

Refund under Inverted Duty Structure (IDS) – Impact of Input Tax Credit (ITC) of Input Services – read in conjunction with Composite Supply

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Introduction: Goods and Services Tax (GST) is a destination based tax regime, wherein tax gets discharged at multiple phases via credit and cash. Tax is paid to supplier on purchase of goods and/or services, which is available as credit to dealer and when dealer sells those goods, he pays tax on sale, after utilizing the credit available on purchase of goods. Hence tax is discharged in two facets - at the time of purchase and at the time of sale. This process goes on until the goods reach to the final customer.

About GST Refund: GST Refund can be of two types –

Type I: Refund of excessive gst paid in cash

Type II: Refund of unutilized credit of gst

While refund of gst under Type I is available at all circumstances, but Refund under type II is available only in the following scenarios-

Scenario 1- On zero rated supplies, made without payment of tax (considering the supplies are not subject to export duty and no duty drawback is claimed thereon)

Scenario 2- Due to rate of tax on Input supplies being higher than rate of tax on output supplies (Input supplies constitute Inputs, Input services and capital goods). Since the rate of inputs being higher than those of output, this is referred to as Inverted duty structure.

Let us understand scenario no. 2 with the help of an example i.e. where the rate on input supplies is higher as compared to the rate on output supplies. In order to manufacture lime, one needs to purchase raw materials like coal, limestone, petro coke and other packing material. Now petro coke and packing material is chargeable at 18% while tax on finished product i.e. Lime is 5%. In such cases, the credit gets carried forward every month leading to continuous blockage of working capital.

Who is not eligible to claim under Refund under IDS?

While this looks like refund of unutilized tax credit, this may not be the case always. For example a super stockist having excessive credit balance available at all times is not eligible to claim refund under IDS merely on account of excessive credit. Hence the dealers involved in mere trading of goods, is not eligible to claim refund under this case. This is the case of parallel duty structure (PDS) and not the inverted duty structure (IDS), where the rate of input is equivalent to the rate of tax on output.

Legal Provision: Refund of Unutilized ITC under IDS is governed by Sec 54(3) of CGST Act read with Rule 89 of CGST Rules. Further Rule 89(5) of CGST Rules prescribes the formula of Refund, which says:

Maximum Refund Amount = **Turnover of Inverted Supply/Adjusted Total Turnover* Net ITC – Tax payable on such Inverted Supply**

“Net ITC” means input tax credit availed on inputs and input services during the relevant period. (This is up till 17th April 2018)

However, after the Notification No. 21/2018 dated 18th April 2018, ITC on Input Services have been specifically excluded from Net ITC, while determining Refund under IDS.

This exclusion of ITC on input services leaves one point open for discussion that whether ITC on Input services, which are ancillary and secondary to the principal transaction is also covered in the scope of above notification, the refund of which is sought to be barred. In order to understand this deeply, let us take an illustration to describe how ITC on Input services, which is a part of main transaction, can be impacted. Say Mr. A of Delhi ordered goods from Mr. B of Mumbai. Obviously Mr. A would like to receive goods in his place of business. Now to operate this commercial transaction, goods are required to be reached to the place of Mr. A. Therefore Mr. B collects packing charges and freight over and above the basic commodity value and recovers the tax on the entire value i.e. being transaction value u/s 15 of the CGST as the value on which tax is payable.

Therefore, the point to be considered is whether ITC on Input Services which is sought to be barred by ***Notification No. 21/2018 dated 18th April 2018***, also covers those input services which are merely a part of dominant transaction. In order to take this discussion forward, let us consider the meaning and scope of Composite Supply.

Composite Supply – Definition Clause and Point of Taxation:

As per Section 2(30) of the Act, “***Composite Supply***” means a supply by a taxable person to a recipient consisting of **two or more taxable supplies of goods or services or both**, or any combination thereof, which are **naturally bundled and supplied in conjunction with each other in the ordinary course of business**, one of which is a **Principal Supply**”

An illustration to above definition reads as follows –

*“Where goods are **packed and transported with insurance**, the supply of goods, packing materials, transport and insurance is a composite supply and **supply of goods is a principal supply**”.*

On a plain reading of the above illustration and to stretch our imagination in practical situations, a supplier who **sell goods** and also **charge Packing Charges, Freight, Insurance, etc** – these ancillary services would fall under the gamut of composite supply and **supply of the goods** shall be a **Principal Supply**

Further attention is called for in referring to **Section 8(a)** of the Act, which deals with the taxability of Composite Supply.

As per Section 8(a) of the Act,

“The Tax Liability on a composite supply comprising of two or more supplies, one of which is a principal supply shall be treated as a supply of such principal supply”

*Whether ancillary or secondary input services, which are a part of dominant transaction, should be a part of composite supply, and hence the same should be considered under gamut of inputs, therefore being eligible for calculation of Maximum Refund under IDS as prescribed under Rule 89(5) of CGST Rules – **Arguments in favour***

- 1) **Presence of Two or More Taxable Supplies** – The Invoices of some supplier contains ancillary and/or incidental charges like Freight, Insurance, Packing Charges, and Coding Charges etc. On taking the illustration annexed to Section 2(30) of the Act in to account, these charges will constitute composite supply and shall therefore be taxable at the rate applicable to dominant principal supply.

It is also observed that these ancillary input services are not charged at a rate different than the rate of Principal Supply, hinting that these charges do not form part of the contract and are a bare minimum necessity to fulfil the contractual obligation, as no goods could be supplied without being packed, and without getting dispatched. Hence the freight and packing charges are the basic minimum equities to carry out a transaction.

Further freight is chargeable at two rates i.e. 5% under the Reverse charge and 12% under forward charge, but in case of a composite transaction, it is charged at the rate of goods which are billed in the invoice, purging it us to confer that this supply is targeted as the composite supply.

- 2) **Account of Natural Bundling-** In order to take care of natural bundling, one must highlight where the scope of transaction ends in a normal parlance. For instance if Mr. A of Delhi ordered goods from Mr. B of Mumbai. Obviously Mr. A would like to receive goods in his place of business. Now to operate this commercial transaction, goods are required to be reached to the place of Mr. A. Therefore the activities which would ensure the completion of supply till the point of termination of contract like freight, packing charges, etc would be the activities naturally

bundled, the opposite interpretation of which would render the transaction unfulfilled. To undertake a transaction without the incidence of above mentioned activities is neither possible nor rational enough to even assume. Hence these services are naturally bundled to carry out a transaction.

- 3) **Ordinary Course** – In the normal circumstances freight, packing charges, insurance etc are the recovered in the day to day transactions. In fact these transactions are itself a basis to facilitate the supply of main transaction in the ordinary conduct of business.
- 4) **Presence of Principal Supply** – As the above mentioned ancillary services merely facilitate the transaction, the supply of goods is a dominant supply. Further this is clear from the fact that these incidental services do not carry their rate per se, they are taxable at the rate applicable to the supply of goods. Hence it can be inferred that, it is the goods which is prima-facie supplied and that the other additional miscellaneous recoveries will fall under the spectrum of composite supply.

Conclusion:

- 1) The proportionate claim of refund of ITC on account of input service under Refund of IDS which is sought to be denied by virtue of Notification No. 21/2018 dated 18th April 2018 is the denial of refund arising on account of **Pure Input Service transactions**, and not the ones which falls under the category of Composite Supplies. This is so because the entire levy of incidental and/or ancillary services falling under the Composite Supply is based upon the levy of Principal Supply, which are goods. Since these supplies never step in to the shoes of Input Services as evidenced from many factors highlighted above, they cannot be said to be the input services, the claim of which is barred by the notification.
- 2) Even considering the opposite view is also equally correct. For instance where the principal supply consist of input services, say a purchase of a Tally Accounting software along with basic CD or Pen drive charges, as may be required to install a software. In such a scenario, even if the charges of such CD/Pen drive are clearly mentioned, we would not be in a position to claim refund of those inward supplies as the principal transaction is an input service transaction.

Hence by the very occasion of considering above facts in to equation, I feel the refund occasioned on unutilized ITC on input services, which are a part of composite supply should not be denied.

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