Saga of Rule 89(4B) and woes of AA/EOU

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Introduction

To mitigate the complexities associated with the direct correlation of inputs and input services utilized for exports, Rule 89(4) of the CGST Rules provides a straightforward proportionate formula to determine the maximum allowable refund of GST. However, to safeguard the interests of the Revenue, Rules 89(4A) and 89(4B) were subsequently inserted. It is pertinent to note that these sub-rules do not prescribe a formula for calculating the eligible refund amount.

Despite the insertion of Rule 89(4A) & 89(4B), numerous Advance Authorisation (**AA**) holders and Export-Oriented Unit (**EOU**), either due to a lack of awareness or enticed by the simplicity of Rule 89(4), have erroneously filed refund claims and obtained refunds from the GST department. In strict compliance with the law, such claims ought to have been submitted under Rule ("**u/r**") 89(4A) or 89(4B).

Recently, the GST authorities have initiated actions to address these erroneous refunds. Notices have been issued to exporters/taxpayers demanding the recovery of refunds along with applicable interest and penalties. In this article, our partner, CA Jignesh Kansara, delves into the intricacies of Rule 89(4B), examines the repercussions of incorrect refund claims made u/r 89(4) and outlines the recommended course of action for affected taxpayers.

Rationale behind Rule 89(4B)

To elucidate the rationale behind Rule 89(4B) of the CGST Rules, let us consider a purely hypothetical scenario involving M/s ABC Manufacturer. M/s ABC imported raw materials valued at Rs. 300 lakhs under an Advance Authorization, exempt from the payment of Customs duty and Integrated Goods and Services Tax (IGST). The company incurred a conversion cost of Rs. 50 lakhs, attracting GST at the rate of 18%, amounting to Rs. 9 lakhs. Subsequently, M/s ABC exported the said manufactured goods for Rs. 450 lakhs under a Letter of Undertaking (LUT) without payment of IGST.

Furthermore, M/s ABC procured raw materials domestically worth Rs. 700 lakhs, subject to 12% GST, amounting to Rs. 84 lakhs. The company incurred an additional conversion cost of Rs. 154 lakhs, attracting GST at 18%, amounting to Rs. 27.72 lakhs, and domestically sold goods for Rs. 880 lakhs, charging 12% GST amounting to Rs. 105.60 lakhs. For the sake of convenience, let us assume these are the only transactions during the given month.

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Further, M/s ABC erroneously claimed and was granted a refund u/r 89. It is important to note that M/s ABC did not file any refund application u/r 89(4B) and, due to a lack of awareness, incorrectly filed a single refund application u/r 89(4), as elaborated below:

Inward supply	Cost (Lakhs)	Input GST (Lakhs)
Import against Advance Authorisation	300	0
Conversion cost for import purchase	**50**	**9**
Domestic purchase	700	84
Conversion cost for domestic purchase	154	27.72
Total	1204	120.72

Outward supply	Outward supply (Lakhs)	Output GST (Lakhs)
Export without tax (Out of Import)	450	0
Domestic supply with 18% Tax	880	105.60
Total	1330	105.60

Rule 89(4) formula in simplistic manner [as no refund was claimed u/r 89(4D)]

Maximum permissible refund = Total ITC * Export Supply/ Total Supply

120.72*450/1330

40.85 Lakhs

However, since the available balance in the electronic credit ledger of M/s ABC is only Rs. 15.12 lakhs (calculated as the total ITC of Rs. 120.72 lakhs less the GST liability on domestic sales of Rs. 105.60 lakhs), **M/s ABC is entitled to a refund of only Rs. 15.12 lakhs.**

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However, upon a closer examination of the aforementioned data r.w. legislature intent behind Section 16 of the IGST Act and Section 54 of the CGST Act, it becomes evident that M/s ABC is entitled to a maximum refund of Rs. 9 lakhs only, which corresponds to ITC related to inputs and input services specifically utilized for export. In contrast, the formula u/r 89(4) permits an additional refund of Rs. 6.12 lakhs to M/s ABC. This occurs primarily because the ITC attributable to domestic inward supplies is factored into the proportionate refund calculation u/r 89(4). To prevent exporters from encashing ITC relating to domestic supplies, it appears that Rule 89(4B) was inserted.

Applicability of Rule 89(4B)

In following situations Rule 89(4B) comes to the fore:

a. **if the exporter is importing and availing of the following benefits**:
   - Import without payment of duty under the export-oriented unit (EOU) Scheme as prescribed in Notification No. 78/2017-Custom dated 13th October 2017
   - Import without payment of duty under advance authorization (AA) scheme as prescribed in Notification No. 79/2017-Custom dated 13th October 2017

b. If the exporter has received supplies Merchant Export Scheme as prescribed in Notification No. 40/2017-CT(R) and Notification No. 41/2017-IGST(R) dated 23rd October 2017

To summarise, if the exporter has either procured goods (other than capital goods) without payment of IGST/Cess on import or at a concessional rate of 0.10% then provisions of Rule 89(4B) get attracted.

Mandate of Rule 89(4B)

If Rule 89(4B) is applicable then the mandate of said rule is explained as under:

Limb	Amount of refund to be granted
#1	ITC availed in respect of inputs received under the aforementioned notifications for export of goods &
#2	ITC in respect of other inputs or input services **to the extent** used in making such export of goods

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Regarding Limb #1, since goods are imported duty-free under the AA or EOU schemes, the ITC/refund eligibility will be nil. For merchant exporters, the corresponding ITC/refund amount would only be the 0.10% GST paid on the procurement of goods.

For Limb #2, particular attention must be paid to the phrase **"to the extent used in making such export of goods."** A straightforward reading suggests that exporters must demonstrate the consumption of inputs and input services in the exported goods to qualify for a refund of ITC related to common inputs and input services. This may be one of the reasons why AA/EOU entities have chosen to claim refunds u/r 89(4), given the difficulty of proving a direct nexus.

Whether AA or EOU can legally apply for a Refund u/r 89(4) in respect of inputs procured without payment of IGST and used for making zero-rated supply?

It can be argued that Rules 89(4A) and 89(4B) provide an additional option and do not prohibit AA and EOU from claiming a refund u/r 89(4). Definitions of "**Net ITC**", "**Turnover of zero-rated supply of goods**" & "**Adjusted Total Turnover**" prescribed u/r 89(4) suggest that these definitions exclude amounts in respect of which refund is **claimed** u/r 89(4A)/(4B). If the intention of the legislature was to restrict AA and EOU from claiming refunds u/r 89(4) they would have excluded amounts in respect of which refund is **claimable** u/r 89(4A)/(4B). In the opinion of the author therefore exporters cannot be faulted for choosing a more beneficial option of Rule 89(4) vis-à-vis Rule 89(4B). However, it is important to note that the department may challenge this position, and taxpayers may face a risk of protracted litigation.

How to work out the amount of eligible refunds u/r 89(4B) in the absence of any formula?

The contentious issue, therefore, is how to compute a refund u/r 89(4B). The Hon'ble Gujarat High Court, in the case of **Filatex India Ltd. vs Union of India [2022-TIOL-297-HC-AHM-GST]**, had the opportunity to address this complex matter. The refund applicant had applied for and was granted refunds up to October 2019 u/r 89(4). However, the refund application for November 2019 was rejected on the grounds that the applicant was required to file a claim u/r 89(4B) instead of Rule 89(4). The appellate authority upheld the view that the refund should have been claimed exclusively u/r 89(4B) and remanded the case with instructions to recompute the eligible refund u/r 89(4B).

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Dissatisfied with the order of the appellate authority, the taxpayer filed a writ petition before the Hon'ble Gujarat High Court, raising, among other issues, the practical difficulties in proving the nexus between the inputs/input services and the exported goods. To shed light on the department's stance, an excerpt from the affidavit-in-reply filed by the Principal Commissioner, CGST (Respondent) before the Hon'ble Gujarat High Court is provided below.

> *"The petitioner's contentions that, they are unable to establish the quantum of ITC availed in respect of inputs or input services to the extent used in making export of goods (being an impossible exercise), is absolutely non-tenable, illogical and far from factual position.*
>
> *Every manufacturing process have clearly specified ratios of inputs/raw materials to be used which are to be strictly adhered to for production of finished goods. Therefore each and every manufacturer / exporter must be aware of input-output ratio of the inputs/raw materials used in such manufacturing of the exported goods and the ITC availed against such input supplies received, otherwise they cannot arrive at the costing of the finished goods. Accordingly, contrary to petitioner's contention the required information can be easily bifurcated along with quantity.*
>
> *Further, the claimant must be aware of the turnover of the exported goods, the input-output ratio i.e. exact quantities of raw materials/input supplies used in such export of goods, and ought to have the capacity to bifurcate the ITC availed on such input supplies used in such export of goods and hence the claimant's contention that they can't identify the input supplies used in exports exclusively as input supplies are common in both exports and DTA supply is not tenable and also not sustainable. Thus, emphasizing that they are unable to follow the procedure as prescribed* u/r 89(4B) *is not possible to them, is totally baseless and not acceptable."*

Gujarat High Court in the present case directed the GST department to re-adjudicate the refund claim of the taxpayer keeping in mind the formula of input/output ratio of the inputs/raw materials used in the manufacturing of the exported goods.

It would be appropriate to reference the concept of a **Bill of Materials (BOM)**. BOM refers to a detailed and exhaustive listing of all components, materials, and their respective quantities required for the production of a specific product. BOM is an integral part to the manufacturing process, serving as a critical tool for planning procurement, estimating production costs, and managing inventory. Comprehensive documentation of BOM is essential and may be utilized as supporting evidence to claim a refund u/r 89(4B). In deserving cases, BOM may be further supported by a certificate from CMA.

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What if the exporter has claimed a refund u/r 89(4) instead of Rule 89(4B)?

In such circumstances, the department may insist on the recovery of an erroneously granted refund. It has been observed in numerous cases that the department seeks to recover the entire amount previously sanctioned on the grounds that the taxpayer applied for a refund under an incorrect category. It is undisputed that the taxpayers have filed refund applications under the category "refund of unutilized ITC on account of exports without payment of tax" as per Rule 89(4), instead of the appropriate category "any other category" as per Rule 89(4B). However, relying on various judicial pronouncements, it can be effectively argued that a mere technical or procedural lapse should not prejudice the substantive right to a refund. In particular, reference is made to the following judgments:

- **Filatex India Ltd. vs Union of India [2022-TIOL-297-HC-AHM-GST]**
- **Shobikaa Impex Pvt Ltd vs Union of India [2024-TIOL-1454-HC-MAD-GST]**
- **Pitambra Books Private Ltd. Vs. UOI [2020-*TIOL-1236-HC-DEL-GST]***

The taxpayer thereafter shall recompute their refund eligibility u/r 89(4B). In the event of an erroneous refund, the taxpayer may make an informed decision regarding the appropriate course of action.

In case the taxpayer chooses to pay back erroneous refunds, whether taxpayer is entitled to recredit of credit utilized at the time of filing the original refund application?

Rule 86(4B) provides for the re-crediting of the amount of an erroneous refund to the electronic credit ledger, provided that the demand for the erroneous refund has been settled by payment in cash through Form DRC-03, along with the applicable interest and penalty.

Whether exporter is required to pay interest for wrongful availment of refund?

On a strict interpretation of Section 50(1) and Section 50(3) of the Act, the taxpayer may contend that no interest liability arises in the present case, as it does not fall under the provisions related to failure to pay tax [Section 50(1)] or incorrect availment or utilization of ITC [Section 50(3)]. However, it is likely that the department may disagree with the taxpayer's interpretation and may initiate litigation to challenge this position.

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Applicability of the Extended Period of Limitation in the present case

In the considered opinion of the author, the issuance of a Show Cause Notice (SCN) invoking an extended period of limitation is not applicable in the present case. All relevant details would have been disclosed in the GST returns, GST refund application, and GSTR-2B. Therefore, it is incorrect to assert that information was deliberately withheld with the intent to evade tax. Furthermore, the fact that the department granted the refund to the taxpayer after conducting a thorough verification may weigh in favor of the taxpayer. This, in turn, strengthens the argument against the invocation of the extended period of limitation.

Similar arguments can also be made to contest the imposition of a penalty.

Option of paying back IGST/Cess exemption availed at the time of import

Following the beneficial amendment to Rule 96(10) introduced by Notification No. 16/2020 on 23rd March 2020, taxpayers now have the option to repay the exemption availed for IGST/Cess on import, along with interest, while still retaining the Basic Customs Duty (BCD) exemption. Taxpayers may weigh this option before taking a final call on this issue.

Conclusion

Refund litigations are inherently complex, and given the stakes involved, taxpayers may not find relief at the lower levels. Taxpayers should exercise caution and not be swayed by the apparent simplicity of Rule 89, hastily applying the proportionate formula to calculate the refund amount. While the government's objective is to prevent the export of goods along with taxes, taxpayers are also not entitled to claim a refund of input tax paid on domestic supplies. Ideally, taxpayers should first determine the applicability of Rule 89(4A) and/or Rule 89(4B) before applying for a refund u/r 89(4).

Thanks for your time!!

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