GST COUNCIL TO RATIONALIZE RATES OF INVERTED DUTY STRUCTURE

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INTRODUCTION

The 54th meeting of Goods and Services Tax (GST) Council is scheduled to convene on September 9, 2024, in New Delhi, where significant issues such as the regulation of online gaming and health insurance premiums will be discussed. Alongside these, the Council will also deliberate on reforms pertaining to the all-important issue of inverted duty structure as part of its rate rationalization efforts.

One of the principal objectives behind the introduction of GST, replacing the earlier indirect tax system, was to eliminate inefficiencies in the input tax credit (ITC) chain and fully eradicate the cascading effect of taxes. Under the pre-GST regime, taxes were levied under different legislations at multiple stages—on inputs, processes, and final goods—leading to an inflationary burden on the final consumer due to the resultant cascading effect. GST sought to resolve this by ensuring that various such legislations are consolidated, and the Input Tax Credit (ITC) chain is maintained till the supply of final product or service.

In other words to achieve credit efficiency, the system allows businesses to claim ITC on taxes paid for goods and services used in the course of their operations at different stages. This mechanism ensures that tax is effectively borne by the end consumer, and there is no incidence and effect unnecessarily on intermediate inputs. GST law, therefore, prescribes a robust system for availing ITC on most inputs and input services that are linked to output supplies.

However, despite the introduction of this well-thought-out system, certain inefficiencies persist due to the inverted duty structure—a scenario where the tax rate on inputs is apparently higher than that on the final product leading to a situation of perennial overflow of ITC.

This analysis will aim to dissect the structural issues and policy-level inconsistencies that have led to imbalances in the credit system, undermining one of the key goals of GST—eliminating tax inefficiencies.

CONCEPT OF INVERTED TAX STRUCTURE

Basically, the situation of Inverted tax arises where the rate of tax on inputs purchased (i.e.GST rate paid on inputs received) is more than the rate of tax on outward supplies (i.e. GST rate payable on sales/supplies). This leads to a situation where the supplier is not able to utilize the entire ITC. This may also lead to a situation where the supplier may have to charge a part of unabsorbed ITC from the recipient, which leads to a higher tax burden on the final consumer.

PROVISIONS RELATING TO REFUND OF OVERFLOWING ITC UNDER THE INVERTED DUTY STRUCTURE

For the purpose of refund of taxes, the CGST Act provides for elaborate provisions for refund of any unabsorbed credit due to inverted tax structure. CGST Act provides for an inclusive definition of "Refund', which is reproduced below :

> ***Section 54. Refund of tax. —***
> *Explanation. - For the purposes of this section, -*
>
> *(1) "Refund" includes refund of tax paid on zero-rated supplies of goods or services or both or on inputs or input services used in mot gouch area as deemed exports or run on unutilized input tax credit as provided."*

[Emphasis Supplied]

Further, CGST Act' also provides for enabling provisions to claim refunds, where rate of tax on inputs is higher than the rate of tax on outputs. The said provision is extracted below for the sake of brevity –

> ***Section 54 - Refund of tax****. —*
>
> *(3) Subject to the provisions of sub-section (10), a registered person may claim refund of any unutilised input tax credit at the end of any tax period:*
>
> *Provided that no refund of unutilised input tax credit shall be allowed in cases other than —*

(i) zero rated supplies made without payment of tax;

(ii) where the credit has accumulated on account of rate of tax on inputs being higher than the rate of tax on output supplies (other than nil rated or fully exempt supplies), except supplies of goods or services or both as may be notified by the Government on the recommendations of the Council:

[Emphasis Supplied]

Thus, the refund of ITC is allowed in case either the output supplies are zero rated or where the credit has accumulated on account of rate of tax on inputs being higher than the rate of tax on output supplies.

It is important to highlight here that, Section 54(3) of CGST Act, uses the expression "inputs", which are not defined under the Act. The CGST Act and CGST Rules merely define the terms 'input' and 'input services', which are as follows –

(59) "input" means any goods other than capital goods used or intended to be used by a supplier in the course or furtherance of business;

(60) "input service" means any service used or intended to be used by a supplier in the course or furtherance of business;

In this regard, it is also relevant to note the specific provision of Rule 89(5) of the CGST Rules, which reads as under :

(5) In the case of refund on account of inverted duty structure, refund of input tax credit shall be granted as per the following formula:-

***Maximum Refund Amount** = {Turnover of inverted rated supply of goods and services) X Net ITC ÷ Adjusted Total Turnover} - tax payable on such inverted rated supply of goods and services.*

***Explanation**. - For the purposes of this sub-rule, the expressions –*

(a) Net ITC shall mean input tax credit availed on inputs during the relevant period other than the input tax credit availed for which refund is claimed under sub-rules (4A) or (4B) or both; and
(b) "Adjusted Total turnover" shall have the same meaning as assigned to it in sub-rule (4)?'
Thus, from the above provision it is clear that the intent of the Government is to allow refund of ITC in relation to Inputs and not in relation to Input Services. In this regard, the Board had also issued a Circular, which clarified that refund of tax paid on input services will be kept out of the purview of refund of ITC accumulated on account of inverted duty structure.

VALIDITY OF RESTRICTION OF REFUND OF ITC IN RELATION TO SERVICES

The said amended provision of Rule 89(5) was challenged before the Hon'ble Gujarat High Court in the case of ***VKC Footsteps India Pvt. Ltd. v. Union of India AIR 2021 Supreme Court 4407***. The grievance of the Petitioner was that the said provision prohibits the petitioners from claiming of refund of accumulated credit of tax on input of services. The court noted that Section 54(3) of CGST Act provides that a registered person may claim refund of any unutilised ITC. The definition clause was referred to understand the scope of the phrase “input tax”. It was observed that there are separate definitions of “inputs” and “input services”, and the definition of “input tax” includes supply of goods as well as services (that is both inputs and input services). Hence, the intention of the legislature, under section 54(3) is to permit refund of input tax of not just 'goods' but also of 'services'. On the other hand, Madras High Court in ***Tvl. Tanstonnelstory Afcons Joint Venture v. Union of India'*** had taken a diametrically opposite view in this regard. As per the Madras High Court, under Section 54(3)(ii), Parliament has provided the right of refund only in respect of unutilized credit that accumulates on account of the rate of tax on input supplies being higher than the rate of tax on output supplies. Goods and services have been treated differently from time immemorial. While there has been a legislative trend towards a more uniform treatment as between goods and services, the distinction has certainly not been obliterated as is evident on perusal of the CGST Act, including provisions such as Sections 12 & 13, etc., which are specifically targeted at goods and services. The High Court also observed that the wide Parliamentary latitude as regards classification qua tax and economic legislations, is recognized and affirmed by the Supreme Court. In view of the above, the Hon'ble High Court concluded that the classification is valid, non-arbitrary, and far from invidious. This issue was also raised by various taxpayers before different High Courts across the Country.

SUPREME COURT JUDGMENT ON VALIDITY OF RULE 89(5)

That the Department challenged the judgment of the Hon'ble Gujarat High Court in VKC Footsteps (supra) before the Hon'ble Supreme Court. The Supreme Court in its landmark judgment overruled the judgment of the Gujarat High Court and upheld the validity of Rule 89(5) of the CGST Rules. Supreme Court made the following observations in the judgment –

i. **Principle of equivalence & neutrality** - The Petitioner in the said case had argued that though 'goods' and 'services' have been distinctly defined in the Constitution and CGST Act, they have been treated substantially in a similar manner for practical purposes. For the purpose of achieving the goal of tax neutrality, goods and services cannot be treated differently. However, the Court held that while interpreting the provisions of Section 54(3), it must give effect to its plain terms. The Court cannot redraw legislative boundaries on the basis of an ideal which the law was intended to pursue.

ii. **Interpretation of Section 54(3)** - The Petitioners further argued that the Court may interpret, Section 54(3) of the CGST Act in a manner, where 'inputs' used in the said provision would include both input' as well as input services'. The purposive interpretation shall ensure that removal of cascading effect of taxes remains a reality and does not become an illusion prescribed on paper. However, the Hon'ble Supreme Court held that to construe 'inputs' to include both input goods and input services would do violence to the provisions of Section 54(3) and would run contrary to the terms of Explanation- 1 of Section 54(3) of the CGST Act. Consequently, it is not open to the Court to accept the argument of the assessee that in the process of construing Section 54(3) contextually, the Court should broaden the expression 'inputs' to cover both goods and services.

iii. **Validity of Rule 89(5)** - Further, the provisions of Rule 89(5) of the CGST Rules were challenged by the Petitioner on the ground that it was ultra vires Section 54 (3). However, the said challenge was based on the interpretation of Section 54(3) of the CGST Act that it allows the refund of unutilized ITC on both goods and services. However, as noted earlier, the Court had rejected the said interpretation of Section 54(3) of the CGST Act. Consequently, the challenge to validity of Rule 89 (5) of CGST Rules was also dismissed.

iv. **Validity of formula prescribed in Rule 89(5)** - It was also argued by the Petitioners that the formula prescribed under Rule 89(5) of the CGST Rules is flawed and it provides unintended results. The formula provided under Rule 89(5) of the CGST Rules, seeks to deduct the total output

tax from only one component of the ITC, namely ITC on input goods. However, in the ordinary course, the ITC on both input goods and input services is accumulated by the taxpayer in the electronic ledger and is then utilised for the payment of output tax. However, the Court while noting the said inconsistency, held that an anomaly per se cannot result in the invalidation of a fiscal rule. Accordingly, the Court refused to read down the formulae on the basis that the formula led to wrong results. The Court however, strongly urged the GST Council to reconsider the same and take a policy decision.

AVAILABILITY OF REFUND WHEN INPUT GOODS AND OUTPUT GOODS ARE SAME

Another interesting issue had arisen before Hon'ble Guwahati High Court in the case of ***BGM Infomatics Pvt. Limited v. Union of India***." In the said case, the refund claim of unutilised credit was filed by the taxpayer. However, the said Credit was rejected on the ground that, input and output supplies made by assessee were of same goods. In this regard, departmental authorities placed reliance on the Board Circular, which provided that the Credit shall not be available where the input and output goods are same. The relevant portion of the said circular is reproduced below –

> *3.2 It may be noted that refund of accumulated ITC in terms clause (ii) of sub-section (3) of section 54 of the CGST Act is available where the credit has accumulated on account of rate of tax on inputs being higher than the rate of tax on output supplies. It is noteworthy that, the input and output being the same in such cases, though attracting different tax rates at different points in time, do not get covered under the provisions of clause (it) of sub-section (3) of section 54 of the CGST Act. It is hereby clarified that refund of accumulated ITC under clause (ii) of sub-section (3) of section 54 of the CGST Act would not be applicable in cases where the input and the output supplies are the same.*

The Hon'ble High Court was of the view that such declaration/ provision/ clarification by the Board through its circular appears to be in conflict and runs contrary to the provisions of Section 54(3)(ii) of the CGST Act of 2017. The Court noted that on one hand Section 54(3)(ii) of the CGST Act of 2017 provides that no refund of unutilized input tax credit shall be allowed in cases other than where the credit has accumulated on account of rate of tax on inputs being higher than the rate of tax on output supplies and on the other hand, the Board Circular provides that such refunds will not be available in the event the input supplies and the output supplies

are the same, even though there may be a difference in the tax rates on the input supplies and the output supplies made at different points in time. The Court held that the provisions of statutory Act would prevail over such conflicting provisions of a notification or a circular of an administrative authority. Consequently, the Writ Petition was allowed, and the said refund rejection order was held to be not sustainable.

CONCLUSION

From the above, it is clear that while the Supreme Court has upheld the validity of Section 54(3) of the CGST Act as well as Rule 89(5) of the CGST Rules, the said provisions are against the clearly stated objective of the CGST Act. There are no clear reasons as to why ITC relating to Input services must treated differently to Input goods. Legal and judicial interpretation aside, a clear trend can be noted regarding uniform treatment of goods and services. In order to completely eliminate the cascading effect, it is imperative that any excess input tax credit due to inverted tax structure must be refunded irrespective of the fact whether it concerns goods or services. The Central Government and GST Council, while reconsidering the formula under Rule 89(5) of the CGST Rules, must also reconsider the policy of differentiation between goods and services under CGST Act.

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