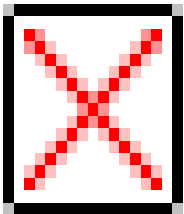


Conundrum of refund in case of inverted duty structure - Climax or Prelude?

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"We shall refrain from replacing the wisdom of the legislature or delegate with our own"
-Apex Court in the case of UOI vs VKC Footwear and Others



THE Supreme Court in its judgment in the case of ***UOI vs VKC Footwear and Other*** - [2021-TIOL-237-SC-GST](#) has pronounced a landmark judgment on whether Rule 89(5) of the CGTS [Rules, 2017](#) is ultra vires the legislation. Rule 89(5) which has been in the news for more than three years now, restricts the refund of the unutilized Input Tax Credit (ITC) pertaining to input services used in products which suffer from Inverted Duty Structure (IDS).

Recap

About one year ago, the Gujarat High Court (HC) in the case of VKC Footsteps India Private Limited vs Union of India - [2020-TIOL-1273-HC-AHM-GST](#) held that Rule 89(5) of the CGST Rules, 2017 is contrary to Section 54(3) of the CGST [Act, 2017](#) to the extent that it does not include unutilised credit pertaining to input services. The HC read down the explanation to Rule 89(5) and held the said rule to be partially ultra vires the Act.

Almost a month later, in the case of ***Tvl. Transtonnelstroy AFCONS Joint Venture vs. UOI*** - [2020-TIOL-1599-HC-MAD-GST](#), the Madras HC pronounced a completely contradictory ruling holding that that granting refund to input goods and not services are not unconstitutional in any sense considering that credit is allowed in respect of both; refund is a statutory right and not vested right and hence a differentiation can be made. The constitutionality of Section 54(3) and Rule 89(5) was also upheld.

With the above two conflicting rulings in place, the industry was looking forward to the SC's intervention on the subject.

What did the SC say - top 10 key takeaways

The SC in a 140-pager judgment has discussed the issue at length to affirm the decision of Madras HC and disapprove the ruling of Gujrat HC. The SC has also recommended the GST Council to look into the rule and revise the formula as per the policy. The top ten key takeaways from the judgment are tabulated below:

SN	Issue	SC's observation
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1	Inverted duty structure	The SC noted that distortion of unutilized ITC due to higher rated inputs and lower rated output was noticed much before the advent of GST. In the Gujarat VAT law, a provision was embodied for refund of unadjusted ITC. While discussing the GST regime, the Empowered Committee of State Finance Ministers acknowledged this issue and suggested that a refund may be provided of accumulated ITC. Therefore, while enacting the law, the Parliament took special cognizance of this and enacted Section 54(3) Â
2	Interpreting the provisos to Section 54(3)	There are essentially three provisos to Section 54(3). The first proviso begins with "No refund of unutilized ITC shall be allowed in cases other than". The language indicates that the two clauses of the first proviso are not conditions of eligibility, but are restrictive in nature. Further, the clauses are distinct to the extent that refund of zero-rated supplies is allowed without any distinction between inputs and input services; however, for the other clause i.e. in case of inverted duty structure, there is a limitation in respect of rate of tax on inputs being higher than the rate of tax on outputs. The Court also held that they cannot restrict the ambit of the proviso basis a circular issued by the department in 2018 especially when its effect would be expanding the area of refund contemplated by the legislature. With the clear language used by the legislature, the court cannot accept the submissions of the counsels as it would involve a judicial re-writing of provision which is impermissible.
3	Interpreting the Explanation 1 to Section 54	Explanation 1 to Section 54 defines 'refund' as - " refund includes refund of tax paid on zero-rated supplies of goods or services or both or on inputs or input services used in making such zero-rated supplies, or refund of tax on the supply of goods regarded as deemed exports, or refund of unutilised input tax credit as provided under sub-section (3)". This indicates that w.r.t. exports, the legislature has indicated the ITC on inputs and input services both. However, for unutilised credit in respect of inverted duty structure, it is only input goods, where refund can be allowed.
4	On doctrine of equivalence	The Court noted that the petitioners had submitted that a doctrine of equivalence should prevail in as far as refund of inputs and input services are concerned. However, the SC decided that while interpreting the provisions of Section 54(3), effect must be given to its plain terms. The Court cannot redraw legislative boundaries on the basis of an ideal which the law was intended to pursue.
5	On the ideal GST framework	Fiscal legislations around the world, with India being no exception, complex balances are established which are based on socio-economic complexities and diversities which permeate. The GST regime in unitary state differs from a dual model GST like that of India's which operates in a federal structure. Article 279A(6) of the Constitution lays down an ideal GST framework, which can only be realized progressively. The arguments of petitioners do furnish the rationale of enactment of law (like removal of cascading effects etc.), however, they do not make a case for judicial review of legislation or holding an enacted law as invalid.

6	On the differentia that is created by Section 54(3)	While replying to the petitioners' arguments that Section 54(3) creates a class of persons and each of such person are entitled to claim refund of unutilized ITC whether its origin lies in inputs or input services, the SC noted that accumulated ITC may result due to variety of circumstances and not all circumstances would warrant a refund under section 54(3). Once this fact is recognized, the legislature should be allowed the autonomy to distinguish between credits of inputs and input services. To draw the balance for granting refund, the legislature can create a differentia.
7	Definition of input u/s 2(59)	The CGST Act, 2017 defines input as goods other than capital goods. However, the plural expression 'inputs' has not been defined as such. The SC noted that there is no reason why the usual principle of construing the plural in the same plane as singular should not be adopted. Nonetheless, construing 'inputs' to include both input goods and input services would do violence to the provisions of Section 54(3) and would also run contrary to Explanation 1 as noted above.
8	On Constitutional rights	No Constitutional right is being asserted in claiming a refund. Refund is a statutory prescription and Parliament is within its legislative authority to determine whether refunds should be allowed of both input goods and input services.
9	On Constitutional validity	Commenting on the submissions of the counsels of assessee wherein it has been submitted that Article 14 would be attracted and section 54(3) suffers from the vice of arbitrariness, the SC noted that a cause of invalidity arises where equals are treated as unequally and unequal are treated as equals. However, under the Constitution and the CGST Act, 2017, goods and services and inputs and input services are not treated as one and they are distinct species. Parliament is entitled to make policy choices and adopt appropriate classification. A refund claim is governed by statute; it is not a constitutional entitlement.
10	Vires of Rule 89(5)	The SC accepted the justification of the formula given in Rule 89(5) by the ASG (to create a legal bifurcation). However, the SC also accepted that the formulas is not perfect. The formula presumes that output tax is entirely paid from the ITC of Input goods and ITC of input services is not utilized. A comparison of this formula with Rule 89(4) also reveals that it considers both - input goods and input services. The SC opined that there are certain anomalies with the formula, however, it cannot render the rule as invalid. The Court also urged the GST Council to reconsider the said formula and take appropriate policy decision.

Conclusion

While the industry was keenly awaiting this judgment, there will be some unrest and appeals against the same. The SC's comment upon not intervening with the legislature's role in formulation of policy has certainly come as a surprise. There have been innumerable cases, where Courts have held the legislature to be ultra vires and unconstitutional, wherever they believed that there was ambiguity. However, this certainly will become a stepping stone in times to come where this judgment will be relied upon whenever a question of correctness of a mechanism or formula may arise.

Another important drift in this case was an alternative mechanism which was recommended by the Counsel's for the assessee. Even though the Court took cognizance of the same, no way forward was prescribed as such. The Counsels had suggested that an order of utilization should be prescribed in the provision whereby a supplier suffering from IDS can first set-off the ITC of input services from the tax due on output supplies and then the remaining ITC can be used for the purpose of applying the formula. This alternative mechanism can be considered by the GST Council especially because it does not hamper the revenue's interest in any way and also grants relief to the industry.

From the perspective of the industry, there could be three scenarios namely, taxpayers who have not filed the claim, taxpayers who have filed the claim but have not received it as yet and taxpayers whose claims were credited in the past. In case of the first scenario, there is no action

required; as a result of the SC's judgment, they will not be entitled to file any refund claim henceforth. In case of the second scenario, the taxpayers would have reflected the claims filed in their current assets; such taxpayers would have to write back the asset created in the books and take a hit in the P&L account. In the third case, the refund granted may be recovered along with interest as a fallout of this judgment.

Though, the Apex Court has urged the GST Council to discuss the policy again, it remains to be seen whether this would form a part of the GST Council's first physical meeting since the start of pandemic, today.

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