

Blocked Credit on Free of Cost Supplies — The Gloomy Picture and a Glimmer of Hope

- Contributed by CA Sri Harsha and CA Manindar

Introduction:

One of the objectives for implementation of GST in India is to ensure seamless flow of credit among business to shift the entire tax burden to ultimate consumers of the supply. In line with this objective, Section 16(1) of the CT Act¹ facilities input tax credit ('ITC'/'Credit') availment by a registered taxable person on all inward supply of goods or services that are used in the course or furtherance of his business. However, Section 17(5) blocks credit availment on certain inward supply of goods and services specified thereunder. Clause (h) of section 17(5) provides blocks credit on goods lost, stolen, destroyed, written off or disposed by way of gifts. The presence of this clause in section 17(5) coupled with the Revenue's perception on the meaning of the term 'gift' let the taxpayers into defense. They are forced to forego credit on certain expenditure to avoid potential litigation. These expenditures include expenses incurred towards incentives and promotional schemes, promotional gift articles, dairies, pens etc., to promote brand name and expenses towards Corporate Social Responsibility ('CSR') Activities. In the humble opinion of the paper writers, credit is available on this expenditure and are not covered by section 17(5)(h). An attempt is made in this article to bring out the reasons why credit can be claimed on these expenditures.

'disposed of by way of gift or free samples' and the possible rationale:

As mentioned above, credit is blocked on goods disposed of by way of gift or free samples under section 17(5)(h). The exact words in which Section 17(5)(h) was laid as is '*goods lost, stolen, destroyed, written off or **disposed of by way of gift or free samples***'.

In view of the above extracts of Section 17(5)(h), goods which are lost, stolen or destroyed or otherwise disposed of by way of gift or free sample shall not be available as credit. The phrase '*disposed of by way of gift or free samples*' is preceded by the words '*goods lost, stolen, destroyed, written off*' which indicate that the goods involved can no longer be used in the course or for furtherance of business or commerce. Applying the 'Noscitur a Sociis' interpretation rule, the meaning of subsequent phrase 'disposed of by way of gift or free samples' would also be limited to those goods which can no longer be used in the course or for furtherance of business or commerce and are taken away from business.

Further, the words 'gift' or 'free samples' is preceded by the words 'disposed of'. The contextual dictionary meaning² of the word 'disposed of' means to **get rid of somebody/something that you do not want or cannot keep**. This implies that goods which are procured in the course of or furtherance of business or commerce which no longer required for business and when they are removed as gifts or free samples for no consideration, then would come under the ambit of the phrase 'disposed of by way of gift or free samples'.

In view of the above understanding of the clause (h), one can envisage that the rationale for blocking ITC under this clause is for the reason that the **goods involved can no longer be used in the course of or for furtherance of business**

¹ Central Goods and Services Tax Act, 2017

² <https://www.oxfordlearnersdictionaries.com/definition/english/dispose-of?q=dispose+of>

or commerce. As no tax is payable on the output for the reason that the goods involved are taken away from business, no ITC can be claimed of the tax paid on these goods when procured.

Further, the term 'gift' has not been defined in CT Act. The meaning given under Gift Tax Act, 1858 is as under:

'Gift' means **the transfer by one person to another** of any existing **movable or immovable property voluntarily and without consideration** in money or moneys worth...

In the case of Sonia Bhatia vs State of UP³, the Supreme Court held that 'gift' has been held to be a voluntary transfer of property by one to another, without any consideration or compensation therefor. **A 'gift' is a gratuity and an act of generosity and does not require a consideration; if there is a consideration for the transaction, it is not a gift.** In the same case, it was also held that a gift is a transfer which does not contain any element of consideration in any shape and form - Love, affection, spiritual benefit and many other factors may enter in the intention of the donor to make a gift but these filial considerations cannot be called or held to be legal considerations as understood by law.

In the case of Commissioner of Taxation (Cth) Vs. McPhail⁴, the Australian High Court held that **to constitute a 'gift' the property should be transferred voluntarily and not as a result of a contractual obligation.** In this case a person agreed to give a donation to a school in return of school charging less fees for the education of the child of said person. Hence, the Court held that such donation cannot be termed as 'gift' as it was made under a contractual obligation wherein school was required to charge lower fees against the donation made.

In view of the above references to the meaning of 'gift', it can be understood that it involves transfer of movable or immovable property voluntarily out of gratuity or generosity without any consideration. Further, it should not arise out of contractual obligation.

Incentives and Promotional schemes:

It is quite a regular feature for many businesses to incur business promotional expenditure in the form of incentives and gifts to dealers and distributors who achieve the specified targeted sales. Revenue was not allowing the ITC availment on this expenditure incurred towards these incentives/gifts by referring to section 17(5)(h).

In order to promote their sales, various schemes are promoted by companies among their dealers/distributors to achieve desired sales targets. The dealers/distributors who achieve the sales target will be given various gift items like TVs, refrigerators, washing machines, laptops, gold coins etc. Sometimes, under the schemes, the dealers/distributors are entitled for free tours as arranged by the companies at their own cost by taking tour operator, air travel, hotel accommodation and other services on which appropriate tax has been charged by vendors. These items are considered by Revenue as gifts extended by company to dealers/distributors which were given on free of cost basis and credit was being disallowed in the hands of company.

Incentive and promotional schemes announced by companies to their dealers/distributors signifies a contractual obligation between them. It is a promise to the dealers/distributors that they will be rewarded with the specified monetary or non-monetary items if they put in those extra efforts and achieve the targeted sales. Considering the above

³ [1981] 2 SCC 585

⁴ [1968] 41 ALJR 346

understanding of the meaning and scope of the phrase 'disposed of by way of gift or free samples', one can understand that items given to dealers/distributors under sales promotion scheme cannot be considered as disposed of by way of gifts for the following reasons:

- The items involved are given based on the terms of the schemes. They are not of the nature that they are no longer required for business to dispose of as gifts. They are procured for the purpose of the schemes and accordingly used.
- The items involved are not given voluntarily and they are given only to those dealers/distributors who have achieved targeted sales by putting extra efforts. The items given under schemes results into indirect consideration which is contingent by way of increase in sales revenue on which applicable GST is collected from buyers and paid to Government.
- Promotional schemes announced by companies involves contractual obligation between companies and their dealers/distributors and thereby the items given under these schemes cannot be called as gifts.

Therefore, as items given under promotional schemes are not of the nature of gifts, it can be said that the restriction placed under section 17(5)(h) is not applicable and ITC can be claimed on these items.

However, as mentioned above, Revenue perception on the meaning of 'gift' is different and are of the view that it includes every kind of supply on free of cost basis without considering the commercial motive and business objectives surrounded by such transactions. CBIC⁵ vide Circular 92/11/2019-GST dated 07.03.2019, clarified as under:

*Further, clause (h) of sub-section (5) of section 17 of the said Act provides that ITC shall not be available in respect of goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples. Thus, **it is clarified that input tax credit shall not be available to the supplier on the inputs, input services and capital goods to the extent they are used in relation to the gifts or free samples distributed without any consideration.** However, where the activity of distribution of gifts or free samples falls within the scope of 'supply' on account of the provisions contained in Schedule I of the said Act, the supplier would be eligible to avail of the ITC.*

Further, the said issue was examined by various Advance Ruling Authorities and have taken adverse view disallowing ITC on items given to dealers/distributors on free of cost basis under incentive schemes. A few are referred hereunder:

- a) In Re: Biostadt India Limited⁶
- b) In Re: M/s Sanofi India Limited⁷
- c) In Re: M/s Page Industries Limited⁸
- d) In Re: Moksh Agarbatti Co⁹

⁵ Central Board of Indirect Taxes and Customs

⁶ 2019 (3) TMI 540— AAR, Maharashtra

⁷ 2019 (6) TMI 1305 – AAR, Maharashtra

⁸ 2020 (12) TMI 902— AAR, Karnataka

⁹ 2020 (4) TMI 593— AAR, Gujarat

The above clarification issued by CBIC circular and the adverse advance rulings resulted into confusion over availability of ITC on items given to dealers/distributors on free of cost basis under the promotional schemes. In order to avoid litigation with department, many taxpayers have foregone ITC on the items involved in these promotional schemes though they have given these items with commercial intention to increase their sales and are not convinced that the items involved are gifts .

Having said this, the Appellate AAR in the case of In Re: M/s. Sanofi India Limited¹⁰ created a ray of hope to the taxpayers to believe that they claim ITC on these items and can successfully defend their claim when the same is objected by the Revenue. The Appellate AAR examined the issue and allowed ITC by setting aside the ratio laid down by the AAR. It was held as under:

*28. As regards the AAR findings that there is no consideration, whatsoever, involved in the transaction related to the supply of the promotional goods and services as per the “Shubh Labh Trade Loyalty Program” by the Appellant to the wholesalers, it is observed that though there is no direct consideration in the monetary terms, received by the Appellant from the beneficiary Wholesalers against providing the promotional goods and services under the Subject scheme, but it is conspicuous from the subject scheme that the subject transaction i.e. **provision of the promotional goods and services under the subject scheme is the consequence or the outcome of the antecedent, which is the purchase of the Appellant’s pharmaceutical products by the wholesalers in order to claim more and more rewards points under the Shubh Labh Trade Loyalty Program, leading in the sales volume of the Appellant’s products, which in turn result in the increased income/consideration. Thus, it is clearly seen that there is an involvement of the consideration, although indirect, in the impugned transactions carried out under the Shubh Labh Trade Loyalty Program, whereas the Hon’ble Supreme Court judgment, relied upon the AAR had explicitly held as under:***

“.....A ‘gift’ is a gratuity and an act of generosity and does not require a consideration; if there is a consideration for the transaction, it is not a gift.....”

*Further, it is manifest that the Appellant’s act of providing the promotional goods and services under the subject scheme is certainly not an act of generosity, as the Appellant is not giving these goods and services to each and every wholesalers, but only to such participating wholesalers, who have achieved their sales targets and accumulated adequate reward points to fetch such promotional goods and services in terms of the catalogue prescribed by the Appellant. **There is presence of the pure commercial intention of the Appellant in the said scheme i.e. to increase their business and sales.***

*29. In view of the above discussions, **it is clearly established that the provision of the promotional goods and services by the Appellant to the eligible wholesalers under the Shubh Labh Trade Loyalty Program is not gift, as the same does not satisfy the essential ingredients of the gift as envisaged by the above cited Hon’ble Supreme Court Judgment. Accordingly, the provision of the section 17(5)(h) of the CGST Act, 2017, which proposes to disallow the ITC on the goods disposed by way of gift, will not be applicable in the transaction under question.***

The above Appellate AAR is really welcoming development on this issue. The Appellate AAR has considered the Supreme Court decision in the case of Sonia Bhatia (Supra) and held that the items given under promotional schemes are not of the nature of gifts to attract the restriction under section 17(5)(h) in order to disallow the ITC.

¹⁰ 2019 (10) TMI 1384— App. AAR, Maharashtra

Promotional gift articles dairies, pens to promote brand name:

Further, business entities procure promotional gift articles, dairies, pens etc. with their brand name printed/embossed on them. These promotional items are given to customers, vendors, dealers, distributors etc. without any charge on free of cost basis as their brand reminders. These are inputs to the business and are procured with an objective of brand promotion. These are distributed with a commercial motive. Thereby, they are said to have consumed in the business and cannot be said that these are disposed of as gifts voluntarily out of generosity.

Under Income Tax Act, 1961, in the case of PHL Pharma Private Limited¹¹, the Mumbai Tribunal examined the allowability of expenditure towards promotional items as business expenditure. The Tribunal held that these items cannot be reckoned as freebies. The relevant extracts:

*“Coming to the gift articles and free samples of medicines, it is seen that the assessee gives various kind of articles like, dairies, pen sets, calendars, paper weights, injection boxes etc. embossed with bold logo of its brand name and the product name so that the doctors remembers the brand of the assessee and also the name of the medicine. **All the gift articles, as pointed out by the assessee before the authorities below and also before us are very cheap and low cost articles which bears the name of assessee and it is purely for the promotion of its product, brand reminder, etc. These articles cannot be reckoned as freebies given to the doctors.**”*

Thus, items given as brand reminders cannot be considered as gifts. Therefore, the ITC involved on the same cannot be said to be blocked. Having said this, the advance ruling authorities under GST law, ignored the commercial motives involved and considered these items as gifts given without consideration. The following are for reference in this regard:

- a) In Re: BMW India Private Limited¹²
- b) In Re: Biostadt India Limited¹³
- c) In Re: M/s Sanofi India Limited¹⁴
- d) In Re: M/s Page Industries Limited¹⁵

However, the Appellate AAR in the case of In Re: M/s. Sanofi India Limited(supra) examined the issue and has overturned the ruling of the AAR. It was held as under:

“30. Now, we will examine the final issue (f), which is whether the promotional goods e.g. pen, notepad, key chain, etc., embossed with the brand ‘Sanofi’, which are given free of cost by the Appellant to its distributors or doctors as brand reminders can be construed as gift for the determination of the applicability of section of the CGST Act, 2017.

¹¹ 2017 (1) TMI 771 - ITAT MUMBAI

¹² 2019 (4) TMI 1943— AAR, Haryana

¹³ 2019 (3) TMI 540— AAR, Maharashtra

¹⁴ 2019 (6) TMI 1305 – AAR, Maharashtra

¹⁵ 2020 (12) TMI 902— AAR, Karnataka

31. The Advance Ruling Authority, on this above issue, has ruled that the goods e.g. pen, notepad, key chain, etc., embossed with the brand 'Sanofi', which are given free of cost by the Appellant to its distributors or doctors as brand reminders are in the nature of gifts, as these goods have been transferred in the absence any contractual obligation between the Appellant and its wholesalers, and without any commercial consideration, thereby satisfying the parameters of a gift, which have been laid out by the Hon'ble Supreme Court in the case of the Sonia Bhatia vs. State of UP (supra)

32. As regards the above AAR observation, it is stated that the AAR has completely ignored the advertising potential of the such goods given by the Appellant to its distributors or doctors as brand reminder, thereby holding the subject goods duly embossed with brand Sanofi as any other general goods, which may not have been embossed. This is certainly not the case here. **The goods embossed with the Sanofi is clearly distinct from the goods which are not embossed as such. Further, it has already been established in para 22 above that the subject goods, given free of cost to the distributors or doctors as brand reminders are nothing but inputs for the Appellant in terms of the provision of section 2(59) of the CGST Act, 2017, as the same fulfill the advertisement need of the Appellant and its products.** Hence, it can reasonably be concluded that these goods are given to the distributors or doctors with a purpose or motive, which is clearly commercial in nature i.e. The appellant is providing these goods to the distributors or doctors with an implicit commercial motive related to the growth in the sale of their products with the aid of their distributors and doctors. **Thus, it can be deduced that the act of the Appellant, wherein they supply the subject goods to their distributors or doctors, is anything but generous, and there is certainly an element of the commercial consideration involved into this.** Therefore, the provision of the subject goods cannot be held to be gift, as interpreted by the above cited Supreme Court Judgment. Accordingly, the provision of the section 17(5)(h) of the CGST Act, 2017, which proposes to disallow the ITC on the goods disposed by way of gift, will not be applicable in the transaction under question."

In view of the above excerpts of the decision of Appellate AAR, the commercial motive involved in giving the brand promotion items as gifts are noticed and it is clearly observed that such items distributed on free of cost basis is anything but not generous and cannot come under the ambit of 'gift' in order to block the corresponding ITC by referring to the restriction under section 17(5)(h). Therefore, as Appellate AAR accepted the view that items given as brand reminders are not gifts and entitled for ITC, it gives a ray of hope for the industry to claim ITC on these items and defend their claim.

Expenditure towards CSR activities:

Section 135 of the Companies Act, 2013 requires every company having a specified net worth or turnover or profit, to contribute at least two per cent of its average net profit towards activities of Corporate Social Responsibility. Further, Schedule VII of the Act and the Companies (Corporate Social Responsibility) Rules, 2014 provide for certain conditions and guidelines which are geared towards advancing CSR objectives.

Question is about the eligibility of ITC involved in incurring the expenditure towards CSR activities. The Revenue's contention is that these activities involve supply of goods on free of cost basis without any charge from beneficiaries and there by no ITC can be claimed in view of the restriction imposed under section 17(5)(h) of the CT Act. This view is also supported by AAR, Kerala in the case of In Re: M/s. Polycab Wires Private Limited¹⁶.

¹⁶ 2019 (4) TMI 111, AAR- Kerala

In the said case, the Kerala State Electricity Board has requested from the distributors of the applicant to supply electrical goods for the restoration of power supply at flood ridden areas. These materials are supplied by the distributors at free of cost being CSR Activity for reinstating connectivity in flood ridden areas. In addition to this supply to Kerala State Electricity Board, the applicant has distributed electrical items like, switches, fan, cables etc. to flood affected people under CSR expenses on free basis without collecting any money. The AAR referred to the provisions of section 17(5)(h) of the CT Act and held that ITC cannot be claimed as goods are disposed on free of cost basis for CSR activities.

Having said this, the issue was examined by Mumbai Tribunal under CENVAT Credit Rules, 2004 in the case of Essel Propack Ltd. v. Commissioner of CGST¹⁷, wherein the Honorable CESTAT held as under:

“CSR not only holistic approach but integrating core business strategy since same address well-being of all stake holders and not just company's shareholders, also CSR not charity as same having direct bearing on manufacturing activity of company that is largely dependent on smooth supply of raw materials- CSR also augmenting credit rating of company as well as its standing in corporate world-Hence, sustainability of company dependent on CSR without which companies cannot operate smoothly for long period as they are dependent on various stakeholders to conduct business in economically, socially and environmentally sustainable manner.

*Hon'ble Tribunal has further observed that **CSR which was a mandatory requirement for the public sector undertakings, has been made obligatory also for the private sector and unless the same is to be treated as input service in respect of activities relating to business, production and sustainability of the company itself would be at stake**”*

Despite the above legal position laid down by Honorable Mumbai Tribunal, doubts were raised over the applicability of the said decision under GST regime as erstwhile CENVAT Credit Rules, 2004 does not have a clause similar to that of section 17(5)(h) of the CT Act.

Having said this, recently, the Uttar Pradesh AAR in the case of In Re: M/s Dwarikesh Sugar Industries Limited¹⁸ examined this issue and ruled in favor of taxpayers. it was held as under:

“As regard to the question whether free supply of goods as a part of CSR activities is restricted under Section 17 (5) (h) of CGST Act, 2017, we observe that the applicant supplies of furniture/ fittings such as tables, chairs etc. and electrical goods to be used in the school under the CSR activity, free of cost. In this regard, we observe that Section 17 of the CGST Act, 2017 talks about apportionment of credit and blocked credits. Further, as per Section 17(5)(h) of the CGST Act, 2017, input tax credit shall not be available in respect of

“goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples.”

The aforesaid section restricted credit of the goods which were written off or disposed off by way of gift or free samples. Now the moot question before us is to decide whether the furniture / fittings such as tables, chairs etc. and electrical goods supplied by the applicant are to be treated as gift or not. The term 'Gift' has not been defined under the CGST Act, 2017, however in common parlance gift is provided to someone occasionally, without consideration and which is voluntary in nature. Further, the applicant has also relied upon the Judgment of Hon'ble Supreme Court of India, in the case of Ku. Sonia Bhatia v. State of UP, wherein Hon'ble Court has cited the definition of 'gift' from Corpus Juris Secundum,

¹⁷ 2018 (362) E.L.T. 833 (Tri.-Mumbai)

¹⁸ 2020 (1) TMI 1430— AAR, Uttar Pradesh

Volume 38 in the following words: “A 'gift' is commonly defined as a voluntary transfer of property by one to another, without any consideration or compensation therefor. A 'gift' is a gratuity and an act of generosity and not only does not require a consideration, but there can be none.” Citing the definition, it has been observed by the Hon'ble Court that

“The concept of gift is diametrically opposed to the presence of any consideration or compensation. A gift has aptly been described as a gratuity and an act of generosity and stress has been laid on the fact that if there is any consideration then the transaction cease to be a gift.”

In view of above discussion, we are in unison with the applicant that a clear distinction needs to be drawn between goods given as 'gift' and those provided / supplied as a part of CSR activities. While the former is voluntary and occasional, the later is obligatory and regular in nature. CSR expenses incurred by the applicant have been mandated under the Companies Act, 2013. It is the applicant's obligation to incur such expenses in order to be in compliant with the law. Since CSR expenses are not incurred voluntarily, accordingly, we are of the opinion that they do not qualify as 'gifts' and therefore its credit is not restricted under Section 17(5) of the CGST Act, 2017”

In view of the above excerpts of the decision of AAR, one can strongly argue that CSR activities are generally undertaken under statutory obligation and they cannot be considered as gifts given without any charge to disallow ITC under section 17(5)(h).

Conclusion:

Basis the above discussion, it can be understood that ‘gift’ is an act of generosity and gratuity and does not involve any consideration. It does not include those items which are distributed on free of cost basis with commercial or business motives or under contractual or statutory obligation. However, the Revenue perception is that anything and everything given on free of cost basis would come within the meaning of ‘gift’. The circular issued by CBIC as well as the presence of AARs in favor of Revenue forced the taxpayers to forego ITC on these expenditures to avoid potential litigation. Having said this, the recent rulings in favor of taxpayers certainly be considered as glimmer of hope to taxpayers to believe that they can claim ITC on these expenditures and can successfully defend their claim if questioned by Revenue.

(This article is contributed by CA Sri Harsha Vardhan K and CA Manindar K, Partners of SBS and Company LLP, Chartered Accountants. The authors can be reached at harsha@sbsbandco.com & manindar@sbsandco.com)