

## DECRYPTING THE NUANCES OF RELATED PARTY TRANSACTIONS UNDER THE GST LAW



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*You don't pay taxes – they take taxes – By Chris Rock*

Till now, the transaction with related persons has been a special area of consideration for Government and Tax Authorities on the assumption that the transaction may be motivated by the relationship between the transacting parties to mould the transaction in their favour. To avoid the tax evasion in such transaction, various safeguards are adopted in tax laws, such as transfer pricing provision, Section 40(A)(2), etc. introduced in Income Tax Act. Similar provisions for related party transactions are adopted under various indirect tax laws viz., the Customs Act 1962, the Central Excise Act 1944, the Service Tax laws – Chapter V of the Finance Act 1994), select State VAT Laws, etc.

Under GST regime, supply of goods and/or services between distinct person, as described in Section 25(4) and 25(5) of the CGST Act, 2017 ('the Act'), and related person, as defined in an explanation (a) attached with Section 15 of the Act, would be subject to levy of GST with specific provisions governing taxability and valuation. Therefore, it is important to determine the correct value of supply of goods and services to distinct persons or related persons to avoid litigation.

This article seeks to analyse the concept of related party transactions, expectations of the taxpayers for transactions between the distinct persons and related parties locally as well as for the cross-border flow of services between them i.e., related party transactions, introduced in GST framework.

### Why understanding the distinct persons and related person is important?

Clause 2 of Schedule I of the Act, provides that:

*“Supply of goods or services or both between related persons or between distinct persons as specified in section 25, when made in the course or furtherance of business **SHALL BE TREATED AS SUPPLY EVEN IF MADE WITHOUT CONSIDERATION**”*

Section 15 of the Act provides that the value of a supply of goods or services or both shall be the transaction value, which is the price actually paid or payable for the said supply of goods or services or both where the supplier and the recipient of the supply are not related, and the price is the sole consideration for the supply.

That means, for supply of goods or services or both between related persons or between distinct persons, the transaction value has to be ignored and valuation as per Rule 28 of GST Rules, 2017 ('the Rules') has to be considered. Also, by virtue of Schedule I, the GST law has created a deeming fiction to tax supplies between distinct / related person even if made without consideration.

**Related Party** (Explanation (a) to Section 15 of the Act)

Under GST, persons shall be deemed to be “related persons” if –

- (i) such persons are **officers or directors** of one another's businesses;
- (ii) such persons are **legally recognised partners** in business;
- (iii) such persons are **employer and employee**;
- (iv) any person directly or indirectly owns, controls or holds **twenty-five per cent. or more of the outstanding voting** stock or shares of both of them;
- (v) one of them **directly or indirectly controls** the other;
- (vi) both of them are **directly or indirectly controlled by a third person**;
- (vii) together **they directly or indirectly control a third person**; or
- (viii) they are **members of the same family**.

While the related party definition is quite self-explanatory, there are some aspects of the related party definition that warrants attention. First of all, the GST law has brought employer and employee under the roof of related party thereby making it critical for business to evaluate all employer-employee transactions from a GST standpoint as well. Varied nuances of employer-employee transaction are discussed in the ensuing paras of this article. Another aspect of the related party definition is the term 'direct and indirect control'. The term control is neither defined under the GST law nor any guidelines are prescribed in this regard thereby leaving it open to interpretation.

Let us now understand the concept of '**distinct person**' under the GST law:

*“As per Section 25(4) of the Act, a person who has obtained or is required to obtain more than one registration, whether in one State or Union territory or more than one State or Union territory shall, in respect of each such registration, be treated as distinct persons for the purposes of GST Act.*

*As per Section 25(5) of the Act, where a person who has obtained or is required to obtain registration in a State or Union territory in respect of an establishment, has an establishment in another State or Union territory, then such establishments shall be treated as establishments of distinct persons for the purposes of GST Act.”*

In a nutshell, two different branches in different states / UT having the same PAN shall be considered as 'distinct person' under the GST law. An 'distinct person' is treated at par with 'related person' under the GST law.

Let's peep into some nuances on related party / distinct person transactions:

### **Transaction between Employer and Employee**

An employer and employee are considered as related party for the purpose of GST law thereby creating a deeming fiction to tax such transaction (*by virtue of Schedule I to the Act*). However, not all transactions between employer and employee shall be taxable to GST. The following transactions are outside the purview of GST:

- Gifts not exceeding INR 50,000 in value in a financial year by an employer to employee (*first proviso to Clause 2 of Schedule I*);
- Services by an employee to the employer in the course of or in relation to his employment (*Clause 1 of Schedule III*);

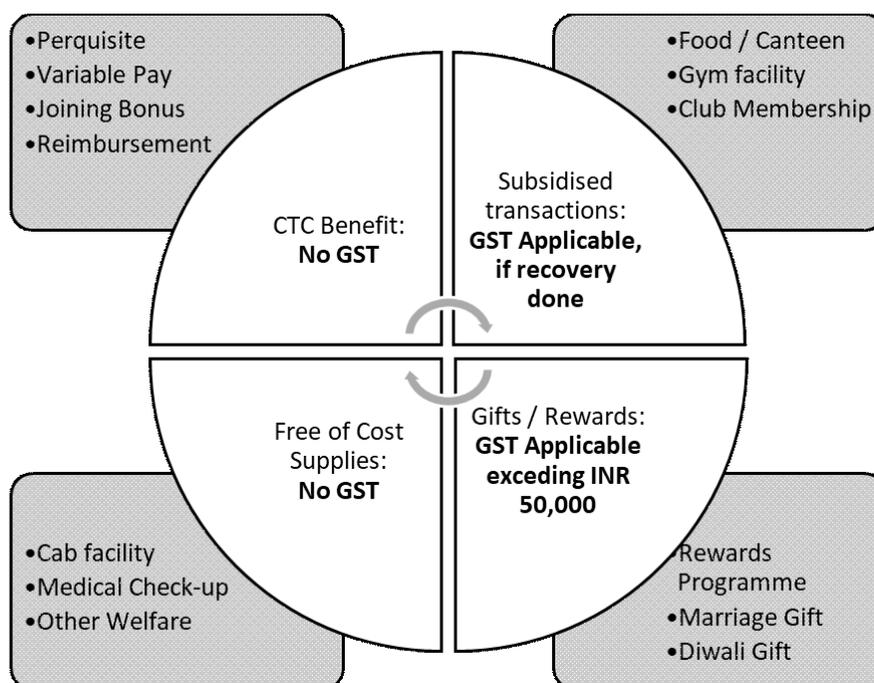
The term 'gift' is not defined under the GST law. However, as per a Press Release by CBIC which states, in common parlance, a gift is made without consideration, is voluntary in nature, and is made occasionally. It cannot be demanded as a matter of right by the employee and the employee cannot move a court of law for obtaining a gift. The GST law has also put a limit on the monetary value of gifts given to employees to INR 50,000 in a financial year. Thus, if the value of gifts given to employees in a financial year exceeds the limit of INR 50,000, the same shall be taxable in the hands of the employer.

In addition to gifts, services by employee to employer in the course of or in relation to his employment has been kept outside the purview of the GST law. The CBIC has also *vide* press release dated 10 July 2017, provided clarifications on the said matter. The broad principles enumerating out of the clarifications given by the CBIC are as follows:

- Any supply by the employer to the employee in terms of contractual agreement between the employer and the employee will not be subject to GST;
- Any services provided free of cost to all employees will not be subject to GST provided appropriate GST was paid when procured by employer;
- Free housing (or any similar facility / perquisite) provided in terms of the contractual agreement between the employer and employee - is part and parcel of the cost to company and should also not attract GST.

It is to be noted that in case any recovery / discounted recovery is made by the employer from employee for any services / facility provided, the same shall be subject to GST as the said scenario is not covered in the press release. There are many advance rulings on various employer-employee transactions issued till date with both positive and negative views and thus, business have to ensure that all employer-employee transactions are dealt with in lines with the provisions of the GST law.

Listed below are certain employer-employee transactions along with possible GST implications on the same:



Further, determination of credit eligibility to the employer under each scenario also requires a deep analysis in light of the specific restrictions envisaged under Section 17(5) of the Act.

### **Transaction between 'related person' (other than employer-employee)**

These transactions typically include transaction within the group companies, companies involved in joint venture or between holding company and subsidiaries, etc. While exchange of monetary consideration is present in majority of the transactions, there are few transactions, which by its very nature do not involve any monetary consideration. However, due to the deeming fiction of the GST law are brought under the ambit of taxability. Example of such transactions would include, Corporate Guarantees & Pledging of Shares, Issuance of Letter of Credit, Brand Usage etc. Thus, it becomes imperative for business to identify transactions wherein no consideration is involved, evaluate the GST implications considering the deeming fiction and determine tax liability if any.

Having said that, for transactions where consideration is involved, the same will be subject to the valuation provisions which are discussed in the ensuing paragraphs.

### **Transaction between 'distinct person'**

As stated above, unlike the erstwhile regime, branches / GSTIN's in different states are considered to be distinct person for the purpose of GST law and thus, any transaction between branches would be considered as a supply. Accordingly, all provisions as applicable for supply to a normal customer would also apply for transactions between branches.

For example, under the erstwhile VAT regime, transfer of raw materials / finished goods from branch in Maharashtra to a branch in Gujarat did not suffer tax and transfers were made under declaration for 'branch transfer'. However, under the GST law, the same would be a taxable supply in the hands of Maharashtra branch. A tax invoice for supply of goods will be raised by Maharashtra branch and Gujarat branch shall avail ITC basis such tax invoice while filing its GST returns.

Further, as pointed out in the foregoing para's, the GST law has also created a deeming fiction for transactions between distinct persons even if made without consideration. A question would arise to understand what type transactions would get covered under the said deeming fiction.

Let's take an example of a company having presence in multiple States / Union Territories in the country and has a Head Office ('HO') in the state of Maharashtra. The HO would, in ordinary course of business, handle various activities on PAN India basis *viz.*, Taxation, Finance, Human Resources, Supply Chain etc. For the above mentioned activities various third party services *viz.*, Statutory audit, Tax return filings, Legal services, Banking and finance services etc., would also be procured by HO. Invoices for such services are usually received by HO and accordingly ITC of GST paid is also availed by HO.

While the GST law provides for an option to transfer ITC pertaining to the third party invoices mentioned above through the ISD mechanism, by virtue of the deeming fiction, the activities undertaken by HO for PAN India operations or such internally generated services would be considered as taxable supply (*ordinarily known as 'cross charge'*). The taxable value for the purpose of such supply would have to be determined basis Rule 28 of the Rules (*discussed in the ensuing paragraphs*). As a result, even in absence of any actual service and consideration being exchanged, businesses are required to undertake cross charge activity which includes determining common HO functions, allocation of costs, ensuring compliance with valuation rules etc., on regular basis and discharging GST.

## Valuation Rules under the GST law

Let us now look at the Valuation Rules i.e., Rule 28 of the Rules in relation to related / distinct person. The Rule provides 4 methods to determine the value of supply, which are discussed below:

Sr. No.	Particulars	Remarks
1	Open Market Value ( ' O M V ' ) (Explanation (a) to Rule 35 of the Rules)	<p>It means the price at which the supplies of goods or services are made when the supplier and recipient are not related and the price is the sole consideration for supply. Determination of OMV in case of goods should ordinarily be an easy task. However, in case of services, determining OMV could be a challenging task because of its subjective nature.</p> <p>The jurisprudence and research material to determine OMV for services is not available in the public domain, which is as established under the transfer pricing laws. Hence, for GST purpose, one may rely on the transfer pricing laws and judicial precedence available on several transfer pricing issues in other taxation laws in India as well as taxation laws of other countries where similar provisions are applicable to ascertain OMV in case of services.</p>
2	Like kind and Quality Method (Explanation (b) to Rule 35 of the Rules)	<p>The value of the supply, where the open market value is not available, value of supply of goods or services of like kind and quality would be considered as the assessable value. The essential characters of the definition are as follows:</p> <p>(a) Supply shall be made under similar circumstances.</p> <p>(b) Comparable should be selected on the basis of similar to the characteristics, quality, quantity, functional components, materials, and the reputation of the goods or services or both first mentioned, is the same as, or closely or substantially resembles.</p> <p>Under GST, selection of comparables will be a tedious task for the taxpayers and any wrong determination of value of supply will invite the litigation in near future. There is a lot of subjectivity in this matter, leading to numerous litigations. In case of services, the application of this Rule will be very difficult task because quality of services or services for the satisfaction can't be measured.</p>
3	Cost Plus Method (Rule 30 of the Rules)	<p>If the value is not determinable under earlier valuation methods, value of supply shall be the value as determined by the application of Rule 30 or Rule 31, in that order. Accordingly, in this method, value of supply of goods and services shall be 110% of the cost of production or cost of manufacturing of the product or cost of provision of services. As such law does not specify the clear guidelines or procedure or standards to determine the cost of the goods or provision of services. Under the erstwhile Excise tax regime, Cost Accounting Standard-4 (CAS-4) was permitted to be referred for determining cost of production for goods. Thus, the CAS-4 or any similar provisions can be relied in this regard. It is important to note that in the case of supply of services, the supplier may opt for Rule 31, ignoring Rule 30.</p>

Sr. No.	Particulars	Remarks
4	Residual Method (Rule 31 of the Rules)	This rule provides that where the value of supply of goods or services or both cannot be determined under any of the foregoing Rules, the same shall be determined using reasonable means consistent with the principles and the general provisions of Section 15 of the Act and the Valuation Rules.

It can be seen from above options provided to adopt the valuation that taxpayers will have to perform logical analysis and maintain robust documentation to prove that the related party transactions are not distorted.

In addition to the above mentioned Valuation provisions, Rule 28 also provides for the following relaxed / simplified method for valuation for specified cases:

***First proviso to Rule 28 (Re-sale price method)***

The essential characters of this provision are as follows:

There must be 'as such' supply (i.e., supply in the same form in which received). In other words, this method can be applied for trading industry only.

This method is available at the option of supplier only.

The value of supply shall be an amount equivalent to 90% of the price charged for the supply of goods of like kind and quality by the recipient to his customer not being a related person.

Accordingly, taxpayers can pay GST on 90% of the market value in case of supply of goods to entities such as subsidiaries, branches and joint ventures. By opting to pay GST on 90% value of supply of goods instead of 100% value of supply of goods, a taxpayer can save working capital blockage of GST on 10% value of the supply of goods. This approach can be used for goods transfers between branches in different States / Union Territories.

***Second proviso to Rule 28***

As per Second proviso to Rule 28 of the CGST Rules, 2017, where the recipient is eligible for full input tax credit, the value declared in the invoice shall be deemed to be the open market value of the goods or services. GST being a creditable tax for most of the transactions, it would not pose any loss to the exchequer inspite of slanted valuation if full ITC is available to recipient related party. Thus, Second proviso to Rule 28 of the Rules accepts valuation adopted by the supplier where full ITC is available to the recipient related party.

However, adoption of any value under Rule 28 has not been free from dispute of tax authorities. An example of this is that while the GST law did not mandate cross charge of employee cost, despite that there have been contrary Advance rulings mandating inclusion of employee cost in value of cross charge. Having said that, the ambiguity around inclusion of employee cost in valuation has been put to rest basis the clarification issued by the CBIC *vide* circular bearing number 199/11/2023 dated 17 July 2023.

It is also apposite to note that, basis the principle enumerated under the Second proviso to Rule 28, the said Circular has also clarified the following in relation to internally generated services (*services by HO to BO*) in cases where full ITC is available to BO:

- In tax invoice for cross charge has been raised, any value declared in the invoice shall be deemed to be open market value; and
- Where no invoice has been issued for internally generated services, the value of services shall be deemed to be NIL and thus be considered as open market value.

Further, there seems to be a lack of clarity regarding ambit of Rule 28 as to whether the same warrants a wider interpretation or a transaction wise approach towards eligibility of ITC to the recipient related party. Thus, in a scenario where the recipient has exempt supplies and is not eligible for full credit, it poses a question on the supplier related party as to whether it can adopt any value or such supplies should be made at open market value.

To summarize, in respect of related / distinct person transactions, the GST Law prescribes certain methods which have to be sequentially applied to determine the value of such transaction. Non-compliance could lead to litigation and huge tax liabilities in the hands of service providers.

### **Related party under Customs Law - An overview**

For the purpose of the Customs Law, the definition of related person is notified under the Customs Valuation (Determination of Price of Imported Goods) Rules, 2007 (*'Customs Valuation Rules'*). The definition of related person under the Customs law is similar to that under the GST law.

The Customs Valuation Rules aims to bring the import price for related party imports at arm's length and ensure that importers do not undervalue the import price, directly or indirectly, to avoid customs duty. The Customs Valuation Rules provide for adjustments to be made to the import prices in case of related party imports and also provides for underlying principles basis which import prices can be equated with arm's length pricing.

Where the entities in question are found to be related, the Customs Authorities have the power under the law to refer the Valuation issue to the Special Valuation Branch (SVB) which would try to ascertain the veracity of the value declared. Detailed guidelines with respect to investigation of related party imports including SVB are mentioned in Circular 5/2016-Cus dated 9 February 2016.

### **Conclusion**

To conclude, as the transaction between related person and distinct person, whether for supply of goods or services, attract greater scrutiny from the revenue authorities and may have serious consequences on the taxability of the transaction, it becomes imperative for the companies to ensure that reasonable care of the legislative provisions is taken while planning business operations.

