

# EY Tax Alert

**AAR allows GST input tax credit to manufacturer on certain promotional materials provided to franchisees, distributors and retailers**

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

## Executive summary

This Tax Alert summarizes a recent ruling<sup>1</sup> of the Karnataka Authority for Advance Ruling (AAR). The issues involved were whether the materials used for marketing and promotion of brand can be considered as inputs and tax paid on procurement can be availed as input tax credit (ITC).

Applicant had transferred goods to franchisees, distributors and retailers free of cost to promote its brand and market its products at point of purchase.

AAR observed that such goods can be divided into two categories, non-distributable goods and distributable goods.

Non-distributable goods like hoardings, where the ownership is retained by the applicant, are capitalized in the books of account and are not a direct cost to the products sold. Thus, they qualify as capital goods and not as inputs under GST. ITC can be claimed in respect of such goods. In case they are subsequently destroyed or written off, ITC has to be reversed.

Distributable goods (where the ownership is transferred) such as carry bags, gifts, etc. when provided to franchisee without consideration shall be treated as supply since it is a related party transaction. While ITC can be claimed, the applicant needs to pay tax on the outward supply.

Distributable materials provided free of cost to distributors and retailers does not qualify as supply under GST and will be treated as "gift" basis Circular No. 92/11/2019-GST dated 7 March 2019. Thus, ITC cannot be claimed due to the restriction provided in Section 17(5) of CGST Act.

<sup>[1]</sup> [TS-1104-AAR-2020-NT]

## Background

- ▶ The applicant is engaged in the manufacture, distribution and marketing of knitted and woven garments and swim-wear along with swimming equipments.
- ▶ It markets and sells the products through its own outlets (franchisees) and also through its distributors and retailers.
- ▶ To promote its brand and market its products at point of purchase, it procures promotional materials and thereafter, without transferring the title, shifts the same to its own showroom and distributor's showrooms under delivery challans.
- ▶ In some of the cases, it transfers the said materials directly from the supplier's premises to the point of purchase on bill to ship to basis. The title in goods remain with the applicant.
- ▶ Similarly, for promotion purpose, it is getting manufactured marketing items like carry bag, table and wall calendar, diary, leather bags with embossing of its brand etc.
- ▶ It also exports such materials to its overseas distributors/ dealers on free of cost basis to promote its brand in overseas countries.
- ▶ It sought advance ruling on whether these materials can be considered as inputs and tax paid on procurement can be availed as input tax credit (ITC).

## Applicant's contentions

- ▶ Section 16 of the Central Goods and Services Tax Act, 2017 (CGST Act) enables a registered person to avail ITC on goods and services used in the course or furtherance of business.
- ▶ The term 'business' in fiscal statutes must be construed in a broad rather than a restricted sense<sup>2</sup>.
- ▶ The items such as display boards, hangers, uniform for staff, outdoor hoarding, carry bags, etc. which are provided to franchisee, distributors and retailers form an integral part of the business as it is used for promoting brand name.
- ▶ Thus, such materials qualify as "input" as per Section 2(59) of CGST Act and ITC should be available.

- ▶ Reliance was placed on the Bombay HC rulings<sup>3</sup> wherein it was held that credit can be availed if the manufacturer demonstrates that input services are integrally connected with business of manufacturing final product and such cost forms part of cost of final product. The said test also applies to sale promotion.
- ▶ The marketing and promotional materials are not provided free of cost to distributors and retailers. Basis the agency/ dealership agreement, the distributors and retailers are under an obligation to promote the brand and market products by utilizing the materials provided.
- ▶ ITC is not restricted under Section 17(5) of CGST Act as the materials provided for marketing do not qualify as gifts.

## AAR Ruling

- ▶ The promotional materials can be bifurcated into two categories:
  - ▶ Non-distributable goods - Those which are delivered to franchisees, distributors and retailers for use in their premises, but the ownership lies with applicant.
  - ▶ Distributable goods - Those which are delivered free of cost to the franchisees, distributors and retailers for distribution to their employees or customers.
- ▶ In case of non-distributable goods, there can be cases where the goods are returned and the applicant either use it further or destroy if the same is not usable, or there can be instances where the goods are not returned and thus, written off.

Such goods are recognized as capital goods in books of account and depreciation is claimed. Further, these goods are not a direct cost to products sold.

Thus, they will be treated as capital goods and not inputs.
- ▶ Accordingly, the taxes paid by the applicant on procurement of these goods can be claimed as ITC.
- ▶ The applicant has not made any submissions regarding what is ultimately done to these goods after the end of usage period. Assuming that they are written off or destroyed or lost, ITC needs to be reversed

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<sup>2</sup> Mazagon Dock Ltd vs. CIT and Excess Profit [1958 (5) TMI 2 - Supreme Court]

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<sup>3</sup> Coca Cola India Private Limited vs CCE [2009 (15) STR 657 (Bom)], CCE vs Ultratech Cement Ltd. [2010 (260) ELT 369 (Bom)]

as per Rule 43 of the Central Goods and Services Tax Rules, 2017.

- ▶ The distributable goods, used for sales promotion, are provided free of cost to the distributor, franchisee and retailer. On distribution of such materials, they would no longer be in the books of account.
- ▶ Since the franchisee is treated as a related person under section 15 of CGST Act, read with para 2 of Schedule I to CGST Act, the transfer of distributable goods will be treated as supply even if made without consideration. Thus, the applicant needs to pay output tax and can claim ITC.
- ▶ As per Circular No. 92/11/2019 - GST dated 7 March 2019, free supply of distributable goods to distributors and retailers qualifies as gifts. Thus, ITC cannot be claimed due to the restriction provided in Section 17(5) of CGST Act.

## Comments

The ruling provides clarity on the key parameters to be kept in mind while claiming ITC on promotional and marketing materials.

The ruling highlights that in case where the capital goods are lost or destroyed, the credit needs to be reversed as per rule 43 of CGST Rules. Earlier, there was a dilemma on the quantum of reversal since rule 43 is not linked to section 17(5).

The cost of promotional items supplied free of cost to either franchisees or other retailers is factored in the cost of the overall business on which GST is paid by the businesses. Hence, ideally no GST should be applicable on such free supplies whereas ITC on procurement should be available. The law may need to be appropriately amended to facilitate manufacturers who engage in such promotional activities.

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