Loss of Goods by Fire under GST

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The issue of reversal of credit in case of loss by fire was under litigation for years in Central Excise regime. It got settled with amendment in erstwhile CENVAT Credit Rules, 2004. However, while transitioning to Goods and Service Tax regime, this issue remained unsettled again. The provision of reversal of input tax credit on goods lost has been provided in section 17(5)(h) of Central Goods and Service Tax Act, 2017. This provision is ambiguous and is subject to several interpretations. This piece of articulation covers the detailed analysis of this provision and the ambiguities attached to it.

Legal provisions related to loss of goods under Central Excise regime

The concept of reversal of input tax credit (ITC) in case of goods lost has its roots from erstwhile Central Excise Regime. The relevant provisions from Central Excise Regime are discussed as follows: -

- As per section 3 of Central Excise Act, 1944, Central Excise Duty is leviable on "manufacture" of goods. The duty liability used to arise once the goods were "manufactured"; duty was demanded even in case the goods were destroyed after manufacture.
- However, there was provision of remission of duty under section 5 of Central Excise Act, 1944 read with rule 21 of Central Excise Rules, 2002. Under these provisions, the manufacturer was allowed to apply for remission of Central Excise Duty due on manufactured goods in specified cases.
- The remission of duty was allowed if the goods were destroyed by natural causes or unavoidable accident or were claimed as unfit for consumption.
- As mentioned, the provision of remission of Central Excise Duty was on the final product. As no duty was payable on final products in case of remission of duty, the credit availed on inputs used in the manufacture of such products was demanded by Revenue Department. However, there was no express provision for reversal of CENVAT credit taken on the inputs or input services used in manufacture of final products on which duty has been remitted.
- After much litigation, the Circular No.650/41/2002-CX dated 7th August, 2002 was issued by the Board to clarify that the reversal shall not be required on the inputs contained in finished goods on which Central Excise Duty has been remitted.
- Later, CENVAT Credit Rules, 2004 were amended vide Notification number 33/2007-CE(N.T.) dated 07.09.2007. This notification added sub-rule 5C to rule 3 of CENVAT Credit Rules, 2004. This sub-rule prescribed that where the Duty has been remitted under rule 21 of Central

Excise Rules, 2002; the CENVAT Credit taken on inputs and input services used in manufacture of such goods will be required to be reversed. Consequently, it became mandatory to reverse the credit on inputs before applying for remission of duty.

If the goods were lost due to fire or any other reason, the remission had to be applied in respect of Central Excise Duty on final products.

In view of above discussion, we can conclude that just before arrival of Goods and Service Tax, the Central Excise law was clear: -

- If the goods were lost due to fire or any other reason, the remission had to be applied in respect of Central Excise Duty on final products.
- Before applying for remission of duty, reversal was required on inputs, inputs contained in semi-finished and finished goods by virtue of rule 3(5C) of CENVAT Credit Rules, 2004.

As the issue of reversal of credit on inputs got settled in Central Excise regime after substantial debates, the law makers have taken care of it while drafting Goods and Service Tax law.

Legal provisions related to loss of goods under Goods and Service Tax regime

Section 17(5)(h) of Central Goods and Service Tax Act, 2017: -

In GST, section 17(5) of Central Goods and Service Tax Act, 2017 prescribes the cases where input tax credit is not allowed. The relevant part of this section, prescribing the reversal in case of loss of goods, reads as follows: -

"(5) Notwithstanding anything contained in sub-section (1) of section 16 and sub-section (1) of section 18, input tax credit shall not be available in respect of the following, namely: -

> *17 (5) (h) -goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples; and*

The analysis of section 17(5)(h) of Central Goods and Service Tax Act, 2017 clarifies that the ITC shall not be available in respect of goods lost, stolen, or destroyed.

Rationale behind section 17(5)(h) and ifs and buts attached to it: -

ITC is allowed in any indirect tax regime to eliminate the cascading effect. In other words, where the outward supply is leviable to tax, the tax element included in the inward supplies is allowed as ITC. Clause (h) of section 17(5) restricts the input tax credit in specified cases where tax is not payable on outward supplies. This clause covers the cases of goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples. In such case, no tax is payable. Therefore, it is logical also that the input tax credit on the respective inward supplies should not be allowed.

However, there are several complexities attached to this clause. The scope of Goods and Service Tax law is very wide, and it covers several cases where tax is payable even if the goods are not sold against consideration. These are the cases listed in schedule I of Central Goods and Service Tax Act, 2017. Thus, these will be typical cases where the tax is payable on the supply of goods for which no consideration is received. In other words, tax will be payable, however, no ITC will be available if the case is listed in section 17(5)(h). One such issue was faced by trade in respect of distribution of samples which was later clarified by way of issuance of Circular No. 92/11/2019-GST dated 7th March , 2019 by Board. The issue was related to common practice followed by certain sectors like the pharmaceutical sector which often provide drug samples to their stockists, dealers, medical practitioners, etc. without charging any consideration. If these free samples are given to its related or distinct person, the activity falls in definition of supply, thus, tax is payable on the same even if no consideration is involved. Tax is payable on outward supply, however, no ITC is allowed as the inward supplies are prescribed under section 17(5)(h). This was perhaps against the intention of law makers, therefore, Circular No. 92/11/2019-GST dated 7th March, 2019 was issued to clarify the situation. In this Circular, it was clarified that where the activity of distribution of gifts or free samples falls in Schedule I of the said Act, the supplier would be eligible to avail of the ITC.

Can analogy drawn by Circular no. 92/11/2019-GST dated 7th March, 2019 be applied in case of fire accidents?

The intention behind issuance of Circular no. 92/11/2019-GST dated 7th March 2019 is to remove the blockage in input tax credit. In case of fire accidents, 100% destruction is rare. There is always some scrap that is sold in the market against some consideration. Can the sale of scrap of outward supply be equated with normal supply to claim the input tax credit on the inward supplies? It may be interpretated this way however, this interpretation is prone to litigation.

Though tax is payable on scrap, yet the admissibility of input tax credit cannot be debated merely on fact of payment of tax on scrap, particularly when the finished goods have completely lost their identity and there is no value addition in the said transaction. This happens more when the lawmakers have specifically used the word "lost, stolen or destroyed" which themselves means the said goods cannot be used for intended purpose or sold as such. Further, the overriding effect given to section 17(5) also clarifies the intention of law makers where there is no outward supply or if there is outward supply with no value addition, the input tax credit should not be allowed.

It is also interesting to check if the insurance claim is received against the said loss, whether the person has option to pay tax treating it as supply and claim the input tax credit pertaining to it. However, the option doesn't seem to be available within the current tax framework. Insurance claims are types of actionable claims which are outside the purview of Goods and service tax by virtue of para 6 of schedule III of Central Goods and Service Tax Act, 2017. So, there is no option to pay tax on outward supply in case of fire accidents and claim the input tax credit. Thus, the benefit of above-mentioned Circular dated 7th March 2019 is not admissible.

Burning issues in GST arising in case of mishaps and fire accidents

1) Mystery of phrase "in respect of"

Section 17(5)(h) restricts the ITC *in respect of* goods lost, destroyed, stolen, or written off. However, to what extent the input tax credit should be denied, is subject to several interpretations. One school of thought, is of the opinion that this section restricts the input tax credit only on the inputs and not in cases where the input has already changed its form in process of manufacture. This is so interpreted because once input enters in the manufacturing process, it can be said to be used in course or furtherance of business. As the language of section 17(5)(h) uses the phrase *"input tax credit shall not be allowed in respect of goods lost, stolen, destroyed, etc."*, the followers of this school of thought are of the view that the ITC will be denied only if the said goods itself is lost, stolen, or destroyed.

However, there is another school of thought which interpret this phrase - "in respect of" in wider terms. According to them, the term "in relation to" must be given an extended meaning, thus, ITC should be denied irrespective of fact whether input has changed its form or not. This school of thought

therefore holds a view that input tax credit is denied on inputs, inputs contained in semi-finished goods as well as in finished goods. This approach is more likely inspired from erstwhile Central Excise Regime.

Well, amidst this debate of interpretations, Revenue Department is super clear about its approach, and it always follow the second school of thought. As such, in case of fire and other mishaps, reversal is demanded on inputs, inputs contained in semi-finished goods and inputs contained in finished goods.

2) Loss of inputs - in transit & during manufacture

In Central Excise Regime, no ITC was allowed on the inputs not received in the factory as the said inputs will never be used in the manufacturing process. However, a normal transit loss of inputs was allowed by various appellate authorities in Central Excise Regime. In the case of ***Hindalco Industries Ltd. v/s Commissioner of Central Excise, Allahabad,*** reversal of credit was sought by Revenue Department on account of short receipt of inputs. However, hon'ble Delhi CESTAT vide final order number 259/2009-EX dated 23rd March 2009 allowed the credit on the grounds that short receipt of inputs by just 0.08% to 0.38% is nominal and should not be a ground of reversal.

Similar situation is there in GST as well. Clause (b) of section 16(2) of Central Goods and Service Tax Act 2017 specifically mentions that the receipt of goods or services is must for the availment of input tax credit. Thus, no input tax credit is allowed if the goods are lost in transit due to fire or any reason.

However, there is different story in the case of process loss. In the case of *ARS Steels & Alloy International*

(P.) Ltd. v/s State Tax Officer, Group-I, Chennai, hon'ble Madras High Court on 24th June 2021 has held that where loss in consumption of inputs is inherent to manufacturing process, the reversal is not required as it does not fall in ambit of section 17(5)(h). Though this judgment is related to process loss, however, its analogy may be applied in case of short receipt of inputs due to inherent nature of goods.

Loss of goods by fire or accident is critical for any business. Apart from risking loss of customers and financial crisis, its tax implications are severe, particularly under Goods and Service Tax.

3) Capital Goods lost in fire

Capital goods are defined in section 2(19) of Central Goods and Service Tax Act, 2017 as follows: -*"Capital goods" means goods, the value of which is capitalised in the books of account of the person claiming the input tax credit and which are used or intended to be used in the course or furtherance of business;*

Thus, capital goods are also goods, hence will be duly covered in the ambit of section 17(5)(h) which is applicable on all types of goods which are lost, stolen, destroyed, etc. Thus, reversal is also required on the capital goods as may be inferred from the language of section 17(5)(h). But how much input tax credit is required to be reversed on capital goods destroyed is an unsolved mystery in view of following:

- Language of section 17(5)(h) states that 'NO' input tax credit is allowed on capital goods destroyed or lost. Thus, as per principle of literal interpretation, Revenue Department demands 100% reversal on capital goods in case of mishaps.
- On the flip side, according to the taxpayers, framing of provisions in Goods and Service Tax law clarifies that the effective life of capital goods is deemed as five years, so, input tax credit attributable to remaining effective life of capital goods will be required to be reversed.
- There is no clarity as to whether reversal is required on those capital goods which were purchased in erstwhile indirect tax regime and credit of Central Excise Duty or VAT was availed and the said credit was transitioned through TRAN-1?
- If reversal is required, it will be covered under which rule? There is no rule specifying the manner of computation of reversal of input tax credit on capital goods lost by fire. Whether you may choose not to reverse any input tax credit following the doctrine of *"Lex non Cogit Ad impossibilia"* mentioning that it is not possible to compute the reversal in absence of any rule specifying the manner of such reversal.
- Alternatively, whether such reversal can be computed under rule 40(2) or rule 44(6) of Central Goods and Service Tax Rules, 2017? As per language of these rules, these are applicable only in case of supply of capital goods. Whether it can be applied in case of capital goods lost in fire? Clarification is needed on this matter.

Conclusion

Loss of goods by fire or accident is critical for any business. Apart from risking loss of customers and financial crisis, its tax implications are severe, particularly under Goods and Service Tax. Above all, there is no clarity on the issue of reversal at all, neither a Circular nor any judicial pronouncement. However, there is an Advance Ruling given by AAR-Telangana on 2nd September 2023 in the case of ***GEEKAY WIRES LTD.***. In this ruling, the Authority for Advance Ruling held that reversal is required on the inputs already used in manufacture of finished goods and finished goods are destroyed in fire accident completely. Now what? Should a person who had fire accident in his premise be afraid of this ruling? Certainly not. As per section 103 of Central Goods and Service Tax Act, 2017 an advance ruling is binding only on the person who sought it and on the concerned jurisdictional officer in this respect. So, the issue is still under consideration.

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