

## Has GST Fulfilled the Dream of Seamless Input Tax Credit?

Jan 23, 2023



### Karthik Mani

Associate Partner, Indirect Tax, BDO India LLP

The object and purpose of transforming the Indian Indirect tax environment from the proliferation of multiple indirect tax laws under Central and State level to a uniform, pan-India GST was to weed-out tax cascading by allowing seamless flow of Input tax credit (ITC), free Indian goods and service from cost escalation on account of embedded tax and to provide ease of doing business. Availment and utilisation of ITC was expected to be a game changer, which will provide incremental working capital to taxpayers by eliminating working capital blockage and being price competitive due to tax credits.

In an ideal and well-crafted VAT structure, the amount of tax paid by a registered person shall be equal to the tax rate applied on the 'value addition' / 'profit element' added at each stage of supply chain. Such a tax structure can be possible, only when full ITC is allowed on all the procurements and the tax cost is only borne by the ultimate consumer. However, restrictions under Section 17(5), numerous exemptions, and period of limitation for availing of ITC, etc. have ultimately resulted in break of credit chain, and has led to a proportional cascading effect.

Over the past 5 years from introduction of GST, on one hand the Government has brought several proactive changes/amendments in the law to address key concerns and to address the issues faced by the taxpayers and on the other hand, purportedly to address the menace of tax frauds by claim of ineligible ITC or ineligible refunds, have complicated the ITC availment process and created hurdles to free flow of ITC. Unless the Government addresses the following key issues in the upcoming Union budget, the aim of achieving the stated objective of progressive Indirect tax ecosystem would remain elusive.

#### 1. **Blocked credits under Section 17(5):**

Section 17(5) of CGST Act, 2017 provides a negative list wherein the input tax credit on expenses incurred by taxpayers would be considered ineligible, even when such expenses are incurred in the course and furtherance of business.

#### **Goods and services incurred in regular business expenses.**

Input tax credit on goods or services such as motor vehicles, food and beverages, outdoor catering, beauty treatment, health services, cosmetic and plastic surgery, leasing, renting, or hiring of motor vehicles, vessels or aircraft are considered ineligible unless such goods or services are used for making outward taxable supply of same category goods or services or both or as element of taxable composite or mixed supply.

In addition to the above, the credit of services pertaining to membership of club, health and fitness centre and travel benefits extended to employees on vacation such as leave, or home travel concession is considered ineligible unless the services or goods or both are provided by the employer to the employees under an obligation of any other law.

The above restriction of ITC on genuine business expenditures leads to avoidable increase in costs

wherein the GST element is expensed-off and added to cost of goods or services. The traditional thought of employee expenditure is not an essential expenditure in the business and denying credit needs revisit. Employees are key assets in any organisation, attracting and rewarding a skilled manpower is becoming a major challenge and key risk in the business operation. With increase in focus on service-oriented business sectors, the Government may take re-look into the eligibility of input tax credit on genuine business expenditures which are essential for efficiency and retention of employees in an organisation.

### **Works contract and Immovable property related ITC.**

Section 17(5)(c) restricts ITC towards expenses pertaining to works contract services received for construction of immovable property (other than plant and machinery) except when such works contract service is used as input for further supply of works contract service. Further, Section 17(5)(d) restricts ITC on goods or services, or both received for construction of immovable property (other than plant and machinery). The provisions add additional condition that the credit would be ineligible to the extent of expenditures capitalised as part of the immovable property.

The above provisions have led several confusions and challenges in determining the eligibility of ITC on several expenditure incurred by businesses as part of set-up, renovation, or repair of offices/factories. The Government may consider change of law and provide necessary clarification illustrating the nature of expenditures where ITC is restricted and nature of expenditures where ITC is allowed.

In addition to the above, the restriction of ITC on goods or services or works contract services when restricted to builders or developers who are involved in renting/leasing of constructed immovable property, the entire ITC incurred during the construction of the premises becomes a substantial cost even though the ITC on all the construction related goods and services are incurred for taxable output supply by way of leasing/renting of the premises. An appeal on this matter has been admitted by the Hon'ble Supreme Court in the case of **M/s Safari Retreats Pvt Ltd**, wherein the Odisha High court had ruled that ITC would be available for the GST paid during the construction of immovable property for the purpose of rent.

### **Personal consumption, goods lost, stolen, destroyed, written off or disposed by way of gift or free samples.**

The restriction of ITC under Section 17(5)(g) and Section 17(5)(h) is not specific and has led to several interpretational challenges. For a business organisation what expenditure would be treated as for personal consumption is a subjective matter. Further, the mechanism to compute the value of goods lost, stolen, destroyed, written off or given as gifts and free samples is a challenge to taxpayers. It is usual practice in every business to factor such free supplies/samples while pricing decision are taken on their product, on which applicable GST is paid. Thus, it would be incorrect to deny the corresponding ITC, merely because some free supplies are effected.

Loss of goods in manufacturing process is part of generally accepted business norms and there shall not be ITC reversal towards standard manufacturing losses. Further, clarity should be provided on what amounts to gifts or free samples. Several taxpayers have adopted the methodology to charge nominal value for the goods given to customers as gifts or free samples, which will make the ITC eligible on such goods. Considering the above the Government should provide clarifications to address the confusions in determining eligibility of ITC under Section 17(5)(g) and Section 17(5)(h) and allow ITC on genuine business expenditures or standard manufacturing losses.

## **2. Exempt Supplies**

The GST law was expected to reduce the number of exemptions compared to erstwhile Indirect tax laws, however due to the necessity of providing exemption to key sectors such as Health care services, educational services, and transportation services, the Government has given complete exemptions or condition-based exemptions to these sectors. The exemption of services rendered by these sectors has resulted in a break of ITC flow. The organisations operating in health care or educational services, or Goods transportation services are denied ITC on their procurements used for rendering exempt outward supplies, which has ultimately resulted in higher cost of goods or services to the ultimate consumer.

### 3. Credit loss due to limitation

Section 17(4) of CGST Act, 2017 provides time restriction to a taxpayer for availment of ITC, wherein a taxpayer is denied ITC if the credit of invoices pertaining to one financial year is not claimed before any GSTR-3B filed before 30th November of succeeding financial year.

The above time restriction results in denial of substantial benefit of ITC to the taxpayers for a mere procedural lapse of not claiming the credit within stipulated period. Several High courts have accepted Writ petitions challenging the validity of Section 17(4). The Government should re-look into the current limitation provisions to provide limitation period similar to limitation provided towards issuance of notices and initiating proceedings against the taxpayers.

### 4. Capital goods restriction to Exporters.

Currently, the refund claim mechanism under the GST law allows exporters to claim refund of ITC accumulated towards export transactions under two routes, namely 'Refund claim of unutilised input tax credit for exports made under Letter of Undertaking (LUT)' and 'Refund claim of IGST paid on exports made without LUT'.

The refund claim formula towards exports made under LUT excludes the value capital goods credit while computing the refund amount and hence the exporters who are operating as Domestic Tariff Area (DTA) unit are forced to accumulate the credit of capital goods over a period of time and apply for refund under the option of 'exports made without LUT'.

Further, the option of claiming refund under 'exports made without LUT' is not allowed for entities operating as EOU/STPI. Even though the Government's intention of not providing this option to EOU/STPI is to encourage upfront exemption available for procurements by units operating in EOU/STPI, the practical reality is different. Several EOU/STPI units procure capital goods domestically and suffer GST, since the suppliers are not ready to go through the complex process of making deemed export and claiming refund of taxes paid at their end. This situation has resulted in EOU/STPI units expensing the entire GST credit on their capital goods procurements and ultimately resulting in break of seamless flow of ITC.

The Government should either ease the process by providing zero rated supply status towards supplies made to EOU/STPI in line with current benefit provided to SEZ units or allow inclusion of the ITC pertaining to 'Capital goods' as part of the regular export refund made with LUT.

### 5. Insertion of Section 16(2) (aa) of CGST Act 2017

The insertion of Section 16(2) (aa) of CGST Act, 2017, effective from 1st January 2022 has created additional conditions and burden on the taxpayers to avail ITC. The amendment requires the taxpayer to ensure that the following condition is satisfied for the taxpayer to avail input tax credit.

*16(2) (aa) the details of the invoice or debit note referred to in clause (a) has been furnished by the supplier in the statement of outward supplies and such details have been communicated to the recipient of such invoice or debit note in the manner specified under section 37.*

The above amendment has created additional onus on the taxpayer to ensure that the supplier is correctly disclosing the details of the supply in his GSTR-1 in order to avail the input tax credit. This requirement has created additional compliance burden on the recipient. Even for genuine transactions where the supplier has delayed filing returns or incorrectly captured the invoice details or GSTIN details, the credit is denied to the recipient for extremely procedural data errors.

The Government should consider the ruling of the Madras HC in the case of M/s DY Beathel Enterprises which held that the tax authorities should initiate proceedings against a taxpayer only after initiating assessment/proceedings against the supplier and concluding that there is no non-compliance at the supplier end. The GST law should be suitably amended to remove the onus of proving tax payment from the recipient of supply to that of supplier.

Considering the above factors, while the Government's intention is to address fraudulent transactions and provide tax relief to key economic sectors, the measures adopted by the Government in this regard cause burden to honest taxpayer and defeat the fundamental plank on which GST was enacted. With digitisation and control over the transactions, after introduction of e-invoicing, the Government may ease the compliance burden of genuine taxpayers and allow free flow of Input tax credit.