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Overview of GST Law and the Concept of Supply

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GST – Key Design Aspects



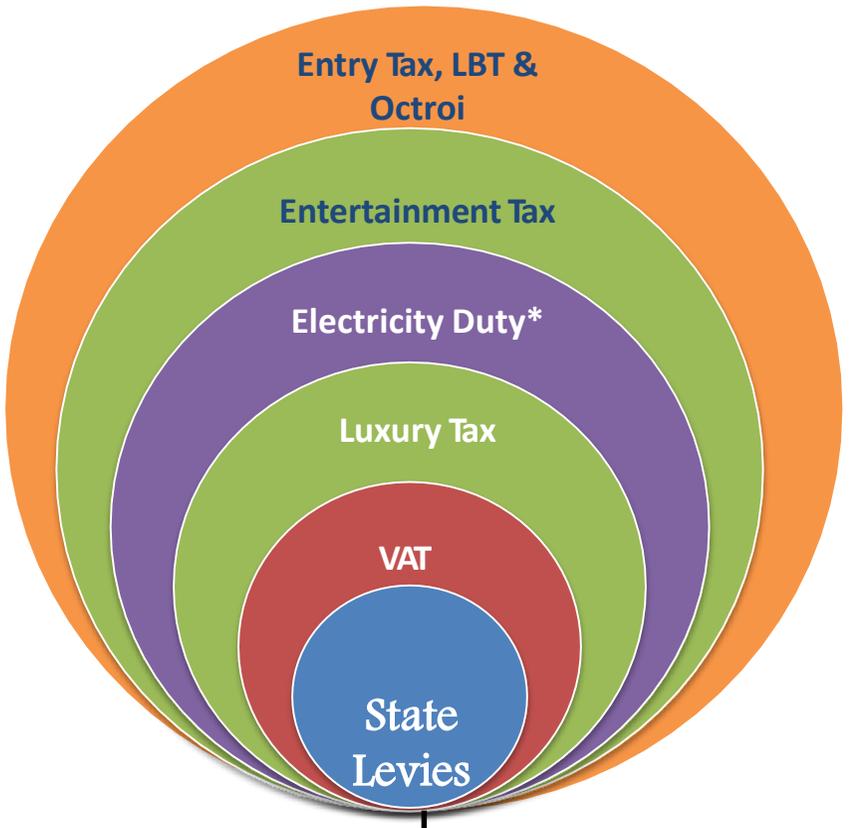
Snapshot of 101st Constitution Amendment Act, 2016

- ❖ **Article 246A** – Concurrent power with Centre and State to levy GST. Exclusive power with Centre to levy GST on interstate supplies
- ❖ **Article 248** – Residuary power of Centre to levy tax (on matters not listed in the State list and Concurrent list) is now made subject to Article 246A
- ❖ **Article 279A** – Constitution of the **GST council**
- ❖ **Entries in List I, VII Schedule** – (i.e. areas meant for Central Govt. to legislate)
 - Entry 92 (tax on sale of news papers & advertisements) – **Deleted**
 - Entry 92C (tax on services) – **Deleted**
 - Entry 84 (duties of excise) – **Restricted** to 5 petroleum products & tobacco
- ❖ **Entries in List II, VII Schedule** – (i.e. areas meant for State Govt. to legislate)
 - Entry 52 (Entry tax) – **Deleted**
 - Entry 55 (taxes on advertisements other than those in news papers etc.) – **Deleted**
 - Entry 54 (tax on sale of goods) – **Restricted** to 5 petroleum products & alcohol
 - Entry 62 (tax on luxury, betting and entertainment) – **Restricted** to cases where levied by Panchayats and Municipalities, District/ Regional Council
- ❖ **'GST' defined** = Tax on supply of goods or services or both except taxes on supply of alcoholic liquor for human consumption: **'Services'** = *Means anything other than goods*; and **'Goods'** (as always defined thus far and continues to be so) = *Includes all materials, commodities and articles*

Setting the context: Present Indirect Tax Structure in India – subsuming into GST..... *ONE NATION, ONE TAX*



Indirect Tax – Current Regime (typical rates)	
BCD	10%
CVD	12.50 %
SAD	4%
Excise Duty	12.50%
Service Tax (incl. SBC & KKC)	15%
Central Sales tax	2 % – 15 %
Value Added tax	5% – 15 %
Entry Tax / Octroi/ LBT	1% – 15 % or fixed rate per unit



*BCD – not subsumed in GST

*Electricity duty – not subsumed in GST

Usually a Cost Usually a 'Pass through'

GST (CGST+SGST OR IGST)

Fundamental questions under GST, for taxability

- ❖ Is there a 'supply' as defined under the CGST Act?
- ❖ Is the said 'supply' a 'supply of goods' or 'supply of services'?
- ❖ What is the 'place of supply' for such supply? Whether this 'supply' will attract CGST and SGST of a particular State or will attract IGST (being inter-State in nature)?
- ❖ What is the value of such 'supply' on which GST will need to be paid?
- ❖ What is the rate at which GST will need to be paid?
- ❖ What is the point of time at which the above GST liability accrues - what is the point of taxation (or in GST phraseology - what is the 'time of supply')?

GST – the various sources of law

- ❖ **Indian Constitution – relevant aspects discussed in earlier slides**
- ❖ **The Central Goods and Services Tax Act, 2017 (“CGST Act”):**
 - Both the Parliament and the State Legislatures are empowered to make laws with respect to GST that is leviable on intra- State supplies of goods and services.
 - CGST Act is the law that levies GST on intra-State supplies of goods and services from the Central Government’s side.
 - Each such supply is also leviable to GST under the relevant State GST legislation or Union Territory GST legislation (discussed below).
 - Typically, if effective GST rate on a supply of service is 18%, 9% is levied under the CGST Act and the remaining 9% under the relevant State GST legislation or Union Territory GST legislation.
 - Section 9 of the CGST Act provides for the levy and collection of GST. The same has been extracted as follows:–

*“9. (1) Subject to the provisions of sub-section (2), **there shall be levied a tax called the central goods and services tax on all intra-State supplies of goods or services or both, except on the supply of alcoholic liquor for human consumption, on the value determined under section 15 and at such rates, not exceeding twenty per cent., as may be notified by the Government on the recommendations of the Council and collected in such manner as may be prescribed and shall be paid by the taxable person.**”*

GST – the various sources of law (Cont.)

❖ The Central Goods and Services Tax Act, 2017 (“CGST Act”):

- Section 7 of the CGST Act prescribes an inclusive definition for the expression “**supply**” and a portion has been extracted as follows:

“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, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business;.....”

- “**Consideration**” is defined under Section 2(32) of the CGST Act and a portion of the same has been extracted as follows:—

“(31) “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;....”

The majority of the substantive law pertaining to GST can be found in the CGST Act itself

GST – the various sources of law (Cont.)

- ❖ The various State Goods and Services Tax legislations (“SGST Acts”) passed by each State and commonly referred to as, for example, Maharashtra GST Act or Odisha GST Act etc.
 - The State GST legislations are substantially *pari materia* to each other except for some State-specific matters of detail. Further, the key provisions under the State GST statutes are largely the same as the CGST Act (except for State-specific aspects)

- ❖ **The Integrated Goods and Services Tax Act, 2017 (“IGST Act”):**
 - The IGST Act seeks to levy **GST on all inter-State supplies** of goods and services.
 - Unlike in the case of intra-State Supplies, if effective GST rate on a supply of service is 18%, the whole 18% is levied under the IGST Act itself.
 - The IGST Act is a short piece of legislation and it incorporates by reference several substantive provisions from the CGST Act.
 - However, the **most important substantive aspect that emerges from the IGST Act are:**
 - ✓ **provisions pertaining to ‘place of supply’; and**
 - ✓ **definitions of ‘inter-State’ and ‘intra-State’ supplies** of goods and services.

GST – the various sources of law (Cont.)

❖ The Union Territory Goods and Services Tax Act, 2017 (“UTGST Act”)

- The Constitution (One Hundred and first Amendment) Act, 2016, inserted Clause 26B on “State” in Article 366. As per this clause, “State” with reference to Articles 246A, 268, 269, 269A, and 279A includes a Union territory with Legislature. Even ‘State’ for the purposes of GST, includes a **Union territory with Legislature**
- Therefore, technically SGST cannot be levied in a Union Territory without legislature. This applies to the following Union Territories of India: **Chandigarh**, **Lakshadweep**, **Daman and Diu**, **Dadra and Nagar Haveli** and **Andaman and Nicobar Islands**
- UTGST Act plugs this gap - **Where intra-State supplies pertain to a ‘Union Territory’ as defined instead of a ‘State’, GST gets levied under the CGST Act along with the UTGST Act** (instead of a State GST legislation)
- However, SGST can be applied in Union Territories such as New Delhi and Puducherry, since both have their individual legislatures, and can be considered as “States” as per GST laws
- ‘Union Territory’ is defined under Section 2(114) of the CGST Act to mean the territory of Andaman & Nicobar, Lakshwadeep, Dadra & Nagar Haveli, Daman and Diu, Chandigarh **and ‘Other Territory’**.
- ‘**Other Territory**’ has been defined under Section 2(81) of the CGST Act whereunder it “*includes territories other than those comprising in a State and those referred in sub-clauses (a) to (e) of clause 114*” - thus **everything other than the States and the 5 specific Union Territories mentioned in Section 2(114) of the CGST Act will also qualify as an Union Territory** for the purposes of GST.

GST – the various sources of law (Cont.)

❖ The Union Territory Goods and Services Tax Act, 2017 (“UTGST Act”)

- Concept of ‘**Other Territory**’ is an **important point** to remember. Given that:
 - ✓ Definition of ‘India’ under GST laws extends upto 200 Nautical Miles from the coastal baseline even though ‘territorial waters of India’ extends only upto 12 nautical miles; and
 - ✓ In terms of Explanation to Section 25(1) of the CGST Act - *“Every person who makes a supply from the territorial waters of India shall obtain registration in the coastal State where the nearest point of the appropriate baseline is located”*

the entire sea area surrounding India, from 12 nautical miles upto 200 nautical miles, whether part of the Arabian Sea, Bay of Bengal or the Indian Ocean will constitute a ‘Union Territory’ for the purposes of levy of GST and will most likely be subject to the UTGST Act for contracts (e.g., for oil and gas exploration works) carried out in such offshore areas.

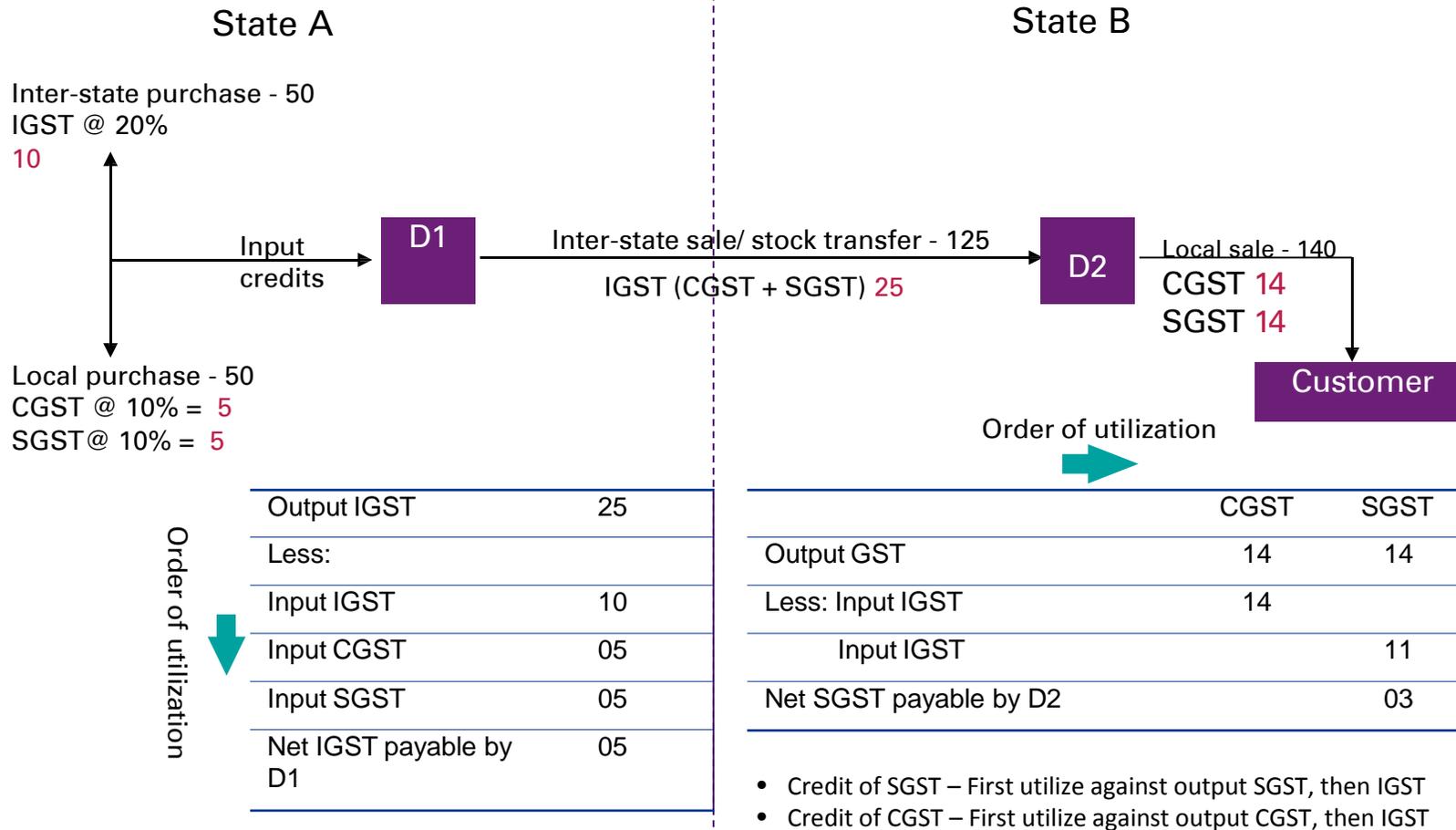
❖ The GST Compensation Cess Act:

- This legislation was brought in to compensate the State Governments for their projected loss of indirect tax revenue owing to introduction of GST.
- Under this law, a **GST Compensation Cess is levied** on intra-State/ inter-State supply of **few notified** goods or services (e.g coal, cars etc) to create a corpus for providing compensation to the States.

GST – the various sources of law (Cont.)

- ❖ **The next source of law would be the various delegated legislations under the above GST legislations**
 - the **Rules issued** under the CGST Act [which have been substantially borrowed for the purposes of IGST (vide Notification 4/2017-Integrated Tax dated 28.6.2017) as well as GST Compensation Cess (vide Notification 2/2017-Compensation Cess dated 1.7.2017)]
 - the State GST Acts (similar to CGST Rules); and
 - the various notifications (dealing with rates as well as other aspects) issued under the above legislations.
 - **Rates of GST** applicable under CGST Act (Similar rate notifications exist under the other GST laws too) would need to be gleaned from:
 - ✓ Notification 11/2017-Central Tax (Rate) dated 28.6.2017 read with exemption Notification 12/2017-Central Tax (Rate) **for rate of services** (as amended from time to time);
 - ❑ It is pertinent to note that a comprehensive **scheme for classification of services under GST**, with detailed description of various types of services, has been prescribed under Notification 11/2017-Central Tax (Rate) dated 28.6.2017 as an annexure to that notification.
 - ✓ Notification 1/2017-Central Tax (Rate) dated 28.6.2017 read with exemption Notifications 2/2017 and 3/2017-Central Tax (Rate) for rate of goods
 - **Thus, in order to answer the fundamental questions on GST indicated earlier, the above sources of law would need to be perused and analysed carefully**

CGST, SGST & IGST - illustrative working





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Concept of Supply



Taxable event under GST - Section. 7: "Supply includes...."

Supply

All forms of supply of goods or services or both **such as** sale, transfer, barter, exchange, license, rental, lease or disposal, **for consideration**

Importation of services **for consideration** (whether or not in the course of business)

Supply specified in Schedule I made or agreed to be made **without consideration** (e.g. supply of goods/services between branches of same entity or related parties, supply of goods by principal to agent where agent has to supply such goods on behalf of principal)

Schedule II needs to be applied to identify matters which are to be treated as supply of goods or services (e.g. 'works contracts', 'supply of food/beverages' = supply of services)

Activities or transaction specified in Schedule III (e.g. service by employee to employer, sale of land or completed buildings etc);

Separately, activities undertaken by CG/SG/LA as may be notified = supply of goods or services

Composite supply shall be taxed based on the principal supply and mixed supply shall be taxed based on the supply which attracts highest rate

- **Inclusive definition provided** – Therefore, has wide amplitude. **Illustrates events qualifying as supply via usage of "such as"**
- On **Intra-State** supplies of goods or services - **CGST & SGST** by the Central and State Government respectively; On **Inter-State** supplies of goods or services - **IGST** by the Central Government

Barter & Exchange as a Supply

❖ Barter & Exchange

- **Dhampur Sugar Mills Ltd vs Commissioner Of Trade Tax;** - Molasses supplied for an amount equivalent to the licence fee for running of the sugar mill was held to be a sale of molasses since the price of molasses was to be adjusted from the amount payable by the appellant to the owner by way of consideration for use of the mill.

.....It is inconceivable in law that a licence fee can be a subject matter of barter or exchange. A barter or exchange indisputably is distinct and different from a sale. A contract of sale denotes a transfer of property in goods by mutual consent. Such a transfer of ownership must be in relation to transfer from one person to another. The consideration would be a price in the form of money. Only when the consideration for transfer consists of other goods, it may be an exchange or barter. Such is not the position here.

- **Is it a two way supply or a single supply? – development of ‘residential complexes’ in exchange of ‘Development Rights’?**
 - Reasonable interpretation – to be treated as a single supply
- **If two way supply then what would be the consideration for such a transaction**
- **Who would be the supplier and the receiver – both?**

Supply *vis a vis* Inter-State inter-branch transactions (stock transfers) - liable to GST?

- ❖ **As per Section 7(1)(a) of the CGST Act, 'supply' requires consideration. However, Section 7(1)(c) read with Schedule I: supply without consideration = 'Supply' in two situations:**
 - Supply of goods/services between **"Related parties"**
 - Supply of goods/services between **'distinct persons as specified in Section 25'** when made in the course or furtherance of business

- ❖ **Tax on all inter-state transactions between registered branch offices or between registered head office and registered branch offices**

- ❖ **Cross charges of administrative expenses incurred by the Group Head Office:**
 - Administrative expenses including **expenses for centralized functions of finance, legal, HR, book-keeping etc. are often cross charged by Group HO to all group companies** on the basis of an internal computation based on the headcount of the entity and other factors
 - Earlier, service tax was discharged on such cross-charges. Similar treatment should continue under GST too.
 - Further, **similar approach may need to be adopted even for cross-charges to other branches/divisions of the same legal entity, since, such services may qualify as a supply of service between 'distinct persons' leviable to GST**

Supply *vis a vis* Inter-State inter-branch transactions (stock transfers) - liable to GST?

- **Contrary argument** based on ‘in the course of employment’ argument:
 - ❑ A view may be adopted that **services rendered by the Centralized Finance teams, HR teams, legal teams etc. which are cross charged to other registered branches/offices in other States would essentially qualify as ‘services rendered by the Employee to the Employer’** (since the actual services in question would be rendered by employees at the centralized location who are employed for the entire company and not merely for that centralized location – it can be argued that the deeming fiction of ‘distinct person’ under GST cannot eclipse the contract of employment which is legal entity specific)
 - ❑ Thus, even if such services are provided to the other branches/divisions of the same company, it would not change the nature of such services and they would continue to be services of an Employee to an Employer and thus excluded from GST. **The tenability of this argument needs to be tested in the GST regime**
- **Cross-charges can also be argued to be cost-sharing arrangements** and thus supply of ‘money’ and hence not qualifiable as a supply of service and not liable to GST – however, **this would need greater clarity and a clarification/advance ruling may be sought in this regard for certainty of treatment**
- **What will be the mechanism to determine the transaction value? Rule 28 of CGST Rules applies for intra-company transactions between registrations – prescribes ‘open market value’ or ‘value of supply of goods or services of like kind or quality’**
- **Proviso to Rule 2: “Provided where the recipient is eligible for full input tax credit, the value declared in the invoice shall be deemed to be the open market value of goods or services”**
 - Effectively, for such transactions the invoice value will be accepted as the arms’ length taxable base (as long as the recipient is eligible for full credit)
 - The fact that the tax authorities would not be scrutinizing the values attributed by us for various inter-branch transactions can be a significant relief

Imported supplies: How GST applies on import of goods?

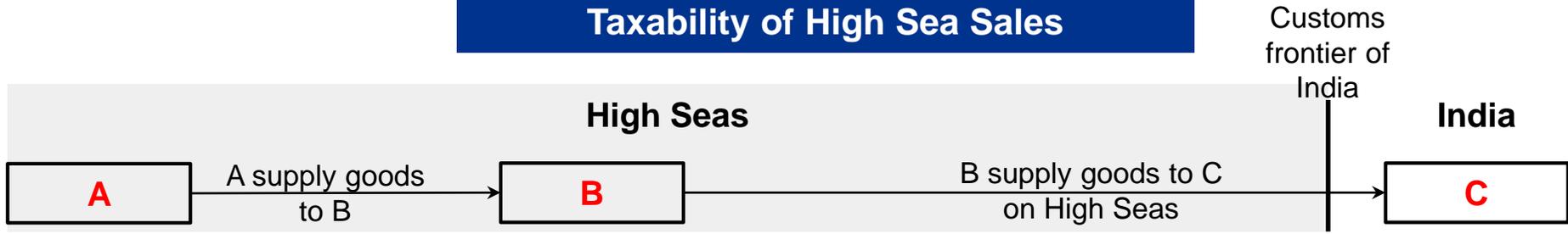
- ❖ **Section 7(2) of IGST Act:** *“Supply of goods imported into the territory of India, till they cross the customs frontiers of India, shall be **treated to be a supply of goods in the course of inter-State trade or commerce**”*
 - Proviso to Section 5(1) of IGST Act: *“....tax on **goods imported into India shall be levied and collected in accordance with the provisions of section 3 of the Customs Tariff Act, 1975 on the value as determined under the said Act at the point when duties of customs are levied on the said goods under section 12 of the Customs Act, 1962**”*

- ❖ **Basis above, imports would be liable to basic customs duty (BCD) + IGST** at the time of clearance of goods for home consumption. **IGST to apply on the value of goods + BCD**
 - **‘Place of supply’ of goods imported into India – location of the importer**
 - Therefore, even if the customs clearance is done at the port of unloading of goods, the **subsequent transport of goods to the importer’s factory/office address shall not qualify as a separate supply**. Thus, if the ‘importer’ is for example is of Delhi location there is only one place of supply apropos the subject imported goods – Delhi)

- ❖ As per subsection (8) added to Section 3 of Customs Tariff Act vide the ‘Taxation Laws (Amendment) Act, 2017: **IGST to apply on the value of goods+BCD**

Goods imported on High-Sea-Sales basis

Taxability of High Sea Sales



- ❖ **Section 7(2) of the IGST Act**– “Supply of goods imported into the territory of India, **till they cross the customs frontiers of India**, shall be treated to be a supply of goods in the course of inter-State trade or commerce”
- ❖ **Proviso to Section 5(1) of IGST Act**: “....tax on goods imported into India shall be levied and collected in accordance with the provisions of section 3 of the Customs Tariff Act, 1975 on the value as determined under the said Act at the point **when duties of customs are levied on the said goods under section 12 of the Customs Act, 1962**”
 - Does it mean that **all** supplies of goods **till the goods cross the customs frontiers** of India are supply of goods in the course of inter-state trade?
 - **Clarification on ‘High Sea Sales’ - only the last supply which results in the goods crossing the customs frontier will be taxable under Proviso to Section 5(1) of IGST Act read with Section 3 of the Customs Tariff Act**

Supply without consideration

- **Free of cost supplies - In case customer makes available equipment to contractor on bailment (without consideration i.e. FOC supply) – whether ‘supply’?**
- **Section 7(1)(c) read with Schedule I: supply without consideration = ‘Supply’ in two situations:**
 - Supply of goods/services between “**Related parties**”
 - Supply of goods/services between ‘**distinct persons as specified in Section 25**’ when made in the course or furtherance of business
 - Gifts from employer to employee > INR 50,000 – **Liable to GST**
- **Tax on all inter-state transactions between registered branch offices or between registered head office and registered branch offices**
- **Whether the value of such FoC supplies is includible in the taxable base for the contractor/supplier?**
 - **Section 15(2)(b)** provides – “*any amount that the **supplier is liable to pay** in relation to such supply **but which has been incurred by the recipient** of the supply and not included in the price actually paid or payable for the goods and/or services*”

Basis relevant contract, if it can be inferred that supplier of service was liable to bear the costs of such equipments, then value of such FoC supplies to be added to Contractor’s taxable base for GST

Supply without consideration

- **Cross charges of administrative expenses incurred by the Group Head Office:**
 - Administrative expenses including expenses for centralized functions of finance, legal, HR, book-keeping etc. are often cross charged by Group HO to all group companies on the basis of an internal computation based on the headcount of the entity and other factors
 - Earlier, service tax was discharged on such cross-charges. Similar treatment should continue under GST too.

❖ Disposal of business assets

- **Business assets must have been permanently transferred**
- **Input tax credit on such assets must have been availed**
- **Thus, scrapping or disposal of business assets without consideration - 'supply'. Further, transfer of an asset pursuant to a compromise agreement/ court order without consideration may be contemplated under this entry**
 - **Phoenix Optical Technologies Ltd. v. Commissioners for her Majesty; [2015] UK FTT 0463 (TC) wherein it was held that disposal of a machine pursuant to a compromise would qualify as a deemed 'supply' leviable to VAT**

Definition of 'supply' in other jurisdictions

India	Malaysian GST	New Zealand	EU VAT	Australia GST
<p>7. (1) For the purposes of this Act, the expression “supply” includes –</p> <p>(a) all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal <u>made or agreed to be made for a consideration</u> by a person in the course or furtherance of business;....</p>	<p>4. (1) subject to subsections (2) and (3), “supply” means all forms of supply, including supply of imported services, done for a consideration and anything which is not a supply of goods but is done for a consideration is a supply of services.</p>	<p>5. Meaning of term supply</p> <p>(1) For the purposes of this Act, the term supply includes all forms of supply.</p> <p>....</p>	<p>Article 14 - supply of goods</p> <p>1. ‘Supply of goods’ shall mean the transfer of the right to dispose of tangible property as owner.....</p> <p>Article 24 - Supply of services</p> <p>1. ‘Supply of services’ shall mean any transaction which does not constitute a supply of goods.....</p>	<p>You make a taxable supply if:</p> <p>(a) <u>you make the supply for consideration</u>; and</p> <p>(b) the supply is made in the course or furtherance of an *enterprise that you carry on; and....</p>

Definition of 'supply' across jurisdictions

- ❖ **'Supply' has been defined differently in different jurisdictions** – EU and Malaysia have a restrictive definition, whereas, India and New Zealand have expansive definition
- ❖ However, concept of 'supply' is not infinite even if an 'inclusive' definition is used – even under New Zealand GST It was held in **Databank Systems Ltd v Commissioner of Inland Revenue (NZ)** (1987) 9 NZTC 6213 that **"supply" means "to furnish or provide"** – a voluntary act of provision is necessary
- ❖ Relying upon the Databank case above, under Australian GST, in **Shaw v. Director of Housing and State of Tasmania (No. 2), [2001] TASSC 2**, the Court stipulated that the term 'supply' requires a voluntary act by the supplier –
 - **Facts involved in this case** – The plaintiff was entitled to recover damages from the defendants for negligent misstatement.
 - **Issue involved** – Whether tax liability arose in consequence of payment of the judgement sum? In other words, when the Court finally assesses the damages and makes an order, will there be any supply (*supply includes a release from an obligation*) leviable to tax?
 - **Held** – **The Court noted that the obligation of a judgment debtor to pay a judgment sum, extinguished by the act of payment, did not constitute a supply because it did not depend upon any voluntary action on the part of the judgment creditor.** Thus, there cannot be a supply constituted by a release of an obligation that occurs independently of the act of the releaser.

Definition of 'supply' across jurisdictions

- Relevant excerpt from the judgement -

“..... When the judgment is satisfied the debt created by the judgment is thereby extinguished and does not depend on the surrender of any rights or the release of the judgment debtor.”..19. It is true that in some circumstances, a release occurs by operation of law....However, the Act, s 9-5 opens with the words, “You **make** a taxable supply if...”**The verb “make” indicates a legislative intention to impose the tax only on voluntary supplies, not upon those supplies that occur without an act of the releasor.....** Application of that proposition to the word “supply” as enacted in the Act, s 9-10 reinforces the concept that there is a legislative intention not to include in the word “supply” the release of an obligation that occurs independently of the act of the releasor...”

- ❖ **GSTR 2006/9 issued by Australian Tax Office – Compulsory Acquisitions by Operation of Law**
 - In cases where land vests in the authority as a result of the authority seeking to acquire the land, and **initiating the compulsory acquisition process pursuant to its statutory right, then the owner does not make a supply.**
 - **This is because the owner does not provide anything to the authority. It takes no action to cause its legal interest to be transferred or surrendered to the authority.** It has no obligation to do anything, to refrain from doing something or to tolerate an act or situation.
- ❖ **Learning for India:** an activity would qualify as a **‘supply’ only if a voluntary act is undertaken by the supplier**

Definition of 'supply' across jurisdictions

- In contrast to compulsory acquisitions by government, where an owner initiates the acquisition by writing to the appropriate authority, such acquisition shall be regarded as supply.
- ***Hornsby Shire Council v Commissioner of Taxation [2008] AATA 1060***
 - **Facts involved in this case** – CSR Ltd owned a quarry in Hornsby which was zoned “Open Space A”. As per the enactment, land zoned as “Open Space A” must be acquired if the landowner makes a formal request in writing. In March 2001, CSR made such a request and subsequently acquisition took place. The acquirer subsequently wanted to claim input tax credit.
 - **Issue involved** – whether in respect of the compulsory acquisition of the quarry from CSR, there was a "supply" within s 9-10 of A New Tax System (Goods and Services Tax) Act 1999?
Section 9-10(2)(d) - supply includes a grant, assignment or surrender of real property
 - The Court held that When CSR gave notice, in terms of the LEP it did indeed incur legal obligations, and moreover did so in respect of subsequent actions leading up to the acquisition of the quarry. **Hence, there was a supply within s 9-10(2)(g) of the GST Act. There was, moreover, a surrender within s 9-10(2)(d).**
- Thus, Australian GST makes a distinction between extinguishment of an owner's interest by statute and doing of a thing that is compelled by statute. The former when, initiated at the request of the owner, shall be supply and the latter being compulsory acquisition shall not be regarded as supply.

Learning for India: an activity would qualify as a **'supply' only if a voluntary act is undertaken by the supplier**

'Supply' is 'made' only if there is identifiable 'consumption' - lessons from EU VAT

❖ Case C-215/94: Jurgen Mohr's case

- Mr Mohr was the owner of an agricultural holding on which he kept dairy cattle. He made an application to the Federal Office for Food and Forestry for a grant for receiving compensation for the definitive discontinuation of milk production. In his application he undertook definitively to discontinue milk production and not to make any claim for a milk reference quantity under the common organization of the market. The office upheld his application and granted him a single payment and subsequently, Mr Mohr sold his cattle thus ceasing all milk production.
- **Issue - Whether an undertaking to discontinue milk production given by a farmer constitutes a supply of services so that the compensation received for that purpose is subject to turnover tax.**
- Article 6(1) of the Directive provides "Supply of services" shall mean any transaction which does not constitute a supply of goods within the meaning of Article 5. Further, such transactions may include inter aim....— **obligations to refrain from an act or to tolerate an act or situation,..**

'Supply' is 'made' only if there is identifiable 'consumption' - lessons from EU VAT

❖ Case C-215/94: Jurgen Mohr's case

Revenue's contentions	European Court of Justice ("ECJ") ruling
Compensation and milk production are mutually dependant – clear link between consideration and service of discontinuation (refraining from an act)	VAT – a tax on consumption of services Local authority, by compensating for milk production, is not acquiring services for its own use but for community's good – they are not the consumers. Hence, the same is not a supply

- ❖ **Learning for India:** an activity would qualify as a 'supply' only if a voluntary act is undertaken by the supplier **AND there is an identifiable consumer for such activity**

Intention to create legal relationship - concept

Intent to create legal relationship – Balfour v Balfour [1919] 2 KB 571

- Mr. Balfour agreed to pay his wife a sum of money for maintenance while he was posted to Ceylon. After they separated, Mrs. Balfour took action to hold him to his payments. The action failed because there was no indication that the arrangement was intended to be a contract
- Important because Mrs. Balfour was suing Mr. Balfour under contract – not because he married her, but, because he **promised** her
- **Lord Atkin** – “*..there are agreements between parties which do not result in contracts within the meaning of that term in our law. The ordinary example is where two parties agree to take a walk together, or where there is an offer and an acceptance of hospitality.... To my mind those agreements, or many of them, do not result in contracts at all, and they do not result in contracts even though there may be what as between other parties would constitute consideration for the agreement. The consideration, as we know, may consist either in some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other. That is a well-known definition, and it constantly happens, I think, that such arrangements made between husband and wife are arrangements in which there are mutual promises, or in which there is consideration in form within the definition that I have mentioned. **Nevertheless they are not contracts, and they are not contracts because the parties did not intend that they should be attended by legal consequences”***

'Supply' - intention to create legal relationship

❖ Case C-16/93: Tolsma's case

- Mr Tolsma played a barrel organ on the public highway in the Netherlands. During his musical performance he offered passers-by a collecting tin for their donations; he also sometimes knocked on the door of houses and shops to ask for donations, but without being able to claim any remuneration by right.
- **Issue** - A service which consists of playing music on the public highway, for which no payment is stipulated but payment is nevertheless received, be regarded as supply of services for consideration and hence, leviable to turnover tax.

Revenue's contentions	European Court of Justice ("ECJ") ruling
<p>Direct link between payments by passers-by and service of musical performance by Tolsma</p> <p>Doesn't matter if payments received were not a matter of right for Tolsma</p>	<p>'supply of services' is effected 'for consideration', and hence is taxable, only if there is a legal relationship between the provider of the service and the recipient pursuant to which there is</p> <ul style="list-style-type: none"> - reciprocal performance, -the <u>remuneration received</u> by the provider of the service <u>constituting the value actually given in return for the service supplied to the recipient</u> <p>Upheld Tolsma's claim - "no agreement between parties"</p>

'Supply' - intention to create legal relationship

❖ Case C-16/93: Tolsma's case

- The Court noted that a supply of services is effected 'for consideration' within the meaning of Article 2 (1) of the Sixth Directive, and hence is taxable, **only if there is a legal relationship between the provider of the service and the recipient pursuant to which there is reciprocal performance. Thus, it was held that if a musician who performs on the public highway receives donations from passers-by, those receipts cannot be regarded as the consideration for a service supplied to them.** Further, where a person's activity consisted exclusively in providing services for no direct consideration, there was no basis of assessment and the services were therefore not subject to VAT.

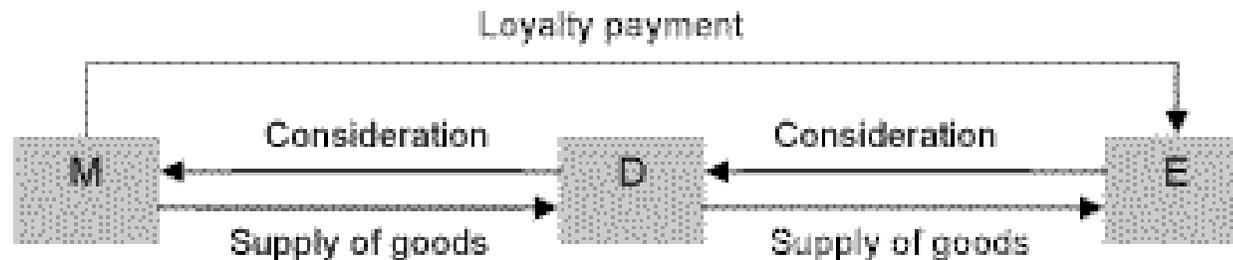
❖ Illustration under Australian GST Law which **contradict** the principles of the Tolsma case: **voluntary payments for restaurant supplies** - *A restaurant run by a sole trader accepts tips from its customers which are not passed to the restaurant's employees. Such tips are unsolicited and are in addition to the price stipulated by the restaurant.*

- It was held that tips are voluntary payments made in connection with the restaurant supplies made by the sole trader to its customers and thus form part of the consideration charged for such supplies. **Although there is no obligation on the customers to make these payments, the tips form part of the consideration for the restaurant supplies by the sole trader to its customers.** On the other hand, if the sole trader passes the tips on to the restaurant's employees then such tips constitute income of the restaurant employees and such payments are not subject to GST as the employees are not carrying on an enterprise for GST purposes.

'Supply' - intention to create legal relationship

❖ GSTR 2006/9 (Australia) - Illustration – Loyalty payments with no supply of goods/ services

- *M is a manufacturer of goods and supplies goods to authorized dealer (D). D further supplies goods to end users (E) and makes a standing offer to E that if E's purchases from D reach a certain level, M will pay E a 'loyalty payment'.*



- **Whether supply** - E is not under any binding obligation to M to purchase goods through D and does not make a supply to M simply by making acquisitions from D. Thus, the loyalty payment made by M to E cannot be consideration for a supply from E to M because E does not make a supply to M.

'Obligation to refrain from an act' - Case study vis-à-vis Liquidated Damages

- ❖ **Having established the fact that ‘supply’ requires a positive act from the supplier – whether liquidated damages would qualify as a ‘supply’?**
- ❖ It is pertinent to note that the taxability of ‘liquidated damages’ was unclear even under the erstwhile taxation regime
 - **In Service tax law, Section 66E(e) categorized** – “*agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;*” – as a ‘declared service’
 - **Similarly under CGST Act – Clause 5(e) of Schedule II expressly categorizes** – ‘*tolerating an act or situation*’ as a ‘supply of service’
 - Even under EU VAT, as per article 25 of the VAT Directive - ‘*A supply of services may consist, inter alia, in one of the following transactions: (b) **the obligation to refrain from an act, or to tolerate an act or situation***’
- ❖ *In this regard, we have discussed the tax implication on liquidated damages – in the subsequent slide*

'Obligation to refrain from an act' - Case study vis-à-vis Liquidated Damages

- ECJ in **Landboden-Agrardienste vs. Finanzamt Calau [Case C-384/95]** – held, compensation received by a farmer under the national compensation scheme, pursuant to a declaration given by him that he would not harvest at least 20% of his potato crop – **is not taxable under EU VAT**
 - **Facts involved in this case** – Landboden-Agrardienste gave an undertaking for reduction in potato production pursuant to the order by Food, Agriculture and Forestry Office of the local authority promoting the extensification of agricultural production. The undertaking was accepted and compensation was granted in return for a 20% reduction in annual potato production.
 - **Issue involved** – Whether an undertaking given by a farmer under a national compensation scheme not to harvest at least 20% of his potato crop constitutes an obligation to refrain from an act or tolerate an act/ situation and is thus a supply of services under Article 6 (1) of the 6th Directive?
 - The Court noted that for –
 - *“24. Since the **undertaking given by a farmer to reduce production does not entail either for the competent national authorities or for other identifiable persons any benefit which would enable them to be considered to be consumers of a service, it cannot be classified as a supply of services within the meaning of Article 6(1) of the Sixth Directive”***

'Obligation to refrain from an act' - Case study vis-à-vis Liquidated Damages

- **Liquidated damages are agreed pre-estimated sums to be paid in the event of a breach of contract by one of the parties and should not qualify as 'benefit' to the other party**
- **Liquidated damages are a pre-agreed consequence of breach – there is no 'tolerance'**
 - ✓ **UK VAT Instruction Manual VATSC35600** – “Liquidated damages:They are not consideration for supplies and are outside the scope of VAT.”
 - ✓ **Entry 22.3 of the VAT Notice 708 issued by HM Revenue and Customs, UK provides -** “Liquidated damages are agreed pre-estimated sums to be paid in the event of a breach of contract by one of the parties. The amount is either a set figure or determined by a formula.. If you receive liquidated damages, you are not receiving payment for a supply by you and no VAT is due on that amount.”
- It is important to note Section 73 read with Section 74 of the Indian contract Act:

“73. Compensation of loss or damage caused by breach of contract

When a contract has been broken, the party who suffers by such breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it..”

“74. Compensation for breach of contract where penalty stipulated for

When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.”

- Section 74 dispenses with the requirement of proving actual damage once breach of contract is established, the Court is enabled to award the “reasonable compensation” not exceeding the amount specified in the contract or the amounts which can be arrived at on application of the formulae or method prescribed in the contract.
- Hon’ble the Madras High Court in the case of **Sri Sri Sri Palahari Mahant Raja Ram Doss Bavaji Vs. Sri Sri Sri Gajapathi Krishna Chendra Deo Garu [AIR 1933 Mad 729]** noted that “liquidated damages” is a term that is not used in the Contract Act but employed to denote a sum named in the contract as the amount to be paid in case of a breach.

Obligation to refrain from act – When ‘Supply’

- ❖ **As discussed earlier, ‘Supply’ = a positive act of doing something requiring **consumption by the recipient** ?**
- ❖ It is pertinent to look at instances where obligation to refrain from an act or tolerance of an act is treated as a supply:
 - **Under service tax law** – ‘Non compete clauses’ in contracts furnish an example of when ‘obligation to refrain from an act’ constitutes a supply
 - **Under Australian GST** - As per GSTR 2006/9, *an entity may be said to be making a supply by refraining from doing something or tolerating some act or situation if the entity was subject to an obligation to do so and then performed accordingly.*
 - **MBI Properties Pty Ltd.** - MBI Properties Pty Ltd (MBI) acquired three apartments in a hotel complex, each of which was subject to a lease entered into between the vendor, South Steyne Hotel Pty Ltd (South Steyne), and the operator of the hotel, Mirvac Management Ltd (MML). MBI, on acquiring the rights of the lessor, became the recipient of a "supply of a going concern" and assumed the lessor's rights and obligations with respect to the aforesaid lease.
 - **Issue – Whether the continuing observance of lessor's obligations by MBI constitute a supply?**

Obligation to refrain from act – When ‘Supply’

- The High Court noted that a transaction which involves a supplier entering into and performing an executory contract will in general involve the **supplier making at least two supplies**. The first being creation of contractual rights and obligations and secondly, a supply by means of contractual performance of the obligation.
- The High Court recognised that providing continuing use and enjoyment of premises by observing an express or implied covenant of quiet enjoyment under a lease, *the supplier was providing something, albeit by means of refraining from doing something or tolerating some act or situation*



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