Amicus
Transcending Frontiers

Tax Times

Issue:1.3|May, 2017

Not Really a Seamless Credit Mechanism – The Story of 'Blocked Credits'

A seamless credit flow is the bedrock of an efficacious GST mechanism whereby cascading effect of taxes is eliminated through a chain of tax credits allowed for set off against output tax liability at each stage. With the introduction of GST regime in India, expectations were high on seamless availability of Input Tax Credits ('ITCs) on various business expenses such as employee insurance, business travel, rent-a-cab etc., that are currently 'blocked' under the 'existing law'. Strangely enough, expectations were belied as these ITCs continue to be 'blocked' under the imminent GST regime. In brief, the taxpayer cannot avail ITCs on following important categories of expenditure under the GST regime:

- Motor vehicles (except for a few taxpayers like transporters, vehicle dealers etc);
- Food & beverages and outdoor catering etc;
- Health treatment, membership of fitness club etc;
- Taxi/ cab service, Insurance (except when required by law); and
- Works contract services;

A perusal of the above list reveals that the situation has remained unchanged or become stricter as regards 'blocked credits' under the GST Regime.

Rationale for 'Blocked Credits' – 'Business' vs 'Personal' Expenditure

The fundamental principle for denial of ITCs is the argument of 'personal expenditure'. ITCs on goods and services used for personal consumption should not be allowed. However, there is a thin line of distinction between 'personal' and 'business' expenditure. It so happens that under the pretext of personal expenditure, genuine business expenditure also suffers disallowance of legitimate ITCs.

Let's take the case of food consumed on business trips? One could argue that it is not really business expenditure, as one would have consumed food in any case, whether or not one were on a business trip. Another view could be that credit of tax paid on all business expenses including food expenses should be allowed because after all, the trip was 'in furtherance' of business and all the expenses including food expenses were incurred by the company on behalf of the travelling employee.
The case for travel expenses stands on an even stronger footing. The Company would normally not have incurred it without a business purpose nor would the employee have necessarily incurred it in absence of the corporate objective. Hence, it does appear to be somewhat harsh that corporates should be denied the benefit of ITCs on such expenditure. Similar is the case of works contract services utilized in the course of business.

There are other reasons why 'blocked' credits do not strike a logical chord in a scheme of input-output tax. If certain expenditure is allowed as 'business' expenditure for income-tax purposes then it fails reason how the same expenditure can be viewed differently by another arm of the same Government. It is a classic case of two arms of the same Government maintaining different opinions on the same issue – whether expenditure is 'business' or 'personal' in nature? Moreover, while denial of legitimate ITCs may not necessarily provide additional revenues to the Government, as higher input costs are passed on to end-consumer, 'blocked credits' may contribute to inflationary pressure.

Comparative View

In the UK, Australia and Canada, input tax paid on purchase of motor vehicles and their maintenance and running costs are allowed as credits, provided the vehicles are used exclusively for business purpose. In contrast, Indian law does not provide for credit of input taxes paid on motor vehicles at all, except where the taxpayer is a transporter, dealer or taxi service provider using such vehicles.

Canada allows 50% of ITCs for business meals and entertainment expenses. UK also allows ITCs on Taxi Charges, Car and restaurant expenses. On the other hand, taxes paid on hotel accommodation are almost universally allowed as credits (including in India).

On a comparative evaluation of 'blocked credits', it cannot be denied that Indian Law takes an extremely conservative approach on admissibility of ITCs.

Conclusion

The framework of ITCs under GST allows far greater admissibility of credits for every kind of business compared to the existing regime. Every business entity, whether a manufacturer, trader or service provider can avail tax credits on all kinds of inputs whether capital, raw material or of service nature with a a relatively simpler documentation. There are no restrictions on claim of credits between state and central taxes. However, the credit mechanism would have been truly seamless had the government approached the issue of 'blocked credits' in a more flexible manner. The current scheme of blocked credits seems to be a carry forward from the past with its attendant consequences of cascading impact and pricing pressures. Be that as it may, this is what taxpayers must reckon with while factoring ITCs in GST returns as we move forward. As the Central GST Legislation has now been finalized, we shall have to wait and see if at all the Government re-visits its stand on 'Blocked Credits' in future years.

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