

Decoding the Model GST law

Impact on Automobile 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, elaborate compliance obligations and tax cascading. The Industry also has witnessed several types of cesses such as automobile cess, NCCD, infrastructure cess etc.

The automobile industry has its own complexity such as longer investment cycle, development of vendors/ part makers, substantial outsourced processes, unique market approach, etc..

Under the proposed GST regime, all the key Indirect tax legislations 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.

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 the 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 the light of the above developments, industry would now need to analyse the provisions of the draft law in detail, and assess 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.

While there are issues of concern common across sectors, in the ensuing paragraphs, we have sought to identify the key aspects of the Model GST Law as may be relevant for the automobile sector.

1. Valuation - Re-birth of FIAT Ruling?

The Automobile industry has seen significant disputes under central excise valuation like:

- Sale below the cost for market penetration treated as ‘additional consideration’
- Inclusion of State Industrial Promotion Subsidies retained by the manufacturer
- Deductibility of post-sale discounts from value under excise
- Valuation of demo cars
- Treatment of PDI charges and other dealer reimbursements, advertisement charges recovered from dealers etc
- Sales through marketing companies and mutuality of interest

The Model GST law continues with the concept of ‘transaction value’ which is a welcome measure. The transaction value shall be adopted where the supplier and buyer are not related, and price is the sole consideration for sale. However, the definition of the term, ‘related’ and the methods for determination of value are similar to the present customs valuation rules.

The powers for rejection of the transaction value are very wide, and could lead to significant valuation disputes.

Some of the significant valuation points arising out of the draft law are as follows:

- **Likely re-birth of ‘FIAT’ principles:** Under the Model GST law, the transaction value can be rejected when ‘price is not sole consideration’ for sale. The Supreme Court has held in the case of FIAT India that sale below manufacturing cost for market penetration would be treated as if ‘price is not the sole consideration’. The excise law was amended with a view to remedy the implications arising out of this ruling. The principles laid out in the FIAT ruling may apply in respect of valuation under GST, unless proper safeguard rules are included.
- **Inclusion of subsidy:** Under the Model GST law, any subsidy linked to supply of goods is to be included in the valuation for payment of GST. Majority of the automobile manufacturers enjoy special benefits from the State Government in the form of State Investment Promotion Subsidies (‘IPS’). This is given in the form of refund of VAT/ CST paid, or as a loan. While the IPS scheme has to be appropriately modified under the GST regime, the question arises as to whether these subsidies have to be included in the taxable value for GST purposes.

- **Discounts in invoice and normal trade practice:** The deduction for discounts is provided subject to the condition that the same is shown in the invoice and is in the course of normal trade practice. The term ‘normal trade practice’ is very subjective and especially in the automobile industry, the discounts vary depending upon the variants, new product launch, etc., and this may lead to potential disputes.
- **Post-supply discounts:** The post-supply discounts are allowed as a deduction only when they are pre-determined and linked to the supply invoices. There would be practical challenges in claiming such discounts, especially in the context of practices followed by the automobile industry, as these discounts or incentives are not applied to specific invoices. Whether provisional assessment is required in such cases, and the procedures therefor, need clarity. Further, in case such discounts are not claimed as deduction, whether the same would be again subjected to GST in the hands of the dealers is also not clear.
- **Sale through marketing companies:** The trigger for related party valuation mechanism is similar to customs. The term, ‘related’ is different from the present concepts in excise valuation like ‘interconnected undertaking’, ‘holding/ subsidiary relationship’ and ‘mutuality of interest’. The GST valuation rules also provide for determination of value by comparison with goods of like kind and quality (as the first method in the list of sequential methods). This is very subjective, and is likely to result in controversies and challenges in substantiating the valuation.

Key Action points

- Evaluate the impact of the valuation rules and resultant GST impact on transactions between related persons and with dealers.
- Represent to Government:
 - Appropriate amendments in the Model GST law
 - Specific automobile sector guideline on the principles of valuation.

2. Job work and GST

The job work process is the backbone for automobile industry operations.

The Model GST law treats ‘job work’ as a service and seeks to maintain the existing excise procedures for job work transactions, i.e. non-taxability of job work transaction and providing credits to the principal for supplies to job worker, 180 days condition for bringing back goods after job work, etc.

However, there is lack of clarity in the conceptual framework for job work. To illustrate a few:

- Does ‘job work’ include situations where the job worker adds his own materials, or should all the materials belong to the principal?
- Is job worker engaged in exempted or non-taxable supply?
- Whether the input tax credit in respect of inputs, capital goods and input services received by job worker is eligible in the hands of the job worker or the principal?
- Intra-State vs Inter-State job work – Whether provisions relating to supply and procedure for job work apply to both, intra-State and inter-State job work activities?
- In case of inter-State job work transactions and supply directly from the job worker’s premises, there could be accumulation of credits in the principal’s State – possibility of utilisation or transfer of such credits to be examined (including whether removal for job work can be treated as a supply by the principal)

Key Action points

- Evaluate if there are any potential credit leakages on the job work transactions and the related cost impact, if any
- Evaluate whether job worker exemption is optional or mandatory – its related tax impact
- Represent for further clarity on ‘job work’ transactions and also possible special provisions for job work for automobile industry

3. Credits on vendor tooling

It is a common practice in the automobile industry for vendors to develop tools/ moulds for manufacture of parts of automobiles. Typically, the ownership of such tools is transferred to the OEMs, and the cost is also recovered from the OEM's. However, the tools are physically located in the vendors' factory for manufacture of parts.

Under the Model GST law, the definition of 'capital goods' covers only those goods which are *used at* the place of business of supply of goods. Thus, only goods which are used in the place of business of OEM seem to be eligible for GST credit in the OEM's hands.

This definition would pose a challenge to the OEMs in availing credits relating to tools located in the vendor's premises, on which cost is recovered by the vendors. This could possibly result in increase in the cost of tooling and the cost for manufacture.

Key Action points

- Evaluate the GST impact on tooling arrangements
- Evaluate the need for alternative business arrangement of movement of tools from vendor to OEM and back to vendor location (this may not be practically feasible in many situations)
- Represent to liberalise definition of 'capital goods' to include all assets used for business, including assets located at vendor premises

4. Time of supply for payment of GST

Currently, under the excise law, duty is paid at the time of removal of the vehicles manufactured. VAT is paid at the time of sale of vehicles.

The Model GST law specifies that the time of supply of goods shall be at the **earliest** of:

- Date of removal of goods
- Date of which goods are made available to recipient
- Date of invoice
- Date of receipt of payment with respect to the supply
- Date of receipt of goods as shown in the books of accounts by recipient.

Under the existing law, receipt of advance towards supply of goods is not a taxable event, both under Central Excise and VAT law. However, under the Model GST Law, receipt of advance is sought to be treated as a taxable event.

Considering the practice of 'cash and carry' followed by vehicle manufacturers and also the dealer network following advance for supply with its customers, the change in the timing of supply would result in significant changes in the cash flow, and also procedural changes for manufacturers and dealers.

In this context, it is also relevant to note the definition of the term 'consideration', which states that any deposit shall not be treated as payment made for the supply, unless the same is applied as consideration for the supply. Thus, there is an alternative view that the advances for supply can also be treated as a 'deposit'. If this view is taken, the date of appropriation of the deposit towards a supply may be treated as the date of payment. This would also lead to interpretation as to what is the date of such appropriation (like date of Vehicle Identification Number (VIN), date of registration of vehicle with the regional transport office etc.). This needs to be clarified.

The industry would also need to consider that there could be more than one GST invoice for the supply of vehicles. This has to be factored along with the procedure followed by various State Regional Transport Office (RTO), to avoid any hassles in relation to registration of vehicles.

Key Action points

- Evaluate the cash flow impact for OEM's and also for Dealer Networks on requirement for payment of GST on advances
- Industry to represent before the Government to clarify the timing of supply. This clarity would be fundamental for the industry to begin its implementation process
- Industry to also work with the States in relation to procedure for registration on account of GST

5. Dealer Incentive Schemes and GST impact

At present, dealer incentive schemes are not subject to VAT, but there are issues on applicability of service tax on dealers, depending on the terms of each scheme. The industry is of the view that these schemes are not an independent service by dealers to the manufacturers, but are in the nature of post-sale discounts.

The Model GST law does not provide as to whether these incentives or discounts are subject to GST. Further, since the original supply would have already suffered GST and the buyer would have taken the input tax credit, the issue of whether these incentives/ discounts would impact the price and credits, or will these be kept out of GST (in the VAT chain), needs to be addressed. This requires a deeper analysis.

Further, in case such schemes are subject to GST, whether the same would be treated as a service or goods is also another aspect that needs to be clarified.

Key Action points

- Review of the existing dealer schemes for GST compatibility
- Assess the incremental cost in case GST would be applicable, the place of supply and availability of credit on the same
- Represent to Government for clarity on incentive schemes

6. Lack of clarity on subsuming of cess

The automotive industry has witnessed several cesses, including automobile cess, NCCD, tractor cess and infrastructure cess.

In the discussions on GST, the Government has indicated its intention to subsume all Central and State cesses into GST. However, on a reading of the Model GST law and the constitutional amendment bill, it is not clear as to whether the cesses levied under different legislations (for specified purposes) will be subsumed into GST or would continue under the GST scenario.

7. Input Tax Credit

The definition of 'capital goods' has been drafted on the same lines as the existing CENVAT Credit Rules. Accordingly, input tax credit will be allowed only of those goods falling within specified Chapters to the Model GST Law. Further, the definition of 'inputs' and 'input services' also provides 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. Accordingly, nexus-related litigation could continue under GST.

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 OEMs or the automobile 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.

Key Action points

Represent on the premise that placing the responsibility on the automobile manufacturers for non-compliance by vendors will cause unnecessary hardship to the companies. Therefore, a representation should be made to the effect that interest should not be recovered from automobile manufacturers.

8. Stock in the hands of dealer on the transition date – possible double taxation

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

In case of stocks lying with dealer which are procured on payment of excise duty and CST, such excise duty and CST is not admissible as credit under the present regime. Accordingly, the transition of such taxes/ duties included in the stocks lying with the dealer have to be allowed. Otherwise, under the GST regime, such stocks would suffer tax again, i.e. excise duty and CST paid, and CGST and SGST on supply after the appointed date.

Key Action points

- Industry to evaluate the impact of stock in the hands of dealers and plan for the same
- Automobile industry should make a representation to allow credit of excise duty and CST in respect of such stocks of dealers

9. Lack of clarity on MOU incentives

The investments by automobile companies are significant, and have a multiplier effect on the State's economy. Generally, States provide for various incentives including Investment Promotion Subsidies (IPS). A majority of the automobile manufacturers enjoy special benefits from the State Government in the form of State Investment Promotion Subsidies (IPS). This is given in the form of refund of VAT/ CST paid, or as a loan.

With the introduction of GST, taxes move from the Origin State to the Consumption State. This would result in significant reduction of flow-back of IPS, since GST on inter-state sales is not credited to the Origin State.

While this issue does not strictly arise under the GST law, the shift in the place of supply significantly impacts the IPS. Unless there is a compensation mechanism to the States or to the OEMs with regard to the impact on the IPS due to GST, the effect on project viability for some of the mega automobile projects would be severe.

Key Action points

- Evaluate the impact on account of non-availability of IPS
- Represent to the Government for appropriate compensation for the unutilized portion of the incentive

In Conclusion

The automobile industry is looking forward to introduction of GST. However, there are quite a few concerns in the draft Model GST law, including some of the key aspects highlighted above, which need to be addressed. Restrictions and conditions on eligibility to tax credits on assets used for business is also a major area of concern, and the credit mechanism should be more liberal. Proper GST administration and dispute resolution (more importantly on inter-state transactions) is very critical. The industry is also expecting the procedural changes to be notified in advance, and may require a lead time of at least six months before introduction of GST.

Let's talk

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

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