

Inverted Duty Structure: Concept introduced but not followed

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1. Introduction

The GST legislation was rolled out in the Indian economy with the object to cure various complexities and defects which existed in the previous tax regimes and to provide simple and uniform tax policy to the Country. One of the major objectives behind its introduction is to remove the cascading effect, which could be achieved in twin manner *i.e.* by allowing seamless flow of credit of taxes paid on inputs and by enforcing single rate of tax so that credit should not be accumulated on account of disparity of tax rate on output *vis-à-vis* inputs. However, since GST is a regressive tax, it would be inequitable to apply a single rate of tax on all products in countries where there are wide income disparities and a large number of people are below poverty line and thus, the GST structure in India was introduced with Multiple Tax Slab Rates.

Due to the Multiple Tax Slab Rates, the problem of non-utilization of Input Tax Credit ('ITC/Credit') was fairly anticipated and the same was addressed by incorporating the scheme to refund the unutilized ITC under Inverted Duty Structure which is prescribed in Section 54(3)(ii) of the Central Goods and Services Tax Act, 2017 ('CGST Act') and its machinery provision is provided in Rule 89(5) of the Central Goods and Services Tax Rules, 2017 ('CGST Rules'). As the time passed, the Government has brought changes and amendments to this concept in order to secure its interest, which has faced criticism from a large section of taxpayers.

Recently, Central Board of Indirect Taxes and Customs ('CBIC') has issued Circular No. 135/2020¹ ('the Clarification') through which the Government has excluded the traders from claiming refunds under Inverted Duty Structure and has restricted its applicability only to the cases where the inputs and output supplies are not the same.

This article has critically analyzed the legal validity of the Clarification issued by CBIC. Further, it explores the said changes/amendments in GST.

The document is updated till 12 April 2020.

2. Inverted Duty Structure: Concept

The term 'Inverted Duty Structure' ('IDS') refers to the scenario where due to various Tax Slab Rates, the rate of tax on Inputs is higher than the rate of tax on Output. In such a situation, the ITC received by a registered person remains unutilized and if the same is not refunded to the tax payer then it would increase the cost of production and would result in cascading effect. In order to claim the refund of such unutilized ITC which has

accumulated on account of Inverted Duty Structure, the tax payer derives substantive right to claim the refund under Section 54(3)(ii) of the CGST Act. The relevant provision reads as under:

"Section 54

(1) ...

(2)

"(3) Subject to the provisions of sub-section (10), a registered person may claim refund of any unutilised input tax credit at the end of any tax period:

Provided that no refund of unutilised input tax credit shall be allowed in cases other than,-

(i)

(ii) where the credit has accumulated on account of rate of tax on inputs being higher than the rate of tax on output supplies (other than nil rated or fully exempt supplies), except supplies of goods or services or both as may be notified by the Government on the recommendations of the Council:"

The formula for calculating "refund amount" has been prescribed in Rule 89(5) of the CGST Rules, which is the relevant rule for Inverted Duty Structure. The relevant rule reads as under:

"Rule 89

(1)

(2)

.....

(5) In the case of refund on account of inverted duty structure, refund of input tax credit shall be granted as per the following formula:-

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.

Explanation:- For the purposes of this sub-rule, the expressions -

(a) Net ITC shall mean input tax credit availed on inputs during the relevant period other than the input tax credit availed for which refund is claimed under sub-rules (4A) or (4B) or both; and

(b) Adjusted Total turnover" and "relevant period" shall have the same meaning as assigned to them in sub-rule (4)."

3. Analysis of recent clarification denying benefit of IDS to traders

3.1. Analysis of relevant legal provisions

As discussed in previous Para, a registered person can claim refund of unutilized ITC where credit has accumulated due to rate of tax on inputs being higher than the rate of tax on the output supplies. From the bare perusal of the language of the section it is evident that the essential conditions for seeking refund under section 54(3)(ii) is that the rate of tax on inputs must be higher than the rate of tax of the output supplies which results in accumulation of unutilized ITC.

The term 'input' has been defined u/s 2(59) of the CGST Act, 2017 which means *"any goods other than capital goods used or intended to be used by a supplier in the course or furtherance of business"*. Though the term "output supplies" has not been defined in the CGST Act, but the guidance can be sought from the term "outward supply" which has been defined u/s 2(83) as per which *"outward supply in relation to a taxable person, means supply of goods or services or both, whether by sale, transfer, barter, exchange, licence, rental, lease or disposal or any other mode, made or agreed to be made by such person in the course or furtherance of business."*

Here, the term inputs include all kinds of input goods including those procured by the manufacturer or trader for carrying out manufacturing or trading activity respectively. Similarly, the term output supplies include outward supplies made by both the manufacturer and trader. From the bare perusal of language of the statute it is evident that all the registered persons including the traders are covered under the ambit of Inverted Duty Structure, which is further confirmed by the language of Rule 89(1) of the CGST Rules which says that *"any person, except the persons covered under notification issued under section 55, claiming refund of any tax, interest, penalty, fees or any other amount paid by him, other than refund of integrated tax paid on goods exported out of India, may file an application electronically in FORM GST RFD-01 through the common portal, either directly or through a Facilitation Centre notified by the Commissioner."* Thus, the term "any person" should include all registered persons such as manufacturers, suppliers, traders, exporter, merchant exporters, etc.

3.2. Clarification : Decoded

The Government has been undertaking the best possible efforts in order to secure its interest and to avoid the payment liability in cases of refunds of accumulated unutilized ITC arising from Inverted Duty Structure which are bound to cause heavy burden on the exchequer. In pursuance of which Circular No. 135/2020 has been issued which further restricts the claim of refunds of accumulated unutilized ITC under section 54(3)(ii) of the CGST Act.

The clause 3 of the Circular deals with the clarification issued by CBIC wherein the traders have been excluded from claiming refund of unutilized accumulated ITC under section 54(3) of the CGST Act as the Inverted Duty Structure has been restricted to the cases where the inputs

and output supplies are different. The Circular restrict refunds in the cases where the ITC remained unutilized due to the subsequent reduction in the rate of tax on the same good *i.e.* when the input and output are the same and the trader procured the Input at the higher GST rate, which was subsequently reduced by the Government and these goods were sold by the trader by charging the reduced GST Rates. Due to subsequent reduction in the GST rates, the trader is left with the unutilized ITC which got accumulated due to change of GST rate on the same product. The aforementioned circumstance can be understood through following illustration:

M/s XYZ is a trading firm which procured input goods (A) at 18% GST rate on 01.01.2020. The GST rate on Goods A was subsequently reduced from 18% to 5 % through the notification dated 01.02.2020. Goods A were sold by M/s XYZ to ultimate buyer on 10.02.2020 by charging the GST at the reduced rate of 5%. M/s XYZ has procured that Input at 18% GST rate but has sold the output at 5% GST rate due to which M/s XYZ was left with unutilized accumulated ITC. M/s XYZ filed the Form GST RFD-01 claiming refund of unutilized ITC due to difference in rate of tax of input and output.

In order to deal with such refund applications, the Board *vide* the clarification has provided that *"It may be noted that refund of accumulated ITC in terms clause (ii) of sub-section (3) of section 54 of the CGST Act is available where the Credit has accumulated on account of rate of tax on Inputs being higher than the rate of tax on Output supplies. It is noteworthy that, the Input and Output being the same in such cases, though attracting different tax rates at different points in time, do not get covered under the provisions of clause (ii) of sub-section (3) of section 54 of the CGST Act. It is hereby clarified that refund of accumulated ITC under clause (ii) of sub-section (3) of section 54 of the CGST Act would not be applicable in cases where the Input and the Output supplies are the same."*

In light of the above clarification, it is evident that the Government is unwilling to allow refunds of accumulated unutilized ITC to traders by stating that for the purpose of refund under section 54(3)(ii) of the CGST Act, the input and output must not be same. From the language of the Circular it can be inferred that the Government has restricted the scope of section 54(3)(ii) of the CGST Act only to the cases where the input has been procured for carrying out the manufacturing process and there is a difference in GST rates of input and output at the time of procurement of Input.

4. Legal scrutiny of impugned restriction imposed by the clarification

The clarification is bound to deny the refund of accumulated unutilized ITC to all traders who sale their output at the reduced rate of tax. It is believed that this would not be ordinarily accepted by the registered

persons whose refunds are denied on the basis of this Circular and it is bound to undergo legal scrutiny in the coming time. The said circular would face the challenge on the following grounds:

4.1. Section 54(3)(ii) does not provide for the restriction as provided in the clarification

Section 54(3)(ii) of the CGST Act does not stipulate any requirement that the inputs and output supplies must be different in order to claim the benefit under that section. Further, the term "any person" in Section 54(1) and Rule 89(1) have been used in wider connotation to include even the trader and such exclusion of the traders cannot be inferred from the language of the section and the rules made therein. The only requirement stipulated in Section 54(3)(ii) is that the credit must have accumulated on account of rate of tax on inputs being higher than the rate of tax on output supplies, which is duly met out in the refund applications filed by the traders.

It is essential to note that the legislature always had the option to provide for the exclusion of the traders from Inverted Duty Structure by introducing the restrictive language in the statute but the same has not been done rather the language of the statute duly direct towards the inclusion of traders in Inverted Duty Structure. Thus, the executive cannot be allowed to travel beyond the intention of the legislature and such exclusion cannot be presumed by the Government.

4.2. No intelligible differentia in exclusion of trader & violation of Article 14 of the Constitution

The Inverted Duty Structure has been introduced to tackle the issues pertaining to unutilized ITC and to remove the cascading effect. If the unutilized ITC is not refunded to the trader then he has to either add the unutilized ITC in the cost of output or he himself has to bear the losses. It is evident that the trader or any other person are equally affected by the Inverted Duty Structure and stand on equal pedestal and further, no difference would be caused if the inputs and output supply is the same.

In this regard it is pertinent to note that as per the FAQs issued by the CBIC for Handicraft Sector², while answering the ninth question, the CBIC has itself stated that the merchant exporter is entitled to claim refund of accumulated ITC and thus, the merchant exporter is covered under the ambit of section 54(1) of the CGST Act to claim the benefit of refund under Inverted Duty Structure.

Similarly, in the FAQs issued by the CBIC for Exporter³, in response to question four the Board has stated that "*the concept of merchant or manufacturer exporter would become irrelevant under the GST regime. The procedure in respect of the supplies made for export is same for both merchant exporter and a manufacturer exporter*". Thus, when the exporter and the merchant exporter have been treated equally then there

exist no reason to distinguish between the trader and manufacturer or supplier.

In this regard, reliance may be placed on the case of *Ajay Hasia etc. v. Khalid Mujib Sehravardi & Ors.*,⁴ wherein the Hon'ble Apex Court has held that a classification would not be discriminatory if it fulfills two conditions i.e. (i) that the classification is founded on an intelligible differentia which distinguishes persons or things that are grouped together from others left out of the group; and (ii) that differentia has a rational relation to the object sought to be achieved by the impugned legislative or executive action. If the classification is not reasonable and does not satisfy the two conditions referred to above, the impugned legislative or executive action would plainly be arbitrary and the guarantee of equality under Article 14 would be breached. However, in the instant case the discrimination made by the instant Circular lacks the rational and legal basis due to which it violates Article 14 of the Constitution.

4.3. Right to claim refund is based on legitimate expectation

The provision for refund due to Inverted Duty Structure was incorporated in the GST structure as the Government itself had the realization that due to various Tax Slab Rates the tax payer may not be able to fully utilize the ITC received by him. While procuring the Inputs, the trader duly pays the input tax on such goods at the GST rate prescribed by the Government. The trader pays the input tax due to the assurances received from the Government that the trader can charge the Output Tax from the consumer at the similar GST rate, as paid by him at the time of procurement of Input, and he would be able fully realize the ITC at the time of the payment of the output tax. However, if the Government subsequently changes the rate of tax on such product by reducing the rate of tax then the excessive credit received by the trader would go unutilized due to which the trader is entitled to seek refund under Inverted Duty Structure. The Government cannot later deny such right to the tax payer as the same was accrued to him at the time of procurement of input itself. The guidance can be obtained from the case of *Eicher Motors Ltd. v. Union of India*,⁵ wherein the Hon'ble Apex Court has held that the new scheme cannot take away the benefits accrued under the previous scheme.

Thus, the understanding of the aforementioned principle suggests that it is not permitted to surprise the tax payer by denying the benefit previously accrued to him. The tax payer is merely acting in accordance with law laid down by the Government and he cannot be made to suffer the losses due to change in GST rate by the Government. The CBIC is estopped from changing its stand at the later stage and deny the benefit of refund of unutilized ITC to the traders who have not added such unutilized ITC in the cost of the output as the same would stand contrary to the doctrine of legitimate expectation as per which the action of state must not be arbitrary and give due weight to the reasonable or legitimate expectations of the persons likely to be affected by the decision or else that unfairness in

the exercise of the power may amount to an abuse or excess of power apart from affecting the *bona fides* of the decision in a given case.⁶

4.4. Circular cannot take away the right created by the Statute

The right to claim refund which has accrued to the tax payer on account of Inverted Duty Structure has been conferred under Section 54(3) of the CGST Act. It provides the substantive right to the tax payerto file and claim the refund of "**any**" unutilized ITC. Though the term "**any**" has not been defined under the CGST Act, however, as per Black's Law Dictionary (4th Ed., 1968) "**Any**" means "one out of many; an indefinite number; one indiscriminately of whatever kind and quantity".

Further, as per the requirement mentioned in section 54(3)(ii) it merely requires that the Credit has accumulated on account of rate of tax on Inputs being higher than the rate of tax on Output. Furthermore, Rule 89 of the CGST Rules prescribes for filing of Form GST RFD-01 for claiming the refund and does not require the input and output to be different. However, the instant Circular has travelled beyond the substantive provision of the parent statute and CGST Rules by imposing such restrictions. In this regard, it is relevant to quote the recent finding of the Hon'ble Madras High Court in the case of *M/s. Precot Meridian Limited Vs Commissioner of Customs*⁷ wherein after relying on the case of *CCR, Bolpur v. Ratan Melting and Wire Industries*⁸, the Hon'ble Court observed that "*it is held that circulars cannot prevail over the statute. Circulars are issued only to clarify the statutory provision and it cannot alter or prevail over the statutory provision.*"

Further, the Hon'ble Delhi High Court in a recent decision in case of *Pitambra Books Pvt. Ltd. v. Union of India*⁹, while citing its earlier decision ruled that "*Circulars might mitigate rigours of law by granting administrative relief beyond relevant provisions of the statute, however, Central Government is not empowered to withdraw benefits or provisions of the statute.*"

4.5. Circular results in ambiguity and uncertainty

The Circular lacks clarity in language as it fails to propose the solution for the unutilized ITC left with the trader due to change in rate of tax and does not also provide for the reason of exclusion. It appears that the said Circular has been issued merely to deny the right to refund to the tax payerwithout stating the reasonable ground for the same. It is settled proposition of law in the case of *Ramana Dayaram Shetty v. The International Airport*¹⁰, that "*the Government cannot act arbitrarily at its sweet will and, like a private individual, deal with any person it pleases, but its action must be in conformity with standard or norm which is not arbitrary, irrational or irrelevant.*" The law must be certain at the time when the subject has to act by reference to it.¹¹ If the

Government keeps on changing its stand arbitrarily, then the tax payer would no more be able to place its faith on the rule of law.

Basis the aforementioned reasoning, the instant Circular would surely face the legal scrutiny. However, the Government may stand firm with its reasoning that for purpose of claiming refund under Inverted Duty Structure it is necessary that the inversion must exist on the date of procurement of inputs and not at the later stage.

Conclusion

The detailed study of the issues pertaining to the Inverted Duty Structure suggests that the Government is gradually moving forward in the direction to do away with the Inverted Duty Structure by harmonizing the tax rate slabs to the maximum extent possible as the ultimate aim of the Goods and Service Tax could be achieved only with the minimum slab rates. However, in this process the Government should not deny the genuine and legitimate claims of refunds of the accumulated unutilized ITC of the Registered Person merely to reduce the burden on the exchequer.

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 2. GST Sectoral Series- Handicrafts, Central Board of Excise & Customs, Available at: <http://www.cbic.gov.in/resources//htdocs-cbec/gst/faqs-handicrafts.pdf>
 3. GST Sectoral Series-Exports, Central Board of Excise & Customs, Available at: <http://cbic.gov.in/resources//htdocs-cbec/gst/sectoral-booklets-exports.pdf;jsessionid=8468A0D86DF1D8DE66FD6037C970AB5F>.
 4. *Ajay HasiaEtc v. Khalid Mujib Sehravardi & Ors.*, 1981 AIR 487
 5. *Eicher Motors Ltd. v. Union of India* (1999) 2 SCC 361.
 6. *Food Corporation of India v. Kamdhenu Cattle Feed Industries* (1993) 1 SCC 71.
 7. *M/s. Precot Meridian Limited v. Commissioner of Customs*, W.P.(MD) No. 20504 of 2019
 8. *Bolpur v. Ratan Melting and Wire Industries* [2008(12) S.T.R. 416 (S.C.)
 9. *Pitambra Books Pvt. Ltd. v. Union of India* W.P(C) No. 627 of 2019.
 10. *Ramana Dayaram Shetty v. The International Airport*, 1979 AIR 1628.
 11. Should the law be certain? The Oxford Shrieval lecture, Available at: https://www.supremecourt.uk/docs/speech_111011.pdf