

Proportionate Credit - Rule 42

Capital Goods with Rule 43

&

**Precautions on Vendor Non-
Compliance**

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TOPIC I

PROPORTIONATE ITC UNDER RULE 42

Key Definitions

Section 2(47) exempt supply means **supply** of any goods or services or both **which attracts nil rate of tax or which may be wholly exempt** from tax under section 11, or under section 6 of the Integrated Goods and Services Tax Act, and **includes non-taxable supply**;

Section 2(78) non-taxable supply means a **supply** of goods or services or both which is **not leviable to tax** under this Act or under the Integrated Goods and Services Tax Act;

Section 2(108) taxable supply means a **supply** of goods or services or both which is **leviable to tax** under this Act

Section 2(52) goods means 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;

Section 2(102) services means anything **other than goods, money and securities** but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged;

Proportionate ITC - Legal Provision

- ✓ Section 17(1): *Good or Services or both used **partly** for business and partly for other purposes, credit shall be restricted to so much of the input tax as is attributable to the purposes of his business*
- ✓ Section 17(2): Where the goods or services or both are used by the registered person
 - ✓ **partly** for effecting taxable supplies including zero-rated supplies and
 - ✓ **partly** for effecting exempt supplies

credit shall be restricted to so much of the input tax as is attributable to the said taxable supplies including zero-rated supplies.
- ✓ **Where is the restriction of ITC on goods or services solely used for exempt supplies??**
- ✓ **Is there overlapping in Section 17(2) between taxable, exempt and zero-rated supplies?**
- ✓ Section 16(2) of the IGST Act, 2017 carves out an exception to the same and permits availment of ITC on the zero rated supplies of goods notwithstanding that such goods are exempted from GST

Proportionate ITC - Deeming Fiction

- ✓ Section 17(3) provides that the value of exempt supply under Section 17(2) would include
 - ✓ supplies on which the recipient is liable to pay tax on reverse charge basis
 - ✓ transactions in securities
 - ✓ sale of land
 - ✓ subject to clause (b) of paragraph 5 of Schedule II, sale of building
- ✓ **Deeming Fiction - J.K. Spinning and Weaving Mills Ltd. and Another [1987 (32) E.L.T. 234 (S.C.)]**
- ✓ **Explanation** - For the purposes of this sub-section, the expression “value of exempt supply” shall not include the value of activities or transactions specified in Schedule III, except those specified in paragraph 5 of the said Schedule
- ✓ Section 17(6): Government may prescribe the manner in which credit may be attributed under 17(1) & 17(2)

Rule 42(1) – Monthly Procedure

- ✓ Rule 42 is with reference to Section 17(1) and Section 17(2)
- ✓ The said rule prescribes the manner to determine the **proportion of ITC which would be eligible**, i.e. which is attributable to taxable supplies including zero rated supplies. Manner of computation is as under

Denoted as	Description	Example
T	Total input tax on inputs and input services	1,00,000
T1	Input Tax attributable to inputs and input services intended to be used exclusively for the purpose other than for business	1000
T2	Input Tax attributable to inputs and input services intended to be used exclusively for effecting exempt supplies	25,000
T3	Restricted credits under Section 17(5) of the CGST Act,2017	14,000
C1	ITC credited to Electronic Credit Ledger [C1 = T-(T1+T2+T3)]	60,000
T4	ITC attributable to inputs and input services intended to be used exclusively for effecting supplies other than exempt supplies but including zero rated supplies	40,000
C2	Common Credit [C2 = C1-T4]	20,000

Rule 42(1) – Monthly Procedure (Cont.)

Common credit computed under D1 & D2

- ✓ The rule provides formula to compute the restricted credit on the basis of exempt turnover percentage
$$D1 = (E \div F) \times C2$$
 - ✓ E - is the aggregate value of **exempt supplies** during the tax period
 - ✓ F - is the total **turnover in the State** of the registered person during the tax period
- ✓ Section 2(112) turnover in State or turnover in Union territory means the aggregate value of all taxable supplies (excluding the value of inward supplies on which tax is payable by a person on reverse charge basis) and exempt supplies **made within a State or Union territory** by a taxable person, *exports of goods or services or both and inter-State supplies of goods or services or both made from the State* or Union territory by the said taxable person but excludes central tax, State tax, Union territory tax, integrated tax and cess
- ✓ **D2 = 5% of C2** (common for business and other than for business)
- ✓ **Common credit attributable to taxable & zero rated supplies**
$$C3 = C2 - (D1 + D2)$$

Proportionate ITC – Certain Issues

- ? Whether credit can be availed on the basis on intention of use, when the actual usage of such inputs towards taxable/exempt may not be known at the time of purchase.
- ? Packing materials purchased for exempt goods, which may be sold in domestic market and also be exported. How to treat the said transaction. Can it be considered as common?
- ? Can we consider any other rationale to compute D1. For example, sq.ft. area of factory used for manufacture of exempted goods (single factory where both taxable and exempt goods are manufactured)
 - Jet Airways India Limited Vs. Commissioner of Central Excise [2019-TIOL-1229-CESTAT-MUM]**
 - Dipak Babaria & Anr vs State Of Gujarat & Ors [2014 (3) SCC 502]**
- ? Hospital has income from Health care services and Pharmacy income. Some of the pharmacy items are exempted. In case of common inputs/input services, what shall be considered as total turnover under 'F' (i.e. total turnover of Company or turnover of Pharmacy)
 - Law of Averages provided by law. Specific procedure provided for Real Estate Sector**
 - Concept of Duty Drawback is based on law of averages – Favorable for some / negative for some**

Rule 42(2) – Annual Procedure

- ✓ Where the aggregate of the amounts calculated finally in respect of 'D1' and 'D2'
 - ✓ is greater than the aggregate of the amounts determined under sub-rule (1), such additional amount shall be reversed by the registered person in **FORM GSTR-3B or through FORM GST DRC-03** in the month **not later than the month of September following the end of the financial year** to which such credit relates
 - ✓ is lower than the aggregate of the amounts determined under sub-rule (1), the excess amount already reversed shall be claimed as credit by the registered person **in his return** for a month **not later than the month of September following the end of the financial year** to which such credit relates
- ✓ Where the strict interpretation of the law results in acute absurd results and defeat the very purpose of the law, then such literal interpretation should be avoided, **K.P. Varghese vs ITO 1981 4 SCC 173**
- ✓ Person shall be liable to pay interest on the said excess amount at the rate specified in sub-section (1) of section 50 for the period starting from the first day of April of the succeeding financial year till the date of payment

Rule 42(1) & 42(3) – Real Estate Sector

- ✓ Prior to 1st April 2019, reversal of ITC for real estate was also based on the rationale of proportion of exempt turnover. W.e.f. 01st April 2019, all the units in respect of which amounts are received from customers before the project completion (i.e. receipt of completion certificate) would be considered as **taxable units** i.e. amounts received towards their sale would be liable to GST.
- ✓ Amounts received in respect of the other units (**i.e. sold after date of completion certificate and unsold units**) are considered as those that are not liable to tax (i.e. exempt) and thereby requiring reversal of credit in terms of section 17(2) & 17(3) of the CGST Act, 2017.
- ✓ Some of the flaws in computation of restriction based on proportion of exempt turnover
 - ✓ During the **initial phase of the project, huge amount of expenses** are incurred commonly for the entire structure. At this time, there is no exempt turnover, whereby entire credit becomes eligible.
 - ✓ It is possible that **even after the project is completed there are taxable receipts**, which only diminish as the **expenses in the project diminish** thereby leading to a sizable amount of credit being availed at such point of time.
 - ✓ **If units were never sold**, it will never get considered towards the credit reversal as there is no revenue recognised in the books in this regard to take part in the credit reversal calculation

Rule 42(1) & 42(3) – Real Estate Sector (Cont.)

- ✓ With effect from 01.04.2019, all credits relating to the project are to be considered as common credit and the monthly reversal is to be computed which would be **in proportion to the carpet area (and not revenue) of the units** that are exempt or identified to be sold after completion (say for example the mortgaged units)
- ✓ The said requirement has been provided for **all on-going projects and projects which commence from 01.04.2019**. Whether a provision which is effective from 1st April 2019 can require re-computation of any credit that has already been availed by the assessee. Will it impact ITC availed as per earlier provisions of Rule 42 for previous FY's.
- ✓ Rule 42(3) requires **re-calculation of the final amount that is to be reversed in the project** which has attained completion, by considering the credit ascertained under rule 42(1)
- ✓ When the project was still ongoing as on 31st March 2019, full ITC was available and there was no requirement to follow Rule 42(1). Hence, requirement under Rule 42(3) should not apply for that period
- ✓ **Hon'ble Supreme Court** in the case of Collector Of Central Excise, Pune Versus Dai Ichi Karkaria Ltd. 1999 (112) E.L.T. 353 (S.C.) where it held that the credit once availed is indefeasible more so when there is no provision in the law for reversal unless credit has been taken illegally or irregularly.

Rule 42(1) & 42(3) – Real Estate Sector (Cont.)

- ✓ Then, finally on project completion, the said reversal is to be recalculated for the entire project period, which would be in proportion to the carpet area of the units that actually remain unsold as on the date of completion certificate.
- ✓ Credit reversal in respect of a project is to be done before the month of September following the end of the financial year in which the project completion is attained.
- ✓ Interest applicable in case excess reversal required on computation of Final reversal, for the Project as a whole, from the first day of April of the subsequent financial year

TOPIC II

CAPITAL GOODS AND OPERATION OF RULE 43

CAPITAL GOODS

- ✓ Section 2(19) - 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
- ✓ Section 16(3) – Restriction on availment of ITC, in case depreciation is claimed on the tax component, under the provisions of the Income Tax Act
- ✓ Section 18(6) : In case of supply of capital goods or plant and machinery, on which input tax credit has been taken, the registered person shall pay an amount **equal to the input tax credit taken** on the said capital goods or plant and machinery **reduced by such percentage points** as may be prescribed **or the tax on the transaction value** of such capital goods or plant and machinery determined under section 15, whichever is higher
- ✓ Explanation : Meaning of the term capital goods for the purpose of Rule 43 to include P&M as provided under Section 17

CAPITAL GOODS – RULE 43

- ✓ Restriction on credit of input tax under Section 17(1) and 17(2) covers capital goods used for
 - ✓ being partly used for the purposes of business and partly for other purposes
 - ✓ partly used for effecting taxable supplies including zero rated supplies and partly for effecting exempt supplies
- ✓ **No ITC** – Capital goods used or intended to be used exclusively for non-business purposes or for effecting exempt supplies
- ✓ **Full ITC** - used or intended to be used exclusively for effecting supplies other than exempted supplies but including zero-rated supplies
- ✓ **Common Use** – Full ITC to be availed immediately. Life of the asset to be considered as 5 years **from the date of the invoice for such goods.**

CAPITAL GOODS – RULE 43 (Cont.)

- ✓ What if a capital goods was originally used or intended to be used for exempt supplies, is then used partly for taxable supplies
 - ✓ **Prior to 01.04.2020** – Amount of ITC to be reduced by 5% for every quarter or part thereof, and the balance amount would be considered as common credit
 - ✓ **W.e.f. 01.04.2020** – Entire amount of tax charged in invoice to be considered as common credit. Amount equal to 5% for every quarter or part thereof, where the said capital goods was not eligible for ITC, shall be added to the output tax liability of the tax period in which such credit is claimed
- ✓ **Tc** – Aggregate amount of input tax availed on capital goods used commonly
- ✓ **Tm = Tc ÷ 60** Amount of input tax (common credit) attributable to a tax period
- ✓ **Tr** = aggregate of **Tm** of all capital goods
- ✓ **Te = (E ÷ F) x Tr**
- ✓ **What if there is no turnover in the current tax period?** Proviso under Rule 43(1) – Last Tax period for which details of such turnover is available
- ✓ Amount arrived in **Te for every tax period** shall be added to the output tax liability and applicable interest would be payable

CAPITAL GOODS – RULE 43 - SOME ISSUES

- ? How to determine the date in case where a capital goods consists of various components purchased under multiple invoices. Example – Construction of Boiler Plant in factory, which could take a period of 3 years for commissioning.
- ? What if the capital goods purchased has not been put to use?
- ? Can we consider the intention of usage, to determine the eligibility of credit?
- ? What if the capital goods originally used only for taxable supplies during the first 5 years, is later put to use exclusively for exempt supplies
- ? Is there any requirement to re-compute the monthly reversals, on a Annual basis?

CAPITAL GOODS – RULE 43 – REAL ESTATE

- ✓ **Explanation under Rule 43:** The amount of input tax in respect of capital goods used or intended to be used exclusively for effecting supplies other than exempted supplies but including zero rated supplies, shall be zero during the construction phase
- ✓ Hence during construction phase, the entire input tax paid on capital goods should be considered as common credit
- ✓ **$T_e = (E \div F) \times T_r$**
 - ✓ **E** = aggregate carpet area of the apartments, construction of which is exempt from tax plus aggregate carpet area of the apartments, construction of which is not exempt from tax, but are identified by the promoter to be sold after issue of completion certificate or first occupation, whichever is earlier

In the tax period in which the issuance of completion certificate or first occupation of the project takes place, value of E shall also include aggregate carpet area of the apartments, which have not been booked till the date of issuance of completion certificate or first occupation of the project, whichever is earlier
 - ✓ **F** = aggregate carpet area of the apartments in the project

CAPITAL GOODS – RULE 43 – REAL ESTATE

- ✓ The amount of common credit attributable towards exempted supplies (T_e^{final}) shall be calculated finally
 - ✓ for the entire period from the commencement of the project or 1st July, 2017, whichever is later, to the completion or first occupation of the project, whichever is earlier,
 - ✓ for each project separately,
 - ✓ before the due date for furnishing of the return for the month of September following the end of financial year in which the completion certificate is issued or first occupation takes place of the project

Precautions on Vendor Non-Compliance

KEY PRECAUTIONS

- ✓ Verify the Compliance record of vendor in GST portal
- ✓ Compliance with reporting requirements in Tax Invoice – Indication of level of compliance followed by vendor
- ✓ GSTR-2A is only an indication of compliance by vendor, which can be referred. It may not be conclusive for the purpose of payment of tax by supplier
- ✓ Vendor rating to be done based on various risk parameters – Industry Type, Sole Proprietor Vs. Company etc.
- ✓ As a safeguard - Obtain declaration/certificate from CA of the vendor for compliance with payment of tax – Courts have held that what is not practically possible, cannot be imposed as a condition.
- ✓ Amendment in terms of existing contracts with vendors

KEY PRECAUTIONS

- ✓ Verification of E-Way bill raised by vendor, to ensure level of compliance and accuracy of data
- ✓ Indemnity Bond may be sought from risky vendors (but critical vendors for business)
- ✓ System to make payment of GST only when invoice is reflected in GSTR-2A
- ✓ Internal risks – Not attributable to vendor non-compliance
- ✓ Continuous training and awareness sessions for vendors on the importance of compliances
- ✓ System of sharing critical updates on GST compliance with all vendors

THANK YOU