Resolving Distortions of the Inverted Duty Structure: Disconnect between the Legal and Economic Perspectives

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Introduction

VAT on goods and services regimes across the globe envisage the full credit of tax paid on underlying inputs, such as goods and services, for the payment of outward tax applicable to the principal transaction. This is to ensure that there is no cascading effect of tax, that is, 'tax-on-a-tax', after every stage in the supply chain.

However, an anomaly arises in the inverted duty structure, where the rate of tax on inputs is higher than the rate of applicable tax on the outward supply. In such cases, taxpayers are left with an ever-increasing pool of unutilised credit that is not utilised for the payment of output tax.

Because credit accumulation on account of unutilised input tax credit (ITC) can result in higher tax costs to businesses and/or a rise in the hidden tax cost for consumers, governments have sought to address this issue in different ways.

This article discusses the anomalies of the inverted duty structure in the Indian goods and services tax system against the backdrop of prevalent global methods for resolving such an issue, and recent Indian judicial and legislative developments in this regard.

Position across the globe

The position of law, in general, across developed economies is that the unutilised credit of tax paid on inputs is to be either carried forward for a prescribed period and/or refunded if enough output tax is not present to absorb the input tax credit.

In the European Union, the VAT Directive prescribes that, in the case of excess input tax deductions (ie, credit), Member States may either refund the said deductions or carry them forward to the next period for utilisation in the future. It further provides that such a refund or carry forward may not be allowed if the amount of excess deductions is insignificant.[1]

In France, VAT credit is carried forward as a rule. However, the refund of unutilised credit can also be claimed subject to the fulfilment of certain monetary thresholds. The refund can be claimed on a monthly, quarterly or half-yearly basis. Separately, the refund of a certain minimum amount can be claimed at the end of each calendar year.[2] By

1 See https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32006L0112 accessed 3 May 2022.

2 See www.legifrance.gouv.fr/codes/texte_lc/LEGITEXT000006069569?etatTexte=VIGUEUR&etatTexte=VIGUEUR_DIFF accessed 3 May 2022.

contrast, in Germany, there is no provision for carrying forward credit, and an application for a refund is required to be filed in the form and manner prescribed under local regulations.[3] Similarly, in the United Kingdom, if any credit of a taxpayer remains unutilised in an accounting period, it becomes refundable to the taxpayer.[4] In Japan, enterprises are required to pay consumption tax on taxable sales. If the amount of consumption tax on purchases to be deducted is more than the amount of consumption tax payable on the taxable sales made by the taxpayer, a refund of the difference can be claimed in the tax return. In New Zealand, the relevant tax authority may set off the unutilised deduction of excess input tax against the taxpayer's liability under other statutes.[5]

None of the aforementioned jurisdictions differentiate between the input tax paid on input goods and input services while refunding the unutilised credit of input tax.

The Indian scenario

Before the inception of the new VAT regime in India, which is called the goods and services tax (GST), the recognition of the principle of providing a refund in the case of the inverted duty structure was limited to a few states by way of their independent VAT legislation. The constitutional power of states to impose VAT was limited to goods, and not on services. However, provisions pertaining to inverted duty were absent under the erstwhile indirect taxes regime.

This anomaly was cured by the advent of a unified GST regime in effect from 1 July 2017. The newly instituted regime provided for the refund of accumulated input tax credit due to the rate of tax on the inputs being higher than the rate of tax applicable on the outward supply. Such a refund could be claimed within a two-year period.

For sectors such as textiles, footwear, pharmaceuticals and mining facing a tax rate differential on the input and output side, such a provision was particularly important for hedging against the ensuing tax costs.

The central government, however, amended the relevant rules in 2018 such that the refund of unutilised ITC was only limited to credit availed by the payment of tax on input goods and not on input services. Additionally, the said amendment was brought into force with retrospective effect from the date of the institution of GST in India, that is, 1 July 2017.

Due to the wide-ranging impact of this amendment, multiple representations were made by taxpayers, and writ petitions filed before various high courts challenging the validity of the retrospective amendment and/or statutory provisions. While the High Court of Gujarat decided the issue in favour of taxpayers[6], the plea of taxpayers was rejected by the Madras High Court.[7] Owing to conflicting decisions of different high courts, the matter ultimately travelled to the Supreme Court of India.

The Supreme Court, on appeal, decided the issue in favour of the tax department, and upheld the constitutional validity of the retrospective amendment brought about by the government and that of the underlying statutory provisions. While acknowledging that the ideal state of GST legislation would envisage a destination-based tax, where taxpayers can utilise ITC in a way that does not enter the pricing structure for supplies made by them, the Supreme Court observed that such a framework can only be realised progressively. The court further negated the argument of equivalence between input goods and input services in respect of a refund on account of the inverted duty structure by holding that a refund is a matter of statutory prescription and not a right.[8] However, because the

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3 See https://dejure.org/gesetze/UStG accessed 3 May 2022.
4 See www.legislation.gov.uk/ukpga/1994/23/section/25 accessed 3 May 2022.
5 See www.legislation.govt.nz/act/public/1985/0141/latest/whole.html#DLM84577 accessed 3 May 2022.
6 VKC Footsteps India Pvt Ltd v Union of India, TS-472-SC-2021-GST.
7 Tvl Transtonnelstroy Afcons Joint Venture v Union of India, TS-596-HC-2019(PAT)-NT.
8 Union of India v VKC Footsteps India Private Limited, TS-472-SC-2021-GST.

statutory rules governing a refund of unutilised ITC in the case of the inverted duty structure resulted in certain inequities, the court strongly urged the GST Council (a body comprising central and state governments) to make a policy decision in that respect. Regarding this direction of the Supreme Court, the GST Council and government responded by notifying higher tax rates on footwear, while deferring such a rate revision in the case of textiles. Other sectors have also been left unaddressed. The problems and distortions of inverted duty structures, accordingly, continue to adversely impact Indian businesses and consumers.

Observations and recommendations

While deciding against the inclusion of credit on input services for a refund on account of the inverted duty structure, the Supreme Court gave precedence to legislative autonomy over the principle of tax neutrality. Tax neutrality is one of the formative pillars on which the indirect taxation systems of various nations across the globe have been built. The principle ensures that relevant participants in the indirect taxation system are entitled to recover all the tax costs that they bear on inputs that are then used to effectuate a further taxable supply. It further ensures that there is no cascading effect of underlying taxes, which was also one of the primary purposes for bringing in a unified GST for the entire nation.

A necessary corollary to the principle of tax neutrality is that taxpayers should be able to utilise the credit availed in toto to ensure that tax paid on inputs does not take the colour of additional costs. Further, in situations in which taxpayers are not able to utilise the credit of tax paid on inputs in their outward transactions, fully or partially, the option to get a refund of such unutilised credit should be available to them. However, even after acknowledging the importance of tax neutrality, the Supreme Court chose to not interfere with the wisdom of the legislature.

As a direct consequence of the Supreme Court's judgment, taxpayers can expect the initiation of recovery proceedings for refunds granted previously following the decision of the Gujarat High Court. The decision of the Supreme Court also may have an impact on the pricing/profitability of businesses facing the inverted duty structure. Wherever possible, businesses may explore the option of re-modelling their transactions to mitigate the impact of the inverted duty structure as much as possible. For instance, where businesses are closely aligned, multiple registrations may be merged into a single registration in a state to create a common ITC pool, which may then be utilised in the most efficient way to avoid the accumulation of unutilised input tax credit.

However, against the backdrop of the Supreme Court's ruling, neutrality in the value chain and a complete pass through of taxes at each level can be achieved only by way of appropriate changes to the existing GST law by the legislature.