
REFUND OF UNUTILIZED CREDIT ACCUMULATED ON ACCOUNT OF INVERTED DUTY STRUCTURE FOR TAX PAID ON INPUT SERVICES CANNOT BE CLAIMED: SC

A Division Bench of the Hon'ble Supreme Court in a recent judgment of *Union of India & Ors. vs. VKC footsteps India Pvt. Ltd.*¹ held that the amount of input tax credit (“ITC”) accumulated on account of rate of tax on input services being higher than the rate of tax on output supplies cannot be refunded as per section 54(3) of the Central Goods and Services Tax Act, 2017 (“CGST Act”) read with rule 89(5) of the Central Goods and Services Tax Rules, 2017 (“CGST rules”).

Background:

- Section 54 of the CGST Act provides for a refund of tax. Furthermore, Section 54(3) provides for a claim of refund of unutilized ITC in cases involving:
 - (i) Zero rated supplies made without payment of tax; and
 - (ii) Credit accumulation on account of “inverted duty structure” i.e., when rate of tax on inputs is higher than rate of tax on output supplies.
- Rule 89(5) of the CGST Rules provides a formula for the refund of ITC, in case of inverted duty structure. It uses the component of “Net ITC” for calculation, which is defined in Rule 89(4) as ITC availed on input goods.
- Rule 89(5) of the CGST Rules as originally enacted provided for refund of ITC availed on both inputs (that is input goods) and input services and was substituted with prospective effect from 18th April, 2018² prescribing a revised formula for refund by only taking into account the ITC availed as input goods in the purview of “Net ITC”. The above substitution was given retrospective effect from 1st July, 2017³.

¹ WMP (MD) No. 17152 of 2019

² Notification No. 21/2018-CT dated 18 April 2018

³ Notification No. 26/2018-CT dated 13 June 2018

Brief Facts of the case:

- VKC footsteps India Pvt. Ltd. (“Respondent”) was engaged in the manufacture and supply of footwear which attracted output tax at the rate of 5%. The rate of GST paid by the Respondent on procurement of input goods and input services was higher than the rate of tax on the outward supply. Therefore, there was an accumulation of unutilized ITC in the electronic credit ledger of the Respondent;
- The Respondent applied for refund of such unutilized accumulated ITC under Section 54(3) of the CGST Act read with Rule 89(5) of the CGST Rules, which was denied on the ground that Section 54(3) only allows for refund on account of inverted duty structure for the credit of the input tax paid on input goods and not on input services.
- Writ petitions under Article 226 of the Constitution were filed before the Hon’ble High Court of Gujarat and the Hon’ble High Court of Judicature at Madras on the following grounds:
 - Section 54(3) of the CGST Act allows for a refund of ITC originating in inputs as well as input services and Rule 89(5) of the CGST Rules is ultra vires in so far as it excludes tax on input services from the purview of the formula
 - If Section 54(3) CGST Act is interpreted as a restriction against a claim for refund of accumulated ITC by confining it only to tax on inputs, it would be unconstitutional as it would lead to discrimination between inputs and input services.
- The Division Bench of the Hon’ble High Court of Gujarat in the case of *VKC Footsteps India Pvt. Ltd. v. Union of India* reported in **R/ Special Civil Application No 2792 of 2019** held Rule 89(5) of the CGST Rules as *ultra vires* Section 54(3). On the contrary, the Division Bench of the Madras High Court in the case of *Tvl. Transtonnelstroy Afcons*

Joint Venture v. Union of India reported in **Writ Petition Nos 8596, 8597, 8602, 8603, 8605 and 8608 of 2019** noted that refund is a statutory right and the extension of the benefit of refund by excluding unutilized input tax credit accumulated on account of input services is a valid classification and a valid exercise of legislative power.

- Considering the divergent views of both the High Courts, a number of appeals were filed before the Supreme Court seeking clarity on the issue.

Observations by the Hon’ble Supreme Court:

Interpretation of Section 54(3) of the CGST Act and harmony with Rule 89(5) of the CGST Rules:

- The meaning of “refund” for domestic supplies, is limited to unutilized credit accumulated with respect to input goods as per Explanation 1 to Section 54. The court while interpreting section 54(3) gave effect to its plain terms and observed that ‘inputs’ will only include input goods.
- ITC accumulation can occur for a number of reasons. For the purposes of granting refund, the legislature took note of the specific eventuality of accumulation of unutilized credit on account of inverted duty structure, while enacting Clause (ii) of the first proviso to Section 54(3) in the CGST Act, and hence restricted the refund of unutilized ITC with respect to the same. Therefore, the first proviso, which entails the language “...no refund shall be given in cases other than...” is restrictive in nature and is not a condition or provision for eligibility, and hence is in line with the substantive section. Furthermore, Rule 89(5) of the CGST Rules by restricting the refund only to input goods is not ultra vires to Section 54(3) of CGST Act.

Difference between goods and services:-

- Refund is a matter of a statutory prescription. Furthermore, goods and services are defined differently in the Constitution, as well as in the CGST Act. When there is neither a constitutional guarantee nor a statutory entitlement to refund, the differential treatment of goods and services does not violate Article 14 of the Constitution of India.

Anomaly of the formula prescribed under Rule 89 (5) of the CGST Rules:

- The formula for calculation of refund as prescribed under Rule 89(5) is:-

Maximum Refund Amount

$$= \frac{[(\text{Turnover of inverted rated supply of goods and services}) * (\text{Net ITC})]}{\text{Adjusted total turnover}}$$

– *tax payable on such inverted rated supply of goods and services*

- This formula presumes that no ITC has been utilized from the ITC on input services and the entire tax on output supplies is discharged by utilizing ITC on input goods. Hence, the component of “*tax payable on such inverted rated supply of goods and services*” takes into account the entire tax payable on output supplies, even if there was some ITC utilized from the ITC on input services, as happens in case of supplier with more than one products. Therefore, by deducting the entire sum of tax payable on output supplies, the quantum of refund reduces and the cascading effect of tax is maximized, which defeats the purpose of introduction of GST in India.
- The court urged GST council to prescribe an order of utilization of the ITC accumulated on input services and input goods. A formula is only read down by the court if it leads to absurd results. It is not the case in the present scenario, therefore the court observed that there is no need for the court to read down the provisions of Rule 89(5).
- Therefore, the Hon’ble Supreme Court upheld the order of Division Bench of Madras High Court and dismissed the order of the Division Bench of Gujarat High Court.

VA Comments:

- The abovementioned judgment shall have a negative impact upon assessee supplying only one product.
- The GST Council has approved the application of a new formula from 1st January, 2021 to calculate refund for textile and footwear sector.

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