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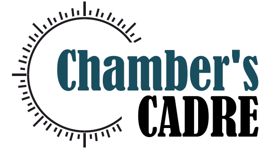

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Vol. XI | No. 12 | September 2023

GST and INCOME TAX

Divergence & Analysis

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Business Expenditure – Similarity and Divergence between Income Tax & GST laws

CA Rohit Jain CA Arihant Tater

Overview

The article attempts to analyse the similarities and divergences in the provisions of the Income Tax and GST laws pertaining to business expenditure. On first flush, it may appear that both the taxing provisions are similar in nature. However, a deeper analysis would reflect that there are certain nuanced differences. The disallowances under both statutes are distinct and unrelated. The authors also highlight certain industry specific issues and point out that it has been recently observed that investigation by one wing of the Tax Department has also eventually invited scrutiny from the other Department.

In the modern economy, the power to levy taxes has been recognized as an essential attribute to sovereignty. The levy of tax by any sovereign nation is premised on three basic considerations – to raise revenue, carry out certain economic and social changes and discourage consumption of articles which the State regards as undesirable. Consistent with this objective, our direct and indirect tax laws have been framed by the legislature.

The Income Tax Act, 1961, which has been in vogue for more than sixty years, is a comprehensive direct tax levy on "income" earned by a person. The younger brother - GST, which was introduced in 2017, is a comprehensive indirect tax levy on the "supply" of goods and services.

Income Tax is levied on "income" and collected by the Central Government under Entry 82 of List I in the Seventh Schedule of the Constitution of India. The term "income" pre-supposes that it should be computed after providing deduction for all the expenditure incurred by the business for earning such income.

GST is levied concurrently by both the Central and State Governments under Article 246A of the Constitution of India. Recently, the Hon'ble Supreme Court (speaking through Chief Justice D Y Chandrachud) in the case of ***Union of India vs. Mohit Minerals [Civil Appeal No. 1390 of 2022 (SC)***] remarked that GST is a symbol of "co-operative federalism" as both the Union and the State legislatures have "equal, simultaneous and unique" powers to make laws on GST. The idea of GST was born out of the desire to have "one nation, one tax" and ensure that every rupee discharged as tax on procurement is correspondingly available as credit.

Common principle governing both levies

Section 37 of the Income Tax Act is the general provision which deals with grant of deduction qua items of business expenditure. Any expenditure which is incurred wholly and exclusively for the purposes of the business

shall be allowed as deduction for computing business income.

On the other hand, section 16 of the Central Goods and Services Tax Act, 2017 ('CGST Act') deals with availment of input tax credit ('ITC') on goods and services used or intended to be used in the course or furtherance of business.

On first flush, on a comparison of section 37 vis-à-vis section 16, it may appear that the Income Tax and GST provisions are similar in nature – they allow seamless claim of expenditure/ITC which are in relation to business and disallow personal expenses. If the true intent of both the taxing provisions is gauged, a business should ordinarily be allowed deduction of all expenditures which are incurred in the course of business.

However, a deeper analysis would reflect that there are certain *nuanced* differences in both the provisions. The article attempts to analyse some of these divergences.

Allowability of expenditure under the Income Tax Act

The Income Tax Act provides detailed provisions to claim deduction of expenses incurred for earning business income. Sections 30 to 36 of the Act deals with specified deductions for computing profits and gains of business or profession and also prescribe certain conditions to avail such deductions.

Section 37 is a residuary section under the Income Tax Act extending the allowance to items of business expenditure which are not specifically covered under any of the preceding provisions. In terms of settled judicial precedents, the following conditions must be fulfilled for a particular item of expenditure to be allowed as deduction in computation of business income under section 37:

a. The expenditure should have been incurred in the accounting year;

b. The expenditure should be incurred exclusively and wholly for the purpose of business which was carried on by the assessee;

c. The expenditure should not be in the nature of personal expenses of the assessee;

d. The expenditure should not be in the nature of capital expenditure.

Once an assessee satisfies the above conditions, the claim of expenditure must be allowed. Courts have consistently held that the Tax Department "*cannot step into the shoes of the businessman*" to decide whether a particular expense is necessary or not. It is also not open for the Department to prescribe what expenditure an assessee should incur and in what circumstances he should incur that expenditure [Ref: ***Phaltan Sugar Works Ltd. vs. CIT reported in 1995 215 ITR 377 (Bom HC)***]

Allowability of ITC under the CGST Act

Under the erstwhile indirect tax regime, no set-off of central levies (such as excise duty, service tax) with state levies (such as VAT, entry tax) and *vice-versa* was permitted. Furthermore, no set-off was available in respect of certain specified levies such as CST, Entertainment Tax, Swachh Bharat Cess etc.

Therefore, one of the primary reasons for introduction of GST was to remove the cascading impact caused by multiplicity of indirect taxes and ensure seamless flow of credit across the chain. This underlying objective ought to be kept in mind at the time of analyzing the GST provisions.

Under section 16 of the CGST Act, the important conditions that must be fulfilled for availment of ITC are, *inter alia*:

a. The expenditure must be used or intended to be used in the course or furtherance of his business.

b. The registered person must have received the goods or services;

c. The registered person must be in possession of valid tax invoice.

d. The expenditure should not be personal in nature.

It is a well settled position in law that that the right to input tax credit accrues consequent to the payment of tax, subject to the applicable provisions of law as on the date of accrual. Once the right to the credit so accrues, the same is in the nature of a vested right which is "indefeasible", as upheld in the landmark ruling of the Hon'ble Supreme Court in ***CCE vs. Dai Ichi Karkaria Ltd. [1999 (112) ELT 353 (SC)***].

Divergence in the negative list of disallowances under the respective statutes

A bare perusal of the statutory provisions would indicate that the negative list of disallowances under the Income Tax and GST law are distinct and separate - in scope as well as objective. Both statutes have drawn their respective negative list of disallowances.

Under the Income Tax Act, the objective behind the negative list of disallowances appears to be to (a) ensure compliance with TDS provisions, (b) curb tax evasion, and (c) identify unaccounted and cash transactions etc. The disallowances under the Income Tax are provided in section 40 & 40A of the Income Tax Act, *inter alia*:

- Disallowance on account of default in deduction of TDS/equalization levy on specified payments made to non-residents;
- Disallowances on account of default in deduction of TDS in respect of payments to residents [30% of the expense is disallowed];
- Income tax payments;
- Remuneration and interest on capital to partner beyond specified limit;
- Excessive on unreasonable payments to related parties;
- Cash payments exceeding INR 10,000.

On the other hand, the negative list of disallowances under GST is provided in section 17(5) of the CGST Act. These disallowances largely borrow inspiration from the erstwhile CENVAT regime as well as past litigation under erstwhile indirect tax regime. They also stem from the intent to disallow credits which do not have any link with a taxable outward supply. In case, for any reason, ITC is not eligible under section 17(5), the taxpayer must explore the option of claiming the said amount as deduction under Income Tax.

The key disallowances under section 17(5) are, *inter alia*:

- Motor vehicles except when they are used for specified taxable supplies;
- Food and beverages, outdoor catering, beauty treatment, health services, cosmetic and plastic surgery, travel benefits extended to employees on vacation;
- Goods and services received for construction of immovable property;
- Goods or services on which tax has been paid under composition scheme;
- Personal consumption;
- Goods lost/stolen/destroyed as well as gifts & free samples;
- Any tax paid u/s 74, 129 & 130 [*viz*. fraud, suppression cases]

Distinction between capital and revenue expenditure

Deduction under section 37 is available only in respect of revenue expenditure. Under the

Income Tax Act, capital expenditure is allowed as a deduction only when the statute expressly so provides.

On the other hand, the GST law does not make a specific distinction between revenue and capital expenditure inasmuch as credit on inputs, input services and capital goods can be availed in full in the year of purchase. This is also a welcome departure from the provisions of the erstwhile CENVAT regime where credit on capital goods was required to be availed in two instalments – 50% in the first year and the balance 50% in the subsequent year.

However, it must be noted that where depreciation under income tax has been claimed on the tax component of capital goods, ITC would not be available to the taxpayer. This is to ensure that double benefit is not taken by taxpayers.

Requirement of making payment to the supplier

Under the Income Tax Act, deduction is available in respect of those expenses which are incurred in the accounting year. Therefore, when the books of accounts are maintained on mercantile basis, expenditure would be allowed in the year when the expenditure is incurred irrespective of whether disbursement has been made or not. The claim of expenditure is not contingent on payment except in certain cases as specified in section 43B (*viz*. provident fund contributions, interest on loan, MSME payments etc.).

However, under the GST law, in order to claim credit, it is mandatory that: (a) the tax in respect of the supply has been paid to the Government and (b) the payment is made to the supplier within 180 days from the date of invoice. The GST law puts an onerous requirement on the recipient to pay the supplier within the specified time limit, failing which the corresponding ITC is liable to be reversed alongwith interest.

Requirement of one-to-one matching

At the time of introduction of GST, it was contemplated by the legislature that a robust matching system would be tech-enabled on the GST portal, which would provide the purchasers and the suppliers the ability to reconcile invoices. The matching requirement has also been introduced in the statute book by insertion of section 16(2)(aa) with effect from 1 January 2022.

Therefore, input tax credit will only be allowed if credit claimed by the recipient in its monthly GST return (Form GSTR 3B) matches with the corresponding disclosure by the supplier in its Form GSTR 1 and is auto-populated in the recipient's Form GSTR 2A.

While the vires of the matching provision is currently the subject matter of Writ Petition before various High Courts, the provision exists in the statute book today and the taxpayer is debarred from claiming credit without fulfilling the matching condition. It would be pertinent to mention that recently the Hon'ble Calcutta High Court in the case of ***Suncraft Energy Private Limited vs Asst. Commissioner, State Tax [MAT No. 1218 of 2023 (Cal HC)***] held that in cases of mismatch, ITC cannot be denied to the recipient without due investigation at the supplier's end.

Unlike the GST law, there is no such matching condition under the Income Tax Act. The claim of expenditure is largely on self-assessment basis. However, in case of scrutiny assessment, the onus of proving that the expenditure has been incurred lies on the assessee.

Expenditure prohibited by law

In terms of Explanation 1 & 3 to section 37 of the Income Tax Act, any expenditure which is an offence or is prohibited by law is specifically disallowed.

Recently, the Hon'ble Supreme Court passed a landmark judgment in the case of ***Apex Laboratories Pvt. Ltd. vs. DCIT [Civil Appeal No. 23207 of 2019 (SC)***]. The issue before the Supreme Court was with respect to deductibility of expenses incurred by the taxpayer for providing freebies (such as conference fees, gold coins, gifts etc.) to medical practitioners to promote sales of healthcare supplements. The Hon'ble Supreme Court emphatically upheld the disallowance on the ground that acceptance of freebies by medical practitioners is in violation of Indian Medical Council Regulations of 2002. If accepting freebies is prohibited by law for the recipient, giving freebies is also impliedly prohibited by law. The Hon'ble Supreme Court also held that one arm of the law cannot be utilised to defeat the other arm of law and doing so would be opposed to "public policy."

Under the GST law, there is no specific provision which disallows credit in respect of an expenditure which is prohibited by law. In the erstwhile regime, the High Court & Tribunal have held that when tax has been collected from the supplier by the Government, the corresponding input tax credit cannot be denied at the recipient's end.

However, recently the Directorate General of Goods and Services Tax Intelligence (DGGI) has issued GST show cause notices against the Insurance companies for illegally paying excess commission to agents. It has been alleged that the payment of excess commission is in violation of the regulations formulated by the Insurance Regulatory and Development Authority of India (IRDAI). The DGGI has sought to deny ITC in respect of such transactions and the matter is currently pending adjudication. The issue is likely to be strongly litigated by both the Insurance Company and the GST Department.

CSR expenditure & legislative overruling

Under both direct and indirect tax regime, Courts have consistently held that any CSR expenditure incurred by a Company is in furtherance of its statutory obligations under the Companies Act. The CSR expenditure has been incurred in the course of the business and must be allowed as deduction.

However, in order to override these rulings, the legislature has made amendments under the Income Tax Act and the CGST Act to specifically disallow CSR expenditure.

Explanation 2 to section 37 was inserted by Finance Act, 2014 to provide that any expenditure incurred in relation to CSR would not be deemed to be an expenditure incurred by the assessee for the purpose of business or profession. Recently, the Hon'ble Delhi High Court in the case of ***Principal Commissioner of Income Tax vs. Steel Authority of India Limited [2023/DHC/000307 in ITA No. 3 of 2023***] held that the amendment even though inserted through an Explanation would be prospective in nature and only apply with effect from 1 April 2015.

Recently, amendment has also been made in section 17(5) of the CGST Act [with effect from 1 October 2023] to disallow ITC on CSR expenditure. If the ratio of the judgment of the Hon'ble Delhi High Court is followed, the amendment must be interpreted as prospective in nature. Hence, ITC for CSR expenditure for the period prior to 1 October 2023 may be available to businesses, subject to fulfilment of other conditions.

As clearly evident, under both statutes, the legislature has sought to overrule the judgments and specifically disallow CSR expenditure.

Specific sectors not eligible for input tax credit under GST

Under GST, certain specific sectors such as the real estate and the restaurant sector are not eligible to avail input tax credit. The benefit of input tax credit has been denied in toto to these sectors in lieu of grant of concessional

rate of tax of 5% on the outward supply. Similarly, a non-resident taxable person is not eligible to claim ITC except on import of goods.

However, there is no such sector specific expense disallowance under the Income Tax Act.

There are also certain other **procedural bottlenecks** in GST which bar claim of ITC. Some of these scenarios are illustrated below:

a. Under GST, each state GST registration is considered to be a "distinct person". Credit pertaining to one state GST registration (say State X) cannot be claimed by another state GST registration (say State Y) even if the expenses have been incurred by the Company in the course of business.

b. Similarly, liability of one state registration (State X) cannot be discharged through ITC availed by another state registration (State Y) qua the same Company. There is also no mechanism for inter-state transfer of credit within the same company.

c. Unlike income tax, ITC would not be available if the expense has been incurred but goods/services are yet to be received.

d. A duty paying document (invoice/bill of entry) is sine qua non for availment of credit.

e. ITC is also not available if the place of supply of goods or services is different from the state where the entity is registered.

It is universally recognised that the greatest virtue of a value added tax system is that a full and free flow of credits ensures that only the value addition in each leg of a transaction is subjected to tax. At the time of introduction of GST, one of the avowed objectives of the Government was to ensure seamless flow of credits. GST was touted as a good and simple tax. However, on account of the numerous legislative amendments as well as procedural bottlenecks, the idea of a good and simple tax and seamless flow of credit appears to be a far-fetched dream.

Conclusion

As analysed hereinabove, the disallowances under the Income Tax and GST law are distinct in both nature and objective. It cannot therefore be assumed that an expenditure which is allowable as deduction under the Income Tax Act would also be eligible for ITC under GST and vice versa.

Similarly, the Department cannot also assume that an expenditure which is not allowable under Income Tax would also not be eligible as ITC under GST. A taxing statute needs to be interpreted strictly and there is no room for intendment.

At the time of assessment, the taxpayer is required to demonstrate compliance to both authorities separately and fulfil the procedural conditions specified in the statute.

Before parting, it would also be important to note that there has been wide facilitation and sharing of data between income tax and GST authorities. It has been recently observed that investigation by one wing of the Tax Department has eventually also invited scrutiny from the other Department. By way of illustration, reference may be drawn to recent investigation initiated against pharma companies qua payments made to medical practitioners, bogus purchase and fake invoicing investigation etc.

It is therefore the need of the hour that taxpayers revisit their tax position with a view to ensure compliance and alignment with both laws.

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