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GST 2.0 Insights

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GST 2.0 – Inverted Duty Structure

GST 2.0 will see rationalised GST rates under a simplified structure, by collapsing the current four-slab structure into a two-slab and a higher slab for sin and luxury goods. Unless carefully calibrated, the rate rejig has the potential to inadvertently create new Inverted Duty Structure (IDS) scenarios even as it resolves existing ones.

Why IDS is a problem today

- IDS arises when the GST rate on input supplies (e.g., 12% or 18%) exceeds the rate on output supplies (e.g., 5%), leading to accumulation of Input Tax Credit (ITC) that cannot be fully utilized against output tax liability.
- While refund provisions exist under Rule 89(5) of the CGST Rules for IDS scenarios, these anyhow exclude ITC on input services and capital goods, resulting in credit blockage and, undermining the principle of seamless credit flow. To recap, the Apex Court in the case of ***VKC Footsteps***[1] acknowledged this legal position; noticing the imbalance caused by the formula Court, urged the GST Council to reconsider it.
- IDS has been a long-standing pain point, for textiles, pharma and edible oil sector, where accumulated ITC ties up liquidity. The Council has resolved the issue for mobile phone and minerals & ores sector.
- In the hospitality industry too, IDS has surfaced; output supply is liable for 5% (without ITC), whereas inward rent is taxed at 18%. This anomaly is without remedy, as per the extant law.
- In the paper industry as well, IDS persists; output paper is taxed at 12%, while essential input services *viz*, logistics, rentals and marketing are taxed at 18%. The electric vehicle industry is also facing a similar hurdle.
- The refund process, in most cases, is compliance-intensive, often involving delays, documentation challenges, and legal disputes, which in turn create uncertainty in cash flows thereby straining working capital.

IDS in the GST 2.0 era

- **Impact of rate reduction:** The proposed consolidation of GST slabs into 5% and 18% is expected to narrow the gap between input and output tax rates. This alignment could ease the IDS challenge by reducing the accumulation of unutilised ITC and lowering reliance on refunds.
- **What businesses should prepare for** Companies should map input-output tax mismatches, run price and margin scenarios, and tighten refund documentation under Rule 89(5). Contracts and ERP systems will need quick updates to capture new rates.
- **Transitional watchpoints**: Exemptions in place of lower rates could block ITC entirely, negating the intended relief. Lodged refund claims will require careful handling during the rate shift.

[1] 2021 (52) G.S.T.L. 513 (S.C.)

Dhruva Comments

As the GST Council sets out to rationalize rates, in order to truly revamp GST and induce 'ease of living'[2] the GST Council would do well to: (i) ensure that it does not inadvertently create new instances of IDS, (ii) recommend legislative amendments for refund of input services and capital goods (iii) revise the refund formula under Rule 89(5) (iv) specifically address sectoral anomalies, (v) enable IDS refund for the services sector.

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[2] As pronounced by the Prime Minister in the 79th Independence Day speech.

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