Rationalization of credit and decriminalization of offences

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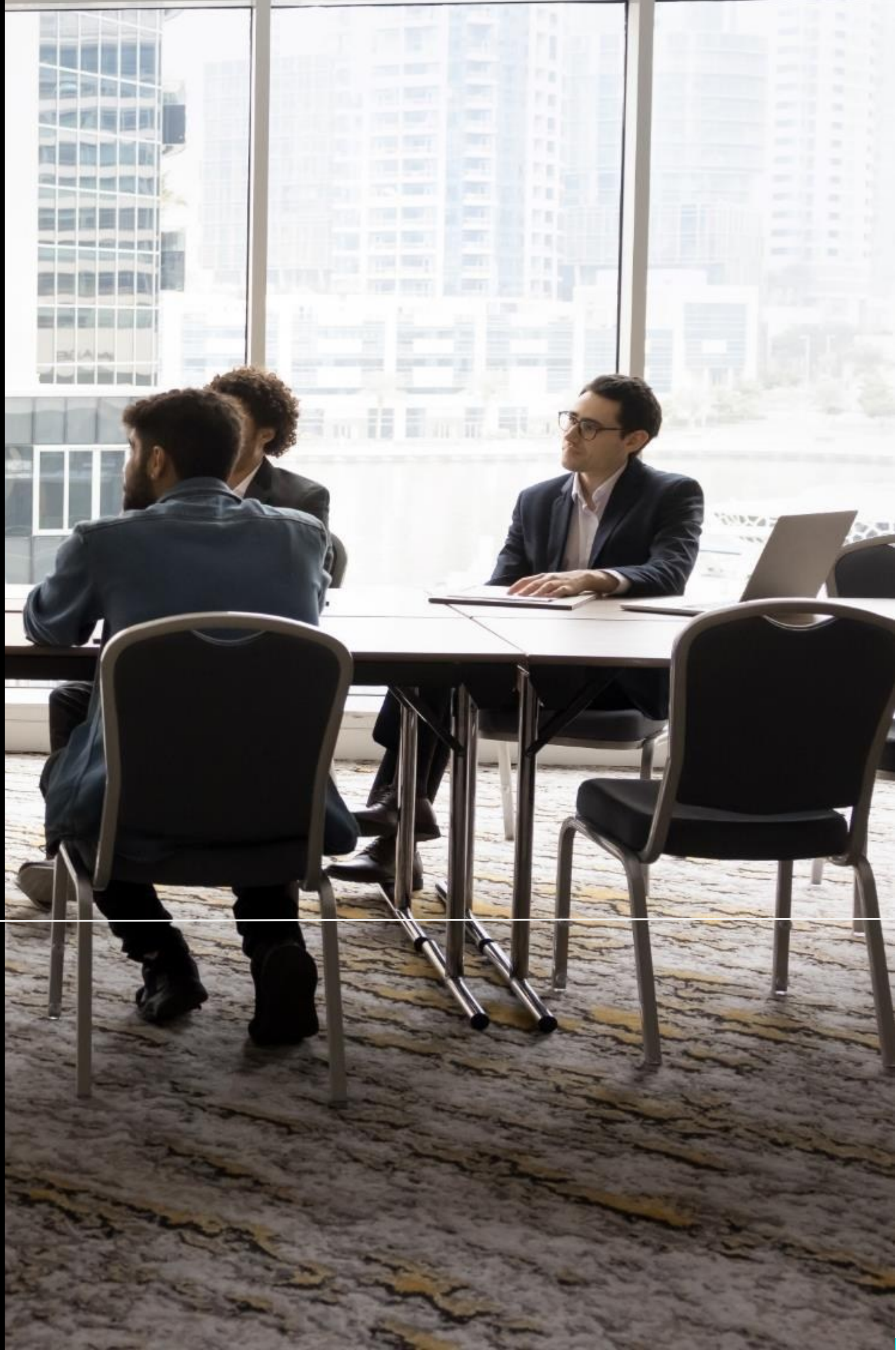
Rationalization of Section 17(5)



Rationalizing of Input Tax Credit under Section 17(5) (1/3)

- **Denial of ITC on inward supplies falls under Section 17(5) of the Central Goods and Services Tax (CGST) Act, 2017**
  - Section 17(5) of the CGST Act, 2017 specifies a list of inward supplies on which is not available to registered person irrespective of whether the same is used in the course or furtherance of business or not, except under specific circumstances as specified therein.
  - Such denial of ITC leads to increased cost burden, adversely affecting the working capital and restricting the free flow of funds of the taxpayer. Accordingly, ITC should be allowed on such expenses incurred in the course of business operations.
  - In this regard, the categories of inward supplies covered under Section 17(5), the basis for restriction of ITC, and the rationale for allowing credit are provided in the table below

<table>
<tr><th>Clause</th><th>Nature of blocked credit</th><th>Rationale</th></tr>
<tr><td>Clause (a)</td><td>Motor vehicles for transportation of persons having approved seat capacity of not more than thirteen persons (including driver), except when they are used for making
• Further supply of such motor vehicles or
• Transportation of passengers or
• Imparting training</td><td rowspan="3">• ITC should be allowed on in respect for expenses incurred on procurement or hiring/ renting of motor vehicle as the same is critical for daily operations in industries such as IT/ITES, airports, and mining, as well as for manufacturing, particularly in remote locations

• Several jurisdictions globally, including Australia, the United Kingdom, and Germany, allows ITC on such expenses, recognizing them as legitimate business costs incurred in the course of business activities.

• As the use of motor vehicles is essential for carrying out business activities, the costs related to their maintenance , repair, insurance are directly linked to the functioning and continuity of the business. Accordingly, ITC should be allowed on such expense.</td></tr>
<tr><td>Clause (b)</td><td>Renting/hiring of motor vehicles except where the same is used in relation to motor vehicles used for purposes specified therein.</td></tr>
<tr><td>Clause (ab)</td><td>Services of general insurance, servicing, repair and maintenance of vehicles specified in clause (a) except where the same is used in relation to motor vehicles used for purposes specified therein.</td></tr>
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Rationalizing of Input Tax Credit under Section 17(5) (2/3)

Clause	Nature of blocked credit	Rationale
Clause (b)	**Food and beverages, outdoor catering** except where it is • obligatory for an employer to provide the same to its employees under • any law for the time being in force.	• These expenses are frequently incurred for legitimate business purposes, such as employee welfare, business meetings, and client engagements. • Allowing ITC on such expenses would reduce the cost burden on businesses and align India's GST framework with global practices followed in jurisdictions such as the United Kingdom, Canada, and Germany.
Clause (b)	**Supply of health services** except where it is obligatory for an employer to provide the same to its employees under any law for the time being in force	• In high-risk industries such as oil & gas, coal extraction, airport operations, and construction risk to employee health and safety is significant, and the use of hazardous materials often requires additional insurance coverage beyond the legal minimum. • Allowing ITC on these expenses would support businesses in managing their risk-related costs while ensuring employee welfare, thus aligning the tax system with the practical needs of high-risk industries and practice followed by Germany.
Clause (h)	**Goods lost, stolen, destroyed, written off or disposed of by way of gift or free sample**	• In industries such as pharmaceuticals and food & beverage, product expiration is an inherent part of the business cycle. Although such goods may become unusable, the associated losses arise in the course of business operations and should not result in an undue denial of ITC. • Currently, ITC is required to be reversed under Section 17(5) from the date of availment when goods are written off. It is proposed that the reversal, if any, should instead be required from the date such goods are written off in the books of account, as this better reflects the actual occurrence of the loss.

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Rationalizing of Input Tax Credit under Section 17(5) (3/3)

Clause	Nature of blocked credit	Rationale
Clause (c) and (d)	**Construction services in relation to immovable property, other than plant and machinery**, to the extent capitalised in the books of account	• . For businesses such as manufacturing plants, malls, warehouses, data centres, and hotels, buildings and fit-outs are integral to business operations and are specifically designed to meet operational requirements. • In Safari Retreats, the Hon'ble Supreme Court recognized that a building may qualify as a 'plant' based on the functionality test, thereby supporting ITC eligibility on related expenditures. however; the same has been made ineffective by a retrospective amendment in law by replacing 'plant or machinery' to 'plant and machinery' • Notwithstanding the retrospective amendment, the principle laid down in the judgment remains relevant, particularly for businesses such as manufacturing plants, malls, warehouses, data centres, and hotels, where buildings and fit-outs constitute an integral part of business operations and accordingly merit eligibility for ITC. • Further, jurisdictions such as Australia, Canada, and Singapore allow ITC on such expenses, recognizing that such infrastructure-related costs are inherently connected with the conduct of business operations.

Streamline the liquidation of ITC accumulation

Factors contributing to ITC accumulation

- **Inverted duty structure (IDS)**
  - Refund of unutilised ITC is not available on input services or capital goods (eligibility is confined to inputs), and
  - Rule 89(5) formula further caps the refund by limiting **“Net ITC”** to inputs only
- **Mandatory payment of liability under RCM in cash (Section 9(3) / 9(4) of CGST Act)** which is subsequently available as ITC (revenue neutral situation)
- **Absence of commensurate outward supply-** In several instances, taxpayers incur substantial expenditure, such as on research and development, startups, without corresponding outward supplies during the relevant period. This results in significant accumulation of ITC, leading to prolonged blockage of working capital and financial strain on the business.
- **Timing difference (Project offices/ SPVs etc) -** ITC may accumulate due to timing gaps between output tax liability and ITC availment caused by various reasons including:
  - **Tax payment on advances** – In the case of supply of services, GST is payable at the earlier of the date of issuance of invoice or receipt of payment. However, the recipient becomes eligible to avail ITC only upon receipt of services. This timing gap results in working capital blockage
  - **Mismatch between GSTR-2B and actual invoices** – Delays in receipt of invoices, non-reflection in GSTR-2B, or credit matching restrictions can defer ITC availability, resulting in eligible credit remaining unavailed and causing liquidity constraints
- **Mandatory requirement to take registration in each state** –
  - Multi-State entities often accumulate ITC in certain GST registrations where outward tax liability is minimal, resulting in credit being effectively trapped within those States
  - Further, in cases where business operations in a particular State are discontinued or a registration is surrendered, the ITC balance in the electronic credit ledger remains unutilised due to the absence of any mechanism to transfer it to other active registrations under the same PAN

ITC accumulation across multiple sectors

- 56th GST Council Meeting, GST Council rationalised the GST rate on various supplies from 12%/ 18% to 5% with the intent to address sector-specific concerns around inverted duty structure (IDS), namely:
  - **Textile-** GST rate on manmade fibre is reduced from 18% to 5% and on manmade yarn from 12% to 5%, which are major inputs for the textile sector, while final products are taxable at 5% where the value of supply is not exceeding INR 2500 per piece; otherwise, 18%
  - **Fertilizer-** GST on key raw materials such as sulphuric acid, nitric acid, and ammonia reduces from 12% to 5%, thereby aligning tax rates on major inputs with outward GST rate
  - However, despite these efforts, IDS continue to persists all sectors (indicative)

Automobile: Electric vehicles (EVs) are taxed at 5%, but major inputs such as batteries attract higher GST rate of 18%.

Pharmaceutical: While GST on formulations has been reduced from 12% to 5%, Active Pharmaceutical Ingredients (APIs) and Key Starting Materials (KSMs) continue to attract GST at 18%, leading to rate inversion

Textiles: Inputs such as nylon chips, Purified Terephthalic Acid (PTA), Mono-Ethylene Glycol (MEG), and polyester chips are taxed at 18%, while finished textiles and garments are taxed at 5% in case where the value of supply does not exceed INR 2,500 per piece, resulting in a continued inverted duty structure

Edible oil is taxed at 5%, while most of the essential inputs such as packaging materials, chemicals, and processing inputs attract 18%

FMCG: Although most consumer goods are taxed at 5%, key inputs including flavouring agents, food additives, and packaging materials remain taxable at 18%, resulting in continued ITC accumulation

- Additionally. Post GST 2.0 majority of the input services and capital goods continue to be taxed at 18%. The same has resulted into a considerable amount of ITC accumulation especially in industries wherein the rate of inputs and output have been brought down to 5%.

Adverse impact of ITC accumulation on industry

The accumulation of ITC has emerged as a significant structural challenge for capital-intensive sectors, particularly manufacturing. With limited avenues available for monetisation or seamless utilisation, ITC balances effectively **become non-earning assets**, resulting into:

- **Working Capital Blockage:** Accumulation of unutilised ITC in the electronic credit ledger results in significant working capital being locked in, thereby constraining liquidity that is critical for day-to-day operations and capacity expansion
- **Financial Impact on Companies:** Dependence on borrowings increases, raising financing costs and capex burden (~18%). Funds that could support expansion, technology upgrades, R&D, and productivity improvements remain tied up.
- **Impact on Competitiveness of Indian Manufacturing**: Higher capital cost results into increase in production costs which adversely affects pricing flexibility and weakens the global competitiveness of Indian manufacturing and supply-chain integration goals

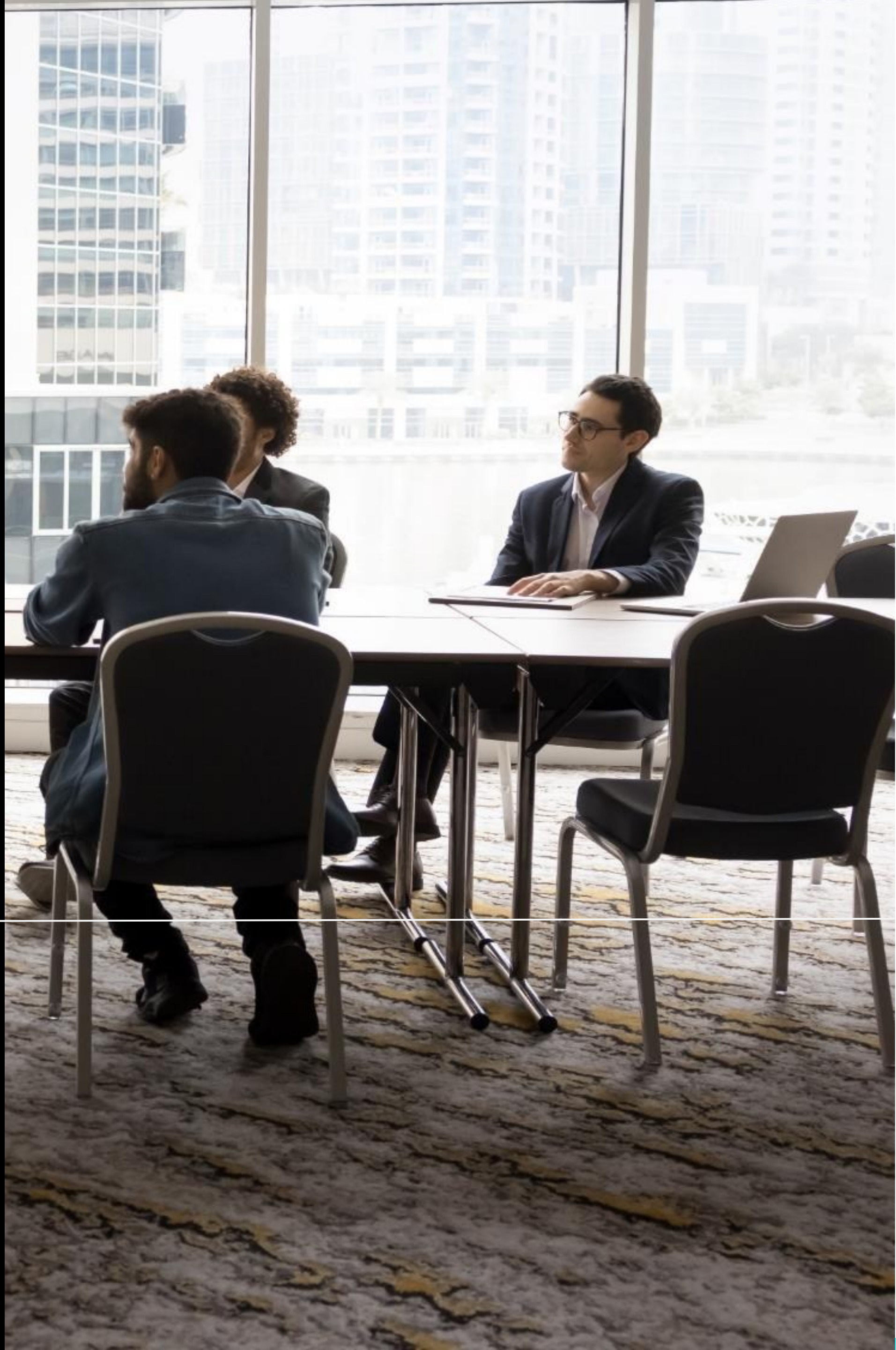
Addressing this structural accumulation and enabling faster utilisation or refund of credits is therefore imperative to restore GST neutrality, ease financial stress, and support investment-led growth

Recommendations to reduce ITC accumulation

Policy Asks *(indicative)*

- Eligibility to claim inverted duty refunds where inversion is on account of services too. (Sec 54(3))
- Allow refund of accumulated ITC pertaining to Capital goods in a phased manner
- Allow refund of accumulated ITC pertaining to Services
- Allow fungibility of ITC between distinct persons and among group companies
- Allow payment of RCM Liability via utilization of balance in electronic credit ledger
- Issuance of tradeable scrips corresponding to accumulated ITC balance in electronic credit ledger

Decriminalization of offences



Rationalization of penal provisions u/s 122

- **Challenges -**
  - Section 122 of the CGST Act read with Circular No. 171/03/2022-GST dated 6 July 2022 prescribes a penalty of 200% of the disputed amount in case of person involved in issuance of tax invoice and utilization of ITC on the inward tax invoices without underlying supply of goods [122(1)(ii)] and 100% of ITC wrongly availed and utilised [122(1)(vii)] is imposed as per the Circular.
  - No benefit of reduced penalties in case of voluntary disclosure by taxpayers of offences covered under Section 122 of the CGST Act, 2017.
  - No consideration given to mitigating factors for determining penalty amount under Section 122 of the CGST Act, 2017.
- **Recommendations -**
  - **Amendment :** A necessary amendment should be made to cap the max penalty u/s 122 to align with Section 74, as there is no legal rationale to restrict applicability of penalty u/s 74.
  - **Clarification :** Taking recourse to Section 126(5), a circular should be issued clarifying that in cases wherein no element of fraud in terms of tax evasion is involved, the penalty under Section 122 will be limited to the maximum penalty as imposed under Section 74 of CGST Act.

Decriminalisation of offences – Prosecution

S No.	Section ref	Issue	Recommendations
1	Sec. 69	Power to authorise arrest exercised by Commissioner	Power to authorise the arrest should lie with CBIC or the Principal Chief Commissioner instead of the Commissioner
2	Sec. 121	No appeal can be filed against the order sanctioning prosecution	Suitable amendment in Section 121 to allow filing of appeal against the order sanctioning prosecution
3	Sec. 132	• Absolute amount specified instead of percentage to apply provisions relating to prosecution • Genuine cases involving classification, valuation, ITC issues may be considered for prosecution proceedings	• Prosecution provisions should be made applicable only in cases where the default amount exceeds a prescribed percentage of the total tax outflow of a taxpayer instead of specified absolute amounts • Prosecution should be restricted only to cases where there is an intention to evade tax. Situations like genuine wrong classification of goods or services, valuation and those where there is no loss to the Revenue (revenue neutral) should be excluded from the provisions of section 132
4	Sec. 135	Deemed presumption of culpable state of mind	Onus should be shifted to the tax administration to prove that the offence was committed with guilty mind. This will ensure that prosecution is invoked only in hard cases of grave default

Decriminalisation of offences – Prosecution

S No.	Section ref	Issue	Recommendations
5	Sec. 137	Default due to unintentional negligence on the part of directors, etc. also treated as a punishable offence	Provision should be restricted only to cases where the offence is committed with the knowledge of the specified persons, i.e., with consent or connivance, and exclude the situations where it is attributable to negligence on the part of persons specified
6	Sec. 138	Compounding of offences allowed only once	To reduce litigation and as a part of settlement mechanism, the provisions relating to compounding should not be restrictive and may be allowed for repetitive offences also
7	Sec. 159	Power to publish information in respect of persons may be exercised injudiciously	• Such powers should be exercised in rarest of rare cases and by the Principal Chief Commissioner with prior approval of CBIC • Adequate checks and balances need to be incorporated in the legislation to ensure that such powers are exercised in cautious manner

Thank you