

Decoding the Model GST law

Impact on Infrastructure sector

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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. Under the proposed GST regime, all the key Indirect tax legislations would be subsumed (except for few taxes such as duty on Electricity, Stamp Duty, etc.).

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 India has 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.

Infrastructure projects (including Power) currently enjoy various concessions and benefits from indirect tax perspective, and it is imperative to evaluate whether these benefits would continue under the GST regime.

In 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 the GST regime.

In the ensuing paragraphs, we have sought to identify the key aspects of the Model GST Law as may be relevant for the Infrastructure Sector.

1. Definite single tax with removal of multiplicity of taxes on contracts

Generally, contracts entered into between project owners/ employers and contractors are segregated into the following separate contracts. Details of such contracts are as follows:

Contract 1: Offshore supply contract

Contract 2: Offshore services contract

Contract 3: Onshore supply contract

Contract 4: Onshore services contract (which includes pure services and civil work)

Currently, both VAT and Service tax is applicable on onshore services activities (referred to as 'works contract'). This has not only resulted in higher tax burden but also in numerous litigations for infrastructure projects on the issue of whether different contracts have to be treated as separate 'supply of goods' or 'provision of service' contracts, or could they be treated as a composite works contract involving supply of both goods and services.

The Model GST Law specifically treats a 'works contract' (including any transfer of property in goods in the execution of such contract) as a 'service'. This seems to put to rest the question as to how a particular contract involving both supply of goods and services should be taxed. While it is a welcome move intended to remove the aforesaid ambiguity and avoid possible disputes, it may still not be sufficient to eradicate ambiguity and disputes completely, particularly in the context of the peculiar and varied nature of arrangements in the infrastructure sector, involving multiple scopes of work and multiple participants (consortium) for either full project or for parts of a single project.

Therefore, determining the nature of a particular agreement, or a set of agreements, for a project (i.e. whether it qualifies as works contract or not) would still be critical from the perspective of the place of supply, the taxable value, the applicable rate of tax and the compliances to be undertaken.

The key implications of such change would include:

- Simplified treatment of works contract, since there would be no multiplicity of taxes
- Nature of arrangement - whether works contract or separate supply and services contract - needs to be determined
- Ease in contract structuring - No requirement to split contracts into material and service portion, as entire contract would be treated as service. This would be relevant for onshore services contracts entered into with project owners undertaking supply of both goods and services.
- There may be a requirement to revisit the transaction model and agreement terms to make the scopes definite and clear to remove any possible ambiguities
- Impact of rate to be analysed - Since the entire contract is to be treated as service, the tax incidence would need to be analysed *vis-à-vis* the current and GST regime. Removal of lower composition rates may entail higher output tax liability, and the same would depend on the valuation mechanism adopted for such contracts under the GST law.

- There is a need for clear provisions under the law as to how the invoicing should be done in respect of works contract (considering that supply of goods and services may take place at different points of time, and the eligibility to raise the invoice would be based on completion of specified milestones).
- Also, goods may move on inter-state basis during the execution of contract and if, at that stage, the contractor is not eligible to raise an invoice, which document should be carried along with the goods, and how would the taxability of such supplies take place. These aspects should be clearly dealt with in the law to avoid any future disputes.

Key Action points

- Future contracts to be framed in light of proposed GST provisions to be both tax optimal and fully compliant
- Contractors to review existing contracts with project owners/ employers as well as vendors to analyse impact of change in taxability of works contract – Tax clause and Change in law clause to be analysed
- It also needs to be evaluated whether, under the GST regime, all the 4 contracts could be clubbed together and treated as works contract.
- Representation to be filed for clear provisions with regard to taxability of goods supplied on inter-state basis, or imported as part of works contract under GST.

2. Possible increase in cost of Infrastructure projects?

Removal of exemption/ concession

Under the current policy, infrastructure projects enjoy concessional duty benefits under various indirect tax laws, thus bringing down the cost for infrastructure projects. However, there is no clarity on concessions/ exemptions for infrastructure projects under the GST regime.

A project owner engaged in setting up of a power plant or engaged in power transmission/ distribution can currently procure goods under inter-state sales at a concessional CST rate of 2% (against Form C) and can structure some of the procurements as in-transit sale to reduce tax incidence on the project. However, there is no such concession provided under the Model GST law. In the absence of such exemptions/ concessions, there is a possibility of significant increase in project cost.

There is a concept of ‘deemed export’ defined under the Model GST law. It is yet not clear which types of projects will be eligible for the deemed export benefit. To ensure that there is limited tax burden on infrastructure projects, it is important that all key types of infrastructure projects (including roads, highways, ports, airport, railways and power) should be made eligible for ‘deemed export’ benefits.

Taxability of FOC supplies

Free of cost (FOC) supplies by project owners to contractors appears to be liable to GST. Thereafter, the contractor may need to include value of such free supplies in the value of his services, thereby increasing the tax incidence, especially in scenarios where the project owner is not eligible to take credit, or where the contractor avails any exemption. Else, the FOC supplies would create a cash flow issue.

Credit restrictions

Project cost may be impacted due to GST credit restrictions in many sectors, depending upon the end use.

The following specific restrictions are proposed under credit rules with regard to goods and services acquired for the purpose of construction of immovable property, as per Section 16(9):

‘(c) Goods and/ or services acquired by the principal in the execution of works contract when such contract results in construction of immovable property, other than plant and machinery

(d) goods acquired by a principal, the property in which is not transferred (whether as goods or in some other form) to any other person, which are used in the construction of immovable property, other than plant and machinery’

The above-mentioned restrictions under the credit rules could have significant adverse impact on the infrastructure industry. The industry was expecting a much more liberal credit regime, where it could get credit for all business expenses incurred. However, the draft law could be interpreted to mean that there may not be

any credit available, either to a principal contractor or the sub-contractor involved in construction of immovable property. This does not seem to be the intent of the lawmakers, and hence would need significant revision.

Key Action points

- Assess possible impact if no exemption/ concessional duty is provided under GST
- Representation should be filed for liberal credit regime to ensure that there is no tax cascading
- Representation should be filed for inclusion of all key types of infrastructure projects to be made eligible for 'deemed export' benefits
- Option of composition rate under GST may be analysed to determine whether the same would be beneficial and reduce the tax incidence, and representation may be filed accordingly

3. Possible requirement of contract restructuring

Place of provision for services in relation to immovable property would be location of the immovable property.

There may be possible issues where a single contract is entered into for provision of services related to immovable properties across two or more States. For example, in case of highway construction services, railway track laying project, typically a single contract may be entered into with the vendor, for which consolidated invoices may be raised at one location. Such a contract may involve execution across multiple states.

Under the current regime, contractors are required to segregate contract values (for sale of goods) for the purpose of determining VAT/ CST liability in different States.

However, considering that there would be no distinction between goods and services under the GST regime, the same would need to be done for services as well, and hence, there may be a requirement for the vendor to raise separate invoices (for which separate contracts may also be required).

Key Action points

- Identify vendor contracts which need to be split State-wise to comply with the GST requirements
- Revamp IT system to be in line with place of supply for various transactions
- Make representation to prescribe procedures for accounting of such transactions for better clarity in law

4. Valuation of service in case of related persons

In case of infrastructure projects, Indian entities do procure significant amount of services (especially pertaining to technical know-how, designs) from their parent companies.

Under the GST Model Law, the concept of valuation for services in related party transactions has been introduced. Therefore, for any services provided between group companies, such as royalty for access to global brand, group company cost allocations, etc., it needs to be demonstrated that the transaction is at arm's-length.

If this cannot be demonstrated, the value shall be determined based on the GST Valuation Rules, i.e. based on services of like kind and quality, or the cost of providing the services, including profit.

These provisions may be challenging to implement with respect to cross-border transactions, as it may not be feasible for the resident entity to obtain the value of similar services, or to provide the details of their cost of supply of services, to substantiate that the price is at arm's length.

Additionally, 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.

Key Action points

- Evaluate the impact of the valuation rules and the resultant GST impact on transactions with related persons and with dealers.
- Representation should be filed for simpler valuation rules under GST regime

5. Job work and GST

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' includes situations where the job worker adds his own materials, or should all the materials belong to the principal?
- Is the 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 v. 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 – the possibility of utilisation or transfer of such credits has 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 job work transactions, and the related cost impact, if any
- Evaluate whether job worker exemption is optional or mandatory – and its related tax impact
- Represent for further clarity on 'job work' transactions

6. Input Service Distributor concept (ISD)

ISD concept has been proposed for transfer of credit of input services between two or more locations. ISD can transfer credit of all types of GST (CSGT, SGST or IGST). Further, an ISD can be any supplier of goods or services. Considering the possibility of multiple state-wise registration, ISD may be an efficient mechanism to ensure optimal utilisation of head office-related credit, and hence resulting in actual reduction in cost.

Key Action points

- Locations to be identified where there may be accumulated credit, and there may not be sufficient output liability – ISD registration may be taken in such State to distribute credit to other locations

7. Impact on ongoing contracts

Specific transition provision has been stipulated *vide* Section 159 and 160 for works contract/ periodic supplies as under:

'159. The goods and/ or services supplied on or after the appointed day in pursuance of a contract entered into prior to the appointed day shall be liable to tax under the provisions of this Act.

160. Notwithstanding anything contained in section 12 and 13, no tax shall be payable on the supply of goods and/ or services made on or after the appointed day if the consideration for the said supply has been received prior to the appointed day and the duty or tax payable thereon has already been paid under the earlier law'

As per the above, it appears that in case of periodic/ continuous supply of goods/ services, GST Act would not apply on advances received prior to the GST law for goods/ services to be provided during the GST regime, provided tax has been paid on the same. This provision does not cater to the scenario where tax has not been paid, but is payable under the earlier law post enactment of the GST regime.

Also, there is no provision for treatment of supplies prior to the GST law, where either the invoice has not been raised for the same, or payment has not been received, or tax has not been paid, prior to enactment of the GST law. This could result in dual taxation, both under the previous regime as well as under the GST regime.

Contractors would need to examine the coverage of the transition provision as to whether implications for all its possible transactions during the transition period are clear. Accordingly, necessary representation would need to be filed for clear transition provisions.

Key Action points

- Contractors to analyse tax liability for all ongoing projects in line with transition provision
- Transition planning for timing of supplies, advances and payment of tax
- Representation to be filed to provide more clarity on transition provisions for ongoing contracts

8. Eligibility to avail credit of goods held as service provider

Currently, a service provider is not eligible to avail credit of the tax paid on goods (especially VAT). Under GST, since all supplies would be liable to GST, there needs to be a provision to allow a service provider to avail credit of the inputs held on the date of enactment of GST. There should be a mechanism to this effect.

In the Model GST law, there is no specific transition provision to the above effect.

Key Action points

- Representation to be filed to include more specific and clear provisions for transition, and to allow credit of stock in hand for service providers as well as traders

9. Compliance requirements

Registration may be required in each State where there is a premises from where supplies are being made. Hence, contractors may need to obtain registration in each State where there is a premises (including site office) from which services are being provided.

One aspect which may be analysed is, if place of business is located in one State and service relating to immovable property are provided in various States (where there is no place of business), would registration be required in all States, or would it suffice to obtain registration in only one State.

Key Action points

- Identification of States where registration may be required
- Evaluation of a tax optimal and easy to comply supply model
- Appropriate changes required in IT systems to be GST compliance ready

Let's talk

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

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