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GST on inter establishment supplies - A critique on the Columbia Asia Ruling!

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*"**TAXATION** should not be a painful process for the people…. Ideally, Governments should collect taxes like a honeybee, which sucks just the right amount of honey from the flower so that both can survive."*

- Quote from Kautilya's Arthashastra

Since the advent of the Goods and Services Tax ('GST') in India, one of the most debatable issues faced by the industry has been whether to cross-charge for the benefit that accrues to one establishment of a legal entity towards the operations carried out by another one. For instance, whether value attributable to the senior management's time spent sitting at the corporate office needs to be cross charged to other establishments since all the such establishments are overseen by the senior management? While the taxpayers were expecting some relief on the issue, the recent order in the case of *Columbia Asia Hospitals Private Limited,* **2018-TIOL-113-AAR-GST** by AAR, Karnataka has left corporate India in a fix . Before drawing an analysis of the interpretational logic espoused by the above order, it is pertinent to briefly chart the legislative provisions relevant to address the subject issue.

Legal background and the issue

GST is a destination based tax and is a departure from the VAT regime of origin based system of taxation. The basic structure of the GST system as has been adopted by India ensures that the destination of supply becomes relevant not only for the purposes of international transactions, but also for domestic ones. The GST statutes have been designed to ensure that the tax reaches the relevant State where the supply is finally consumed.

In order for a consumption based destination GST system to function successfully, it was quintessential to introduce the concept of taxation of inter-state transactions between different establishments of the same legal entity. It is with this rationale that we find entry 2 in Schedule I of the **Central Goods and Services Tax Act, 2017** ('CGST Act'). The said entry provides that supply of services between distinct persons (the term distinct persons has been defined to mean establishments of the same legal entity who have (or are required) to have separate GST registrations)when made in the course or furtherance of business, will be treated as supply even if the same is made without consideration. While this provision can be practically applied for goods, in respect of services (being intangible), understanding the scope and applicability of the same is, indeed, a huge challenge.

From a well-intended thought to ensure that tax reaches the destination State, this provision has become a nightmare for taxpayers making exempt supplies. Many fear, and rightly so, that the issue is bound to raise department's eye, if not for applicability of GST (if cross-charge is followed), then definitely for valuation.

Applicability of GST

Does a limb perform a service for the heart or the mind? Of course not, both are parts of the same body and work *in tandem* to achieve any objective. Well, the department does not seem to agree with the logic and wishes to tax any activity done by the head office for the other establishments (such as plants, warehouses, research & development centres, marketing & sales offices, service units etc), or *viceversa* . Any multi-locational business to work effectively will logically have a central set-up which takes care of management, finance, accounts, information technology etc for all other locations. The activities performed by the employees located at such set-ups are towards the company *per-se* and not for the branch office or sister units. Further, the employees of head office are employed by, as employees of a company and perform responsibilities assigned accordingly. They are not engaged as employees of head office or branch office. Basis this rationale alone, it is clear that head office cannot be seen as supplying services to its other establishments. Similarly, a centralized sales team sitting in one of the establishments (head office / plant / elsewhere) who works-out pan-India sales strategy cannot be seen as rendering services to sale offices across India!

The view is also supported by jurisprudence under erstwhile service tax law wherein also, similar to the GST provisions, an establishment of a person in taxable territory and other establishment in non-taxable territory were treated as distinct persons. The Tribunals held in number of cases that branches do not provide any service to head offices or *vice versa* . In the case of *Tech Mahindra Limited v. CCE*, **2016-TIOL-709-CESTAT-MUM**, the Tribunal held that there shall be no service tax implications on transactions between branches located outside India and head office in India. The Tribunal further observed that a branch, by its very nature, cannot survive without resources assigned by the head office, thus, the activity of head office and branch are inextricably enmeshed. The employees of branch are the employees of the organization itself. There is no independent existence of the overseas branch as a business. Similar findings have been given in *KPIT Cummins Info Systems Limited v. CCE*, **2013-TIOL-1568-CESTAT-MUM** and *3i Infotech Limited v. CST*, **2016-TIOL-3340-CESTAT-MUM**.

However, the AAR in Columbia Asia *(supra)* suggests otherwise. In this case, the applicant was providing healthcare services from various locations. The employees of the applicant at corporate office performed activities such as accounting, administration, maintenance of information technology system etc. for all the units located in different States. While the corporate office was paying GST on cross-charges to units for third party costs such as renting of immovable property, travel, consultancy etc., it did not include employee cost used for providing support to other units in its periodic cross-charges. The AAR in this case has held that the activities carried out by employees at the corporate office for units located in other States amounts to supply under Section 7 read with Schedule I of the CGST Act and the employee cost should also be included in value of cross-charge. Besides being beyond logic, interestingly, there is a patent error in conclusion drawn in this ruling, inasmuch as the establishments of same legal entity have been held to be 'related persons' (and not distinct persons, as explicitly defined within the GST law!).

Way forward for taxpayers

The legal validity of the advance ruling is doubtful since the same has neither considered the grounds discussed above, nor discussed the jurisprudence under service tax law. Moreover, as mentioned hereinbefore, the rationale of inter-establishment supplies being treated as deemed supplies was simply to ensure that taxes (and along with them, the corresponding input tax credits) travel to the destination state of consumption. The idea has never been to bring into the net of taxation, transactions artificially which have historically never been subject matter of indirect taxation. When this aim is well achieved by limiting the scope of deemed supplies to third party common costs, why bring in complexity by covering internal operational costs within its net?

Having said this, it is expected that the department will issue demands to taxpayers in case they fail to cross-charge even the internal costs such as employee salaries. Not only this, it is also possible that the department seeks to mandate cross charge of value towards infra structural support, depreciation of capital goods used by head office etc and

consequently impose demand of GST thereon!The technical view of this aspect is also fairly clear that the internal operational costs cannot be seen as services rendered to other establishments.

That said, given the heightened litigation exposure after the *Columbia Asia* ruling the taxpayers may look at adopting a pragmatic approach towards this issue. Accordingly, in case taxpayers are making taxable supplies, we suggest them to follow the route of cross charging common costs and expenses to other units. Not only will this save valuable time by avoiding unnecessary litigation, the entire exercise is revenue neutral. Further, the taxpayers have been given the liberty to adopt any value where the receipt units are liable to avail credit *(in terms of second proviso to Rule 28 of Central Goods and Services Tax Rules, 2017)* .

However, where the taxpayers make exempted supplies, GST on cross-charges will become a cost. Further, the taxpayer will not have liberty to adopt any value and need to determine the open market value for cross-charge. In fact, this seems to be a paradox for taxpayers making exempt supplies. While at one end, government is exempting a supply considering its critical nature as well as importance for public at large, on the other hand, cross-charging an amount (specifically employee cost) from head office to units will increase the cost of operation multi-fold. This cannot be the intent of the legislature in the first place. Considering the additional tax burden, the taxpayers making exempted supplies may choose not to pay GST and litigate the matter (if situation arises).

Without prejudice to the views above, there is a need of the hour for the CBIC to step in and issue necessary clarification on this vital issue. If the revenue starts taxing such innocuous transactions, it will merely open up flood gates of litigation, leading the industry nowhere.

(With inputs from Anshika Agarwal, Associate, NITYA Tax Associates. The views expressed in the article are strictly personal.)