Unraveling Dichotomy in Reversal of Credit of GST Paid on Supplies under RCM

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Introduction

The Goods and Services Tax (**"GST"**) Regime introduced five years ago brought major Indirect tax reforms in India. By unifying numerous taxes imposed by the Central and State Government into a single tax and allowing set-off of prior-stage taxes, the GST Regime intended to mitigate the ill effects of tax cascading and pave the way for a common national market. While the intention of the Government has seen the light of the day in majority of the cases, certain lacunas in the provisions of GST law seem to indicate otherwise.

One such issue pertains to reversal of input tax credit in accordance with Section 17(3) of the Central Goods and Services Tax Act, 2017 (**"CGST Act"**[1]), which prescribes the mechanism for arriving at the value of exempt supply and includes "*supplies on which recipient is liable to pay tax on reverse charge basis*". While the simplistic language provided in this sub-section does not imply any ill-effects, let us delve into the background of the issue under the GST laws vis-à-vis the erstwhile laws to interpret the legal position qua reversal of credit.

Legal position under the GST laws

Section 16 of the CGST Act is the enabling provision for availment of input tax credit. In terms of the said Section, a registered person is allowed to take input tax credit of goods or services which are used or intended to be used in the course or furtherance of business, subject to the conditions as prescribed therein.

On the contrary, Section 17 of the CGST Act is the machinery provision which provides for apportionment of credit and blocked credit. The relevant part of the said Section is provided hereunder for ease of reference:

(1) Where the goods or services or both are used by the registered person partly for the purpose of any business and partly for other purposes, the amount of credit shall be restricted to so much of the input tax as is attributable to the purposes of his business.

(2) Where the goods or services or both are used by the registered person partly for effecting taxable supplies including zero-rated supplies under this Act or under the Integrated Goods and Services Tax Act and partly for effecting exempt supplies under the said Acts, the amount of credit shall be restricted to so much of the input tax as is attributable to the said taxable supplies including zero-rated supplies.

(3) The value of ***exempt supply*** *under sub-section (2) shall be such as may be prescribed, and shall include supplies on which the recipient is liable to pay tax on reverse charge basis, transactions in securities, sale of land and, subject to clause (b) of paragraph 5 of Schedule II, sale of building.*"

On a conjoint reading of sub-section (1) and (2) of Section 17 of the CGST Act, it appears that input tax credit pertaining to goods or services which are used for non-business purposes or for effecting exempt supplies would be inadmissible. The said apportionment mechanism is in line with the intention of the legislature, which allows the set-off of input tax credit on goods and services which are used for providing taxable output supplies on which appropriate taxes are paid to the government exchequer, unless and until such credit is restricted under Section 17(5) of the CGST Act. Therefore, once the goods and services are used for effecting taxable supplies and are not covered under the restrictive clause, one shall be eligible to take the input tax credit.

Sub-section (3) inter-alia mandates for the inclusion of the value of supplies covered under reverse charge mechanism while arriving at the value of **"exempt supply"**. The said term has been defined under Section 2(47) of the CGST Act to mean "*supply of any goods or services or both which attracts nil rate of tax or which may be wholly exempt from tax under section 11, or under section 6 of the Integrated Goods and Services Tax Act, and includes non-taxable supply*[2].

At this juncture, let us dwell upon whether the supplies covered under reverse charge viz. legal services, sponsorship services etc. would qualify as exempt supply under the GST laws. From the aforesaid definition of exempt supply, it would be evident that only such supply which is not leviable to tax or outside the purview of GST merits classification as exempt supply. It would be worth noting that legal services, sponsorship services etc. are exigible to GST, albeit the liability to pay tax is vested upon service receiver under reverse charge mechanism. As such, these services would qualify as taxable supply[3] and not exempt supply.

Having said that, while input tax credit shall be dis-allowed to the extent of input and input services attributable to the exempt supply in accordance with sub-section (2); sub-section (3) arbitrarily expands the scope of sub-section (2) by providing for inclusion of supplies on which tax is paid under reverse charge by the recipient. In our view, before arriving at the value of exempt supply for the purpose of reversal of input tax credit under sub-section (3), the service has to first qualify as exempt supply under sub-section (2) and in absence of rendition of such exempt supply, question of valuation and reversal thereon does not arise in any eventuality.

Further, sub-section (3) also creates an artificial distinction between a supplier engaged in taxable supply (including supply under reverse charge) and a supplier engaged in taxable supply (including supply under reverse charge) as well as exempt supply. While it is possible to contend that the provision of sub-section (3) would not be applicable in the first case as there is no exempt supply, such contention may not hold good in the second case as the supplier is engaged in effecting exempt supply.

Let us understand this proposition by way of an illustration. Supplier X is engaged in taxable supply and provides sponsorship service, which is liable to tax under reverse charge, whereas Supplier Y is engaged in provision of taxable and exempt supply along with sponsorship services. In such a scenario, X may not be liable to reverse credit attributable to sponsorship service as provision of sub-section (2) would not be applicable thereto. However, the same may not hold good in case of Y, as it is also engaged in making exempt supply and the rigour of sub-section (3) gets attracted for input tax credit reversal.

Be that as it may, the provision of sub-section (3) seems to be grossly violative of the provision of Section 16 of the CGST Act read with Section 17(2), which confers substantive right to avail input tax credit on taxable supply and restricts credit to the extent attributable to exempt supply only. In our view, since the supply covered under reverse charge merits classification as "taxable supply", any reversal of credit thereon is not warranted.

At this juncture, let us decipher the legal position on the issue of reversal of credit as provided for under the erstwhile laws as well.

Legal position under the erstwhile laws

Under the erstwhile regime, the CENVAT Credit Rules, 2004 (**"CCR"**) prescribed the mechanism for availment and utilisation of credit by an assessee. Rule 3(1) of the CCR enabled a manufacturer or producer of final products or provider of output service to take credit of the specified taxes, duties and cesses paid on inputs or input service.

On the other hand, Rule 6(1) of the CCR carved a restriction on availment of CENVAT credit of inputs/input services used in the manufacture of exempted goods or for provision of exempted services[4]. In terms of the explanation to Rule 6(1), exempted goods included non-excisable goods cleared for a consideration and exempted services included an activity which is not a service under Section 65B(44) of the Finance Act, 1994, provided such activity has used inputs or input services. This mechanism therefore restricted the credit on exempted goods (including non-excisable goods) or exempted services (including activity not qualifying as a service). As a necessary corollary, CENVAT Credit of taxes or duties paid on dutiable goods and taxable services was duly allowed including services covered under reverse charge.

At this point, it becomes necessary to note that while Rule 6(2)/Rule 6(3) of the CCR specified the mechanism to reverse the credit, several notices were issued to assessees demanding tax or duty from them, which was in excess of the total credit availed by such assessees. The Hon'ble Courts took notice of the basic tenet of law that machinery provisions cannot override substantive law and set aside such demands where the credit to be reversed under Rule 6 of the CCR was highly disproportionate to the total credit taken[5].

Conclusion and Recommendation

On a comparative analysis of the legal position stated in the aforesaid paragraphs, it is evident that in the pre-GST era, there was no requirement to reverse the CENVAT Credit on services covered under reverse charge. The very object of purport of the erstwhile laws was to restrict the credit attributable to exempted goods manufactured or exempted services provided and not otherwise.

By way of the introduction of the condition relating to the reversal of credit in case of supplies where payment of tax is made by the recipient, the GST Laws have sought to link the payment mechanism with availment of credit and thereby disentitle the supplier from so much of the credit used to make supply covered under reverse charge. In our view, the payment mechanism should not be a decisive factor in determining the eligibility to avail input tax credit in as much as it amounts to restricting of credit which is otherwise available. The restriction placed under Section 17(3) of the CGST Act by way of a machinery provision seems to over-reach its authority and take away the rights conferred by the enabling provision under Section 16 of the CGST Act by artificially expanding its scope. This is contrary to the legal principle as enunciated in the erstwhile regime, viz., that a machinery provision cannot override an enabling provision.

The denial sought vide the machinery provision of Section 17(3) straddles the very spirit and intent of introduction of GST law, which is to mitigate the ill effects of tax cascading and pass on the credit throughout the supply chain. In fact, to the extent of the supply of services liable to tax under reverse charge, the said Section essentially takes away from one hand the benefit granted and simultaneously deprives the assessee of a benefit, which otherwise have been admissible thereto. While one may contest the legality of the issue before the High Courts, it would be interesting to see whether the balance lies in favour of the assessees or not.

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[1] Pari materia provisions under respective State Goods and Services Tax Act, 2017

[2] Section 2(78) of the CGST Act defines “non-taxable supply” to mean a supply of goods or services or both which is not leviable to tax under this Act or under the Integrated Goods and Services Tax Act

[3] Section 2(108) of the CGST Act defines “taxable supply” as supply of goods or services or both which is leviable to tax under this Act

[4] Section 2(e) provides that “exempted service” means a-

(1) taxable service which is exempt from the whole of the service tax leviable thereon; or

(2) service, on which no service tax is leviable under section 66B of the Finance Act; or

(3) taxable service whose part of value is exempted on the condition that no credit of inputs and input services, used for providing such taxable service, shall be taken; but shall not include a service –

(a) which is exported in terms of rule 6A of the Service Tax Rules, 1994; or

(b) by way of transportation of goods by a vessel from customs station of clearance in India to a place outside India;”

[5] Analogics Tech India Ltd. v. CCE, Hyderabad-II- 2009 (248) ELT 781 (Tri-Bang), Food Fats & Fertilisers Ltd. Vs. CCE, 2009 (247) ELT 209 (Tri.)