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"Supplier sins & Recipient repents...!

Part-I

Background

"It is no doubt fair and in the national interest to check tax evasion with a firm hand; but it is neither fair nor in the national interest that the law should be made to bear hard on a large number of honest taxpayers merely in order to get at a new dishonest one. It is not right that so much should be inflicted on so many in order to rope in a few.

What is wrong with India is the pathological obsession displayed by the lawmakers who frame laws only with a tax evader in mind, regardless of the enormous inconvenience and harassment to the far larger section of hones taxpayers. A departmental store which is wholly preoccupied with prevention of shoplifting is a sure candidate for stagnation."

[Nani Palkhiwala]

There is no gainsaying the fact that a comprehensive and seamless "Input Tax Credit' ('ITC') chain is the 'soul' of the GST tax system. However, the grant of ITC by the 'Invoice Credit Method' has its pitfalls and dangers. The Invoice Credit method remains susceptible to various types of the malpractices and frauds.

As observed by **Michael Keen and Stephen Smith (2007):**

"The implementation of a VAT involves the same core elements as does any other self-assessed tax; the identification and registration of those required (or choosing) to pay the tax; collection and processing of amounts spontaneously remitted with periodical returns; audit to ensure accuracy of returns; and enforcement action on delinquent payers."

Like any tax, VAT (or GST) is also vulnerable to evasion or fraud. At the heart of VAT/GST is the credit mechanism, with tax charged by a seller available to the buyer as a credit against his (buyer's) liability on his own sales and, if in excess of the output tax due, refunded to him (buyer), **[Keen and Smith (2007)]**

This credit and refund mechanism does offer a unique opportunity for abuse and gives rise to several types of fraud characteristic of VAT/GST. Such frauds that can arise under VAT/GST include frauds like non-remittance of tax collected (a case of 'missing dealer' or 'carousel fraud'; false claims for credit or refund; Bogus traders ('Invoice Mills'), amongst other known frauds.

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No doubt, advocates of VAT/GST suggest that the VAT is 'self-enforcing' in the sense that each trader has an incentive to ensure that his suppliers have themselves properly paid VAT, in order that they themselves can claim appropriate credit. As VAT/GST is paid at each stage of production, in order to claim credit for the VAT/GST paid on its inputs against the VAT/GST received on its outputs, a taxpayer would need to show, if required, that the VAT/GST had been paid by its suppliers.

"One man's proof of purchases is evidence of another man's sales."
[National Economic Development Office, Value Added Tax (2nd Ed.1971 HMSO, London)]

It is argued that there would be no incentive for two traders to fail to invoice a transaction between them, since the purchaser's liability for VAT would be increased by the amount the supplier had not been recorded as paying. With an indirect tax levied at only one stage of production, the whole of the tax is potentially at risk at that stage, whereas, with VAT, theoretically at least, it is only the tax added at that stage that is at risk.

["VAT/GST: The UK Experience Revisited" - by Simon James]

It is further suggested that there is an important sense in which the VAT is self-correcting, if not self-enforcing: If for some reason a supply to some registered trader escapes VAT, that missing VAT will be recovered at the next stage in the VAT charged by that trader on their own sales, since there will, in that case, be no credit to offset against their liability.

However, critics point out that the case for these 'self-enforcing' or 'self-policing' or 'self-correcting' features of the VAT cannot be overstated. It had been recognised that there was scope for evasion inspite of these intrinsic features of the VAT. For instance, while traders have an incentive to ensure that their suppliers provide them with invoices that the authorities will accept as establishing a right to refund or credit, they have no incentive - unless specific requirements of this end are imposed - to ensure that tax has actually been paid**. As Hemming and Kay (1981) stress, the notion that the VAT is self-enforcing is ultimately 'illusory'.**

So far as India is concerned, the indirect tax evasion at Centre and States level under the erstwhile CENVAT or VAT dispensation had been rampant. The frauds commonly witnessed were of the types described above i.e. carousal frauds (missing trader), bogus traders (invoice Mill') and false claim for credit or refund.

As noted by Richard M. Bird in his Paper "Review of 'Principles and Practice of Value Added Taxation: Lessons for Developing Countries' (1993**): "A VAT invoice is a check written on the Government."**

Needless to say, in a country like India, it is a cakewalk for the tax evaders to encash such checks (cheque) i.e. VAT invoice, and encashing they have been and how?!

ITC under GST regime - Learning from the past experience

Possibly stung by the frauds witnessed in the erstwhile tax regime, the lawmakers have, contrary to the claim of the expanded ITC regime under GST, subjected the availability of ITC to the various conditions and exclusions. As per S.16(1) of the CGST Act, 2017 ('the Act') every registered person is entitled to take the ITC on the inputs or input services used or intended to be used by him in the course or furtherance of the business. However, this entitlement to ITC is subject to various conditions, safeguards and restrictions. These conditions - total 4 (four) - are specified in sub-section (2) of S.16 of the Act and the same are summarised below for ease of reference and understanding:

- The recipient taxpayer is in possession of the tax invoice or debit note or any other specified taxpaying documents issued by the supplier in accordance with law [Section 16 (2)(a) refers];

- The recipient taxpayer has received the goods or services or both [Section 16 (2)(b) refers];

- Subject to the provisions of Section 41 or Section 43A, the supplier has discharged the tax liability on the supply made by him, in cash, or by debit to the admissible ITC relating to such supply [Section 16 (2)(c) refers];

- The recipient taxpayer has furnished the Return as prescribed under Section 39 [Section 16 (2)(d) refers].

It must be kept in mind that sub-section (2) starts with a non-obstante clause "Notwithstanding anything contained in this section…" and is thus overriding in nature, as far as other provisions of S.16 are concerned.

However, despite the above stringent conditions and particularly the condition at clause (c) of S.16(2), the GST regime has, in a short span of less than 4 years, witnessed massive frauds mainly involving missing or vanishing traders, bogus/fake invoices and bogus ITC and/or refunds. The alarming frequency and sheer magnitude of these frauds has been a cause of serious concern for the GST Council. Alarmed with this gargantuan level of tax frauds/evasion practiced by some dishonest elements and with a view to put a clamp on these frauds, yet another stringent/strict condition has been prescribed for the availment of ITC vide clause (aa) inserted in S. 16(2) of the Act by the Finance Act, 2021 . The said clause (aa) reads as under:

"(aa) the details of the invoice or debit note referred to in clause (a) has been furnished by the supplier in the statement of outward supplies and such details have been communicated to the recipient of such invoice or debit note in the manner specified under section 37;".

While the condition relating to the payment of tax by the supplier so as to entitle the buyer to ITC [see clause (c) of S.16(2)] has already been a cause of concern for taxpayers and a bone of contention between them and the Department, the new condition inserted vide clause (aa) as above will certainly add fuel to the fire. Thankfully, this clause inserted by section 109 of the Finance Act, 2021 is yet to come into force in view of section 1(2)(b) of the Finance Act, 2021. Intertwined with these conditions are the restrictive provisions of Rule 36(4) of the CGST Rules, 2017 ('the Rules') and the provisions of Rules 59 and 60 of the Rules governing the FORM GSTR-2A and FORM GSTR-2B. The implications of the aforesaid conditions and other attendant provisions as well as their legality, validity, constitutionality and maintainability are discussed hereinafter.

[Continued]

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