extract reads as follows:

S. No	Issue	Clarification
1	Whether moulds and dies owned by Original Equipment Manufacturers (OEM) that are sent free of cost (FOC) to a component manufacturer is leviable to tax and whether OEMs are required to reverse input tax credit in this case?	1.1 Moulds and dies owned by the original equipment manufacturer (OEM) which are provided to a component manufacturer (the two not being related persons or distinct persons) on FOC basis does not constitute a supply as there is no consideration involved. Further, since the moulds and dies are provided on FOC basis by the OEM to the component manufacturer in the course or furtherance of his business, there is no requirement for reversal of input tax credit availed on such moulds and dies by the OEM.

		<p>1.2 It is further clarified that while calculating the value of the supply made by the component manufacturer, the value of moulds and dies provided by the OEM to the component manufacturer on FOC basis shall not be added to the value of such supply because the cost of moulds/dies was not to be incurred by the component manufacturer and thus, does not merit inclusion in the value of supply in terms of section 15(2)(b) of the Central Goods and Services Tax Act, 2017 (CGST Act for short).</p> <p>1.3 However, if the contract between OEM and component manufacturer was for supply of components made by using the moulds/dies belonging to the component manufacturer, but the same have been supplied by the OEM to the component manufacturer on FOC basis, the amortised cost of such moulds/dies shall be added to the value of the components. In such cases, the OEM will be required to reverse the credit availed on such moulds/ dies, as the same will not be considered to be provided by OEM to the component manufacturer in the course or furtherance of the former's business.</p>
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The above circular can be understood with the following illustration:

Let us say, the contract price for the building construction is 10 crores wherein the contractor has to incur all the cost. Instead of this, it may be agreed that the cement & steel are to be supplied by the client and contractor would execute the work using the same thereby bringing down the contract price to Rs.7 crores.

In the first case, the Government would be able to levy a tax on entire Rs.10 crores. By virtue of Section 15(2)(b), *ibid*, this position would not change in a scenario wherein recipient actually procured (instead of contractor) and given to the contractor for execution of the contract and invoice was raised after reducing the value of materials given by the recipient. This is because of the fact that contractually, the contractor/supplier is liable for procurement and part of the contract price agreed but actually procured & got reduced while raising the invoice. The same is also clarified in the above referred circular.

In the second case, taxable value is Rs. 10 crores in the earlier regime whereas it is Rs. 7 crores in GST as per the above discussion. Though the revenue earned (by way of a collection of GST) is reduced considering this transaction alone, it is to be noted that the differential value of Rs. 3 crores has also suffered GST at the time of procurement by the recipient from the third party. Hence, considering the entire supply chain, GST is suffered on entire Rs. 10 crores but at different stages. Accordingly, there is no revenue leakage to Government except the materials supplied at free are cost are either exempted or not levied under GST like diesel.

Conclusion:

Due to initial ambiguity, many of the taxpayers continued the earlier practice and has been paying GST on the 'free supplies'. The recent clarification can be taken as a basis and may discontinue the GST payment on the 'free supplies'. The GST paid in past may be claimed as a refund if the recipient did not avail the input tax credit of it or reversed it now.

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