GST implications for supplies of goods that are not in "India" at the time of supply

Harsh Shah & Ruchita Shah *Advocates*

Introduction

As we write this article, India has crossed the ambitious target of USD 400 billion in merchandise exports for the financial year 2021-22. The sharp increase in merchandise exports (i.e., export of goods) has been also observed at the global level, with the global trade in goods reaching an all-time quarterly high of USD 5.6 trillion in the third quarter of 2021[1].

The international trade in goods consists of various types of transactions inter-alia including merchanting trade and high sea sales. Merchanting or merchanting trade transactions are transactions of international trading in goods wherein a trader or merchant buys goods from a non-resident vendor and in turn, sells the same to another non-resident vendor without physically importing the goods. In India, merchanting trade transactions are permitted to be undertaken in terms of the RBI Guidelines[2]. As per the said guidelines, for a trade to be classified as merchanting trade, goods acquired shall not enter the Domestic Tariff Area.

High sea sales are typically transactions of the sale of goods by the original consignee to another person while the goods are still in the course of international transport and have not entered the territorial waters of the consignee or destination country. It may be noted that in the case of high sea sales, there is an eventual import of goods into India as opposed to merchanting trade transactions where goods are never physically imported into India.

Further, in India, a transaction of sale or supply of goods could also be undertaken while the same is lying in Customs bonded warehouse (i.e., before the same are cleared for home consumption) in terms of Chapter IX of the Customs Act, 1962 ('Customs Act'). Such a supply may result in subsequent clearance of goods into India (as per Section 68 of the Customs Act) or direct shipment of the same outside India (as per Section 69 of the Customs Act).

Relevant provisions of the GST law – Entry nos. 7 and 8 of the Schedule III

Amendment in the Schedule III to insert Entry nos. 7 and 8 for merchanting trade, supply of goods lying in Customs bonded warehouses, and high sea sales

The provisions of the Central Goods and Services Tax, 2017 ('CGST Act') did not

1. https://unctad.org/news/global-trade-goods-hits-all-time-quarterly-high-56-trillion
2. A.P. (DIR Series) Circular no. 20 dated January 23, 2020

have any reference to the transactions in question till January 31, 2019. However, Clause 32 of the Central Goods and Services Tax Amendment Act, 2018 ('CGST Amendment Act') inserted Entries no. 7 and 8 in the Schedule III to the CGST Act effective from February 01, 2019, which are reproduced hereunder:

"7. Supply of goods from a place in the non-taxable territory to another place in the non-taxable territory without such goods entering into India.

8. (a) Supply of warehoused goods to any person before clearance for home consumption;

(b) Supply of goods by the consignee to any other person, by the endorsement of documents of title to the goods, after the goods have been dispatched from the port of origin located outside India but before clearance for home consumption."

By the above, the transactions of merchanting trade, supply of goods in Customs bonded warehouses, and high seas sales were treated as neither supply of goods nor supply of services in terms of Section 7(2)(a) of the CGST Act.

Effective date of amendment

As per Clause 1(2) of the CGST Amendment Act, the provisions thereof (except as otherwise provided) shall come into effect from a date as may be notified by the Central Government. It is pertinent to note that some of the Clauses of the CGST Amendment Act explicitly provided July 01, 2017, as the effective date of the amendment and thereby invoking retrospective applicability. However, no specific effective date was provided for Clause 32 and hence, the same came into effect from February 01, 2019, of the Notification[3] issued in this regard.

As evident from the above, while the CGST Amendment Act extended retrospective effect to some of the Clauses, Clause 32 in question was specifically given prospective effect.

It is pertinent to note that as held in the landmark decision of the seven-member bench of the Supreme Court in the case of Keshavan ***Madhavan Menon vs. State of Bombay and various*** other cases, it is normally presumed that statutes are not retrospective. Further, as held in the decision of the Supreme Court in the case of ***CCE vs. Doaba Steel Rolling Mills***[4] and various other cases, a taxing statute should be strictly construed and the intention of the legislature is to be primarily gathered from the words used in the statute itself.

While there are several judicial pronouncements of the Supreme Court supporting that a beneficial Circular or notification should be given retrospective effect[5], the same may not come to the rescue in the present case since the provisions in question are part of the statute itself.

Considering the above, and the fact that Clause 32 of the CGST Amendment Act has not been given retrospective effect, it may be difficult to establish that the Entry nos. 7 and 8 of the Schedule III should be considered as effective from July 01, 2017.

3. Vide Notification No. 2/2019-Central Tax F.No.20/06/16/2018-GST (Pt. II) Dated 29th January 2019
4. 2011 (269) ELT 298 (SC)
5. *Suchitra Components Ltd. vs. CCEx, Guntur 2007 (208) ELT 321 (SC), GOI vs. Indian Tobacco Association 2005 (187) ELT 182 (SC)*

Applicability of GST on these transactions from July 2017 to January 2019 and analysis of the position under the erstwhile Indirect tax laws

Considering that the amendment in Schedule III to cover these transactions is effective only from February 01, 2019, it leaves room for debate on the applicability of the GST thereon for the period before the amendment.

Relevant provisions of the law

In this context, it would be helpful to refer to the relevant provisions of the CGST Act and the Integrated Goods and Services Tax Act, 2017 ('IGST Act') covering definitions of relevant terms and the concepts of inter-State supply.

a. A as per Section 1 of the IGST Act, the Act extends to the whole of India.

b. Section 2(56) of the CGST Act provides that *"India means the territory of India as referred to in article 1 of the Constitution, its territorial waters, seabed, and subsoil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone, and other Maritime Zones Act, 1976 (80 of 1976), and the air space above its territory and territorial waters."*

c. Section 2(5) and 2(10) of the IGST Act, define the terms 'Export of goods' and 'Import of goods' respectively as under:

"export of goods with its grammatical variations and cognate expressions means taking goods out of India to a place outside India"

"import of goods with its grammatical variations and cognate expressions means bringing goods into India from a place outside India"

It is pertinent to note that the aforesaid definitions are l *pari material* to definitions of these terms under the Customs Act and refer to "taking goods out of India" and "bringing goods into India" for export and import respectively. As held by the Supreme Court in the case of ***Union of India vs. Rajindra Dyeing and Printing Mills Limited***[6] and various other judicial precedents, to treat a transaction as an export, goods should have been physically taken outside India. Accordingly, import and export may require physical movement of goods into and outside India respectively.

d. Section 5 of the IGST Act provides for a levy of IGST on all inter-State supplies of goods and services subject to exceptions. In the context of IGST on goods imported into India, it states that:

*"**Provided** that the integrated tax on goods imported into India shall be levied and collected with the provisions of section 3 of the Customs Tariff Act, 1975 (51 of 1975.) on the value as determined under the said Act at the point when duties of customs are levied on the said goods under section 12 of the Customs Act, 1962 (52 of 1962.)."*

e. Section 7 of the IGST Act enlists the supplies which shall be treated as supplies of goods or services in the course of inter-State trade or commerce. The relevant sub-sections of the same, in the context of the present discussion, are reproduced hereunder:

"(2) Supply of goods imported into the territory of India, till they cross the customs frontiers of India, shall be treated to be a supply of goods in the course of inter-State trade or commerce.

6. 2005 (180) ELT 433 (SC)

(5) Supply of goods or services or both,-

(a) when the supplier is located in India and the place of supply is outside India;

(b) to or by a Special Economic Zone developer or a Special Economic Zone unit; or

(c) in the taxable territory, not being an intra-State supply and not covered elsewhere in this section,

shall be treated to be a supply of goods or services or both in the course of inter-State trade or commerce."

In this context, it is pertinent to note that the location of the supplier of goods is not defined under the CGST Act or the IGST Act.

f. Section 2(4) of the IGST Act defines "customs frontiers of India" to mean "the limits of a customs area as defined in section 2 of the Customs Act, 1962(52 of 1962)".

With this background, we would now proceed to discuss the applicability of GST on the transactions in question and position on the taxability of the same under the erstwhile Indirect tax regime.

Merchanting trade transactions

Position in the GST regime and controversy

Merchanting trade transactions effectively involve two legs, supply by the overseas supplier to the Indian entity and supply by the Indian entity to another overseas customer. The taxability of these supplies should be individually examined to determine the GST implications of such transactions.

The underlying goods in such cases do not enter India by way of imports. Considering the same, the supply by the overseas supplier to the Indian entity would not qualify to be the import of goods. Further, since the supplier of such goods is located outside India, such transactions would also not be covered within the scope of inter-State supplies as defined under Section 7 of the IGST Act. Considering the same, this leg of the transaction may not attract GST liability in India.

On the second leg of supply by an Indian entity to the overseas customer, the transaction would not qualify to be exported as such since the goods would not be physically exported outside India. Considering the same, on a strict interpretation, one may say that such transactions would not be eligible for zero-rating as per Section 16 of the IGST Act (which is eligible only in the case of exports and supplies to SEZ). Further, the scope of inter-State supply, as per Section 7(5)(a) of the IGST Act, covers within its scope the supplies where the supplier is located in India, but a place of supply is located outside India. Basis this, there exists a possibility of the Revenue authorities contending that the supplier in such cases is located in India and the place of supply is outside India. The authorities may consequently allege that the outward supplies in such cases qualify to be inter-State supplies but not exports, and hence, the same should be liable to GST in India for the period from July 2017 to January 2019. The Gujarat Authority for Advance Ruling ('AAR') adopted this interpretation in the case of ***Sterlite Technologies Ltd***.[7] A similar view has also been upheld by the Gujarat AAR and further confirmed by the appellate authority in the case of SPX Flow Technology India Pvt. Ltd.

Having said that, it needs to be considered that the provisions of the IGST Act extend only to India. As per the doctrine of territorial

7. 2020 (28) GSTL 323 (AAR – GST – Guj.)

nexus, to levy tax in India, there ought to be sufficient territorial nexus between the subject of tax and the territorial limits of India. The Supreme Court in the case of Ishikawajima Harima Heavy Industries Ltd vs. DIT held that sufficient territorial nexus between the rendition of service and territorial limits of India is necessary for the levy of tax. As held by the Hon'ble Supreme Court in the case of ***GVK Inds. Ltd. vs. Income Tax Officer***[8], the Parliament of India does not have legislative competence concerning aspects or causes which are extra-territorial that do not have any nexus to India. Relying on the above, it may be possible to take a position that the supplies in question, being not associated with India in as much as the goods in question do not come to India, cannot be taxed in India.

At this juncture, it is also pertinent to refer to the Advance Ruling of the Maharashtra AAR in the case of ***Enmarol Petroleum India Pvt. Ltd.***[9] wherein it was upheld that such transactions can be treated as similar to high sea sales and any tax on the same can be levied only at the point when Customs duties are levied under the Customs Act. A similar view was also upheld by the Kerala AAR in the case of ***Synthite Industries Limited***[10].

While the position laid down in these favorable rulings seems logical, on a strict interpretation, the supplies in case of merchanting trade transactions may not be treated as "Supply of goods imported into the territory of India, till they cross the customs frontiers of India" in as much as the underlying goods are never "imported" (i.e., physically brought) into India.

Position under the erstwhile Indirect tax laws

Under the erstwhile VAT laws and the CST Act, such transactions did not qualify to be intra-State s sales, inter-State sales, or sales in the course of import or export. Consequently, no tax liability for the same was attracted under these laws.

Position in other jurisdictions

Under the Australian GST law, to attract a levy of GST, a supply has to be connected with the Australian Indirect Tax zone[11]. In the context of goods, supply is treated as connected only if:

- The goods are delivered or made available in Australia to the recipient or
- The supply involves goods being removed out of Australia or
- The goods are brought into Australia.

Considering the same, a merchanting trade transaction would not qualify to be a supply connected to the Australian Indirect Tax zone and hence, may not attract GST. This position would also conform with the doctrine of territorial nexus discussed above.

Supply of goods in the course of high sea sales

Position in the GST regime

Such supplies would be undertaken before the goods cross the Customs frontiers of India and hence, the same would qualify to be inter-State supply in terms of Section 7(2) of the IGST Act (covering the supply of

8. 2017 (48) STR 177 (SC)
9. 2019 (20) GSTL 442 (AAR – GST)
10. 2018 (12) GSTL 395 (AAR – GST)
11. GSTR 2002/6 – Goods and Services Tax: Exports of goods, items 1 to 4A of the table in subsection 38-185(1) of the A New Tax System (Goods and Services Tax) Act 1999

goods imported into the territory of India, till they cross the customs frontiers of India). Consequently, in terms of proviso to Section 5(1) of the IGST Act, IGST on the same can be levied only at the point when Customs duties are levied under the Customs Act. Therefore, a position could be adopted that such supplies by way of high-sea sales would not be taxed separately and IGST on the underlying goods would have to be paid only once at the stage of filing the Bill of Entry for home consumption.

While a contrary interpretation could be adopted on the basis that the proviso to Section 5(1) of the IGST Act refers to goods imported into India and not earlier supplies of such goods before they cross the Customs frontiers of India, all such potential controversies were put to rest by the issuance of the Circular[12] whereby it was clarified that IGST on such supplies would be levied only once at the time of Customs clearance.

Position under the erstwhile Indirect tax laws

Under the erstwhile Central Sales Tax Act, 1956 ('CST Act'), such transactions qualified to be sales in the course of import and did not attract VAT or CST.

Supply of goods lying in Customs bonded warehouse

Position in the GST regime

The underlying goods in such cases would be lying in Customs bonded warehouses and the supplies in question would take place before the same are cleared for home consumption. The same may therefore be treated as an inter-State supply of goods in terms of Section 7(2) of the IGST Act. Similar to the high sea sale transactions, the controversy surrounding such transactions was whether the underlying goods should be taxed only once (when the same are cleared for home consumption), or at the stage of each supply.

In the early days after GST implementation, a Circular[13] issued in this context stated that such transactions of supply of warehoused goods ought to be treated as an independent supply chargeable to GST at the stage when such supply is made. This position was justified on the basis that the provisions of the Customs Tariff Act, 1975 ('CTA') did not provide any mechanism to add the incremental value of such supplies of bonded goods of usingasses assess Customs duty.

However, in what can be called a subsequent U-turn, an amendment[14] in the CTA was carried out to provide that valuation for levy of IGST on warehoused imported goods at the time of clearance for home consumption would be:

- Transaction value or
- The value as per Section 3(8) of the CTA (i.e., valuation done at the time of filing the into-bond bill of entry), whichever is higher.

After this amendment, another Circular[15] clarified that IGST in such cases should be charged only once at the time of filing the Bill of Entry for home consumption. With this, such transactions were treated at par with high sea supplies.

12. Circular no. 33/2017 – Customs dated 01.08.2017
13. Circular no. 46/2017 – Customs dated 24.11.2017
14. Sub-section (8A) inserted in Section 3 of the CTA vide Section 102 of the Finance Act, 2018 (effective from 31.03.2018)
15. Circular no. 3/1/2018 – IGST dated 25.05.2018

Position under the erstwhile Indirect tax laws

Under the erstwhile Indirect tax laws, taxation of such transactions was surrounded by controversies as to whether such transactions would qualify to be sales in the course of import in terms of Section 5(2) of the CST Act or whether the same would attract State VAT/Sales tax. It is noteworthy that sales in the course of import as per Section 5(2) of the CST Act covered sales occasioning import of goods into India or sales effected by transfer of documents of title to the goods before the goods have crossed the customs frontiers of India. The term crossing the Customs Frontiers of India was defined as crossing limits of an area of a Customs station in which imported goods are ordinarily kept before clearance by Customs authorities.

Various State VAT/Sales tax authorities have from time to time alleged that any sales of goods lying in Customs bonded warehouses situated in their respective States would qualify to be intra-State sales and would attract VAT/Sales tax. In this context, the Supreme Court in the case of ***Hotel Ashoka vs. Assistant Commissioner of Commercial Taxes***[16] held that the sale of imported goods kept in bonded warehouses in duty-free shops in the international airport could be treated as sales before goods have crossed the customs frontiers of India and hence, not liable to VAT. The position was widely followed in various High Court decisions across States before the same was unsettled in the decision of the Bombay High Court in the case of ***Commissioner of Sales Tax vs. Radhasons International***[17] wherein it was held that filing of ex-bond Bill of Entry can be treated as crossing Customs frontiers of India and such sales of goods lying in Customs bonded warehouses would attract VAT. Recently, the Supreme Court in the case of ***Nirmal Kumar Parsan vs. Commissioner of Commercial Taxes*** has distinguished various judicial precedents including Hotel Ashoka, and held that while the transaction of import gets completed upon payment of Customs duty at the time of clearance for home consumption, the same is not an impediment in levy of Sales tax on the sale of goods lying in bonded warehouses. It was held that such warehouses cannot be treated as located within an area notified as a Customs port and/or land Customs station and hence, goods in such cases can be treated to have crossed Customs frontiers of India.

Implications of the Supreme Court decision in the case of Nirmal Kumar

While the said decision is issued in the context of the erstwhile West Bengal Sales tax law, the findings that goods can be treated to have crossed Customs frontiers of India even while the same is lying in bonded warehouses could be relevant in the context of GST regime as well. While such transactions have been treated as inter-State supplies in terms of Section 7(2) of the IGST Act and hence, held liable to IGST, the finding of the Supreme Court may contradict this position and Circulars issued in this regard. This may potentially create room for the demand of CGST and SGST on such supplies for the period up to 31.01.2019.

Reversal of Input tax credit ('ITC')

As per Section 17 of the CGST Act, the amount of ITC attributable to non-business purposes or exempted supplies ought to be reversed.

16. 2012 (276) ELT 433 (SC)
17. 2019 (2) TMI 551 (Bom HC)

Section 17(3) provides a mechanism for determining the value of exempt supply for ITC reversal. As per the definition provided in Section 2(47) of the CGST Act, the term 'exempt supply' means supplies attracting nil rate, supplies wholly exempted or non-taxable supplies. However, the Explanation to Section 17(3) provides an exception in this regard and states that in determining the value of exempt supply for ITC reversal, the value of activities or transactions specified in Schedule III (except for Entry 5) would not be considered. of this Explanation, an inference can be drawn that reversal of ITC may not be required to be done in respect of supplies covered under any entries of Schedule III (except for Entry 5).

The amendment in Schedule III to the CGST Act with effect from 01.02.2019 thus directly impacts the position as regards eligibility to retain ITC attributable to the transactions in question. For the period post amendment, reversal of ITC would not be required on such transactions despite the non-applicability of GST on the same. However, for the period up to 31.01.2019, the authorities may require reversal of ITC on such transactions to the extent GST is not paid on the same.

At this juncture, it is noteworthy that under the erstwhile regime also, reversal of CENVAT credit in respect of such transactions of like trading was required before[18] as well as after the amendment to treat trading as an exempted service.

Key take-aways and conclusion

The transactions of high sea sales, bonded sales, and merchanting trade can typically be treated as somewhere in between pure import/export and domestic transactions. This unique nature of such transactions has historically resulted in controversies and litigation on the applicability of tax on the same. Even under the GST regime, the interpretational issues did exist, and the controversy has been given rest by the inclusion of such transactions in the Schedule III to the CGST Act effective from February 01, 2019.

However, for the intermediate period from July 2017 to January 2019, potential litigation may arise for merchanting trade transactions. Further, while the Circular issued by the CBIC has clarified the non-applicability of IGST on the supply of goods lying in Customs bonded warehouses, the recent decision of the Supreme Court in the case of Nirmal Kumar leaves some room to argue the applicability of CGST and SGST on the same.

Although no reversal of ITC for such transactions would be required effective from February 2019, the authorities may insist on the reversal of ITC for the earlier period to the extent GST was not discharged on the same.

A look at these controversies for the period from July 2017 to January 2019 leaves us perplexed on the rationale to introduce the amendments in Schedule III on a prospective basis, as opposed to a retrospective basis as done for some other provisions of the CGST Act.

To conclude, for the in-between period from July 2017 to January 2019, we continue to be in-between the clear and controversial as regards the tax treatment of these transactions, which are in-between pure import/export and domestic, go.

18. *Orion Appliances Limited vs. Commissioner of Service tax 2010 (19) STR 205 (Tri. – Ahmd.)*

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