DegreeLive

B.Com Honours

Semester V

Calicut University

Indirect Tax Laws and Practice

Course Code: COM5EJ314 (7) • Module 3 Notes

MODULE III: INPUT TAX CREDIT (ITC)

THE BEATING HEART OF GST: SEAMLESS CREDIT, REVERSALS & DISTRIBUTION

MODULE OVERVIEW

Input Tax Credit (ITC) is the lifeblood and defining operational mechanism of the Goods and Services Tax (GST). It operationalizes the core economic promise of a value-added tax by ensuring that businesses pay tax strictly on the incremental value added, preventing the archaic cascading of tax on tax. However, the legal right to claim ITC is neither absolute nor automatic; it is governed by rigorous statutory conditions, strict negative-list exclusions, complex apportionment formulas, and institutional distribution mechanics. This module provides a comprehensive, rigorous examination of Input Tax Credit under the **Central Goods and Services Tax (CGST) Act, 2017**: statutory definitions of inputs, input services, and capital goods; eligibility criteria and four mandatory conditions under Section 16; the blocked credits negative list under Section 17(5); apportionment between business and personal/exempt supplies; the reversal of common credit under Rules 42 and 43; and the distribution of input credit by an **Input Service Distributor (ISD)** under Section 20.

Eligibility & Conditions

Section 16 prerequisites, invoice possession, physical receipt, tax payment to treasury, return filing, and 180-day rule.

Blocked Credits (Sec 17(5))

Negative list: motor vehicles, catering, employee insurance, works contract on immovable property, lost goods, personal use.

Reversal & ISD (Sec 20)

Rules 42 and 43 mathematical reversals for exempt supplies, common credit apportionment, and Input Service Distributor rules.

1. Essential Statutory Concepts: Inputs, Input Services, and Capital Goods

To establish the legal boundary of Input Tax Credit, the CGST Act draws sharp statutory distinctions across three categories of business inward supplies:

CORE STATUTORY DEFINITIONS UNDER SECTION 2 OF THE CGST ACT, 2017

STATUTORY DEFINITIONS

Statutory Term & Section	Statutory Definition under the Act	Practical Examples & Accounting Treatment
"Input" **[Section 2(59)]**	Any goods, other than capital goods, used or intended to be used by a supplier in the course or furtherance of business.	Raw materials, packaging boxes, lubricating oil, spare parts, and consumables used in manufacturing. Charged directly to profit and loss account as revenue expenditure.
"Input Service" **[Section 2(60)]**	Any service used or intended to be used by a supplier in the course or furtherance of business.	Factory electricity, factory building rent, software maintenance, auditing and legal counsel, transport freight, and business broadband. Revenue operating expenses.
"Capital Goods" **[Section 2(19)]**	Goods, the value of which is **capitalized in the books of account** of the person claiming the input tax credit and which are used or intended to be used in the course or furtherance of business.	Industrial plant and assembly machinery, delivery trucks, laboratory testing equipment, office computers, and servers. Capitalized on balance sheet; depreciated over useful life.
"Input Tax" **[Section 2(62)]**	The Central tax (CGST), State tax (SGST), Integrated tax (IGST), or Union territory tax (UTGST) charged on any supply of goods or services made to a registered person, including:	• Tax on inward supplies. • Tax paid under Reverse Charge Mechanism (RCM) [Sec 9(3)/9(4)]. • Integrated tax charged on import of goods. *(Excludes tax paid under Section 10 Composition Scheme).*

2. Eligibility and Conditions for Availing Input Tax Credit (Section 16)

Under **Section 16(1) of the CGST Act**, every registered person is entitled to take credit of input tax charged on any supply of goods or services used or intended to be used in the course or furtherance of business. However, **Section 16(2)** mandates four indispensable statutory prerequisites:

THE FOUR MANDATORY PILLARS FOR AVAILING ITC UNDER SECTION 16(2)

ELIGIBILITY PILLARS

1. Possession of Valid Tax Invoice

The registered person must be in physical or electronic possession of a valid **Tax Invoice**, Debit Note, or Bill of Entry issued by a registered supplier containing all prescribed statutory particulars (GSTIN, description, value, tax split).

2. Actual Receipt of Goods / Services

The taxpayer must have actually received the goods or services. Includes deemed receipt under the **"Bill to Ship to" model** where goods are delivered to a third party on the direction of the buyer before or during transit.

3. Tax Actually Paid to Government

The supplier must have actually deposited the tax charged into the government treasury (in cash or through eligible ITC). Under Section 16(2)(aa), the invoice must be reflected in the buyer's auto-generated **GSTR-2B statement**.

4. Furnishing of Valid Return

The recipient taxpayer must have formally furnished the monthly/quarterly return under Section 39 in **Form GSTR-3B**. Zero ITC can be claimed without filing the statutory return.

Critical Statutory Restrictions on Input Tax Credit under Section 16

- **The 180-Day Payment Rule (Second Proviso to Section 16(2)):** The recipient must pay the supplier the value of the invoice along with the tax within **180 days** from the invoice date. If unpaid within 180 days, the ITC availed must be reversed and added to output tax liability, along with 18% statutory interest. When payment is subsequently made, the credit can be re-availed without time limit.
- **No Double Benefit on Capital Goods Depreciation [Section 16(3)]:** If a taxpayer capitalizes the input tax amount and claims income tax depreciation on the tax component under Section 32 of the Income Tax Act, 1961, **Input Tax Credit shall NOT be allowed**. The taxpayer must choose: claim ITC under GST OR claim depreciation under Income Tax.
- **Statutory Time Limit for Availing ITC [Section 16(4)]:** ITC in respect of any invoice or debit note cannot be claimed after the **30th day of November** following the end of the financial year, or the actual date of filing the relevant annual return (GSTR-9), whichever is earlier.

3. Blocked Credits: The Negative List under Section 17(5) of CGST Act

Notwithstanding that goods or services are used genuinely in the course of business, **Section 17(5)** contains an overriding non-obstante clause specifying certain inward supplies where **Input Tax Credit is completely blocked and legally prohibited**:

COMPREHENSIVE CATALOG OF BLOCKED CREDITS UNDER SECTION 17(5)

BLOCKED CREDITS LIST

Clause under Section 17(5)	Category of Inward Goods / Services	Statutory Ineligibility & Authorized Exceptions
Section 17(5)(a) & (aa) Motor Vehicles & Conveyances	Motor vehicles for transportation of persons having approved seating capacity of **not more than 13 persons** (including driver), vessels, and aircraft.	**ITC is BLOCKED.** *Exceptions (ITC ALLOWED):* When used for: (i) further supply of such vehicles (car dealership); (ii) transportation of passengers (taxi operators); or (iii) imparting driving training.
Section 17(5)(b)(i) Personal Care & Catering	Food and beverages, outdoor catering, beauty treatment, health services, cosmetic and plastic surgery, life insurance, and health insurance.	**ITC is BLOCKED.** *Exceptions (ITC ALLOWED):* Where inward supply is used to make an identical outward taxable supply, or where it is **statutorily obligatory for the employer** to provide under any law (e.g., mandatory employee health insurance).
Section 17(5)(b)(ii) & (iii) Club Memberships & Travel	Membership of a club, health, and fitness center; and travel benefits extended to employees on vacation (LTC/LTA).	**100% BLOCKED.** Pure personal welfare benefits; zero exceptions under any commercial circumstance.
Section 17(5)(c) Works Contract for Immovable Property	Works contract services supplied for construction of an **immovable property** (other than plant and machinery).	**ITC is BLOCKED.** *Exceptions:* (i) Where it is an input service for further supply of works contract; or (ii) Construction of **Plant & Machinery** (foundations, structural supports).
Section 17(5)(d) Self-Construction of Immovable Property	Goods or services received by a taxable person for construction of an immovable property (other than plant and machinery) **on his own account**, including when used in business.	**ITC is BLOCKED.** Cement, steel, paint, and architect fees used to construct a corporate office, hotel building, or factory shed cannot be credited.
Section 17(5)(g) Personal Consumption	Goods or services used for personal consumption of promoters, directors, or employees.	**100% BLOCKED.** Direct extraction of business resources for private personal utility.
Section 17(5)(h) Lost, Stolen, or Gifted Goods	Goods lost, stolen, destroyed, written off, or disposed of by way of gift or free trade samples.	**ITC is BLOCKED.** If input credit was already claimed at purchase, it must be reversed immediately upon loss, theft, destruction, or gifting.

4. Apportionment of Credit and Common Credit Reversals (Rules 42 & 43)

Where a business incurs input taxes on inputs, services, and capital goods that are used for mixed commercial purposes, the law demands scientific apportionment:

1	2	3	4
Total Credit (T) ➔	**Direct Ineligible** ➔	**Identify Common** ➔	**Rule 42 Reversal**
Aggregate input tax paid on all inward invoices during the tax period.	Deduct T1 (non-business), T2 (exempt supplies), and T3 (blocked under Sec 17(5)).	Deduct T4 (exclusively taxable) to isolate common pool: Common Credit (C2).	Reversing D1 = (Exempt Turnover / Total Turnover) × C2, and D2 = 5% of C2.

MATHEMATICAL MECHANICS OF RULE 42 (INPUTS AND INPUT SERVICES)

RULE 42 FORMULA

Step-by-Step Rule 42 Computation Protocol:

- **Total Input Tax (T)**
- *Less:* T1 = Input tax attributable exclusively to non-business purposes.
- *Less:* T2 = Input tax attributable exclusively to exempt supplies.
- *Less:* T3 = Input tax blocked under Section 17(5).
- **Eligible Credit credited to Electronic Credit Ledger: C1 = T - (T1 + T2 + T3)**
- *Less:* T4 = Input tax attributable exclusively to taxable supplies (including zero-rated exports).
- **Common Input Tax Credit (C2) = C1 - T4**

Reversals from Common Credit:

- **D1 (Credit attributable to Exempt Supplies) = (E / F) × C2**

(Where E = Aggregate value of exempt supplies during the month, F = Total turnover of the registered person).

- **D2 (Credit attributable to Non-Business Purpose) = 5% of C2**
- **Net Eligible Common Credit: C3 = C2 - (D1 + D2)**
- *Note: D1 and D2 must be added to the output tax liability in Form GSTR-3B.*

5. Input Service Distributor (ISD) Mechanism (Section 20 of CGST Act)

Large corporate enterprises often maintain a centralized corporate headquarters (e.g., in Mumbai) that procures common national services (statutory software licenses, nationwide brand advertising, legal advisory, management consultancy) on behalf of distinct manufacturing plants and branch offices located across multiple States. The **Input Service Distributor (ISD)** mechanism codifies the legal procedure for distributing this centralized credit:

STATUTORY RULES FOR CREDIT DISTRIBUTION BY AN ISD (SECTION 20 & RULE 39)

ISD RULES

1. Specific Unit Allocation

If an input service is attributable exclusively to one specific operating recipient unit, the credit must be distributed **entirely to that recipient unit alone**, and cannot be shared with other branches.

2. Pro-Rata Turnover Allocation

If an input service is common to multiple units (or all units), the credit must be distributed pro-rata based on the operational turnover of each unit:
Credit to Unit A = (Turnover of Unit A / Total Turnover of all recipient units) × Common Credit.

3. Cross-Border Distribution Rules

• **Different State Units:** CGST and SGST credit held by the ISD is distributed to units located in other States as **Integrated GST (IGST)**.
• **Same State Units:** CGST and SGST are distributed as respective CGST and SGST.

4. Mandatory Registration & Invoicing

The corporate office must obtain a separate dedicated **ISD Registration** under Section 24, issue formal **ISD Invoices**, and file monthly return **Form GSTR-6** by the 13th of each month.

6. Comprehensive Worked Numerical Problems and Practical Applications

WORKED NUMERICAL PROBLEM 1: CLASSIFICATION OF INELIGIBLE BLOCKED CREDITS UNDER SECTION 17(5)

BLOCKED CREDIT PROBLEM

Context: Apex Manufacturing Ltd. incurs the following GST expenditures during November 2026. Evaluate the statutory eligibility of each line item under Section 16 and Section 17(5):

Inward Expenditure Item	GST Paid (₹)	Statutory Status	Eligible ITC Admissible
Raw materials used in manufacturing factory	₹500,000	Eligible Input [Sec 16(1)]	₹500,000
Factory assembly machinery capitalized	₹300,000	Eligible Capital Goods	₹300,000
Executive saloon car (7-seater) for MD	₹180,000	**BLOCKED [Sec 17(5)(a)]**	₹0 (Blocked)
Outdoor catering for Annual General Meeting	₹45,000	**BLOCKED [Sec 17(5)(b)(i)]**	₹0 (Blocked)
Mandatory factory workers health insurance	₹60,000	**ELIGIBLE (Statutory Duty)**	₹60,000
Civil construction of new administrative office	₹250,000	**BLOCKED [Sec 17(5)(d)]**	₹0 (Blocked)
Goods stolen from central warehouse	₹35,000	**BLOCKED [Sec 17(5)(h)]**	₹0 (Blocked)
Total Input Tax Paid on Purchases	**₹1,370,000**	-	**Total Eligible ITC = ₹860,000**

WORKED NUMERICAL PROBLEM 2: RULE 42 APPORTIONMENT & REVERSAL OF COMMON CREDIT

RULE 42 COMPUTATION

Context: Zenith Enterprises reports the following figures for December 2026:
• Total Input Tax (T) = ₹1,000,000.
• T1 (Non-business) = ₹50,000; T2 (Exempt supplies) = ₹100,000; T3 (Blocked Sec 17(5)) = ₹50,000.
• T4 (Exclusively taxable supplies) = ₹500,000.
• Turnover of Exempt Supplies (E) = ₹2,000,000; Total Turnover (F) = ₹10,000,000.
Compute the common credit and the exact reversals D1 and D2 under Rule 42.

Step-by-Step Rule 42 Computation:
1. C1 (Credit credited to ledger) = T − (T1 + T2 + T3)
C1 = ₹1,000,000 − (₹50,000 + ₹100,000 + ₹50,000) = ₹1,000,000 − ₹200,000 = **₹800,000.**
2. Common Credit (C2) = C1 − T4 = ₹800,000 − ₹500,000 = **₹300,000.**
3. D1 (Credit attributable to Exempt Supplies) = (E / F) × C2
D1 = (₹2,000,000 / ₹10,000,000) × ₹300,000 = 0.20 × ₹300,000 = **₹60,000.**
4. D2 (Credit attributable to Non-Business Purpose) = 5% of C2
D2 = 0.05 × ₹300,000 = **₹15,000.**
5. Total Ineligible Reversal (D1 + D2) = ₹60,000 + ₹15,000 = **₹75,000** (Added to GSTR-3B output liability).
6. Net Eligible Common Credit (C3) = C2 − (D1 + D2) = ₹300,000 − ₹75,000 = **₹225,000.**
• **Total Final Retained ITC** = T4 (₹500,000) + C3 (₹225,000) = **₹725,000.**

WORKED NUMERICAL PROBLEM 3: DISTRIBUTION OF CREDIT BY INPUT SERVICE DISTRIBUTOR (SECTION 20)

ISD PROBLEM

Context: National Retailers Ltd. has its Corporate Head Office in Mumbai (registered as an ISD). During December 2026, the ISD receives an invoice for nationwide brand advertising services with IGST of ₹600,000. The turnover of its operating retail units in the preceding financial year was:
• Unit Mumbai (Maharashtra): ₹50 Crores.
• Unit Bengaluru (Karnataka): ₹30 Crores.
• Unit Kochi (Kerala): ₹20 Crores.
• Total Turnover of all recipient units = **₹100 Crores**.
Determine the distribution of credit to each unit under Section 20.

```
Distribution Calculation (Pro-Rata Turnover Basis):
1. Credit to Unit Mumbai (Same State):
• Proportion = 50 / 100 = 50%.
• Credit Amount = 50% of ₹600,000 = ₹300,000 (Distributed as IGST).
2. Credit to Unit Bengaluru (Different State):
• Proportion = 30 / 100 = 30%.
• Credit Amount = 30% of ₹600,000 = ₹180,000 (Distributed as IGST).
3. Credit to Unit Kochi (Different State):
• Proportion = 20 / 100 = 20%.
• Credit Amount = 20% of ₹600,000 = ₹120,000 (Distributed as IGST).
• Total Distributed = ₹300,000 + ₹180,000 + ₹120,000 = ₹600,000.
```

7. Apportionment and Reversal of Credit on Capital Goods (Rule 43)

While Rule 42 governs inputs and input services, **Rule 43 of the CGST Rules** establishes the statutory mathematical procedure for apportioning and reversing Input Tax Credit on **Capital Goods** (industrial plant, machinery, assembly robots, servers) used commonly for taxable and exempt supplies:

THE FIVE-YEAR USEFUL LIFE ARCHITECTURE UNDER RULE 43

RULE 43 PRINCIPLES

60-Month Deemed Useful Life

The useful life of all capital goods is statutorily presumed to be **60 months (5 years)** from the date of the invoice. Credit is not written off in one stroke, but is tracked over a 5-year operational lifecycle.

Initial 100% Credit Booking

The full input tax paid on common capital goods is credited immediately to the Electronic Credit Ledger in the month of purchase to ensure enterprise liquidity and prevent working capital blockage.

Monthly Common Credit (Tm)

The common capital goods credit is broken down into 60 equal monthly tranches:
Tm = Total Common Capital Goods Tax (Tc) / 60 months.

Monthly Statutory Reversal (Te)

For each month during the 5-year lifecycle, the ineligible credit attributable to exempt supplies is computed and added to GSTR-3B output liability:
Te = (Turnover of Exempt Supplies / Total Turnover) × Tm.

WORKED NUMERICAL PROBLEM 4: MATHEMATICAL COMPUTATION OF CAPITAL GOODS REVERSAL UNDER RULE 43

RULE 43 PROBLEM

Context: Precision Polymers Ltd. purchases an industrial injection molding machine for ₹12,000,000 with 18% IGST (Input Tax = **₹2,160,000**). The machine is capitalized and used for producing both taxable industrial automotive components and exempt medical plastic pipettes. In January 2027, the company reports:
• Exempt Supplies Turnover (E) = ₹2,500,000.
• Total Commercial Turnover (F) = ₹10,000,000.
Calculate the monthly input tax credit tranche (Tm) and the exact ineligible reversal (Te) for January 2027.

```
Step-by-Step Rule 43 Calculation:
1. Total Common Capital Goods Input Tax (Tc) = ₹2,160,000.
2. Monthly Credit Tranche (Tm) = Tc / 60 months
Tm = ₹2,160,000 / 60 = ₹36,000 per month.
3. Proportion of Exempt Turnover = E / F = ₹2,500,000 / ₹10,000,000 = 0.25
(25%).
4. Monthly Reversal Amount (Te) = (E / F) × Tm
Te = 0.25 × ₹36,000 = ₹9,000.

Operational Compliance Action:
• Precision Polymers Ltd. credited the full ₹2,160,000 into its Electronic
Credit Ledger upon machine delivery.
• In January 2027, the firm must add ₹9,000 to its outward tax liability in
Table 4(B) of Form GSTR-3B.
• The remaining ₹27,000 represents valid, retained input tax credit for that
month.
```

8. Input Tax Credit in Job Work (Sections 19 & 143) and Business Transfer (Rule 41)

Modern industrial supply chains rely extensively on specialized third-party processing (job work) and corporate reorganizations. The CGST Act provides robust statutory frameworks to safeguard input credit across these commercial transitions:

STATUTORY GOVERNANCE OF ITC ON JOB WORK TRANSACTIONS (SECTION 19 & SECTION 143)

JOB WORK ITC

Compliance Aspect	Statutory Rule & Procedure	Consequences of Non-Compliance
Availing Credit on Inward Dispatch	The principal manufacturer is legally entitled to claim 100% ITC on inputs and capital goods even if they are sent directly to a job worker without first entering the principal's registered factory.	Fosters supply chain efficiency; eliminates unnecessary transportation back-and-forth between suppliers and job work units.
Time Limit for Return of Inputs	Inputs sent for job work must be brought back to the principal's premises (or supplied directly from job worker premises on tax payment) within **1 year** (extendable by 1 year by Commissioner).	**Deemed Supply:** If inputs are not received back within 1 year, it is deemed to be a **taxable supply made by the principal to the job worker on the day the inputs were originally sent out**, with full interest from day one!
Time Limit for Return of Capital Goods	Capital goods sent for job work must be returned to the principal within **3 years** (extendable by 2 years). Exception: Moulds, dies, jigs, and fixtures need not be brought back.	If capital goods are not returned within 3 years, the transaction is deemed to be a supply on the original dispatch date, triggering retrospective tax and interest penalties.

Transfer of Unutilized ITC on Change in Business Constitution (Section 18(3) & Rule 41)

Where there is a change in the constitution of a registered business on account of sale, merger, demerger, amalgamation, lease, or transfer of the business with a specific provision for transfer of liabilities:

- **Transfer of Credit:** The registered person is legally entitled to transfer the unutilized Input Tax Credit lying in their Electronic Credit Ledger to the newly formed or transferee entity.
- **Form GST ITC-02:** The transferor submits **Form GST ITC-02** electronically on the GST Common Portal along with a request for transfer of credit, which the transferee accepts online.
- **Chartered Accountant Certification:** The transferor must upload a certificate issued by a practicing Chartered Accountant or Cost Accountant certifying that the sale, merger, or amalgamation contains a specific statutory provision for the transfer of business liabilities.
- **Apportionment in Demergers:** In the case of a corporate demerger, the unutilized ITC is apportioned between the surviving company and the demerged entity in the **exact ratio of the value of assets** transferred as per the approved court/NCLT scheme.

Synthesis: The Virtuous Cycle of Input Tax Credit

Input Tax Credit is the foundational engine that transforms GST from a burdensome turnover tax into an equitable, growth-oriented value-added tax system. By allowing registered suppliers to offset the tax paid on purchases against their outward tax liabilities, ITC completely eliminates cascading tax on tax, reduces industrial production costs, and bolsters the global competitiveness of Indian trade. Concurrently, by conditioning credit eligibility upon genuine business use, valid invoice matching in GSTR-2B, and strict reversals under Section 17(5) and Rule 42, the law safeguards the public treasury against fictitious billing and fraudulent leakage, cementing the integrity of modern indirect tax governance.