5 CHAPTER Input Tax Credit when exempted as well as taxable supplies made

5.1 Proportionate ITC when partly used for business or taxable supplies

Principle of VAT is that input tax credit is available only when tax is payable on his output. If some of supplies are taxable and some are exempt, the taxable person can take only proportionate input tax credit.

This principle applies to input goods, input services and capital goods. These are provided in section 17 of CGST Act.

Where the goods or services or both are used by the registered taxable person partly for the purpose of any business and partly for other purposes, the amount of input tax credit shall be restricted to so much of the input tax as is attributable to the purposes of his business - section 17(1) of CGST Act.

Where the goods and/or services are used by the registered person partly for effecting taxable supplies including zero rated supplies under CGST or IGST Act and partly for effecting exempt supplies, the amount of credit shall be restricted to so much of the input tax as is attributable to the taxable supplies including zero-rated supplies - section 17(2) of CGST Act.

The Central or a State Government may, by notification issued in this behalf, prescribe the manner in which the proportionate input tax credit is to be taken - section 17(6) of CGST Act.

This provision is similar to rule 6 of Cenvat Credit Rules.

Taxable supply - "Taxable supply" means a supply of goods or services or both which is leviable to tax under CGST Act – section 2(109) of CGST Act.

Non-taxable supply - 'Non-taxable supply' means a supply of goods or services or both which is not leviable to tax under CGST Act or IGST Act – section 2(78) of CGST Act.

Supply of alcoholic liquor is non-taxable supply and hence is exempt supply - Supply of alcoholic liquor is a non-taxable supply and hence included in definition of 'exempt supply' - *Karnani FNB Specialities LLP, In re* (2023) 97 GST 783 = 73 GSTL 653 = 148 taxmann.com 217 (AAR-WB). In this case, the assessee was providing restaurant service and was also supplying alcoholic liquor. It was held that proportionate reversal of ITC is required - view confirmed in *Karnani FNB Specialities LLP, In re* (2023) 77 GSTL 92 = 9 Centax 202 (AAAR-WB).

Zero rated supply - "Zero-rated supply" means a supply of any goods or services or both in terms of section 16 of IGST Act – section 2(23) of IGST Act.

Export of goods or services or both and supplies of goods or services or both to SEZ unit or SEZ developer will be zero rated supply - section 16(1) of IGST Act.

Credit of input tax may be availed for making zero-rated supplies, even if such supply is exempted supply - section 16(2) of IGST Act.

The registered person making zero rated supply can claim refund under either of two options - (a) supply goods under bond or LUT without payment of IGST and claim refund of unutilized input tax credit or (b) supply goods on payment of IGST and claim refund of IGST paid on goods and services. The refund will be in accordance with section 54 of CGST Act - section 16(3) of IGST Act.

5.1-1 Calculation of value of 'exempt supply'

"Exempt supply" means supply of any goods or services or both which attracts *nil* rate of tax or which may be wholly exempt from tax under section 11 of CGST Act or under section 6 of IGST Act, and includes non-taxable supply - section 2(47) of CGST Act.

'Non-taxable supply' means a supply of goods or services or both which is not leviable to tax under CGST Act or IGST Act – section 2(78) of CGST Act.

Exempt supply cannot include activities included in Schedule III of CGST Act, except value of land, buildings and securities – The 'exempt supply' and 'non-taxable supply' can only cover goods or services which are 'supply'. These cannot include any activity which is not 'supply' at all. Thus, 'Exempt supply' cannot include activities included in Schedule III of CGST Act, as the activities specified in Schedule III are neither supply of goods nor supply of services. The exception is what is specified in section 17(3) of CGST Act, i.e. value of land, completed buildings (except where supply is made before completion of building) and securities.

Exempt supply to include value of land, building and securities - As per section 17(3) of CGST Act, value of exempt supply shall include – (a) supply where GST is payable on reverse charge basis (b) transactions in securities (c) sale of land (d) sale of building (except construction of complex where supply is made before obtaining completion certificate).

For determining the value of an exempt supply as per section 17(3) of CGST Act-- (a) the value of land and building shall be taken as the same as adopted for the purpose of paying stamp duty, and (b) the value of security shall be taken as 1% of the sale value of such security – *Explanation* under Rule 45 of CGST and SGST Rules, 2017.

Reversal of common input services for mutual fund investment is required – Mutual funds are securities. Transaction in securities is 'exempt supply'. Reversal of common input services for mutual fund investment is required as per rule 42. Redemption of mutual fund units is commercially equivalent to sale – *Zydus Lifesciences Ltd. In re* (2025) 180 taxmann.com 233 (AAAR- Guj).

Apportionment of ITC between taxable supply and exempt supply on basis of value except in case of real estate services - Section 17(3) of CGST Act envisages that apportionment of ITC between exempt supply and taxable supplies including zero rated supplies shall be on basis of value.

However, as per scheme of GST on service of real estate of residential and commercial apartments w.e.f. 1-4-2019, it is envisaged that such apportionment shall be on basis of area of construction of complex. Hence, Removal of Difficulties Order No. 04/2019-CT dated 29-3-2019 provides that such apportionment shall be on basis of area of construction of complex.

Activities and transactions covered under Schedule III are not 'exempt supply' except covered in paragraphs 5 and 8(a) of Schedule III - For purpose of section 17(3) of CGST Act (proportionate reversal of ITC when taxable person is making both taxable and exempt supply) , the expression "value of exempt supply" shall not include the value of activities or transactions specified in Schedule III of CGST Act, *except (i) the value of activities or transactions specified in paragraph 5 of the said Schedule; and (ii) the value of such activities or transactions as may be prescribed in respect of paragraph 8(a) of the said Schedule* – Explanation to section 17(3) of CGST Act as amended vide Finance Act, 2023 from 1-10-2023 by substituting words in italics. **The earlier words were –** 'except those specified in paragraph 5 of the said Schedule'.

Schedule III of CGST Act specifies transactions or activities which shall be treated neither as supply of goods nor supply of services.

Paragraph 5 of Schedule III of CGST Act pertains to sale of land or sale of building after completion certificate is obtained.

Paragraph 8(a) of Schedule III of CGST Act pertains to supply of warehoused goods to any person before clearance for home consumption. Thus, provisions relating to proportionate reversal of ITC *will* apply to supply of goods from duty free shops at arrival terminal after 1-10-2023 - *Explanation 3* to rule 43 of CGST Rules, inserted w.e.f. 1-10-2023.

Value of exempt supply shall include value of supply of goods from Duty Free Shops at arrival terminal w.e.f. 1-10-2023 - For the purpose of rule 42 and rule 43, the value of activities or transactions mentioned in Schedule III paragraph 8(a) of the CGST Act which is required to be included in the value of exempt supplies under clause (b) of the *Explanation* to section 17(3) of the CGST Act shall be the value of supply of goods from Duty Free Shops at arrival terminal in international airports to the incoming passengers - *Explanation* 3 to rule 43 of CGST Rules, inserted w.e.f. 1-10-2023.

Electricity is exempt supply - Electricity is 'exempt supply'.

Interest is not exempt supply for purposes of rules 42 and 43 i.e. no reversal of ITC required - Interest on loans, deposits and

borrowings are exempt, though it is supply of service. However, it is not 'exempt supply' for purposes of rules 42 and 43 of CGST Rules. The exact wording in rules is as follows -

For the purposes of rules 42 and 43 of CGST Rules, it is hereby clarified that the aggregate value of exempt supplies shall exclude the value of services by way of accepting deposits, extending loans or advances in so far as the consideration is represented by way of interest or discount, except in case of a banking company or a financial institution including a non-banking financial company, engaged in supplying services by way of accepting deposits, extending loans or advances - *Explanation* 1(b) to rule 43(2) of CGST Rules, inserted w.e.f. 23-1-2018 [*Explanation* re-numbered as *Explanation 1* w.e.f 1-4-2019].

Since it is only clarification, it should apply with retrospective effect from 1-7-2017.

Exempt Supply shall not include supply of services to Nepal and Bhutan for purpose of reversal of ITC upto 1-2-2019 – Value of 'Exempt Supply' for purposes of rules 42 and 43 of CGST Rules (reversal of ITC) shall *exclude* the value of supply of services to Nepal and Bhutan where place of supply in Nepal or Bhutan even when payment is received in Indian rupees [These services are exempt vide Notification No. 42/2017-IT (Rate) dated 27-10-2017] – *Explanation* (a) to rule 43(2) of CGST Rules, inserted w.e.f. 15-11-2017 and amended on 23-1-2018. This *Explanation* (a) has been omitted w.e.f. 1-2-2019, as now, in case of export of services, condition of receipt of payment in foreign exchange does not apply where RBI allows receipt of payment in Indian Rupees, as per section 54(8)(c) of CGST Act inserted w.e.f. 1-2-2019.

Since it is only clarification, it should apply with retrospective effect from 1-7-2017.

After 1-2-2019, supply to Nepal and Bhutan will qualify as 'export' even if payment is received in Indian Rupees. It will be 'zero rated'. Hence, the question of treating it as 'Exempt supply' does not arise.

Exempt supply shall include outward freight from India to outside India for reversal of ITC w.e.f. 1-10-2023- For the purposes of rules 42 and 43 of CGST Rules, it is hereby clarified the

aggregate value of exempt supplies shall exclude the value of supply of services by way of transportation of goods by a vessel from the customs station of clearance in India to a place outside India - – *Explanation* 1(c) to rule 43 of CGST Rules, inserted w.e.f. 15-11-2017 and omitted w.e.f. 1-10-2023. Thus, after 1-10-2023, **Exempt supply shall include** outward freight from India to outside India for reversal of ITC.

Exempt supply shall not include value of duty credit scrips – For the purposes of rules 42 and 43 of CGST Rules, 'Exempt supply' shall not include value of supply of duty credit scrips specified in the notification of the Government of India, Ministry of Finance, Department of Revenue No. 35/2017-Central Tax (Rate), dated the 13th October, 2017 – *Explanation* 1(d) to rule 43 of CGST Rules, inserted w.e.f. 5-7-2022 – confirmed in *Kaveri Exports, In re* [2023] 152 taxmann.com 273 = 8 Centax 151 (AAR- Telangana).

5.2 Special provisions in respect of Banks, FI and NBFC

A banking company or a financial institution including a non-banking financial company, engaged in supplying services by way of accepting deposits, extending loans or advances shall have the option to either comply with the provisions of section 17(2) of CGST Act, or avail of, every month, an amount equal to fifty per cent of the eligible input tax credit on inputs, capital goods and input services in that month - section 17(4) of CGST Act.

The option once exercised shall not be withdrawn during the remaining part of the financial year - first *proviso* to section 17(4) of CGST Act.

The 50% restriction shall not apply to the tax paid on supplies made by one registered person to another registered person having same PAN number - second proviso to section 17(4) of CGST Act.

This provision applies when Bank/FI/NBFC in one State provides services (or supplies goods) to its own branch in another State.

In most of the cases, Bank, FI or NBFC may find it easy and profitable to avail 50% of input tax credit instead of availing input tax credit on proportionate basis as per section 17(2) of CGST Act.

Co-operative society accepting deposits and granting loans is Financial Institution - A co-operative society, carrying on business of financing by accepting deposits and granting loans or advances, qualified to be a "financial institution" as per RBI Act, 1934 and consequently also under section 17(4) of CGST Act. Hence, the society is eligible for availing option provided under section 17(4) which prescribes to avail an amount equal to 50% of eligible credit of input tax on inputs, capital goods and input services in that month and rest shall lapse - *Knanaya Multi Purpose Co-operative Credit Society Ltd.,* In re [2020] 119 taxmann.com 65 (AAR - Kerala).

5.2-1 Procedure to claim of credit by a banking company or a financial institution

A banking company or a financial institution, including a non-banking financial company, engaged in supply of services by way of accepting deposits or extending loans or advances that chooses not to comply with the provisions of section 17(2), in accordance with the option permitted under section 17(4) of CGST Act, shall follow the procedure specified below—

(*a*) the said company or institution shall not avail the credit of (i) tax paid on inputs and input services that are used for non-business purposes and (ii) the credit attributable to supplies specified in section 17(5), in form GSTR-2 [*i.e.* ineligible Input Tax Credit]

(*b*) the said company or institution shall avail the credit of tax paid on inputs and input services referred to in the second proviso to section 17(4) and not covered under clause (a) [i.e. services supplied by one branch or division to another i.e. with same Income Tax PAN]

(*c*) fifty per cent of the remaining input tax shall be the input tax credit admissible to the company or the institution and shall be furnished in form GSTR-2.

(*d*) the amount referred to in clauses (b) and (c) shall, subject to the provisions of sections 41, 42 and 43, be credited to the electronic credit ledger of the said company or the institution - Rule 38 of CGST and SGST Rules, 2017. [sections 41 to 43

provide for provisional credit, matching and reversal of ITC and output tax liability].

5.3 Determination of input tax credit when partly used for taxable supply and partly for exempt supply

The detailed mode of calculation has been prescribed in rule 42 of CGST Rules. Initially, input tax used exclusively for taxable or exempt supplies are segregated. Then, for common input tax, eligible credit is calculated on ratio basis. Non-eligible ITC is reversed.

Final calculations are made at end of financial year of eligible ITC before the due date for filing the return for the month of September following the end of the financial year, on same basis.

5.3-1 Final calculations at end of financial year of eligible ITC

Except in case of supply of services covered by clause (b) of paragraph 5 of the Schedule II of the CGST Act, the input tax credit determined under rule 42(1) of CGST and SGST Rules (as above) shall be calculated finally for the financial year before the due date for filing the return for the month of September following the end of the financial year to which such credit relates, in the specified manner [Rule 42(2) of CGST and SGST Rules, 2017]. [amended w.e.f. 1-4-2019]

5.3-2 Final calculations of eligible ITC in case of real estate projects where no transition of ITC

Rules 42(3) to 42(6) of CGST Rules inserted w.e.f. 1-4-2019 make provisions for final calculations of eligible ITC in case of real estate projects or residential and commercial apartments.

5.3-3 Calculation of commercial portion of ITC of real estate project other than RREP

In case of supply of services covered by paragraph 5(b) of Schedule II of the Act, the input tax determined under rule 42(1) shall be calculated finally, for commercial portion in each project, other than residential real estate project (RREP), which underwent

transition of input tax credit consequent to change of rates of tax on the 1st April, 2019 in accordance with notification No. 11/2017-Central Tax (Rate), dated the 28th June, 2017, published *vide* GSR No. 690(E) dated the 28th June, 2017, as amended for the entire period from the commencement of the project or 1st July, 2017, whichever is later, to the completion or first occupation of the project, whichever is earlier, before the due date for furnishing of the return for the month of September following the end of financial year in which the completion certificate is issued or first occupation takes place of the project, in the specified manner.

5.3-4 Final calculations of ITC in real estate projects not required in case of RREP

Input tax determined under rule 42(1) shall not be required to be calculated finally on completion or first occupation of an RREP which underwent transition of input tax credit consequent to change of rates of tax on 1st April, 2019 in accordance with notification No. 11/2017- Central Tax (Rate), dated the 28th June, 2017, published *vide* GSR No. 690(E) dated the 28th June, 2017, as amended - rule 42(5) of CGST Rules inserted w.e.f. 1-4-2019.

[i.e. who opted for 1%/5% scheme] - reiterated in FAQ (Part II) No. 21 issued by CBI&C *vide* circular F No. 354/32/2019-TRU dated 14-5-2019.

5.3-5 Assignment of input tax when used for several projects

Where any input or input service are used for more than one project, input tax credit with respect to such input or input service shall be assigned to each project on a reasonable basis and credit reversal pertaining to each project shall be carried out as per rule 42(3) - rule 42(6) of CGST Rules inserted w.e.f. 1-4-2019.

5.4 Determination of input tax credit in respect of capital goods used partly for taxable supply and partly for exempt supply

If capital goods are partly used for taxable goods and partly for exempt goods, the ITC on capital goods is available on proportionate basis [just like ITC on common input goods and input service].

The calculations seem quite clumsy, but basic concept is simple.