K C Mehta & Co.
Chartered Accountants

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Indirect Tax
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Gujarat High Court allows refund of ITC on input services under Inverted Duty Structure, reads down CGST Rules

Snapshot

The Hon'ble Gujarat HC holds that in case of accumulation of ITC due to Inverted Duty Structure, refund of ITC on "Input Services" would also be allowed.

In arriving at the said conclusion, the Gujarat High Court has held that the restriction contained in Rule 89(5) of the CGST Rules, 2017 travels the beyond the scope of Section 54 of CGST Act 2017, and is ultra vires the Act to the extent it restricted the refund of accumulated ITC only to the extent of ITC relating to "Inputs" and not "Input Services" in case of Inverted Duty Structure.

Footwear, textiles, handlooms, solar modules, e-commerce, steel utensils, mobile phones, irrigation systems, pharmaceuticals, fertilisers, etc. are some of the industries that have an Inverted Duty Structure and players in these industries are sure to benefit from the judgment.

Background and Facts of the case

VKC Footsteps India Pvt. Ltd. ('the petitioner') [1] is a manufacturer of footwear which attracts GST at the rate of 5%. Majority of inputs and input services procured by the petitioner attract GST at the rate of 12% and 18%, which leads to 'Inverted Duty Structure' and thereby leading to accumulation of unutilised Input Tax Credit ('ITC').

The fundamental feature of the Goods and Services Tax is that all taxes paid at the anterior stages should be fully absorbed in the tax paid on outward supply. However, it fails in the present case since the output is chargeable at a tax rate which is lower than the rate of tax on inputs.

Section 54 (3) of Central Goods and Services Tax Act, 2017 ('CGST Act') addresses the above situation by allowing a person to claim refund of unutilised ITC accumulated on account of such inverted duty structure. The method and formula to compute the refund claim is prescribed in Rule 89(5) of Central Goods and Services Tax Rules, 2017 ('CGST Rules') which originally included input services in the scope of 'Net Input Tax Credit ('Net ITC')'. Later, the said formula was revised vide a notification[2] with retrospective effect from 1st July 2017 to exclude 'Input Services' from the scope of 'Net ITC'.

[1] R/SPECIAL CIVIL APPLICATION NO. 2792 of 2019

[2] Notification 21/2018 - CT dated 18.04.2018, 26/2018 – CT dated 13.06.2018

Vide the above revised formula, the petitioner was allowed to only claim refund of accumulated ITC pertaining to tax paid on inputs such as synthetic leather, PU polyol etc. however, refund of accumulated ITC pertaining to tax paid on 'input services' such as job work service, goods transport agency service, etc. was not allowed.

The petitioner challenged the validity of the amended Rule 89 (5) of CGST Rules to the extent it denied the refund of accumulated ITC on input services.

Questions before the Hon'ble HC

Whether the explanation (a) to Rule 89 (5) of the CGST Rules after the amendment is ultra vires the CGST Act?

Petitioner's contentions

Section 54 (3) of CGST Act allows refund of '**ANY** unutilised Input tax credit' and the definition of 'Input Tax' as per section 2 (62) of CGST Act also covers both 'Inputs' and 'Input services'. Accordingly, section 54(3) covers ITC of both 'Inputs' and 'Input services'.

On the other hand, Rule 89 (5) of CGST Rules, 2017 excludes input services from the formula which is contrary to parent Section 54 (3) of CGST Act and even the basic scheme and object of GST Act.

Section 164 (1) of CGST Act, 2017 states that government can make rules only for purpose of carrying out the provisions of the Act. However, it is a well settled principle as held by the Hon'ble High Courts and the Supreme Courts [3] time and again that a rule cannot override the provisions of the Act.

Accordingly, Rule 89 (5) of CGST Rules, 2017 which is not line with the provisions of Section 54 (3) and 164 (1) of CGST Act is ultra vires the Act to the extent it denies refund of input tax credit relatable to input services.

Revenue's contentions

Rule 89 (5) of CGST Rules only provides the mode of calculation of refund available on account of inverted tax structure and the same is not contrary to the provisions of section 54 (3) of CGST Act 2017.

Section 164 of CGST Act 2017 empowers the government to make rules and such power is conferred in the widest possible manner including power to give retrospective effect to such rules.

Revenue also cited a pronouncement of Supreme court [4] and stated that any person cannot claim refund on basis of court decisions in another person's case. In this context, it was observed that any decision contrary to the established law will not only result in substantial prejudice to the public interest, but also offensive to several well established principles of law and will lead to chaos and grave public mischief.

It was therefore submitted that the Rule 89 (5) of CGST Rules cannot be held to be ultra vires as it only provides the method of calculating the refund on account of inverted duty structure.

Findings of the Hon'ble HC

The Hon'ble HC analysed the provisions of Section 54 (3) of the CGST Act which provides for refund of unutilised input tax credit. The Hon'ble HC also referred to the definitions of 'Input tax' and 'Input Tax Credit' and held that such definitions do not distinguish between ITC availed on inputs and input services.

[3] Shri Balaganesan Metals v/s MN Shanmugham Chetty – 2 SCC 707 (1987), Lucknow Development Authority v/s M.K. Gupta - 1 SCC 243 (1994)

[4] Tilokchand Motichand v/s H.B Munshi, CST

On the basis of the above analysis of the provisions of the CGST Act and keeping in mind the scheme and object of the CGST Act, the Hon'ble HC observed that the intent of the Government as also interpreted in the Circular[5] restricting the statutory provision to deny the registered person refund of tax paid on 'input services' as part of refund of unutilised input tax credit, cannot be the intent of law.

The Hon'ble HC, accordingly held that the claim of refund cannot be restricted only to 'Inputs' by not including 'Input Services' within the purview of Net ITC and thus the Explanation (a) to Rule 89 (5) of CGST Rules is ultra vires to the provision of section 54 (3) of CGST Act. Net ITC should mean "input tax credit" availed on "inputs" and "input services" as defined under the Act.

KCM Note

The decision of the Hon'ble HC of Gujarat will be welcomed by players of industries such as textiles, footwear, railway locomotives & parts, handlooms, solar modules, e-commerce, steel utensils, mobile phones, irrigation systems, pharmaceuticals, fertilisers, etc. where Inverted Duty Structure is prevalent. The decision will give a huge relief to these players as they can now liquidate a higher amount of accumulated ITC which would have positive impact on the working capital.

While the above judgment no doubt provides a much-awaited relief to taxpayers, one needs to also consider the following:

1. The Government had retrospectively amended the Rule 89 (5) of CGST Rules to exclude input services w.e.f. 1st July 2017 from the formula to claim the refund of accumulated ITC in case of inverted duty structure. There may be cases where either refund may have been rejected by the department or the taxpayer himself would have not claimed the refund of input services owing to the provisions contained in the CGST Rules.

   Considering that the time limit to claim the refund under GST is prescribed as 2 years, it remains to be seen as to how this judgement will impact those cases where the time limit of 2 years has passed and the taxpayer either did not claim the refund of input services or did not object to the rejection of the claim of refund of input services by the department.

2. Given that the definition of 'input tax' only speaks of tax paid on goods and services and does not bifurcate between capital goods and inputs, it is interesting to note that the present appeal only challenged the exclusion of input services from the refund formula and no point was raised with respect to Capital goods.

   While the Hon'ble HC has elaborately dealt with the definitions of 'input tax' and 'input tax credit' to hold that input tax credit cannot exclude ITC of tax paid on input services, what happens to Capital goods has not been discussed or commented upon in the judgement. Purchase of Capital goods which would have attracted taxes at higher rate may also result into ITC accumulation and logically should also be allowed as a refund going by the logic applied by the Hon'ble HC.

[5] Circular No. 79/53/2018-GST dated 31.12.2018

Conclusion

The Hon'ble HC has upheld the fundamental principle of the GST law which treats goods and services at par. Not allowing the refund of input services seemed to be against the basic structure of GST which subsumed the Service Tax and goods tax (VAT and Excise) into one good and simple tax.

The GST law having just completed 3 years has already witnessed countless amendments including retrospective ones and numerous litigations at various High Courts. The Government also needs to be cautious while bringing out notifications and rules which are not in line with the provisions of the law and the overall scheme of the Act. While decisions of the Hon'ble High Courts like this play a very important role in interpreting the real essence of the GST law, it is also important for the Government to suo moto take cognizance of such issues which are not in consonance with the overall objective behind the implementation of the GST law in India and take corrective actions in line with the objective of ease of doing business in India.

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For further analysis and discussion, you may please reach out to us.

Locations

Ahmedabad
Arpit Jain
Level 11, Tower B,
Ratnaakar Nine Square,
Vastrapur,
Ahmedabad - 380 015
Phone: + 91 79 4910 2200
arpit.jain@kcmehta.com

Bengaluru
Payal Shah
19/4, Between 7th & 8th Cross,
Malleswaram,
Bengaluru - 560 003
Phone: +91 80 2356 1880
payal.shah@kcmehta.com

Mumbai
Vishal Doshi
508, The Summit Business Bay,
Nr. WEH Metro Station,
Gundavali, Andheri East,
Mumbai - 400069
Phone: +91 22 2612 5834
vishal.doshi@kcmehta.com

Vadodara
Milin Mehta
Meghdhanush,
Race Course,
Vadodara - 390 007
Phone: +91 265 2440400
milin.mehta@kcmehta.com