The Sage of Refund of Input Services vis-à-vis Inverted Duty Structure – Supreme Court Decision in VKC Footsteps India

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The recent judgment of Honourable Supreme Court in the matter of Union of India vs. VKC Footsteps India Private Limited[1] is a bitter pill but much needed one. The said judgment serves as a foundation for the future of the goods and service tax litigation in the country. The much hyped belief 'one nation, one tax' needed a jolt and the same was served by the Honourable Supreme Court. In this piece, we would provide a detailed analysis of the issue, the history before the matter reached to Supreme Court, the verdict of Supreme Court and conclude the piece by contributing our view and the impact of the said judgment on the future cases.

The Issue:

Section 54 of CT Act[2] provides for refund of tax. Section 54(3) provides for refund of unutilised input tax credit in two scenarios. One, zero rated supplies without payment of tax. Two, the crux of the current article, where credit has accumulated on account of rate of tax on inputs being higher than rate of tax on output supplies (colloquially known as 'inverted duty structure[3]'). The said refund is subjected to conditions, limitations, and safeguards. Rule 89 of CT Rules[4] deals with application for refund of tax and others. Rule 89(5) lays down the formula for arriving the maximum refund amount eligible for scenarios involving inverted duty structure. The said sub-rule has been amended multiple times before taking the current form.

On a bare perusal of Section 54(3), it is evident that, refund of inputs is being granted, when the rate of output supplies, be it goods or services is lower than the rate of inputs. In simple words, if the rate of inputs is 18% and the assessee is engaged in supply of output goods which are subjected to tax at 5%, then assessee is eligible for refund of unutilised input tax credit due to inverted duty structure. The same holds good for output services. However, the said section restricts the credit of input services which are taxed at higher rate from claiming of refund, which are used for supplies of goods or services which are subjected to lower rate. In simple words, the credit of inputs would be granted and not the input services in the scenario of inverted duty structure.

The main contention of the assessee is that the refund of credit of input services should also be allowed in inverted duty structure scenario. The assessee pleaded that Rule 89(5) provides a restriction on granting of refund of credit of taxes paid on input services involved in an inverted duty structure, which is not barred by the main section that is, Section 54(3) for the reason that the said section uses the expression refund of 'any' unutilised credit, which should include the input services also. The alternate plea was that, if at all there was a restriction in Section 54(3), then the said section is ultra-vires, because it creates a discrimination between input and input services.

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[1] 2021 (9) TMI 626 – Supreme Court

[2] Central Goods and Services Tax Act, 2017

[3] In this structure, the rate of outputs would be lower than the rate of inputs. Because of this peculiar situation, the assessee will never be in a position to utilise his input tax credit. For example, let us say, the rate of output supplies is 5% and the rate of main raw material used for manufacture of such output supplies is 18%. Since the input rate is higher than output rate, the input tax credit would always be available with the assessee, if he is engaged only in a single supply. In such circumstances, in order to relieve the burden of input tax credit, the refund of balance input tax would be granted.

[4] Central Goods and Services Tax Rules, 2017

This is the precise issue before the Honourable Supreme Court. The Court is required to opine, whether Rule 89(5) provides for an embargo which Section 54(3) does not create or if Section 54(3) creates such an embargo, is that possible? Before getting into the analysis of the judgment delivered by the Supreme Court, let us understand the history before the matter was put before the Honourable Court.

The History:

In VKC Footsteps India Private Limited vs. Union of India[5] - Gujarat High Court:

The Gujarat High Court, while dealing with the challenge to Rule 89(5) stated that, when Section 54(3) allows the refund of '**any'** unutilised input tax credit, the restriction placed under Rule 89(5), to restrict the refund only to credit of taxes paid on inputs and not on input services is travel of the rule beyond the section and accordingly held not to be permissible. The Gujarat High Court ordered to grant the credit of taxes paid on input services in the scenario of inverted duty structure, disregarding the provisions of Rule 89(5).

In TVL Transtonnelstroy Afcons Joint Venture & Others vs. Union of India & Others[6] – Madras High Court:

The Madras High Court, while dealing with challenge to Section 54(3) and Rule 89(5), has held that, there is a clear prescription in the Section 54(3)(ii) to restrict the refund of credit only to the tune of inputs. In light of such a clarity, there is no requirement to read input service into the inputs. The Madras High Court has also held that the Rule 89(5) is intra-vires to Section 54(3). The Court stated that refund is a statutory right and extension of the benefit only to the unutilised credit that accumulates on account of rate of tax on input goods being higher than rate of tax on output supplies by excluding unutilised input tax credit that accumulated on input services is a valid classification and a valid exercise of legislative power.

The Union of India has challenged the Gujarat High Court judgment before the Honourable Supreme Court and that was how the Supreme Court had occasion to deal with the subject issue.

Before Honourable Supreme Court:

Submissions by Union of India:

The pleadings by Union of India are that there is a clear distinction between goods and services right from the constitutional level to the legislature level. The interpretation canvassed by the assessee that refund of input services should also be given because the expression 'any' was used in the opening paragraph of Section 54 is not in accordance with settled interpretation of law. This is for the reason that in conspicuous terms, in the first proviso to Section 54(3) which deals with refund in scenario of inverted duty structure, only inputs was used. When there was clear prescription restricting the refund only to the tune of inputs, there cannot be any reading of input services into such expression. The Union of India pleaded that the expression 'any' was used because the first proviso was dealing with two scenarios, which deals with grant of refund of inputs and input services. Hence, in a broader way to cover both scenarios, the opening paragraph used the expression 'any' and the same cannot be used to interpret that it include input services also in the ambit of inputs, while interpreting the provisions of Section 54(3)(ii). The Union concluded its pleadings by submitting that the constitution only guarantees that the levy should be legal and collection of tax should be in accordance with the law, but there is

[5] 2020 (7) TMI 726 – Gujarat High Court
[6] 2020 (9) TMI 931 – Madras High Court

no constitution right to refund. It is further pleaded that even in light of the nine member bench of Honourable Supreme Court in the matter of Mafatlal Industries Limited[7], where the tax was held to be illegal, the refund was not granted in automatic manner unless it is proved that there was no unjust enrichment. Hence, the pleadings were made to state that refund is not a constitutional right but a statutory prescription and can be always subjected to restrictions and conditions and restriction of refund only to the tune of inputs in case of inverted duty structure is one such restriction and which is in accordance with the law.

Submissions by Assessees:

The assessee contended that proviso only provides for cases in which the refund under the main provisions of Section 54(3) will be available. Once the requirement of inverted duty structure in proviso (ii) is fulfilled, the entire unutilised credit has to be refunded. The assessee contended that Circular 79/53/2018 – GST stated that where GST on some inputs is higher than the rate of GST applicable on output supply, while the rate of GST on other inputs is lower than the GST on the output supply, the circular provides that refund will be granted by taking the credit availed on all inputs, including input services, which attract a lower rate of tax than on output supply. The assessee's contention is that circular, in other words, does not treat Section 54(3) read with proviso (ii) as qualifying the extent of refund but only as a pre-condition to qualify for the grant for refund. It was contended that proviso to Section 54(3) lays down 'cases' where refund is eligible but it does not define the quantum of refund. It is also further contended that the distinction between inputs and input services is only relevant at stage prior to availment of credit but once availed, it goes into a common pool, where the distinction diffuses. Alternatively, it is also pleaded the 'rate of tax on inputs' must be read to include whatever goes in making of output supplies namely, both input goods and input services. Accordingly, the restriction placed by Rule 89(5) restricting the refund only to the inputs is pleaded as ultra-vires the Section 54(3).

Another set of arguments made by assessee are that the object and purpose of Section 54(3) must be borne in mind and purpose of the provision is to give effect to the doctrine of equivalence which is the basic objective of GST and this is sought to be achieved by granting seamless credit. It was contended that the expression 'input' in the proviso if read contextually, and not by the strict statutory definition, would cover both input goods and input services. It is contended that the doctrine of reading down the words of statute to save its constitutional validity also includes reading up. If two views are possible, the one which ensures that the provision is constitutionally valid must be adopted.

Analysis by Supreme Court:

On Interpretation of Section 54(3):

The Supreme Court after setting out the legal provisions has started to dissect the provisions of Section 54(3). The Court distributed the provisions of Section 54(3) into main tier and three provisos. The main part of the sub-section (3) provides that a registered person may claim refund of unutilised input tax credit at the end of the tax period. The Court stated that the first tier is the main provision of Section 54(3) which lays down four conditions: a claim of refund, by a registered tax person, of any unutilised input tax credit and at the end of any tax period. The second tier is the first proviso, which begins with the expression 'no refund of unutilised input tax credit shall be allowed in cases other than', which is followed by sub-clause (i) and (ii). The opening line of first proviso contains two significant expressions, namely, 'no refund shall be allowed' and 'in cases other than'. The Court

[7] 1997 (5) SCC 536

stated that the expression 'allowed' in the proviso must be contrasted with the expression 'claim' in the substantive part of sub-section (3). A refund can be allowed only in the eventualities envisaged in clause (i) and (ii) and the expression 'other than' operates as a limitation or restriction. The third tier of Section 54(3) contains of the two clauses of the first proviso which deal with two distinct cases. Clause (i) deals with zero rated supplies made without payment of tax, while Clause (ii) deals with credit which has accumulated on account of rate of tax on inputs being higher than output supplies. The Court after referring to various reports of empower committed before introduction of GST, stated that, Parliament, took legislative notice of a specific eventuality namely 'where the credit has accumulated on account of the rate of tax on inputs being higher than the rate of tax on output supplies' would be cognizant of the fact that credit may accumulate for a variety of reasons, of which an inverted duty structure is one situation.

The Court stated that there is a clear distinction between clause (i) and (ii) of the first proviso. In the case of exports, the contingency is zero rated supplies without any distinction between input goods or input services. In contrast, for domestic supplies, clause (ii) relates to accumulation of credit on account of rate of tax on inputs being higher than the rate of tax on output supplies. The Court stated that legislative draftsperson has made a clear distinction between clause (i) and clause (ii) of the first proviso and it was in this context that the opening words of Section 54(3) have used the expression 'may claim refund of **any** unutilised credit'. The Court accordingly held that clause (ii) of the first proviso in other words ***is a restriction and not a mere condition of eligibility.***

The Court summarised the submissions made by assessees into three planes. The first plane on which the submission has been urged is that the purpose of enacting Section 54(3) was to ensure against cascading effect or 'sticking' inputs tax. The assessee's submission that GST regime is a result of a long-standing exercise of legislative preparation in the doctrine of equivalence and tax neutrality. According to the submission, the doctrine of equivalence postulated an equivalence between goods and services in the VAT regime, which must be a fortiori be so under the auspices of unified GST legislation which contemplates that businesses are only pass-through entities. The second plane of submission is that the function of GST Council, as specified in Article 279A(6), is that it is to be guided by the need for harmonized structure of GST and a harmonised national market for goods and services. Article 366(12A) provides levy of GST on both goods and services and it was urged that except for rates, the goods and services are equal. The assessee's contended that when neutrality was not intended, as in the case of Section 17(5), a specific provision has been made by the legislature where the credit cannot be availed in those cases. Once the threshold is crossed, goods and services are to be treated similarly and the input services has to be read into inputs in proviso (ii) to Section 54(3). The third plane of submission is that an inverted duty structure arises in many cases where the rate of tax on output supplies is reduced in order to fulfil certain objectives guided by public interest such as an encouraging infrastructure development. In this backdrop, it was submitted that where the reduction of rate of tax on outward supplies is in pursuance of the policy of the state, the ultimate objective of achieving tax neutrality must be given full effect by fully effectuating a refund under Section 54(3) by allowing a refund of unutilised credit, whether relatable to goods or services.

On Doctrine of Equivalence:

The Court brushed away the doctrine of equivalence by stating that said doctrine dwelt on the economic rationale underlying the enactment of service tax[8]. The economic rationale is based on the equivalence of goods and services, both of which are instruments for the satisfaction of human needs. The principle recognizes that there is, in economic terms, an equivalence between production or manufacture of saleable goods and production of marketable and saleable services. The Court stated that the issue before them, is, however, whether an a priori equivalence between goods and services for the purposes of bringing both within a composite tax regime must result in the conclusion that a refund of unutilised credit must be made available to both input goods as well as input services, disregarding the provision which has been inserted by the legislature in the present case in the form of Section 54(3). The Court stated that the answer to the above is a clear no. The Court stated that while interpreting the provisions of Section 54(3), the effect has to be given in plain terms. **The Court stated that it cannot redraw legislative boundaries on the basis of an ideal which the law was intended to pursue.** The Court also rejected the contention of the assessee that the expression 'inputs' used in Section 54(3) has to be interpreted to include input and input services, for the reason that there is a definition for 'input' but not for 'inputs'. The Court stated that there is no harm in applying the normal principal of interpretation to understand the plural in the same plane as singular and held that accordingly 'inputs' has to be interpreted as 'input' and cannot be read to include input services. Para 60 of the judgment needs to be read in verbatim to drive home certain important points:

*The jurisprudential basis furnishes a depiction of an ideal state of existence of GST legislation within the purview of a modern economy, as a destination-based tax. But there can be no gain saying the fact that fiscal legislation around the world, India being no exception, makes complex balances founded upon socio-economic complexities and diversities which permeate each society. The form which a GST legislation in a unitary State may take will vary considerably from its avatar in a nation such as India where a dual system of GST law operates within the context of a federal structure**. The ideal of a GST framework which Article 279A(6) embodies has to be progressively realized. The doctrines which have been emphasized by Counsel during the course of the arguments furnish the underlying rationale for the enactment of the law but cannot furnish either a valid basis for judicial review of the legislation or make out a ground for invalidating a validly enacted law unless it infringes constitutional parameters.** While adopting the constitutional framework of a GST regime, Parliament in the exercise of its constituent power has had to make and draw balances to accommodate the interests of the States. Taxes on alcohol for human consumption and stamp duties provide a significant part of the revenues of the States. Complex balances have had to be drawn so as to accommodate the concerns of the states before bringing them within the umbrella of GST. **These aspects must be borne in mind while assessing the jurisprudential vision and the economic rationale for GST legislation. But abstract doctrine cannot be a ground for the Court to undertake the task of redrawing the text or context of a statutory provision. This is clearly an area of law where judicial interpretation cannot be ahead of policy making. Fiscal policy ought not be dictated through the judgments of the High Courts or this Court. For it is not the function of the Court in the fiscal arena to compel Parliament to go further and to do more by, for instance, expanding the coverage of the legislation (to liquor, stamp duty and petroleum) or to bring in uniformity of rates. This would constitute an impermissible judicial encroachment on legislative power. Likewise, when the first proviso to Section 54(3) has provided for a restriction on the entitlement to refund it would be impermissible for the Court to redraw the boundaries or to expand the provision for refund beyond what the legislature has provided**. If the legislature has intended that the equivalence between goods and services should be progressively realized and that for the purpose of*

[8] The assessee has relied on the judgment of Association of Leasing and Financial Service Companies 2011 (2) SCC 352 in the service tax era.

determining whether refund should be provided, a restriction of the kind which has been imposed in clause (ii) of the proviso should be enacted, it lies within the realm of policy.

(emphasis supplied by us)

On Interpretation of Proviso – Condition vs Restriction:

The Court also rejected the contention of the assessee's that proviso is only a condition but not a restriction. The Court after making reference to the Principles of Statutory Interpretation by Justice GP Singh and various judgments on the interpretation of proviso has held that the provisions of Section 54(3) has to be juxtaposed together with all features of statutory provisions namely Explanation I. On such an analysis, it is clear that, on a reading of provision as a whole, clauses (i) and (ii) of the first proviso are restrictions and not mere conditions of eligibility. The Court stated that in substance, the assessee's submissions boils down to an effort to hold that in spite of the language which has been used in clause (ii) of the first proviso, input services must be read into inputs is impressible. The Court stated that no constitutional right can be asserted to claim a refund, as there cannot be. Refund is a matter of statutory prescription and Parliament is within its legislative authority in determining whether refunds should be allowed on unutilised credit qua goods alone or goods and services. The Court conclude that in the case of Section 54(3), the parliament has determined to allow only the credit on goods and accordingly it is well within the legislative authority.

On Class Legislation – Challenge on Article 14:

On the class legislation, the Court stated that the precedents provide for abundant justification for the fundamental principle that a discriminatory provision under the tax legislation is not per se invalid. A cause of invalidity arises where equals are treated as unequally and unequals are treated as equals. Both under Constitution and the CGST Act, goods and services and input goods and input services are not treated as one and the same and they are distinct species. The Court concluded by stating that Parliament while enacting Section 54(3), legislated within the fold of the GST regime to prescribe a refund and as stated earlier, when the is neither a constitutional guarantee nor a statutory entitlement to refund, the submission that goods and services must necessarily be treated at par as contended by the assessee was not acceptable.

On Vires of Rule 89(5):

The Court then proceeded to take up the arguments that Rule 89(5) is invalid because, it was not born out of 'prescribed' used in the Act. The argument was that since Section 54(3) nowhere uses the expression 'prescribed', the Government cannot exercise its authority under Section 164 of CGST Act to frame rules for other sections. The Court rejected the above submission by stating that the absence of expression 'prescribed' cannot be taken to understand that the Government does not have power to frame rules for such instances. The Court held that as long as the rules are consistent with the provisions of the parent enactment, the Government would still have the power to make rules. Accordingly, it was held that though the expression 'prescribed' does not appear in Section 54(3), the Government under its wide powers vide Section 164 is legally competent to prescribe the formula in terms of Rule 89(5).

On Arithmetic of Rule 89(5):

The Court rejected the contention of the assessee that Rule 89(5) has to be struck down because of existence of anomaly. The said rule for arriving the maximum amount eligible as refund asks to reduce the tax payable on such inverted supply of goods from the proportionate credit pertaining to inverted rate of supply of goods. In a sense, the rule presumes that the tax payable on the inverted supply of goods is completely discharged from the input tax on goods and completely disregards a possibility that there exists input services also. By adopting this method, the rule restricts the maximum eligible amount of refund under Section 54(3). This was the anomaly challenged by the assessee and pleaded that the said rule containing the said anomaly should be struck down. The Court stated that by changing the formula to accommodate the usage of credit of both input and input services, the balance would entirely tilt towards assessee. The Court suggested that the said anomaly may be fixed with both parties winning, may be, by fixing a statutory assumption or deeming fiction of utilisation of certain percentage of credit on input services towards the payment of output tax for purposes of calculation of refund. The Court further stated that a rule cannot be struck down just because there is an anomaly, since an anomaly cannot result in invalidation of a fiscal rule which has been framed in exercise of power of delegated legislation. The Court held that since the formula is not ambiguous in nature or unworkable, nor it is opposed to the intent of legislature in granting limited refund on accumulation of unutilised credit, the same cannot be struck down. The Court, however, asked the GST Council to look at the anomalies pointed out by the assessee and to take a policy decision on the said aspect.

Conclusion:

As stated in the opening remarks, this judgment lays down a foundation for the future litigation. This judgment has in candid way stated that legislative boundaries cannot be redrawn on the ideal which the law was intended to achieve. The current judgment sets a tone and direction for the future litigation in GST areas, since there are numerous judgments which have gone by the ideals on which GST is conceived rather than the statutory language. For all such judgments in the further rounds of litigation, this judgment would be a show stopper. One of such is the judgment of Honourable Orissa High Court in Safari Retreats Private Limited[9], wherein the provisions of Section 17(5)(d) were struck down since they are frustrating objectives of the GST laws which is intended to make uniform provision for levy, intra state supply of goods and services and to prevent multi-taxation. Since the said matter has already reached the Honourable Supreme Court, it has to be seen, how the Supreme Court reacts to that in light of the current judgment.

[9] 2019 (5) TMI 1278 – Orissa High Court