Decoding the Model GST law

Impact on the Pharma sector

June 2016
India on the brink of GST

The current Indirect Tax regime in India provides for a complex tax environment due to multiplicity of taxes, tax cascading and elaborate compliance obligations.

Under the proposed GST regime, various Indirect Taxes would be subsumed (except for few taxes such as Stamp Duty), and hence it is expected that it would result in a simpler tax regime, especially for industries like the Pharmaceutical Industry (Pharma Industry).

The Pharma Industry has been representing for addressing the present inverted tax structure in GST and also for a lower GST rate for Pharma products.

GST would have an impact on the pricing, working capital, contracts with vendors and customers, ERP systems, processes, internal control and accounting. Another important impact of GST on Pharma companies would be the opportunity to review the supply chain and move to a supply chain based on business parameters. Hence, GST would impact every aspect of the business.

There has been significant progress on the GST front recently. With the release of the draft Model GST Law on 14 June 2016, a major milestone has been achieved, and we have certainly moved a step closer to GST. It is expected that the Government would push for passage of the GST Constitution Amendment Bill during the upcoming Monsoon session. India finally seems to be on the cusp of implementing this much awaited tax regime.

In light of the above developments, the industry would now need to analyse the provisions of the draft law in detail, and its impact on their business. This is essential to ensure that timely representations are made to the Government, as well as to identify key implementation requirements as part of the preparations for transition from the existing indirect tax regime to GST regime.

In the ensuing paragraphs, we have sought to identify the key issues arising from the Model GST Law as may be relevant for the Pharma Industry.

1. Refund in case of Inverted Tax Structure

   The Pharma industry has represented that the inverted tax structure should be addressed in GST.

   The industry is awaiting the finalisation of GST rates. In this context, the Model GST Law provides for a refund of accumulated credit on account of an inverted tax structure. This is a welcome provision. However, it would be better if, in the first instance itself, the GST regime does not provide for an inverted tax structure.

2. Input Tax Credit

   **Scope**

   The definition of capital goods has been drafted on the same lines as in the existing CENVAT Credit Rules. Accordingly, Input Tax Credit will be allowed only of those goods falling within specified Chapters of the Model GST Law. Further, the definitions of inputs and input services also provide for exclusions.

   Therefore, it appears that even under GST, restrictions on Input Tax Credit will continue. Further, a nexus of goods and services received is also required to be established with outward supplies. Hence, the industry needs to represent for a broad-based credit mechanism.

   **Reconciliation of inward and outward supplies**

   If there is a mismatch between the details of outward supplies uploaded on the GST Network by the vendors and the inward supplies uploaded by the recipient, such mismatch will be communicated to the recipient.

   If the mismatch is not rectified by the vendor in the month of communication, the recipient will be liable to pay the differential GST along with interest in the subsequent month. This provision places the liability for non-compliance on the recipients, i.e. the pharma companies, as against their vendors.
Similar provisions have been prescribed wherein details of credit notes issued by a supplier have to match with the corresponding reduction of Input Tax Credit claimed by the recipient. Accordingly, if the recipient does not adjust the Input Tax Credit, the tax and interest would be recovered from the supplier. This provision places the liability on the pharma companies for non-compliance by stockists. Placing the responsibility on pharma companies for non-compliance by vendors and stockists will cause undue hardship to the companies.

3. **Area based exemptions under the Excise legislation and State Industrial Policy**

The First Discussion Paper on GST had stated that area-based exemptions under the Excise legislation and incentives under the State Industrial policies should be converted to a tax refund mechanism. However, the transition provisions prescribed under the Model GST Law do not provide for the treatment of such exemptions/incentives.

Further, the valuation provisions envisage that subsidies should be included in the transaction value. This would significantly impact benefits available to the industry.

4. **Transition provisions for imported goods**

The transition provisions provide that the credit balances which were admissible under the present regime would be carried forward under GST.

In case of stocks of imported finished goods, Countervailing Duty is not admissible under the present regime, and in case of goods procured from contract manufacturers also, Excise Duty credit is not available. Accordingly, based on these provisions, under the GST regime, such stocks would suffer double taxation.

5. **Taxability and valuation of Stock Transfers**

The charging section of the IGST Act provides for the levy of IGST on the supply of goods made in the course of inter-state trade or commerce. Further, as per the Model GST Law, the term ‘supply’ includes transactions between a principal and an agent. Schedule 1 of the Model GST Law deems any supply between two persons without consideration as a ‘supply’.

It is expected that there would be State-wise registrations for CGST, SGST and IGST. It seems that each registration in a State would be treated as different persons, though presently there is no enabling provision in the Model law for the same.

Based on the above provisions, stock transfers outside the State will be subject to GST. It is unclear whether stock transfers within the State would also be subject to GST. It is to be noted that the GST framework was intended to tax only inter-state stock transfers, and not intra-state stock transfers.

Additionally, with respect to valuation of stock transfers, the GST Valuation Rules provides that the value of goods shall be the transaction value. Transaction value is the price paid or payable for the supply of goods. As stock transfers do not have a consideration, this provision cannot be implemented.

However, the GST Valuation Rules provides that if the transaction value is not available, then the transaction value of goods of like kind and quality should be considered. Further, if goods of like kind and quality are not available, then the computed value i.e. the cost of production, general expenses and profit should be adopted.

Hence, for stock transfers, where a supply for consideration of goods of like kind and quality is available, such transaction value is to be adopted; and if there is no such supply, then the cost of sales would have to be adopted.

There should be a consistent basis for the valuation of stock transfers.

6. **Taxability of Free Supplies**

Supply of goods between persons without consideration is deemed to be a ‘supply’. Accordingly, stock transfer of promotion materials/free samples will be subject to GST. Subsequent supply of the said promotion materials to stockists/end customers will also attract GST.
The valuation of such samples/ materials will be as per the GST Valuation Rules, i.e. the transaction value of goods of like kind and quality or the cost of sales.

Under the present regime, free supplies are not subject to VAT. Hence, the promotion expenses of pharma companies will increase under the GST regime.

7. **Discounts**

Discounts/ incentives provided after the supply of goods will be excluded from the transaction value, provided they are known at or before the time of supply of goods, and are linked to invoices for the supply of goods. Further, discounts at the time of supply are excluded from the transaction value, only if they are in the course of normal trade practice, and are disclosed on the invoices.

Discounts provided under secondary market schemes will therefore not be eligible for exclusion from the turnover.

8. **Place of Supply of Services**

The definition of location of supplier *inter-alia* provides that the establishment most directly concerned with the supply shall be considered to determine the place of supply.

Pharma companies invariably receive services which are provided from multiple locations and received at multiple locations. There are also situations where it is not possible to determine the location of receipt of a service, for example, broadcasting, advertising, etc. In such situations, the Place of Supply provisions are unclear on which establishment would be regarded as the service provider/ receiver, in order to determine whether the supply is an intra-State or inter-State supply.

This needs to be clarified as it is critical to availment and utilisation of Input Tax Credit by pharma companies.

9. **Input Service Distributor**

The Model GST Law provides for the distribution of IGST/ CGST/ SGST. This is a welcome measure.

The distribution of SGST as IGST needs to be clarified, as the GST framework does not contemplate utilisation of SGST of one state against SGST of another state.

10. **Point of taxation**

The point of taxation for supply of goods or services, among other criteria, includes the date on which the recipient shows receipt in his books of account. It would be a challenge to track this date on an ongoing basis.

Further, the Model GST law provides for reverse charge, among other criteria, the date of receipt of goods or services or the date of receipt of invoice as the point of taxation, whichever is earlier. It would be cumbersome to track these two dates.

The point of taxation, in general needs to be restricted to date of invoice or date of payment, whichever is earlier.

11. **Power to challenge the transaction value**

The Model GST Law provides that if there is a reason to doubt the accuracy of the transaction value declared by the supplier, then the authorities can determine the transaction value as per the GST Valuation Rules. Such an unfettered power to question the transaction value can lead to litigation.

12. **Waybills and check-post related compliances**

There is no clarity as to whether the present system of waybills and check-posts would continue. The Model GST Law grants power to the Government to prescribe documents for consignment of goods exceeding INR 50,000 in value. In the light of these provisions, it is important that the Pharma Industry lobby for the
removal of waybills and check-posts related compliances, with the objective of optimisation of delivery schedules, lowering operational costs, and consequently enabling competitive pricing.

**Key Takeaways**

1) The Pharma Industry should file representations to the Government on the key issues arising out of the Model GST Law, as discussed above.

2) Some important action points, arising from the Model GST law, are as under:

- Analyse the impact of GST on business operations such as extent of costs savings in procurements, review procurement contracts, analyse impact on free supplies, discount schemes, product pricing, and the overall financial impact of GST.

- Review impact of Place of Supply provisions on procurement and distribution, and ascertain the extent of credit utilisation and blockage, if any.

- Review the procurement and distribution model and evaluate options to move to an efficient supply chain.

- Changes in the mechanism of utilisation of Input Tax Credit will require effective vendor management. Businesses will need to ensure that their vendors are compliant, by applying appropriate commercial safeguards such as release of payment only after the vendor has uploaded the invoice on the GSTN, or the possibility of vendor consolidations.

- Review arrangements with group companies and the impact on valuation for inter-group transactions.

- Review the impact of GST on business processes and ERP systems, and prepare a high level transition plan.

- Ensure that Input Tax Credits are duly reported on a regular basis in the relevant returns so as to eliminate loss of credit on transition to GST.

The industry needs to commence preparation for transition to GST as the Government makes progress on critical milestones in the coming months, such as passage of the Constitutional Amendment Bill in the Rajya Sabha. GST transition is not just a transition of tax; it impacts every aspect of the business operations and therefore it requires a ‘whole of business’ approach to ensure a smooth transition.

**Lets talk**

For a deeper discussion of how this issue might affect your business, please contact:

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