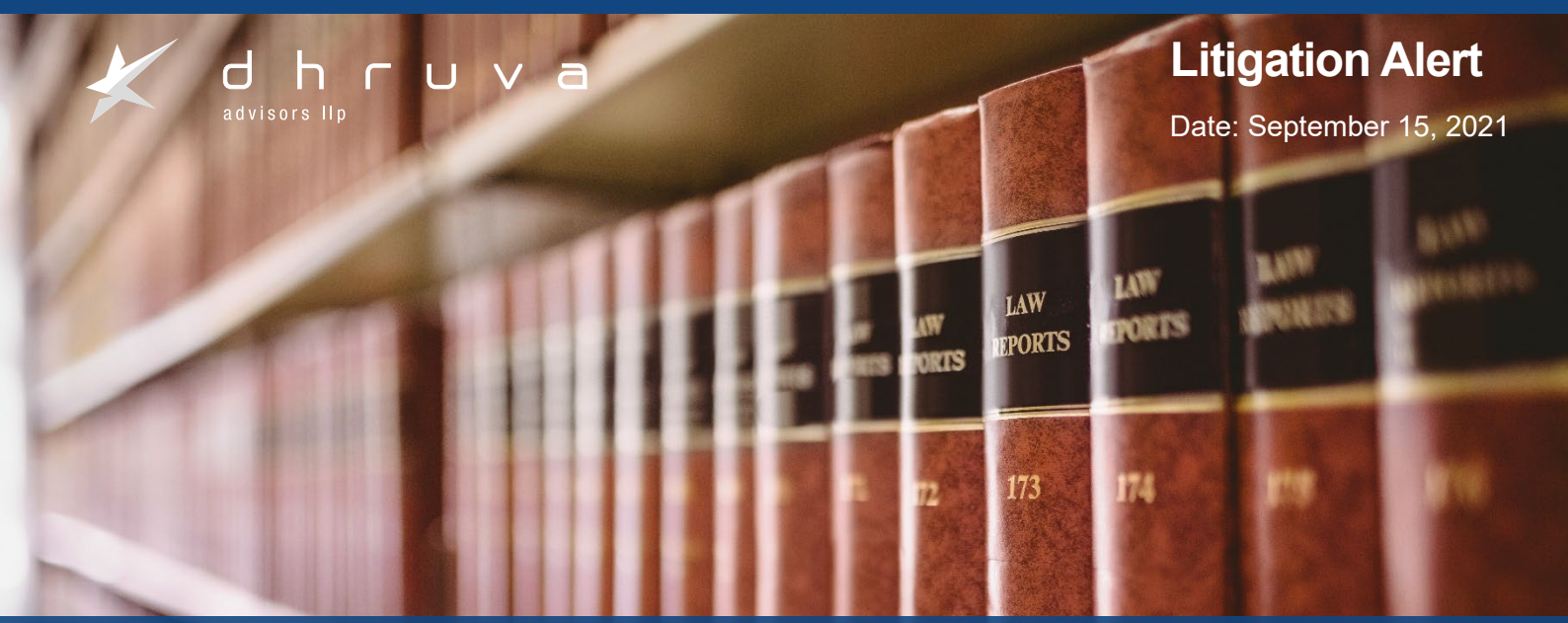

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Litigation Alert

Date: September 15, 2021

Apex court ruling rejects refund of Input services under section 54(3)

Union of India & Ors v. *VKC Footsteps India Private Limited*[1]

The Supreme Court pronounced its much-awaited verdict on the validity and coverage of Rule 89 of the Central Goods and Services Tax Rules, 2017 ('the Rules') excluding input tax credit ('ITC') pertaining to input services from refund claims filed in the case of an inverted duty structure.

Background:

- The question came up before the Hon'ble Supreme Court as a result of two sets of appeals filed against the decision of the Madras High Court,[2] upholding the exclusion of ITC of input services from such refund claims and the second set of appeals filed by the Government against the decision of the Gujarat High Court,[3] which had held the exclusion of ITC pertaining to input services in Rule 89 of the Rules as ultra vires Section 54(3) of the Central Goods and Services Tax Act, 2017 ('Act').
- The circumstances of an inverted duty structure arise when the rate of tax on inputs exceeds the rate of tax on output supplies, as a result of which the ITC remains unutilised and is accumulated. The second proviso to section 54(3) of the Act provides for refund of input tax credit. Rule 89(5) of the Rules prescribes the procedure and the method of calculating the refund amount that a taxpayer is entitled to under section 54 of the Act. The formula prescribed under Rule 89(5) of the Rules for calculating the refund amount in case of an inverted duty structure specifically excludes ITC pertaining to input services from the formula.

Judgment of the Supreme Court:

- The primary grounds raised in the initial writs and the appeals before the Hon'ble Supreme Court were Section 54 of the Act and Rule 89 of the Rules being unconstitutional on the grounds of being discriminatory and arbitrary vis-à-vis ITC pertaining to Input services. It was argued on behalf of the Government that the differentiation is as a result of class legislation, in this case the classes being (i) domestic supplier and (ii) exporters that further involve a sub-classification into (i) ITC of goods and (ii) ITC of input services and as revenue harvesting measures is not the only guiding principle for the legislature to carve out appropriate categories for the purposes of fiscal policies, and hence such

[1] 2021 VIL 81 SC
[2] *Tvl. Transtonnelstroy Afcons Joint Venture* v. *Union of India [2020 VIL 459 MAD]*
[3] *VKC Footsteps India Private Limited* v. *Union of India [2020 VIL 340 GUJ]*

differentiation is valid. The reason to invalidate a provision arises when unequals are treated as equals and equals are treated as unequals, which is not the case in the present matter.

- The challenge of constitutional validity of section 54(3) of the Act and the necessity to treat refund of unutilized ITC of input services at par with a refund of unutilised ITC of Input was not accepted as there is neither a constitutional guarantee nor a statutory entitlement to a refund of ITC. Further, both under the Constitution and the Act, goods and services and corresponding ITC of goods and services are treated as distinct categories, hence it was upheld by the Supreme Court that the Parliament is entitled to make policy choices and adopt appropriate classifications and the court cannot delve into the sphere of policy making. The Supreme Court accepted the arguments advanced by the Government that it is not possible to interpret the clause (ii) of the first proviso to section 54(3) so as to include both inputs and input services within the meaning of *input*. Considering the language used in the section currently, the court cannot read the words into the provisions as it will result in expanding the scope of the provision beyond what is permissible by the provision as it stands today.

- It was held that the parliament is well within its rights to legislate when a taxpayer will be entitled to a refund claim and the extent of it. The Supreme Court held that section 54 of the Act does not embody an eligibility criterion but a restriction which governs the right to refund claims. Based on this premise, it was held that rule 89 is not ultra vires section 54(3) of the Act. It was further held that there is no substance to this challenge, as there is no discord between both rule 89(5) and section 54(3) particularly clause (ii) of its first proviso and also the Explanation (a) to rule 89(5) in defining 'Net ITC' to mean ITC used on ITC of inputs i.e., goods is within the expanse of section 54(3) of the Act.

- With respect to the challenge of the formula prescribed for calculating the refund amount, it was held that once the principle behind section 54(3) is upheld, the formula under rule 89 rightly gives effect to this and hence cannot be struck down. However, the court did recognize that the formula does result in certain imbalances that are unfavorable to the taxpayer and urged the GST council to reconsider the formula prescribed for computation of the refund amount.

Dhruva Comments:

While this decision of the Supreme Court puts an end to the long controversy of exclusion of ITC of input services from refund claim for the past period, it will have a significant impact on the companies that have pending refund claims factoring ITC of input services and were hoping to get such refunds.

While the decision has strictly refrained from exceeding its role of judicial review and dictating to the legislature how the refund provisions should have been drafted in the present case, the reasoning on differentiation between ITC of goods and services is not convincing. While a class legislation is not ultra vires the constitution, per se, the decision does not bring out how the class of "ITC of Input services" needed different treatment, requiring exclusion from refund claims in the case of an inverted duty structure. This is specifically considering Article 279A(6) of the Constitution which mandates that the GST Council is to be guided by the need for a harmonized structure of GST and a harmonized national market for goods and services.

However, all is not lost as the suggestion by the apex court to the GST council to reconsider the formula in rule 89 will shift focus on the next GST council meeting and proposed changes to the formula to address the inequalities relating to the calculation. This will certainly offer some relief to the claimants by which certain portion of the input services would indirectly become refundable. Hopefully the GST council will look into and address this anomaly and gradually also amend the law to allow refund of input services.

ADDRESSES

Mumbai
One World Center, 11th floor,
Tower 2B, 841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road,
Ahmedabad 380015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru 560001
Tel: +91-80-4660 2500

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana 122002
Tel: +91-124-668 7000

Pune
305, Pride Gateway, Near D-Mart, Baner,
Pune 411045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal 700016
Tel: +91-33-66371000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #11-05
Singapore 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
Emaar Square Building 4, 2nd Floor,
Office 207, Downtown,
Dubai, UAE
Tel: + 971 56 900 5849

KEY CONTACTS

Dinesh Kanabar
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Ritesh Kanodia
ritesh.kanodia@dhruvaadvisors.com

Niraj Bagri
niraj.bagri@dhruvaadvisors.com

Ranjeet Mahtani
ranjeet.mahtani@dhruvaadvisors.com

Dhruva Advisors has been consistently recognised as the **"India Tax Firm of the Year"** at the ITR Asia Tax Awards in 2017, 2018, 2019, 2020 and 2021.

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