

Pillar 3 recommendations: Refund-related challenges and recommendations

1) Inverted duty refund for “input services” and “capital goods”:

- Inverted duty structure (‘IDS’) refund is a mechanism prescribed by the government in certain instances to address the challenges arising where the rate of tax on inward procurements is higher than the rate of tax on the outward supply.
- The Inverted Duty Structure formula was originally as below:

“Maximum Refund Amount = {(Turnover of inverted rated supply of goods) x Net ITC Adjusted Total Turnover} - tax payable on such inverted rated supply of goods”

- However, the Supreme Court in the case of **Union of India & Others vs. VKC Footsteps India Pvt Ltd¹** in the context of IDS refunds, while observing that refund is not a constitutional right but a statutory right and specifically acknowledged that the formula for getting the inverted duty structure refund in Rule 89(5) of the CGST Rules is inequitable and therefore, urged the GST Council to take the necessary corrective action.
- In this regard, the GST Council in its 47th meeting held on June 29, 2022, recommended a change in formula for calculation of refund under IDS to take into account utilization of ITC on account of inputs and input services for payment of output tax on inverted rated supplies in the same ratio in which ITC has been availed on inputs and input services during the said tax period, with an intention of helping taxpayers who are availing ITC on input services also.

*“The issue was deliberated by the Law Committee and in the absence of any empirical data, Law Committee had recommended to consider utilisation of ITC on account of **inputs and input services for payment of output tax in the same ratio** in which the ITC has been availed on inputs and input services during the said tax period and to use this deduction to revise the formula prescribed in rule 89(5) as suggested by the Hon’ble Supreme Court. Accordingly, Law Committee recommended the following amendment in formula prescribed in rule 89(5):*

¹ 2021 (52) G.S.T.L. 513 (S.C.)

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 x (Net ITC / ITC availed on inputs and input services)}"

- Pursuant to the recommendation by the GST Council, amendment in the formula under Rule 89(5) of CGST Rules was made which now reads as under:
"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 x (Net ITC ÷ ITC availed on inputs and input services)}"
- However, based on the amended formula, the industry faces the following two challenges:
 - a) Despite the change in the formula to include input services, section 54(3) of the Central Goods and Services Tax Act, 2017 ('CGST Act') still allows refund on account of inverted duty structure **only in cases** where the **rate of tax on input** is **higher** than the **rate of tax on outward supplies**. Therefore, an assessee would be eligible to claim refund only in a scenario wherein the inverted duty structure is on account of inputs and not on account of input services.
 - b) While the formula for inverted duty refund has been amended, the definition of **"Net ITC" does not include input tax credit availed on input services** resulting in reduced quantum of refund.
 - c) **GST rate rationalization:** Further, where GST rates on services procured largely remain at 18%, while the output goods are shifted to the 5% slab. Although refunds for differential tax on goods (excluding capital goods) are allowed under the inverted duty structure, the refund available for services is minimal under current provisions. Since input services and capital goods are excluded from refund eligibility, a substantial amount of input tax credit accumulates, affecting working capital and ultimately impacting margins or pricing over the long term. Moreover, the inverted duty refund spread is now 13% (5% less 18%) as against present spread of 6% (12% less 18%) and time for receiving the refund for goods. The challenge may be even more in the services sector, especially if GST rates on output services are lowered to 5% or exempted altogether.

- The exclusion of "input services" and capital goods" from the scope of refunds under the inverted duty structure leaves a significant portion of credit accumulated. This leads to a cascading effect and diminishes the intended benefit of input tax credit as taxpayers are no longer able to recover taxes paid on purchases of capital goods and input services.
- This inability to recover input credit on services and capital goods affects pricing strategies, making products or services relatively more expensive, directly or indirectly in the hands of the final consumer. Also, this creates an uneven playing field for Indian businesses globally as well, due to the adverse impact on pricing strategies as businesses lose competitive advantage on exports of goods or services from India as compared to exports of similar goods or services from other countries, which is contrary to the 'Make in India' initiative of the government announced for key 14 sectors with an outlay of INR 1.97 Lakh crore (\$ 26 Bn) It is also quite imperative to provide long term fiscal and structural support for businesses and sectors to improve our global export competitiveness in view of the ever evolving geopolitical situation and global competition that primarily hinges on the landed cost of products.
- Additionally, operational costs are adversely impacted due to blockage of working capital and implementation of systems for tracking, claiming, and managing input tax credit. This contradicts the broader goal of creating an environment conducive to Ease of Business in India.

Recommendations:

- Chamber recommends that an amendment in the section 54(3) of the CGST Act may be made to include "input services and capital goods" to allow refund of accumulated input tax credit on account of input services and capital goods under the IDS refunds. Further, that the definition of "Net ITC" in the formula should be amended to include "input services and capital goods" as well.
- Pursuant to the current GST rate rationalization, certain services which are presently under 12% rate slab and could be moved to 5% rate slab. Hence, this will create duty inversion even for service providers and therefore the Chamber humbly recommends that the inverted duty refund should be extended for providers.

2) Permitting refund of credit on capital goods for exporters

- Rule 89(4) of Central Goods and Services Tax Rules, 2017 ('CGST Rules') provides for refund of unutilized ITC for zero rated supply made without payment of taxes. As per the said rule, ITC on inputs and input services is allowed as refund. However, it does not include ITC on capital goods. Thus, a registered person making zero rated supply under the Letter of Undertaking ('LUT') cannot apply for refund of ITC paid on capital goods.
- As a result, exporters who are exporting their goods and services from India under the LUT option are not eligible to claim the refund of GST paid on capital goods used for providing export goods and service.
- Further, GST Council considered the proposal to provide refund of capital goods for exporters with aggregate turnover up to INR 30 CR in the 39th Meeting held on 14 March 2020. The item was discussed to improve India's ranking in the 'Paying Taxes' category of World Bank's 'Ease of Doing Business index, where India has been scoring 'NIL' without any provision to allow cash refund of ITC on Capital Goods.
- Ineligibility of refund of GST paid on capital goods to such companies hampers the working capital of such companies. As discussed earlier, this also adversely impacts competitive advantage towards exports of goods or services from India as compared to exports of similar goods of services from other countries.

Recommendations:

- Chamber recommends that refund of capital goods may be allowed to all exporters who export without payment of tax by opting for the LUT method. Alternatively, refund of capital goods may be allowed in staggered manner in line with provisions of Rule 43 of CGST Rules i.e., which permits 20% per year over a 5-year period.
- Chamber also recommends that GST paid on all "inputs" or "input services" that are covered under restriction for claiming GST ITC by virtue of section 17(5) of CGST Act should be allowed as refund for exporters such that exports do not have embedded duties and taxes that are non-creditable.