GST INPUT TAX CREDIT – ISSUES IN SEC. 17(5)(H)

CA Nihar Dharod
Email : canihardharod@gmail.com

The GST Law – India's biggest indirect tax reform completed 5 years in this year.

During its infant and toddler stage, the GST Law has given sleepless nights to the taxpayers. As the law ages, the taxpayers should expect to see some unanticipated mischiefs and tantrums of this notorious kid.

With the commencement of GST audits/assessments, taxpayers are witnessing tax demands on many unaddressed/open issues- Input Tax Credit ('ITC') being one.

One of the fundamental principles at the heart of the Goods and Services Tax Law is to allow seamless flow of ITC- to address the long outcry of the taxpayers during the erstwhile regime. Ironically, time and again, taxpayers are witnessing instances where their claim of ITC is being challenged by the tax authorities.

Reversal of ITC u/s. 17(5)(h) of the Central Goods and Services Tax Act, 2017 ('Act') on the goods lost, stolen, etc. requires some pondering. Let us try and analyse the said provision in detail.

History

The erstwhile Central Excise law also have the concept of input tax credit i.e. CENVAT. The law provided for the duty remission and credit reversal in similar cases of goods lost, stolen, destroyed, etc.

Rule 21 of the Central Excise Rules, 2002 provided for remission (i.e. waiver) of payment of excise duty if the manufactured goods have been *lost or destroyed by natural causes* or *by unavoidable accident* or are claimed by the manufacturer as *unfit for consumption or for marketing*, at any time before removal. Consequently, Rule 3(5C) of the Cenvat Credit Rules, 2004 provided for reversal of CENVAT credit on *inputs used in* the manufacture of the said goods and on *input services used in or in relation* to the manufacture of the said goods.

Also, Rule 3(5B) of the Cenvat Credit Rules, 2004 provided for reversal of CENVAT Credit on full/partial write-off or provision for write-off of inputs or capital goods.

Similar provisions also existed in some of the state VAT laws.

Thus, reversal of ITC on the grounds specified in Section 17(5)(h) existed under the erstwhile laws as well – which also saw litigation.

Issue 1: Scope and Coverage of reversal

Section 17(5)(h) states that ITC shall not be available '**in respect of**' –'**goods**' – (A) lost, (B) stolen, (C) destroyed, (D)written off or (E) disposed of by way of gift or free samples.

Goods has been defined in Section 2(52) of the Act to mean '*every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply*'.

Whereas input has been defined as '*goods other than capital goods*'.

It is pertinent to note that the term used in Section 17(5)(h) is goods and not inputs. Goods covers raw materials, packing materials, consumables, stock-in-trade, etc. (current assets as per books) as well as plant and machinery, furniture, etc. (i.e. fixed assets as per books). Thus, scope of Section 17(5)(h) is wide enough to cover all goods in GST i.e. inputs as well as capital goods.

Secondly, it is imperative to understand the meaning of the phrase 'in respect of'. The said phrase has not been defined under the GST law. However, the Hon'ble Apex Court analysed the said phrase in the case of State of Madras v. Swastik Tobacco Factory [AIR 1966 SC 1000]. The Hon'ble Apex Court held that *the phrase 'in respect of goods' means only 'on' the goods and cannot include the raw material which is processed and converted to different output. Even if the word "attributable" is substituted for the words "in respect of", the result will not be different, for the duty paid shall be attributable to the goods. If it was paid on the raw material it can be attributable only to the raw material and not to the goods.*

It is pertinent to note that Circular No. 72/46/2018-GST dtd. 26th October 2018 issued by the CBIC talks about reversal of ITC 'attributable' to the manufactured goods. The said Circular says that in cases expired goods are returned and destroyed by the manufacturer, ITC '*attributable to the manufacture of such goods*' needs to be reversed.

One may interpret that – 'in respect of goods' would have to be understood as in respect of or specific to the said goods. This interpretation would mean that ITC shall be ineligible 'only to the extent of goods' that are lost, stolen, etc.

The other school of thought would interpret to also include ITC on inputs, input services and capital goods related to the lost goods within the purview of Section 17(5)(h) [as mentioned in the Circular].However, if the legislature intended to have such wider scope, then the same would have been expressly provided -as specified in Rule 3(5C) of CENVAT Credit Rules, 2004 or the preceding provisions such as 17(5)(d) of the Act.

Further, if Section 17(5)(h) were to include all ITC (i.e. input, input services and capital goods) attributable to the goods lost, stolen, etc., the legislature ought to have provided for a mechanism to determine the same. In the absence of any mechanism, the ineligibility shall not be tenable relying on the Hon'ble Apex Court decision under Income Tax Act in the case of CIT v/s B.C. Srinivasa Setty [(1981) 128 ITR 294 (S.C.)].

Issue 2: Drafting Error or Open to Interpretation?

Chapter V of the Act covers provisions related to ITC. Section 16 of the Act provides for eligibility and conditions for claiming of ITC. Section 17 which provides for apportionment of ITC (in specified circumstances) and blocked/ineligible ITC. It is followed by Section 18 which provides for availability or reversals of ITC in specified circumstances.

Thus, a taxpayer who intends to claim ITC has to first check his eligibility and has to judiciously comply with the conditions prescribed u/s. 16 of the Act. Thereafter, he is required to check if his claim of ITC is blocked u/s. 17(5) of the Act.

If his claim is covered u/s. 17(5) of the Act, the ITC is not available – notwithstanding his eligibility u/s. 16 (1).Thus, Section 17(5) clearly blocks the very 'first' claim of ITC by a taxpayer.

In light of the provisions of Section 17(5)(h) of the Act, it is baffling that the legislature expects the taxpayer to identify whether the goods on which ITC is intended to be claimed shall be lost, destroyed, stolen or written off – thereby blocking the very 'first' claim of ITC on the said goods. It is also quite possible that the taxpayer may not even know that the goods would be given as free samples or gifts.

Here based on the drafting of the provisions, an argument can be taken - that the credit blockage/ineligibility should be considered only at the time of receipt/ 'first' claim of ITC. For example, if the goods are lost/destroyed/stolen before receipt and claim of ITC - then ITC must be blocked u/s. 17(5) but not when goods are lost/destroyed/stolen after their receipt and claim of ITC. Reliance can be placed on the decision of Grasim Industries Ltd. v/s. Commissioner [2005 (179) ELT A38 (SC)], Binani Cement Ltd. vs CCE, Jaipur [2002 (143) ELT 577 (Tri. Del.)], Spenta International Ltd. v/s. CCE, Thane [2007 (216) ELT 133 (Tri – LB)] – wherein it has been held ITC eligibility/ineligibility has to be determined at the time of claim.

Further, on can also argue that after the receipt of goods and claim of ITC, there is no provision in the GST law that requires reversal of ITC already claimed. Reliance is placed on CCE, Chennai III v/s. Joy Foam Pvt. Ltd. [2015 (322) ELT 209 (Mad.)] and Grasim Industries Ltd. v/s. Commissioner [2007 (208) ELT 336 (Tri. - LB)] wherein it has been held that in the absence of specific provisions requiring reversal of claimed ITC – reversal of ITC cannot be made.

Note: These cases of ITC reversals ought to have been part of Section 18 – wherein instances of subsequent reversals of ITC claimed earlier have been provided. The legislature may have to consider rectifying the drafting error to iron out any scope for frivolous litigation.

Issue 3: Meaning of lost, stolen or destroyed

While the Section 17(5)(h) provides for blockage of credit on goods lost, stolen or destroyed, these terms have not been defined under the law.

The dictionary meaning of lost is 'no longer possessed', 'cannot be found or brought back' or 'not made use of'.

Similarly stolen/steal would mean 'to take away from someone without their permission' or 'to take way by unjust means'.

Also, dictionary meaning of destroy is 'to damage something so badly that it no longer exists' or 'to put out of existence'.

Thus, in light of the provision, prima facie these words mean goods that no longer remain in possession of or in existence with the taxpayer such that the taxpayer may not be in a position to put them for the use in the course of business.

Various types of loss, destruction, etc. may happen in the course or furtherance of business. An illustrative list of the same has been provided as under:

A. **Process Loss:** Usage of goods in the course or furtherance of business entails subjecting the goods to various types of processes. Each process entails a set of activities to be undertaken on the goods – wherein loss of goods can be an inherent part or an unavoidable feature. Such loss is often termed as normal loss or process loss. ITC reversal would not be required in case of such losses.

Reliance is placed on:

- **ARS Steels & Alloy Intl. Pvt. Ltd. v/s STO, Chennai [2021 (52) GSTL 402 (Mad.)]**

  "Loss arising from manufacturing process - There is a loss of a small portion of inputs, inherent to manufacturing process. Reversal of input tax credit, involving Section 17(5)(h) ibid, by Revenue, in cases of loss by consumption of input which is inherent to manufacturing loss is misconceived, as such loss is not contemplated or covered by situations adumbrated under Section 17(5)(h) of Central Goods and Services Tax Act, 2017."

- **Rupa & Co. Ltd. v/s CESTAT, Chennai[2015 (324) ELT 295 (Mad.)]**

  "Inputs of such finished product' and 'contained in finished products' cannot be looked at theoretically with its semantics - It has to be understood in context of what is the manufacturing process – Every manufacturing process has some kind of loss such as evaporation, creation of by-products, etc. - Total quantity of inputs that go into making of finished product represents inputs of such products in entirety"

- **R.K. Ganapathy v/s Asst. Comm. (ST), Kangeyam [2022 (56) GSTL 129 (Mad.)]**

  "Invisible loss of input during process of manufacture of Ghee - Every manufacturing process would automatically result in some kind of loss such as evaporation, creation of by-products, etc. - Appellant-assessee entitled to Cenvat credit on total quantity and value of inputs that went into making of Ghee"

- **Rollex Electro Products P. Ltd. v/s CCE [2016 (338) ELT 736 (Tri. - Del.)]**

  "Once credit is taken as per law and inputs are used in manufacture of finished goods, no provision under Central Excise law to deny/restrict Cenvat credit on the ground that excess process loss has been claimed"

- **Lanxess India Pvt. Ltd. v/s CCE&ST [2022 (380) ELT 616 (Tri. - Ahmd.)]**

  "Short receipt of 2% material - Appellant having sent their chemicals in water base, during process certain quantity of contaminated water was wasted; therefore, same was not capable of being returned by job worker - Cenvat credit attributed to any wastage arising during course of manufacture cannot be denied".

B. **Transit/Storage Loss:** Supply of goods in the course of furtherance of business involves storage and transportation to and from the place of business of the taxpayer. Loss of goods during such storage/transportation is normal phenomena. Such transit loss may be due to differences in weighment, minor pilferages, evaporation, loss of moisture content, etc. Such losses are normal and inherent part of the transportation activity – which is an integral part of the business. Such normal loss is termed as transit/storage loss. ITC reversal would not be required in case of such losses.

Reliance is placed on:

- **UOI v/s Hind. Zinc Ltd. [2013 (294) ELT 378 (Raj.)]**

  "It would be too impracticable and unrealistic to ignore in such a matter the ground realities and the natural causes where the excavated contents were being transported from mines to the factory, and where the contents were susceptible to dryage due to atmospheric conditions apart from likelihood of some slight error in recording of measurements due to human or mechanical error - No evidence that assessee had, in any manner, diverted the duty paid inputs with intent to evade duty - Credit not to be denied"

- **Ultratech Cement Ltd. v/s CCE [2015 (327) ELT502 (Tri. Mum)]**

  "Short receipt of inputs - Product being cement, there may be a transit loss of goods like cement - No allegation that goods have been diverted during transit or there is any pilferage of goods during course of transportation - Shortage of input on weighment is found near about 2% of total quantity and in some cases it was found to be excess, the loss of 2% of cement during the course of transportation is to be held as mirage - As the appellant have taken credit on the basis of invoice issued by supplier and the quantity mentioned therein, credit not to be denied"

- **Hind. Petroleum Corp. Ltd. v/s CCE [2014 (307) ELT 919 (Tri. Mum)]**

  "Short receipt of inputs - Transit loss - Lube base oil transported through pipeline - If any goods are transported through pipeline or by other means of transports, if they are not solid, there is every chance of loss of quantity of goods by way of evaporation - Transit loss is varying between 0.01 and 0.72% which is admissible - There may be variation in transportation of quantity of goods - Transit loss allowable - Appellant entitled for input credit as shown in invoices"

- **Bajpur Co.-op. Sugar Factory Ltd. v/s CCE [2008 (226) ELT 715 (Tri. Del)]**

  "Storage loss - Loss of rectified spirit in storage due to its volatile nature and natural causes - No provision in Central Excise Act / Rules or any Circular of the Board to claim remission on quantity of rectified spirit lost on storage - Losses reported to be within permissible limit of 0.5% set by State Excise Authority - Same limit can be adopted as safe basis for allowing similar benefit under Central Excise Law - Impugned order relating to utilization of credit involved in clearance of rectified spirit as wastage set aside."

  It may be noted that any abnormal transit/storage loss of goods may require ITC reversal subject to the arguments discussed in Issue 2 above.

C. **Theft or burglary of goods:** Goods used in the course or furtherance of business can be subject to thefts, burglay, dacoity, etc. In such cases, the goods of the taxpayer seize to be in the possession of the taxpayer.

Inputs lost due to theft, burglary or dacoity shall be subjected to reversal of input tax credit availed on the same. Loss of semi-finished or finished goods due to these reasons may require reversal of ITC on the inputs used in manufacturing the same (subject to arguments in Issue 1).

However, as far as the capital goods are concerned, they are used over a period of time. Accordingly, reversal of entire credit availed on the same shall not be the appropriate mechanism.

Further, Section 18(6) covers only supply of capital goods. Sr. 1 of Schedule I of the Act covers only permanent transfer or disposal of business assets. These terms ought to be the ones where there is an active act by the taxpayer to part away the assets. Thus, loss due to theft or burglary may not get covered under the same. Consequently, one may argue that in the absence of any specified mechanism, ITC reversal is not tenable (refer arguments discussed in Issue 1 above). However, risk averse taxpayer may prudently follow mechanism prescribed in Section 18(6) of the Act.

D. **Goods lost due to destruction:** Goods used in the course or furtherance of business are often destroyed or damaged due to natural calamities, accidents, machinery breakdown/failure or human error/negligence, etc.

Any destruction of goods which is inherent part of the business/manufacturing process shall not require ITC reversal as per arguments discussed in Issue 3(A) above. However, any other destruction of goods may require ITC reversal subject to the arguments discussed in Issue 2 above.

It may also be noted that the provision makes ITC ineligible only in case of destruction of goods and not for damage of the goods (i.e. which results in reduction in the Net Realisable Value or Sale Price of the goods). Classification of the loss into damage or destruction would have to be determined on a case to case basis.

Issue 4: ITC on Promotional Schemes and Free Samples

'*There ain't no such thing as a free lunch*' – is a popular adage communicating the idea that it is impossible to get something for nothing or free. No business provides anything for free – unless a hidden consideration (monetary or non-monetary) is involved.

The ITC ineligibility is based on disposal of goods as 'gifts'. Thus, it is important to understand the meaning and scope of the word 'gift'. The word 'gift' has not been defined in the Act. Hence one will have to refer to other laws as well as case laws to determine the meaning of the term.

The Gift-tax Act (18 of 1958) had defined the word gift to mean transfer by one person to another of any existing movable or immovable property *voluntarily* and *without consideration* in money or money's worth.

Thus, for any transfer of goods to qualify as gift – it has be without any contractual obligation and without any reciprocity (monetary or non-monetary). Transferor may intend to transfer the goods due to love, affection, relation and many other non-commercial factors.

Sales promotional schemes may be run under various models/mechanisms such as:

i. **BOGO:** Buy One Get One free or 2 (or more) for the price of one is a common promotional scheme. Under these schemes same product or connected products (e.g. toothbrush with toothpaste) or even unrelated products (e.g. bag on purchase of TV) may be sold in a combo. Supplier charges for the chargeable goods but supplies the other items along. Since the combo products would be supplied together for a single price – they would qualify as composite or mixed supply. There would also be a contractual obligation of payment of consideration for the supply of the entire combo. The FAQ released by CBIC also confirms the said view. Thus, this would be considered as supply of all the goods for a single consideration (not a free supply). In the absence of any free supply, ITC shall not be ineligible.

ii. **Target based Incentives:** Businesses often announce sales promotional schemes wherein the customers are eligible for certain white goods (laptops, gold coins, scooters, etc.) on FOC basis after achieving certain targets. Thus, the supply/transfer of white goods at a subsequent date is connected with supply of specified quantity of goods/services prior to that. Such schemes and their conditions are specified in advance and become part of the sale contract of the main supply. Since the subsequent supply of white goods is under a contractual obligation, these cannot be considered as gift. Accordingly, ITC shall not be ineligible.

Further, if a taxpayer provides own manufactured goods on FOC basis, one can argue that ITC shall not be ineligible since ITC is claimed in respect of raw materials, etc. and not in respect of the manufactured goods given on FOC basis (Refer arguments in Issue 1).

iii. **Promotional Items:** Businesses often supply random promotional items for creating brand visibility, customer creation/retention, marketing, etc. These include supply of t-shirts, caps, stationary items, calendars, etc. containing the company logo/brand names on it. These are often supplied in general to trade channels, customers, etc. Supplier provides such promotional items without any contractual obligation on the recipient to use/promote such goods in a particular manner. Recipient also cannot demand such promotional items under any contractual obligation.

Either party cannot take legal action for the obligation to supply/use/promote the promotional items. These cases would qualify as gifts. Since majority of these products are purchased specifically for supply as free gift, ITC shall not be eligible at the time of purchase itself.

iv. **Free Samples:** Similar to promotional items, businesses provide free samples of their own goods to the customers or trade channels. Similar to promotional items, ITC shall be ineligible subject to arguments discussed in Issue 1 and Issue 2 above.

It is worthwhile to note that unlike goods there are no provisions for ineligibility of ITC on free supply of services (for e.g. free trial subscriptions of OTT platforms, software applications, gym/fitness centres, internet services, free stays in hotels/resorts, etc.).

Issue 5: Write-off

Write-off is an accounting concept based on the fundamental principles of accounting. Taxpayers procure goods and record the said purchases at the value on which the same is procured. These goods have to be valued in the books of account as per the accounting principles i.e. for fixed goods/capital goods at Written Down Value (net of periodic depreciation) and Inventory at net realisable value.

During the course of business, there can be instances where value of these goods often diminishes more than their book value. In order the report their true value in the books, these goods are written-down (partial reduction in value) or written-off(full reduction in value) or provision is created for loss of value of the goods (goods value at book value but separate provision made for full/partial reduction).

The above 3 are considered to be different from the accounting perspective. The same is considered separate in indirect tax laws as well as can be seen with the amendments made in Rule 3(5B) of the CENVAT Credit Rules to specifically cover all of them.

Section 17(5)(h) states that ITC shall be ineligible/blocked in case of write-off of the goods. Thus, in the absence of specific provisions – ITC shall not be ineligible/blocked in case of write-down or provisions for write-off.

The obligation to forego the ITC would arise, only when the value of goods is fully written off/completely removed from the books of accounts. It may also be observed that there is no provision to take the credit back, when such goods are used subsequently.

Further, there is also no mechanism provided for ITC reversal on write-off of capital goods after usage. In the absence of any mechanism, the reversal shall not be tenable (Refer arguments in Issue 1).

Conclusion: As discussed above, the issues in the ITC provisions of the GST are manifold.

Risk averse taxpayers may opt to reverse the ITC if litigation is not commercially viable. However, they may also reverse the ITC under protest with a subsequent claim of refund (this may also face some litigation).

With the progress in GST assessments/audits by department for the initial years, these issues are likely to travel up the appellate levels owing to the legal interpretations involved. Based on the trends in h=the Advance rulings, it is evident that these issues are likely to travel at least up to the Tribunal (yet to be formed) before any clarity emerges on the case.

Thus, taxpayers will have to factor in the time-period along with the tax exposures while deciding on the further course of action.

Trade may also consider representation at appropriate levels to ensure that the drafting rectifications can be made to bring in broad level clarity.

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