6 April 2023

EY tax alert

Karnataka HC quashes amendment to Rule 89(4)(C) which restricts refund of unutilized ITC under GST

EY Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

Executive summary

This Tax Alert summarizes a recent ruling of Karnataka High Court (HC)[1] on the validity of the amendment carried out in Rule 89(4)(C) of Central Goods and Services Tax Rules, 2017 (CGST Rules).

The amendment restricted the "turnover of zero-rated supply of goods" to 1.5 times the value of like goods domestically supplied by same or similarly placed supplier, for the purpose of computing refund of ITC.

The key observations of the HC are:

- The intention of zero-rating is to make entire supply chain of exports tax free. Accordingly, Section 16(3) of the Integrated Goods and Services Tax Act, 2017 (IGST Act) allows refund of input tax paid in the course of making zero-rated supplies. The Rule in whittling down such refund is *ultra vires* in view of the well settled principle of law that Rules cannot override the parent legislation.
- The amended Rule is violative of Article 14 and Article 19(1)(g) of the Constitution of India as the restriction is only provided in case of refunds of zero-rated supply of goods without payment of tax. There is no such restriction on exporting goods with payment of tax. This results into hostile discrimination between two classes of persons.
- The terminologies used in the impugned Rule "like goods" and "same or similarly placed supplier" does not have any precise meaning in the said Rules and no guidelines is present in that respect.
- The impugned amendment is arbitrary and unreasonable as it bears no rational nexus with the objective sought to be achieved by Section 16 of the IGST Act.

Basis above, HC held that the amendment carried out in Rule 89(4)(C) is *ultra vires* the GST law and the Constitution of India and consequently, deserves to be quashed.

[1] TS-108-HC(KAR)-2023-GST

Building a better working world

Background

- The petitioner is engaged in designing, developing, building and deploying various types of advanced imaging and sensor systems to sense, understand and control complex environments.
- It exported various customized products without payment of tax as per Section 16(3)(b) of the Integrated Goods and Services Tax Act, 2017 (IGST Act) during the period from May 2018 to March 2019 and claimed refund of unutilized input tax credit (ITC) during the month of May 2020.
- Meanwhile, Rule 89(4)(C) of the Central Goods and Services Tax Rules, 2017 (CGST Rules) was amended w.e.f. 23 March 2020 to restrict the "turnover of zero-rated supply of goods" to 1.5 times the value of like goods domestically supplied by same or similarly placed supplier, for the purpose of computing refund of ITC.
- Show cause notices (SCNs) were issued by Revenue on the ground that the petitioner had not given any proof which was required to be given in terms of the amended Rule 89(4)(C).
- The petitioner *inter-alia* submitted that the amended Rule was not applicable in its case since the period of refund was prior to the amendment in the said Rule and therefore, would be governed by the old provisions. Consequently, Revenue passed orders rejecting the refund claim.
- Aggrieved, the petitioner filed a writ petition before the Karnataka High Court (HC) challenging the above orders as well as the validity of Rule 89(4)(C).

Petitioner's contentions

- The very intention of the zero-rating is to make entire supply chain of exports tax free. Accordingly, Section 16(3) of the IGST Act allows refund of ITC paid in the course of making zero-rated supplies. The Rule in whittling down such refund is *ultra vires* in view of the well settled principle of law that Rules cannot override the parent legislation.
- The impugned Rule is also *ultra-vires* Article 269A read with Article 246A of the Constitution of India as the Parliament has no legislative competence to levy Goods and Services Tax (GST) on export of goods.
- No such restriction is provided where refunds are filed on export of goods with payment of tax as per Section 16(3)(a) of the IGST Act. Accordingly, the impugned amendment is violative of Article 14 and Article 19(1)(g) of the Constitution of India.
- The impugned amendment is arbitrary and unreasonable as it bears no rational nexus with the objective sought to be achieved by Section 16 of the IGST Act.

  While the above Section seeks to make exports tax-free by "zero-rating" them, the impugned Rule aims to do just exactly the opposite by restricting the quantum of refund of tax expended in making such exports.
- The entire concept of refund of unutilized ITC relating to zero-rated supply would be obliterated, in case any limitation or condition is placed that takes away petitioner's right to claim refund of all the taxes paid on the domestic purchases used for the purpose of exports.

  The incentive given would lose its meaning and would cause grave hardship to the exporters who are earning valuable foreign exchange for the country. The exporters factor such incentives in the pricing mechanism and thus, the impugned restriction is highly unreasonable.
- The amended Rule also suffers from the vice of vagueness as words "like goods" and "similarly placed supplier" are completely open-ended and not defined anywhere in the GST law.

  It is not possible to have any "like goods" and "same or similar placed supplier" for the unique and customized products manufactured by the petitioner and the preciseness of definitions as found in the customs legislation is missing herein.
- The Rule also fails to clarify, as to what would be the consequence if:
  - no such goods are supplied in domestic market and value of like goods provided by other suppliers is not available;
  - the supplier has different pricing policy for different local customers; or
  - supplier who would be pricing the local goods differently in different states for the same products being exported.

  Thus, when it is impossible for any exporter to show proof of value of "like goods" domestically supplied by the "same or, similarly placed, supplier", the refund itself cannot be denied to such exporter which he is otherwise entitled to in terms of Section 54 of the Central Goods and Services Tax Act, 2017 (CGST Act) read with Section 16 of the IGST Act.

Respondent's contentions

- Zero-rated turnover declared by the petitioner cannot be accepted for the purpose of calculation of eligible refund amount as the petitioner has not submitted the required proof that export turnover is 1.5 times the value of like goods domestically supplied.

HC Ruling

- Rule 89(4)(C) is violative of Article 14 and Article 19(1)(g) of the Constitution of India as the restriction is only provided in case of refunds of zero-rated supply of goods without payment of tax. There is no such restriction on exporting goods with payment of tax. This results into hostile discrimination between two classes of persons.

  The guarantee of equal protection of the laws must extend even to taxing statutes. If the same class of property or persons similarly situated is subjected to an incidence of taxation, which results in inequality, the law may be struck down as creating an inequality amongst holders of the same kind of property or persons.

- The object of zero rating would be lost if exports are made to suffer GST as the exporter would either pass it on to the foreign recipient or would absorb it himself. This would mean that taxes are exported and make exports uncompetitive being against the stated policy of the Government.

  The amending words, therefore, do not sub serve the objectives set out in Section 16 of the IGST Act or 54 of the CGST Act.

- Further, the terminologies used in the impugned Rule "like goods" and "same or similarly placed supplier" does not have any precise meaning in the said Rules and no guidelines is present in that respect.

- As per the minutes of the 39th GST Council meeting, the only ground for the impugned amendment seems to be a possible misuse without any factual data supporting the same. The same cannot be countenanced as having a reasonable basis in law.

  It is well settled that if the Government perceives that there could be a possibility of abuse of a provision, it should adopt measures to keep a check on the same. However, the law cannot be amended on the premise of distrust.

- Further, in the aforesaid GST Council meeting, it was stated that the free-on-board (FOB) value of exports will not be changed, which means that there is no doubt about the valuation of goods. Therefore, the artificial restriction of refunds by taking the value of domestic supplies seems irrational.

  Further, the policy of the Government itself will have to satisfy the test of rationality and must be free from arbitrariness and discrimination.

- The impugned Rule is arbitrary and unreasonable, in as much as possibility of taking undue benefit by inflating the value of the zero-rated supply of goods cannot be a ground to amend the rule.

- Accordingly, HC reiterated and agreed to all the contentions of the petitioner and held that the amendment carried out in Rule 89(4)(C) is *ultra vires* and consequently deserved to be quashed.

Comments

a. This is a welcome ruling for the exporters claiming refund of unutilized ITC w.r.t. export of goods.

b. HC has reiterated that the objective of the Government is not to tax exports in any manner and hence, entire supply chain of exports should be tax free.

c. Taxpayers whose refund claims were rejected in the past or claimed lower refund in accordance with the impugned Rule may evaluate the possibility and mechanism to claim the differential refund.

d. There is yet another disparity in tax implication concerning export of goods made with and without payment of tax. For the purpose of refund of unutilized ITC, the value of goods exported is the least of FOB value or the value declared on invoice, as against invoice value in case where export is made with payment of tax.

Our offices

Ahmedabad
22nd Floor, B Wing, Privilon
Ambli BRT Road, Behind Iskcon
Temple, Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

Bengaluru
12th & 13th floor
"UB City", Canberra Block
No. 24, Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 6727 5000

Ground Floor, 'A' wing
Divyasree Chambers
11, O'Shaughnessy Road
Langford Gardens
Bengaluru - 560 025
Tel: + 91 80 6727 5000

Chandigarh
Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A
Industrial & Business Park, Phase-I
Chandigarh - 160 002
Tel: + 91 172 6717800

Chennai
Tidel Park, 6th & 7th Floor
A Block, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: + 91 44 6654 8100

Delhi NCR
Golf View Corporate Tower B
Sector 42, Sector Road
Gurugram - 122 002
Tel: + 91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad
THE SKYVIEW 10
18th Floor, "SOUTH LOBBY"
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jamshedpur
1st Floor, Shantiniketan Building,
Holding No. 1
SB Shop Area, Bistupur
Jamshedpur – 831 001
Tel: + 91 657 663 1000

Kochi
9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: + 91 484 433 4000

Kolkata
22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: + 91 33 6615 3400

Mumbai
14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: + 91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000

Pune
C-401, 4th floor
Panchshil Tech Park, Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 4912 6000

Download the EY India Tax Insights App

Ernst & Young LLP

EY | Building a better working world

About EY

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EYG member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is one of the Indian client serving member firms of EYGM Limited. For more information about our organization, please visit www.ey.com/en_in.

Ernst & Young LLP is a Limited Liability Partnership, registered under the Limited Liability Partnership Act, 2008 in India, having its registered office at 9th Floor, Golf View Corporate Tower B, Sector 42, Golf Course Road, Gurugram, Haryana - 122 002.