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**Department loses battle against ITC
reversal on Manufacturing Loss**

But will there be any winners at end of war??

Introduction

In a recent survey carried by our firm on social media, around 85% of the people voted that issue of Input Tax Credit ('ITC') eligibility has not settled even after 4 years of GST. Not surprisingly, the industry is encountering a reality mismatch and fears that disputes relating to ITC will fill Courts in coming times.

The main reason for disputes on ITC stems from restrictions placed under Section 17(5) of the Central Goods and Services Tax Act, 2017 ('CGST Act') on eligibility of ITC; and absence of clarity on intention and scope of such coverage. This article revolves around Section 17(5)(h), which inter-alia denies ITC on goods lost or destroyed and dispute raised by the department on its coverage. The department denies ITC on goods lost during manufacturing activity (manufacturing normal loss), stating that Section 17(5)(h) will apply in this case.

Manufacturing loss is unavoidable and occurs majorly due to inherent nature of production operation. Inputs at time of processing may be wasted, spoiled or scrapped, and thus lost. One can also recall the cost accounting principles wherein normal loss is considered as part of direct costs.

In indirect taxation, disputes regarding availability of credit on 'manufacturing loss' were raised in the erstwhile regime too. The issue has now opened its wings in GST law as well.

Chronicle of credit reversal on manufacturing loss in erstwhile regime

Many VAT laws had similar provisions requiring reversal of ITC in case of goods lost, destroyed, stolen etc. Section 19(9)(iii) of the Tamil Nadu VAT Act, 2006 disallowed ITC on inputs destroyed at an intermediary stage of manufacture. Rule 7(3) of the Delhi VAT Rules, 2005 required reversal of ITC where inputs or manufactured goods were lost or destroyed. Similar provision existed in the Uttar Pradesh VAT Rules, 2008.

The erstwhile regime had experienced ample jurisprudence where the Courts consistently held that situation of inputs consumed in manufacture is different from situation where inputs or intermediate goods are destroyed. The Courts under VAT regime thus held that credit reversal will not trigger on inputs consumed in manufacture and suffer some loss in the process. Similarly, under Central Excise as well, the Courts held that goods issued to manufacturing process and destroyed / lost thereafter will be considered as used in manufacturing process and will not warrant any credit reversal.

Recent decisions of Madras High Court and AAAR in GST

In case of **ARS Steels & Alloy International Private Limited v. STO, 2021-VII-484-MAD**, the Petitioner incurred loss of some portion of inputs during manufacturing process. The department demanded reversal of ITC on inputs lost during manufacturing process under the garb of Section 17(5)(h). The High Court observed that Section 17(5)(h) **will cover situations of quantifiable loss of inputs which involve external factors or compulsions**. The High Court held that the loss occasioned by consumption during manufacture is inevitable and hence, is inherent to the process of manufacture itself. Accordingly, ITC reversal under Section 17(5)(h) will not attract.

Similar view was expressed in the case of **General Manager Ordinance Factory Bhandara, 2020-VIL-36-AAAR**. The Appellate Authority for Advance Ruling held that inputs once consumed in testing cannot be said to be destroyed. Once inputs are used in manufacturing process, they cease to exist and lose their identity. Thus, such inputs cannot be later considered as destroyed, lost or stolen.

We concur with the views of Madras High Court in ARS Steels and AAAR in General Manager Ordinance Factory. We believe that inputs which are used in any manufacturing process loses its identity and can be said to be used in manufacturing process, irrespective whether some portion of them are lost during the said process. The inherent nature of such goods or manufacturing process should not result in declaration of such goods as lost. **It is rather a loss in identity than a loss of inputs.**

Will decision bring peace of mind for taxpayers?

The modern era beings (including artificial beings i.e. corporates) crave for peace of mind. While this should be a settled position of no ITC reversal on inputs lost in manufacturing / testing process under GST regime as well, yet the issue is reaching the doors of Courts to provide relief. The decision of High Court brings some relief to the industry regarding ITC on inputs lost during manufacturing process; but also brings forth a concerning fact that department is prepared to interpret 'lost' or 'destroyed' in widest sense. The interpretation adopted by department in this case leads to distrust against the whole idea of GST being the law created for seamless flow of ITC.

Taxpayers will be concerned that questions may now commence on ITC reversal in other situations as well including abnormal loss during manufacturing activity in exceptional cases, inputs or finished goods destroyed during testing or Research & Development, control samples which are destroyed when their useful life is over. In all these cases, the goods were used for intended purposes and such activities are actually part and parcel of business processed itself and thus not lost.

The High Court did not shed light on ITC eligibility in such cases, and the Authors are concerned that department may now target any kind of loss or destruction without considering the nature / cause / circumstance in which such loss or destruction takes place. Author's feel that taxpayers should be provided clarity on intent and coverage of ITC restriction under this clause. Taxpayers may consider filing representations for seeking clarity on these points.



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