Understanding the dynamics of common credits reversal under GST

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It is not a rocket science to understand why the credit of taxes paid on inputs, input services and capital goods were given to the tax payer and allow him to set off against his output tax liabilities. This is purely to avoid the cascading effect that is to avoid taxes on taxes. In the event of inputs, input services and capital goods were used in generating exempted outputs, then credit of taxes paid on inputs, input services and capital goods will not be given as there was no cascading effect for the reason that no tax is collected on output.

This philosophy of input tax credit is not new to indirect taxation regime. It was there under erstwhile CENVAT Credit Rules, 2004 in the form of Rule 6 of the said Rules. Under the GST regime, it exists under Section 17(2) of Central Goods & Services Tax Act, 2017 (CGST Act) which restricts the registered tax person to avail the credit in proportion to the taxable supplies when the registered person uses goods or services partly for taxable supplies and partly for exempt supplies.

In this paper, we wish to detail the contours of Section 17(2) of CGST Act read with Rule 42 of Central Goods & Services Tax Rules, 2017 (CGST Rules) to understand the scope of the said section and the tax treatment to be adopted for common input credit by entities engaged in both taxable and exempted supplies.

Let us take a simple example to understand the situations envisaged under Section 17(2). Consider an entity which runs hospital and pharmacy within a single premise. The services provided by the hospital were exempted and supplies made by pharmacy are taxable under CGST Act. Let us assume the turnover from hospital and pharmacy are in the ratio of 60:40[1] depending upon the previous history of the entity.

The Statutory Auditor of the entity certifies the books of accounts and raises an invoice for the services provided for an amount of Rs 50 lakhs and corresponding taxes amounting to Rs 9 lakhs. The entity pays the Statutory Auditor vide his invoice Rs 59 lakhs and avails the credit of Rs 9 lakhs on such invoice.

However, when it comes to utilisation, the entity will be in a position to utilise 40% of 9 lakhs as against 100% of 9 lakhs. This is because of Section 17(2) which restricts the credit only to the extent of taxable supplies which in the current case is 40%. Hence, the entity is entitled to avail credit of Rs 3.6 lakhs and the balance of Rs 5.4 lakhs has to be recognised as cost as it pertains to the exempted supplies which amounts to 60% in the given case.

The above is a simple proposition to understand the basics of Section 17(2) of CGST Act. However, the practical implementation of Section 17(2) is not simple as above. The methodology enumerated in Rule 42 of CGST Rules calls for a detailed exercise on a monthly basis and to be followed up by year end review. Now let us proceed to understand Rule 42 in detail and then try to implement for the builder community the provisions.

<u>Rule 42 of CGST Rules:</u>

[1] It is assumed all the sales made by pharmacy are taxable and not exempted. If certain supplies made by pharmacy are exempted, then the percentage of exempted supplies will be increased.

The rule lays down a detailed methodology for a registered person when he fits the provisions of Section 17(1) or Section 17(2) of CGST Act. That is to say, when the registered person uses inputs and input services for partly for taxable and exempt supplies or partly for business and other than business, then the credit which is as a result of Rule 42 is only eligible for entitlement.

Before going into the arithmetical part of Rule 42, let us understand the basic objective of the said rule. The rule aims to cull out the proportion of common credit which pertains to the exempted supplies. The said is achieved by first allowing the allowable credit and then restricting the common credit to the extent of exempted supplies. The common credit to the extent of exempted supplies is arrived in proportion to the exempted supplies turnover to the total turnover. In absence of information pertaining to the exempted supplies or registered person does not have any turnover during the relevant tax period, then the details of the last known tax period are taken on provisional basis on monthly intervals and at the end of the year, when the entire information is available, the actuals will be calculated and matched against already availed thereby leading to the adjustments.

<u>To put it simply, the modus operandi is as under:</u>

1. Identify entire input tax credit pertaining to inputs and input services during [T]
2. Identify the input tax credit pertaining to exclusively for other than business [T_1]
3. Identify the input tax credit pertaining to exclusively for exempted supplies [T_2]
4. Identify the input tax credit which is not allowed under Section 17(5) [T_3]
5. Arrive at Allowable input tax credit [C1] by deducting T_1, T_2, T_3 from T {$C_1 = T - (T_1+T_2+T_3)$}
6. Avail C_1 in the electronic credit ledger
7. Identify the input tax credit pertaining to exclusively used for taxable supplies [T_4]
8. Arrive at Common input tax credit [C_2] by deducting T_4 from C_1 {$C_2 = C_1 - T_4$}
9. Arrive at Common input tax credit used for exempted supplies [D_1]
10. D_1 is arrived by multiplying exempted turnover (E) to the total turnover (F) {$D_1 = E/F * C_2$}
11. Arrive at Common input tax credit used for other than business [D_2]
12. D_2 is standard and arrived as 5% of C_2 {$D_2 = 5\% * C_2$}
13. Arrive at Common input tax credit used for taxable supplies [$C_3 = C_2 - (D_1 + D_2)$]
14. Add D_1 and D_2 to the output tax liability
15. Repeat this for every tax for every tax period
16. At year end, calculate D_1 and D_2 based on finalised turnovers
17. Adjust for any changes between provisional and actuals
18. If original D_1 and D_2 is less than final, then tax has to be paid
19. If original D_1 and D_2 is more than final, then avail the balance credit

Ideally, the credit to be taken is T_4 and C_3. Since the rule allows availment of C_1, the summation of T_4 and C_3 is achieved by adding D_1 and D_2 to the output tax. In other words, $T_4 + C_3 = C_1 - D_1 - D_2$

From the above, it is evident that what is allowed as credit to the electronic credit ledger is not the credits exclusively used for taxable supplies and common credits used for taxable supplies but the credit which is allowable. From the said credit which is allowable, the common credit pertaining to exempted supplies and other than business is reduced (by adding it output tax liability), thereby ensuring the taxpayer is entitled to credit which is exclusively used for taxable supplies and common credit used for taxable supplies.

The above is the common understanding of the common credit aspects and methodology to reverse the same. In the next journal, we would be coming up with the challenges pertaining in implementation of Rule 42.

Let us take an example by taking numbers:

Particulars	Legends	Modus Operandi	Jul-17
Total Credits			
Credit on Inputs & Input Services	T		15,00,000
Elimination of Ineligible & Exempt Credits			
Exclusively used for Non-Business	T1		1,00,000
Exclusively used for Exempt	T2		3,00,000
Ineligible under Sec 17(5)	T3		75,000
Credit allowed in Ledger			
ITC credited to ledger	C1	T - (T1+T2+T3)	10,25,000
Credit Exclusively used for Taxable Supplies			
Exclusively used	T4		3,25,000
Common Credits both for Taxable & Exempted			
Common ITC	C2	C1- T4	7,00,000
Common Credits for Exempted & Non-Business			
Common ITC for Exempted (Provisional)	D1	E/F * C2	1,86,667
Common ITC for Non-Business (Provisional)	D2	5%*C2	35,000
Common Credits for Taxable			
Common ITC for Taxable	C3	C2-(D1+D2)	4,78,333
Addition to Output Tax Liability			
To be added to Output Tax (Provisional)		D1+D2	2,21,667
Net Credit Allowed for tax period			
ITC allowed (Provisional)		C1-(D1+D2)	8,03,333
D1 (Actual)	D1	E/F * C2	2,50,000
D2 (Actual)	D2	5%*C2	35,000
To be added to Output Tax (Actuals)		D1+D2	2,85,000
ITC allowed (Actual)		C1-(D1+D2)	7,40,000
Provision vs Actuals			-63,333

[E = 80,00,000 & F = 3,00,00,000]