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EFFECTIVENESS OF INPUT TAX CREDIT (ITC) MECHANISM UNDER GST: A CRITICAL ANALYSIS OF POLICY, COMPLIANCE, AND REVENUE IMPLICATIONS

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Chapter 1: Introduction

Background of GST and Input Tax Credit System:

The introduction of the Goods and Services Tax (GST) in India on 1st July 2017 marked a watershed moment in the country's indirect taxation history. Replacing a complex web of central and state levies such as VAT, excise duty, and service tax, GST aimed to create a unified and transparent tax regime. One of the foundational features of GST is the Input Tax Credit (ITC) mechanism, designed to eliminate the cascading effect of taxes and promote a seamless flow of credit across the supply chain. The ITC system allows businesses to claim credit for the tax paid on purchases or inputs, thereby reducing their overall tax liability on output supplies.

Importance of ITC in Ensuring Seamless Tax Flow:

The ITC mechanism plays a crucial role in ensuring the efficiency and neutrality of the GST regime. By allowing credit for taxes paid on input goods and services, ITC prevents double taxation and reduces the cost of doing business. It encourages tax compliance and incentivizes firms to procure from registered suppliers. A well-functioning ITC system enhances transparency, promotes competitiveness, and strengthens the formal economy. However, issues such as mismatched invoices, procedural delays, and restrictions on credit availability have affected the smooth functioning of the ITC framework, warranting a critical examination.

Objectives of the Study:

This study aims to analyze the practical and legal dimensions of the Input Tax Credit system under GST in India. It seeks to evaluate the effectiveness of ITC in reducing tax cascading, identify key implementation challenges, and assess whether the intended objectives of ITC—

such as seamless credit flow, reduced tax burden, and improved compliance—are being achieved in practice.

Research Questions and Scope:

The central research questions guiding this study are:

1. What are the legal and conceptual foundations of the ITC mechanism under GST?
2. How does the ITC system under GST compare to the credit mechanisms under previous tax regimes such as VAT, excise, and service tax?
3. What practical challenges do taxpayers face in availing and utilizing ITC?
4. How effective is the ITC mechanism in promoting tax neutrality and reducing the tax burden?

The scope of the study includes legal provisions, judicial interpretations, administrative guidelines, and stakeholder perspectives, with a focus on the Central Goods and Services Tax (CGST) framework.

Methodology and Sources:

The study adopts a doctrinal legal research approach, supplemented by empirical insights from secondary sources. It relies on the analysis of statutory provisions under the CGST Act, 2017 (particularly Sections 16–18), relevant rules, notifications, and circulars issued by the Central Board of Indirect Taxes and Customs (CBIC). Additionally, case law, government reports, scholarly articles, and industry analyses are examined to understand both the theoretical underpinnings and real-world implications of the ITC system.

Chapter 2: Conceptual Framework and Legal Provisions

Concept and Evolution of Input Tax Credit in India:

Input Tax Credit, at its core, allows taxpayers to set off the tax paid on purchases against the tax payable on sales. While the concept existed under previous tax regimes—such as MODVAT under excise, CENVAT, and input credits under VAT and service tax—each system was limited by jurisdictional and sectoral boundaries. The GST regime introduced a comprehensive and unified ITC mechanism that spans goods and services across the country, thus simplifying the credit process and ensuring continuity across the supply chain.

Legal Framework: Sections 16–18 of CGST Act and Related Rules:

The statutory foundation of ITC under GST lies in Sections 16 to 18 of the CGST Act, 2017. Section 16 lays down the eligibility criteria for claiming ITC, including possession of a valid tax invoice, actual receipt of goods or services, and payment of tax to the government. Section 17 outlines scenarios where ITC is restricted or apportioned, such as personal

consumption or exempt supplies. Section 18 deals with specific circumstances like new registration or switching from composition scheme, where transitional ITC rules apply. Additionally, Rules 36 to 45 under the CGST Rules provide procedural clarity on documentation, matching, reversal, and re-availment of credit.

Comparative Analysis with Pre-GST Tax Regimes (VAT, Excise, Service Tax):

Under the earlier regime, credit mechanisms such as CENVAT Credit Rules and state-level VAT credits operated independently, leading to several inefficiencies. Credit was not available across different taxes (e.g., VAT credit could not be used against service tax liability), and tax cascading was a frequent occurrence. With GST, the integration of goods and services into a single tax structure has significantly broadened the credit chain. However, the GST credit mechanism also introduced new conditions and compliance requirements, such as invoice matching and return filing, which are more stringent compared to the pre-GST era.

Intended Benefits and Rationale of ITC in GST:

The primary rationale for incorporating a robust ITC mechanism in GST was to ensure tax neutrality and enhance economic efficiency. By enabling seamless credit flow, GST aimed to remove tax-on-tax effects, encourage formalization, and reduce costs for end consumers. The ITC system is also expected to incentivize businesses to maintain clean records and transact with compliant suppliers, thereby improving overall tax compliance. In theory, this aligns with the destination-based nature of GST and fosters a more equitable and efficient tax regime. However, persistent operational and policy challenges have raised questions about the consistency between the intended benefits and actual outcomes of the ITC framework.

CHAPTER 3 : ITC COMPLIANCE AND PROCEDURAL CHALLENGES

The Input Tax Credit (ITC) mechanism is central to India's Goods and Services Tax (GST) framework, enabling businesses to claim credit for the tax paid on purchases of goods and services, thereby ensuring that tax is levied only on value addition. While ITC is designed to simplify taxation and enhance efficiency, in practice it is often encumbered by significant compliance and procedural challenges. These arise due to the complex interplay between statutory conditions, systemic inefficiencies, supplier-side non-compliance, technological gaps, and frequent policy revisions. This chapter provides a detailed examination of the eligibility criteria for claiming ITC, documentation and invoice matching procedures, issues related to blocked credits under Section 17(5), complications in inter-branch ITC utilization, and emerging trends in litigation and audit disputes.

Under Section 16 of the Central Goods and Services Tax (CGST) Act, a registered person is entitled to claim ITC if certain basic conditions are satisfied. These include possession of a valid tax invoice or debit note issued by a registered supplier, actual receipt of goods or services, payment of tax to the government either in cash or through ITC, and proper filing of returns. At a conceptual level, these prerequisites are designed to prevent fraudulent claims and ensure integrity in the credit chain. However, complications arise when buyers are penalized for the non-compliance of their suppliers. For example, if a supplier fails to upload the invoice or remit the tax collected, the buyer's ITC claim may be disallowed, even if the buyer acted in good faith. This contradicts the principle of natural justice and has become a highly contentious issue.

This situation is compounded by the technical mechanism of invoice matching, which forms the backbone of the ITC verification process. The introduction of auto-populated returns such as GSTR-2A and the more recent GSTR-2B was intended to simplify the reconciliation process. GSTR-2A is a dynamic form that reflects real-time invoice data uploaded by suppliers, whereas GSTR-2B provides a static snapshot of ITC available for a given tax period. While these tools have helped standardize reconciliation practices, they are far from foolproof. Mismatches arising from typographical errors, incorrect GSTIN entries, delayed return filings, or cancellation of GST registrations are common, resulting in denial of ITC. In such cases, the burden of proof falls on the recipient to verify and correct errors made by the supplier—a process that is administratively taxing and often beyond the recipient's control.

Vendor compliance has become a pivotal issue in the ITC landscape. The government's decision to introduce Rule 36(4) limited the amount of ITC that could be provisionally claimed if invoices were not reflected in GSTR-2A/2B. Initially, a 20% provisional claim was allowed, later reduced to 10%, then 5%, and ultimately eliminated from January 2022. As a result, buyers can now only claim ITC that is fully matched with GSTR-2B data. This move was intended to curb fake invoicing and tax evasion but has significantly increased the compliance burden on buyers, especially small and medium enterprises (SMEs), which often lack the resources to monitor vendor compliance at such a granular level. Businesses are now forced to invest in reconciliation software, employ dedicated staff for vendor follow-up, and incorporate compliance clauses into contracts to safeguard against potential

ITC losses.

A further complication arises from the restrictive provisions of Section 17(5) of the CGST Act, which specifies categories of inputs and input services for which ITC is blocked. Common examples include motor vehicles (except for certain purposes like transportation of goods), food and beverages, health and fitness club memberships, life and health insurance, and construction of immovable property. These exclusions aim to restrict credit to items used for personal consumption or capital formation. However, their rigid interpretation often leads to unjust denials. For instance, companies are denied ITC on insurance premiums paid for employees, even if such insurance is mandated under labor laws. Similarly, ITC on construction services used for building a factory or warehouse—core to business operations—is also blocked, increasing project costs and discouraging capital investment. Many of these provisions are borrowed from legacy tax regimes but remain misaligned with the objectives of GST as a unified, business-friendly tax system.

Another procedural difficulty involves ITC utilization across different branches and states. GST treats each registration (GSTIN) as a distinct person, which means that ITC accumulated in one state cannot be used to offset liability in another. Businesses with a multi-state presence must rely on the Input Service Distributor (ISD) mechanism or cross-charging to distribute credit. The ISD route requires centralized invoicing and separate returns, while cross-charging necessitates valuation of services exchanged between branches—often a subjective and disputed exercise. These requirements complicate compliance and invite scrutiny during departmental audits. Many businesses either avoid cross-charging due to its complexity or apply ad hoc rates, which later become points of contention during inspections.

The cumulative effect of these challenges is reflected in growing litigation related to ITC claims. A major issue is the mismatch between ITC claimed in GSTR-3B and that reflected in GSTR-2A/2B. Tax authorities often issue show cause notices and initiate recovery proceedings for such mismatches without giving adequate opportunity for clarification or rectification. While the government argues that such measures are essential to prevent revenue leakage, taxpayers argue that they are being penalized for faults beyond their control. Courts have weighed in on this issue multiple times. In *D.Y. Beathel Enterprises v. State Tax Officer* (2021), the Madras High Court ruled that the department must proceed against the defaulting supplier before denying ITC to the buyer. In another case, *Suncraft Energy Pvt. Ltd. v. Assistant Commissioner of State Tax* (2022), the Calcutta High Court held that ITC cannot be denied to a buyer if there is no finding of collusion with the supplier. These judgments underscore the need for a balanced approach that protects both revenue interests and taxpayer rights.

The ITC system also imposes compliance challenges during audits. GST audits conducted by tax authorities often focus heavily on ITC reconciliations, reversals, and ineligible credit claims. Businesses are expected to maintain detailed documentation including purchase invoices, debit notes, goods receipt records, and payment proofs for up to five years. In many cases, minor clerical errors or delays in documentation result in reversals of legitimate credit. The lack of uniformity in audit procedures and interpretations by state GST officers further exacerbates the problem.

Additionally, the process of ITC reversal in specific circumstances adds to procedural complexity. As per Section 16(2), ITC must be reversed if the recipient fails to pay the supplier within 180 days from the date of invoice. While this provision aims to promote

timely payments and liquidity in the economy, its implementation is problematic. Business transactions often involve credit terms that extend beyond 180 days, especially in sectors like construction, infrastructure, and public procurement. Moreover, delays in payments may arise from genuine commercial disputes, insolvency proceedings, or contractual provisions—factors not accounted for in the blanket 180-day rule. The requirement to reverse ITC with interest in such cases creates financial stress and often leads to double taxation if credit is not re-availed correctly upon later payment. The frequent policy changes and retrospective amendments also contribute to uncertainty. Over the years, several circulars and notifications have been issued clarifying the eligibility of ITC on discounts, promotional schemes, bundled supplies, and intermediary services. While these are useful, they are sometimes inconsistent or issued after long delays, leaving businesses in a state of limbo. For example, Circular No. 105/24/2019-GST initially clarified that post-sale discounts tied to performance do not qualify for ITC reversal. However, later circulars created ambiguity by suggesting otherwise. Such conflicting interpretations create avoidable litigation and necessitate stronger legislative clarity.

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CHAPTER 4 : FINANCIAL AND OPERATIONAL IMPACT ON BUSINESS

The Input Tax Credit (ITC) mechanism under the Goods and Services Tax (GST) was introduced with the vision of creating a seamless credit chain that eliminates tax-on-tax cascading and improves the overall efficiency of the tax system. Beyond its conceptual benefits, ITC has a direct and significant impact on the financial health and operational dynamics of businesses across sectors in India. The ability to claim credit for taxes paid on inputs helps businesses optimize working capital, reduce the cost of production, and adjust pricing strategies to stay competitive in a market that has become increasingly complex and regulated. However, the practical implementation of the ITC mechanism has unveiled a mixed reality. While some businesses have reaped substantial benefits, others continue to face challenges due to procedural bottlenecks, compliance costs, and policy ambiguities. This chapter provides an in-depth analysis of how ITC affects the financial performance and operations of businesses, taking into account sector-specific nuances, vendor relationships, and real-world case studies, with a focus on both micro, small, and medium enterprises (MSMEs) and large organizations.

At its core, ITC is designed to relieve businesses of the tax burden embedded in inputs and services, enabling them to pass on tax only on the value addition they create. For companies, this means that the GST they pay on raw materials, intermediates, capital goods, and input services can be set off against their output GST liability. Theoretically, this ensures that tax is not a cost but a pass-through element, thus freeing up working capital that would otherwise be locked in taxes paid upfront. This liquidity advantage is particularly critical in sectors with long production cycles, high input costs, or tight profit margins, such as manufacturing, construction, and export-oriented industries. The timely availability of ITC credits reduces the need for external financing, which is often costly and difficult to access, especially for SMEs.

However, this ideal scenario assumes flawless compliance, timely invoice matching, and smooth government refund processes, which are frequently disrupted by practical challenges. One of the most immediate financial impacts of ITC is on working capital management. Working capital is the lifeblood of business operations, encompassing the funds available for day-to-day expenses like procurement, wages, and utilities. When ITC claims are disallowed, delayed, or partially reversed, businesses are forced to bear the full tax cost in cash, thus squeezing cash flows. This has a domino effect: it constrains the ability to pay suppliers on

time, delays wage payments, and forces postponement of capital expenditure. As a result, businesses may resort to overdraft facilities or short-term loans, increasing their financial costs and vulnerability to interest rate fluctuations. This liquidity crunch is particularly pronounced among SMEs, which often operate with limited reserves and face tougher credit constraints.

The impact of ITC on working capital varies significantly across industries due to differences in business models, supply chain structures, and GST provisions. In manufacturing, ITC on inputs such as raw materials, consumables, and machinery is essential to keep production costs competitive. The sector's reliance on credit for capital goods means that any disruption in claiming ITC directly escalates the capital intensity and delays expansion plans. Capital-intensive industries like automotive, chemicals, and electronics are especially sensitive to such disruptions. For instance, an automobile manufacturer's inability to claim ITC on expensive components or machinery can inflate unit costs, reducing profitability or forcing price hikes that erode market share.

The services sector has its own unique pattern of ITC utilization. Service providers—especially in IT, telecom, consulting, and financial services—primarily claim credit on input services such as software subscriptions, telecommunication charges, office rent, and employee benefits. Unlike manufacturing, where physical inputs dominate, services rely more on intangible inputs. However, Section 17(5) of the CGST Act restricts ITC claims on certain expenses like food and beverages, health club memberships, and motor vehicles. This limitation affects service companies with substantial employee-related expenditures. For example, IT firms with large employee bases often bear costs related to company cars or client entertainment, where ITC is blocked, reducing net profitability. The challenge here is that even legitimately business-related expenses are often denied credit, leading to increased out-of-pocket costs.

Construction and real estate are arguably the most complex sectors when it comes to ITC utilization. Construction businesses grapple with delayed payments, long project cycles, and significant capital investment, making ITC flow critical for financial sustainability.

However, Section 17(5) explicitly disallows credit on inputs and input services related to the construction of immovable property (other than plant, machinery, or equipment). This means that large portions of construction costs, including cement, steel, and labor services, attract full tax without credit, inflating project costs. As a result, construction companies often build the tax cost into project bids, increasing prices for end consumers and delaying infrastructure development. Furthermore, these businesses face procedural hurdles in refund claims and reversals of ITC when payments are delayed beyond stipulated timelines. The compounded effect of blocked credits and delayed recoveries severely impacts their working capital cycle and profitability.

ITC availability also influences pricing strategies and cost structures across sectors.

Businesses typically price goods and services based on costs net of available input credits.

When ITC is delayed or denied, businesses face the choice of absorbing the cost increase or passing it on to consumers. In highly competitive markets with price-sensitive customers, the latter option is often untenable, resulting in margin erosion. Such cost absorption affects investment decisions, innovation, and long-term growth prospects. Conversely, in less competitive or regulated markets, companies may pass on the increased tax cost, potentially reducing demand and affecting market share. For example, the FMCG sector with thin margins carefully monitors ITC availability to maintain profitability without impacting consumer prices.

Vendor management is another operational area significantly influenced by ITC compliance requirements. Since ITC claims depend heavily on supplier compliance—timely filing of returns, correct invoice issuance, and GST remittance—businesses are compelled to enforce strict controls on vendors. This has led to a shift in procurement practices where supplier evaluation now includes GST compliance ratings. Companies demand GST-compliant invoices with accurate details and timely submission of returns to avoid ITC denial. Many enterprises embed GST compliance clauses into vendor contracts, including penalties for non-compliance and indemnity provisions. These measures help safeguard ITC claims but increase administrative burden and sometimes restrict the choice of suppliers, particularly for SMEs or in industries where suppliers are largely unorganized or informal.

The adoption of technology solutions to manage ITC processes has grown rapidly.

Businesses invest in Enterprise Resource Planning (ERP) systems integrated with GSTN portals, enabling real-time invoice matching and auto-population of returns like GSTR-2B. Automation minimizes errors, accelerates reconciliation, and provides early warning of mismatches or blocked credits. Additionally, digital platforms help generate compliance reports, track vendor performance, and facilitate internal audits. For large corporations with multiple registrations across states, centralized ITC management systems reduce duplication and enhance accuracy.

However, such technological investments involve costs and require skilled personnel, often stretching the resources of smaller firms.

To illustrate the real-world impact of ITC, consider MSMEs, which form the backbone of the Indian economy but face disproportionate challenges. A case study of a small textile manufacturer based in Surat reveals the operational difficulties in ITC utilization. The firm struggled with delayed GST refunds due to invoice mismatches caused by suppliers' delayed filings. This forced the manufacturer to finance raw material purchases from working capital loans at high-interest rates, increasing overall costs. Additionally, frequent changes in ITC rules led to confusion and compliance errors, resulting in penalties. The company had to engage consultants and invest in accounting software, which increased overheads. Despite these challenges, the ITC mechanism allowed the business to remain competitive by reducing tax costs on inputs, highlighting a delicate balance between benefits and burdens.

In contrast, large enterprises with advanced compliance frameworks generally manage ITC processes more effectively. For example, a multinational electronics company implemented a centralized GST compliance platform that automated invoice reconciliation using GSTR-2B data, enabling real-time tracking of ITC claims across multiple states. This system helped reduce errors, improved vendor compliance monitoring, and

minimized delays in credit utilization. The company also developed internal guidelines for dealing with blocked credits and inter-branch ITC transfers, ensuring regulatory compliance while optimizing tax costs. However, even such large firms face scrutiny from tax authorities, periodic audits, and litigation risks, reflecting the inherent complexity of the ITC regime.

Operationally, businesses have had to evolve several internal processes in response to ITC challenges. The integration of accounting and GST compliance software has become essential to avoid manual errors and delays. Firms conduct regular vendor audits and training sessions to ensure supplier awareness of GST requirements.

Cross-functional coordination between finance, procurement, and legal teams has increased to align on invoice validation, payment cycles, and dispute resolution related to ITC claims. Many companies also establish dedicated GST cells to monitor compliance, respond to notices, and manage litigation proactively.

The dynamic and evolving nature of ITC regulations, including frequent amendments and clarifications, requires ongoing adaptation by businesses. Changes such as the phased reduction and eventual removal of provisional ITC claims under Rule 36(4) have compelled companies to upgrade reconciliation processes and renegotiate compliance terms with vendors. Similarly, the introduction of e-invoicing and mandatory QR codes for high-value transactions has increased compliance costs but is expected to enhance invoice authenticity and reduce fraud. Companies continuously monitor GST Council decisions and circulars to adjust policies and mitigate risks related to ITC reversals, blocked credits, and audit disputes.

Despite these adaptations, the burden of ITC compliance remains heavy, particularly for MSMEs and sectors like construction where blocked credits and refund delays are common. The costs of compliance—financial, operational, and administrative—can erode the benefits of ITC, especially for smaller firms with limited resources. Many MSMEs perceive the ITC regime as complex and punitive, which discourages formalization and full compliance. For larger enterprises, the risk of litigation and extended audits adds uncertainty and necessitates sustained investment in advisory services.

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CHAPTER 5 : REVENUE AND POLICY IMPLICATIONS

The Input Tax Credit (ITC) mechanism is a cornerstone of the Goods and Services Tax (GST) system, designed to ensure tax neutrality and eliminate the cascading effect of taxes across the supply chain. ITC allows businesses to reduce their tax liability by claiming credit on taxes paid on inputs and input services, thereby only paying tax on the value addition they create. This mechanism not only aids in reducing the overall tax burden on businesses but also contributes to broadening the tax base and improving revenue collections for the government. However, the ITC system, while theoretically sound, has brought significant policy and revenue implications for the government, creating complex challenges around revenue leakage, fraud prevention, compliance enforcement, and balancing ease of doing business with strict regulatory oversight.

India's GST regime, implemented in July 2017, marked one of the largest tax reforms in the country's history. The introduction of ITC was intended to replace multiple overlapping taxes and create a transparent and seamless credit chain. However, the sheer scale of GST implementation—covering millions of taxpayers, a vast diversity of products and services, and complex inter-state transactions—posed enormous challenges in designing a robust ITC policy framework. While the government aimed to facilitate legitimate credit flows, the openness of the system inadvertently created loopholes exploited by unscrupulous taxpayers to claim undue ITC, leading to significant revenue leakage.

One of the most pressing concerns with ITC under GST has been the prevalence of fraudulent claims that deprive the government of rightful revenues. Fake invoice fraud, also known as “bogus ITC,” involves the generation of fraudulent or inflated invoices by fake or shell entities that claim ITC without actual supply of goods or services. These fraudulent credits are then passed through multiple entities, creating a “carousel” or “circular” chain of transactions designed to obscure the fraud and evade tax payments. The complexity of this mechanism, combined with limitations in invoice matching and enforcement, has made it difficult for tax authorities to detect and prevent such malpractices promptly. Multiple reports and investigations by the government and independent watchdogs estimate revenue losses in the thousands of crores of rupees annually due to such fraudulent ITC claims.

These ITC frauds have had a direct negative impact on the government's GST revenue collections. The resultant leakage undermines the credibility of the tax system and hampers

the government's ability to fund public goods and services. To counter this, the government has implemented a series of policy measures aimed at tightening the ITC claim process, improving transparency, and enhancing the audit and enforcement framework. However, these measures have often resulted in a delicate balancing act—between closing loopholes to prevent fraud and avoiding excessive compliance burdens that could stifle genuine business activity.

One significant policy intervention was the introduction of Rule 36(4) under the Central Goods and Services Tax (CGST) Rules. This provision restricts the amount of ITC that a taxpayer can claim on invoices and debit notes not reflected in their GSTR-2B auto-drafted statement. Initially, this restriction limited ITC claims on such invoices to 20% of eligible credit, later reduced to 5%. Rule 36(4) seeks to enforce stricter invoice matching discipline by compelling taxpayers to reconcile their purchases with supplier data to claim credit. While this has been effective in reducing ITC claims based on non-existent or unmatched invoices, it has also generated unintended consequences for compliant taxpayers. Many businesses face genuine delays or errors in their suppliers' filings, leading to inadvertent ITC denial or deferral, thus adversely impacting their cash flows. The government has had to balance enforcement with stakeholder concerns and periodically provide clarifications and relief measures.

Alongside Rule 36(4), the government has promoted the mandatory adoption of e-invoicing for businesses above certain turnover thresholds. E-invoicing directly integrates invoice generation with the GST Network (GSTN), ensuring real-time validation and reporting. This technological intervention helps curb fake invoice generation by creating a secure, traceable digital trail of transactions. E-invoicing improves data accuracy,

reduces mismatches in ITC claims, and facilitates faster detection of fraudulent credits. Additionally, initiatives such as the introduction of QR codes and digital signatures on invoices enhance the authenticity and auditability of transactions. While these technological improvements are promising in reducing revenue leakage, they also require significant compliance and IT investments by businesses, especially MSMEs, which may struggle to adapt quickly.

The government's focus on improving ITC integrity extends to strengthening the audit and investigation framework. The tax authorities have stepped up scrutiny of sectors vulnerable to ITC fraud, such as real estate, construction, and manufacturing. Special audit provisions under Section 65 of the CGST Act empower authorities to conduct detailed examinations of taxpayers' books, records, and credit claims. The use of data analytics and artificial intelligence tools enables targeted risk-based audits, focusing on suspicious transactions or taxpayers with abnormal credit utilization patterns. These measures have increased detection of fraudulent ITC claims, leading to recovery of dues and imposition of penalties. However, frequent audits and notices also increase compliance costs and litigation risks for businesses, leading to uncertainty and disputes.

GST revenue collections since implementation have shown a steady upward trend, reflecting improved compliance and a broader tax base. The availability of ITC incentivizes businesses to comply with GST filing and reporting requirements, as claiming credit is contingent upon the suppliers' compliance. This creates a self-enforcing mechanism that promotes transparency and formalization of the economy. However, challenges remain in ensuring that ITC claims are legitimate and do not result in revenue leakage. The government continues to monitor GST collection patterns and ITC claims closely to identify anomalies and take corrective action. Discrepancies in ITC claims versus output tax filings are flagged for scrutiny, ensuring that only genuine credits contribute to reducing tax liabilities.

Balancing rigorous ITC enforcement with the ease of doing business is a critical policy challenge. While stringent restrictions and detailed compliance checks help curb fraud, they can also impose heavy burdens on genuine taxpayers, particularly MSMEs with limited resources and technical capabilities. Complex ITC provisions, frequent policy changes, and ambiguous interpretations create confusion and compliance challenges. For instance, restrictions on ITC for certain inputs and input services under Section 17(5), mandatory reversal of credit on delayed payments under Section 16(2), and limited refund mechanisms

can disproportionately impact small businesses, leading to delays and higher costs. The government has recognized these challenges and has introduced measures to ease compliance, such as simplified returns, staggered implementation of e-invoicing, and grievance redressal mechanisms.

Taxpayer education and awareness campaigns have been intensified to reduce errors in ITC claims and improve compliance. The GST Council and the Central Board of Indirect Taxes and Customs (CBIC) regularly issue clarifications, FAQs, and circulars to address common issues related to ITC eligibility, blocked credits, and refund procedures. Online portals, help desks, and training programs aim to support taxpayers in navigating complex ITC rules. Despite these efforts, awareness levels vary widely, and many small businesses remain unaware of the nuances of ITC, resulting in inadvertent non-compliance or loss of eligible credits.

The legal landscape surrounding ITC has also evolved with several high-profile litigation cases shaping its interpretation. Courts and tribunals have adjudicated disputes related to eligibility of ITC on capital goods, reversal of credits for non-payment to suppliers within 180 days, and the scope of blocked credits under Section 17(5). These rulings have clarified several contentious points but have also highlighted ambiguities, resulting in ongoing litigation and compliance uncertainty. Taxpayers often face the dilemma of whether to claim disputed credits or risk penalties and litigation, adding to the operational complexity.

The government's enforcement strategy increasingly leverages technology to improve the efficacy of ITC controls. Integration of GSTN data with customs, income tax, and banking information enables comprehensive cross-verification of transactions. Automated invoice matching through the GSTR-2B statement helps taxpayers reconcile credits and detect mismatches early. Artificial intelligence and machine learning models analyze

patterns to flag suspicious transactions or taxpayers for audit. Such data-driven approaches enhance revenue protection while aiming to minimize intrusive compliance interventions for bona fide taxpayers.

The policy implications of ITC also extend to the macroeconomic level. Effective ITC management contributes to lowering the overall tax burden on goods and services, encouraging investment, production, and consumption. A well-functioning ITC mechanism reduces inflationary pressures caused by cascading taxes and supports export competitiveness by enabling refund of unutilized credits on zero-rated supplies. Conversely, delays and denials of ITC can increase business costs, dampen investment sentiment, and distort market competition by penalizing compliant taxpayers. Therefore, policymakers must continuously evaluate the ITC framework's impact on economic growth, tax buoyancy, and formalization.

Looking ahead, the government is poised to further refine ITC policies to balance revenue protection with taxpayer facilitation. Proposals include enhancing automation of credit matching, simplifying reversal and refund processes, and rationalizing blocked credits. There is also a push to expand e-invoicing coverage and integrate it with other indirect tax modules for seamless credit flow. Greater stakeholder consultations and feedback mechanisms are being encouraged to identify pain points and co-create solutions. These efforts reflect an acknowledgment that ITC is not merely a technical tax provision but a dynamic policy instrument critical to the success of the GST ecosystem.

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CHAPTER 6 : GLOBAL COMPARISONS AND BEST PRACTICES

The implementation of the Goods and Services Tax (GST) in India marked a significant reform in the indirect tax landscape. At its core, the system was designed to follow a destination-based, value-added tax model, with the Input Tax Credit (ITC) mechanism being a pivotal feature. Despite this alignment with global tax structures, the Indian ITC mechanism continues to encounter challenges related to procedural complexity, compliance enforcement, fraudulent claims, and credit ineligibility. A comparative analysis of ITC frameworks in other jurisdictions can provide valuable insights into best practices, administrative efficiencies, and technological innovations. This chapter seeks to explore global VAT/GST systems in countries like Australia, Canada, and the European Union, analyze their ITC procedures, and assess how their experiences can inform India's policy evolution, with a particular focus on compliance simplification, fraud prevention, and technology integration.

Australia, one of the early adopters of GST, offers a comparatively streamlined ITC mechanism under its Goods and Services Tax Act 1999. The Australian Taxation Office (ATO) administers the GST and maintains a relatively straightforward input credit framework. Businesses are allowed to claim ITC on purchases directly related to their taxable supplies, provided that they hold valid tax invoices and the purchase is for business purposes. What sets Australia apart is its principle-based approach, which avoids over-regulation and fosters a more trust-based system of compliance. Unlike India, Australia does not mandate invoice matching or auto-populated returns for claiming credits. Instead, it focuses on post-return scrutiny and audits to detect discrepancies. This model reduces upfront compliance burdens and allows genuine taxpayers greater operational freedom, although it requires robust back-end enforcement capabilities to detect and penalize fraud. Moreover, Australia has relatively fewer restrictions on the types of inputs eligible for credit, thus ensuring a broader credit chain and fewer disputes over blocked credits.

In contrast, Canada's federal Goods and Services Tax and Harmonized Sales Tax (GST/HST) system, administered by the Canada Revenue Agency (CRA), incorporates both centralized administration and harmonized tax treatment across multiple provinces. Canada's ITC structure resembles that of Australia in its simplicity and principle-based design. Businesses are entitled to claim input tax credits on inputs used in commercial activities,

subject to certain exclusions. Documentation requirements are reasonable, with businesses required to maintain records of tax invoices, supplier information, and payment details. Importantly, Canada emphasizes risk-based audits rather than preemptive invoice validations. This post-facto enforcement mechanism allows for a smoother credit claiming experience, placing trust in the taxpayer while reserving the right to examine claims retrospectively. One significant best practice in Canada is its transparent dispute resolution and appeals system, which provides clear timelines and reduces prolonged litigation.

The European Union (EU), representing a unique supranational VAT model across 27 member states, presents a more complex but harmonized approach to input tax credit across borders. The EU's VAT system is governed by the VAT Directive (2006/112/EC), which outlines uniform principles while allowing flexibility in domestic implementation. The concept of "deductibility" of input tax in the EU is generally broad, with businesses allowed to recover VAT on goods and services used in their taxable economic activities. However, individual member states have their own rules regarding documentation and compliance procedures. One notable feature in many EU countries is the use of VAT refund mechanisms for cross-border transactions, which promote ease of trade across national boundaries. Another best practice is the emphasis on digital reporting. Several EU nations, such as Spain (SII system) and Hungary (Online Invoice System), have implemented real-time or near real-time invoice reporting to their tax authorities. These digital tools provide governments with immediate visibility into business transactions, thereby improving audit efficiency and reducing fraud without overly complicating the credit claim process.

In terms of technological infrastructure, the global trend is moving towards automation, real-time data sharing, and integration of e-invoicing systems with tax databases. Countries like Italy and Chile have adopted mandatory e-invoicing for B2B transactions, which allows for automated matching of sales and purchase data.

Italy's Sistema di Interscambio (SDI) requires invoices to be sent to the government platform before they are transmitted to the buyer, thus ensuring tax transparency at the source. Similarly, Brazil uses a National Electronic Invoice (Nota Fiscal Eletrônica) system that integrates with customs and tax systems, allowing for holistic monitoring of goods and services movement. These systems not only help in fraud detection but also ease compliance by eliminating the need for redundant data entry and manual reconciliation. Such initiatives demonstrate how technology can be a powerful enabler of ITC efficiency and compliance.

Comparing these international practices with India's ITC mechanism reveals key contrasts and areas for improvement. India's ITC system, though conceptually aligned with VAT principles, is plagued by procedural bottlenecks, restrictive rules, and administrative complexity. A prime example is the restricted eligibility under Section 17(5) of the CGST Act, which disallows ITC on goods and services such as motor vehicles, personal consumption, construction services, and club memberships, among others. This has led to frequent litigation and interpretational issues, unlike in Australia or Canada, where exclusions are limited and clearly defined. Another challenge unique to India is the conditionality of supplier compliance. Under Section 16(2)(c), a buyer can claim ITC only if the supplier has paid the tax to the government. This shifts the burden of compliance to the recipient, who has no direct control over the supplier's tax behavior, thereby leading to unjust credit denial and increased disputes. In contrast, countries like Australia and Canada do not condition ITC eligibility on supplier tax remittance.

Another significant challenge in India is the matching of invoices through GSTR-2B and Rule 36(4), which restricts provisional ITC claims for unmatched invoices. Although this system was designed to curtail fraud, it has created operational difficulties, especially for small and medium enterprises that rely on a wide vendor base. In contrast, most global systems avoid invoice matching as a prerequisite and instead rely on risk profiling and audit to enforce compliance. This reduces day-to-day friction and builds trust in the tax system. Additionally, the requirement to reverse ITC on non-payment within 180 days in India creates cash flow blockages, whereas many international jurisdictions rely on general anti-avoidance rules and interest penalties rather than such micro-management.

The role of dispute resolution in ITC implementation is another area where global practices offer valuable lessons. In countries like Canada and the UK, tax disputes are handled through independent tax courts or administrative tribunals, which follow time-bound procedures and offer fair hearings. In India, ITC-related disputes often face delays due to litigation backlogs

and inconsistent interpretations by adjudicating authorities. Introducing a fast-track GST dispute resolution mechanism or specialized benches for ITC cases could greatly enhance business confidence and reduce litigation overload.

From a technology perspective, while India has made significant strides with the GSTN portal, e-way bills, and e-invoicing mandates, there remains room for improvement. Integration across indirect tax modules is still evolving, and frequent portal glitches or reconciliation errors continue to affect ITC claims. Learning from Brazil, Italy, and Spain, India could consider deeper automation of credit flows, such as direct linkage between supplier invoices and buyer credits, automatic credit unlocks upon supplier payment confirmation, and machine-readable invoices to facilitate seamless matching. These changes would require further strengthening of the digital infrastructure, taxpayer education, and real-time monitoring capabilities.

One promising area is the development of pre-populated returns and AI-driven compliance support tools. Global tax authorities are increasingly adopting AI and machine learning to analyze large datasets, detect anomalies, and issue real-time alerts. Australia and the UK use predictive analytics to identify high-risk taxpayers and transactions, thereby enabling targeted audits. India can build on its early efforts in data analytics to create taxpayer risk scores, flagging entities with suspicious ITC patterns or invoice behaviors. This would not only reduce blanket audits but also create a performance-based compliance ecosystem.

International practices also highlight the importance of clear communication and trust between taxpayers and the tax administration. In many developed jurisdictions, taxpayers are encouraged to engage in voluntary disclosure and seek advance rulings on ITC eligibility. These mechanisms reduce ambiguity and promote a

collaborative compliance culture. India has made progress through advance ruling authorities under GST, but the lack of national uniformity and binding precedents limits their utility. Harmonizing advance rulings across states and making them legally binding would significantly enhance legal certainty.

Furthermore, peer nations place greater emphasis on taxpayer services and education to facilitate ITC compliance. Tax administrations in countries like New Zealand and Singapore provide interactive tools, sector-specific guidelines, and personalized assistance to help taxpayers navigate complex ITC provisions. In India, despite regular circulars and FAQs from the CBIC, many small businesses remain unaware of the nuances of ITC eligibility, reversal, and documentation. More targeted outreach, sectoral helpdesks, and vernacular language support can bridge this information gap and empower taxpayers to comply correctly.

Another notable feature in several countries is the principle of “no unjust enrichment” in ITC refunds. While India requires declaration of non-passing of tax burden to claim certain refunds, the process remains cumbersome. Global systems often have streamlined refund mechanisms with clear timelines and automatic processing thresholds. For instance, the European Union mandates that VAT refunds be issued within specified timeframes, failing which the taxpayer earns interest. Instituting similar service-level guarantees for ITC refunds in India could enhance trust and reduce working capital stress, especially for exporters and high-credit-accumulating sectors.

Lastly, the alignment of ITC systems with broader tax reforms is a global best practice that India can adopt more strategically. Countries like South Korea and Singapore have used their GST frameworks as platforms for broader digitalization, cashless transactions, and formalization of the economy. The Indian government’s Digital India campaign and GST e-governance initiatives are well-aligned with such goals, but integration across departments, real-time data sharing, and single-window compliance are still work in progress. Strengthening these connections will not only enhance ITC effectiveness but also improve overall fiscal governance.

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CHAPTER 7 : FINDINGS, RECOMMENDATIONS AND CONCLUSION

The implementation of the Goods and Services Tax (GST) in India was envisioned as a transformative step towards unifying the country's indirect tax landscape. At the core of this reform lies the Input Tax Credit (ITC) mechanism—a tool designed to eliminate cascading taxes, reduce tax burden on businesses, improve transparency, and ensure seamless flow of credit across the value chain. However, the practical functioning of the ITC mechanism has diverged significantly from its theoretical promise. Over the past few years, numerous amendments, judicial pronouncements, government circulars, and administrative interpretations have shaped the evolving landscape of ITC compliance. Based on the comprehensive analysis undertaken in the preceding chapters, this chapter consolidates the key findings of the study, proposes evidence-based policy recommendations, and provides concluding remarks along with the scope for future research.

One of the most significant findings of this study is that the ITC mechanism in India, while conceptually robust, suffers from excessive procedural rigidity and complex eligibility conditions. The legal framework governing ITC—particularly Section 16 and Section 17 of the Central Goods and Services Tax (CGST) Act—imposes multiple conditions that often make the claim of credit contingent not only on the actions of the recipient but also the supplier. For instance, Section 16(2)(c) mandates that ITC can only be claimed if the supplier has deposited the tax with the government, which effectively shifts the burden of compliance enforcement onto the buyer. This has led to significant hardships where genuine buyers are denied credit due to defaulting suppliers—over whom they have no legal control.

A second key finding relates to the issue of blocked credits under Section 17(5) of the CGST Act. This provision enumerates a wide range of goods and services on which ITC is disallowed, including motor vehicles, construction services, personal consumption expenses, and works contracts. While the rationale is to prevent revenue leakage, this provision often leads to interpretational disputes and litigation, especially in cases where such inputs are essential for business operations. Several High Courts have adjudicated on the scope of Section 17(5), indicating the lack of clarity and the broad brush with which these exclusions are defined. This has created uncertainty and compliance burdens for taxpayers.

Third, the operational aspect of ITC reconciliation has been fraught with complications due to issues such as delayed invoice uploads by suppliers, technical glitches in the GSTN

portal, and frequent changes in rules regarding GSTR-2A, GSTR-2B, and Rule 36(4). The restriction on provisional credit (initially 20%, later reduced to 5% and eventually removed) has further strained the liquidity of businesses. As per the findings in Chapter 3, small and medium enterprises (SMEs) are particularly vulnerable as they lack the resources to continuously monitor and reconcile credits. Furthermore, cross-branch and cross-state utilization of ITC, although allowed in theory under the IGST model, faces practical roadblocks due to poor understanding of the inter-state supply rules and issues of apportionment.

Fourth, the financial and operational implications of ITC constraints are clearly visible. Businesses face working capital blockages due to delays in credit realization, often compelling them to seek external financing. This, in turn, increases the cost of doing business. Sector-specific challenges are also evident: the construction sector faces significant ITC accumulation with limited scope for utilization, while exporters and businesses in the service sector struggle with refund delays and procedural bottlenecks. Large enterprises with digital infrastructure may still manage compliance, but micro, small, and medium enterprises (MSMEs) face disproportionately higher compliance costs relative to their turnover. These factors dampen the spirit of 'ease of doing business' and pose a challenge to the inclusiveness of the GST regime.

Fifth, the government's concern about ITC-related frauds—particularly through fake invoices—has led to a tightening of compliance measures. While measures such as e-invoicing, QR codes, and matching of GSTR-1 and GSTR-3B returns are steps in the right direction, they also increase the administrative burden on honest taxpayers. The policy response, although aimed at curbing tax evasion, has often lacked a proportionate balance

between deterrence and facilitation. The shift from a trust-based to a control-based system of ITC validation runs contrary to global best practices, where post-facto audits and analytics-based monitoring are used instead of pre-verification hurdles.

Sixth, when juxtaposed with international practices, India's ITC system appears overregulated and excessively reliant on compliance by both buyers and sellers. Countries like Australia and Canada offer broader eligibility, fewer exclusions, and post-return verification mechanisms. The EU, on the other hand, has made significant progress in digitalizing VAT systems and reducing refund delays. India's recent efforts in implementing e-invoicing and analytics through the GSTN are commendable, but their effectiveness is still limited by portal issues, inadequate support for small businesses, and manual reconciliation procedures.

Given the above findings, the study proposes several policy-level recommendations to enhance the effectiveness of the ITC mechanism under GST. Firstly, the government should consider re-evaluating the provisions of Section 16(2)(c) and delink ITC claims from the supplier's tax compliance status. A mechanism similar to Tax Collected at Source (TCS) or a buyer verification model could be adopted, wherein ITC is allowed based on the buyer's bona fide intent and possession of valid documentation. Penal action against defaulting suppliers can be pursued independently, rather than penalizing the buyer.

Secondly, the list of blocked credits under Section 17(5) should be rationalized. A sector-specific approach, rather than a blanket restriction, would be more equitable. For example, allowing credit on construction-related expenses for real estate developers or ITC on motor vehicles used for business transportation can significantly reduce disputes. An objective test—such as “predominant use in business”—can be applied to determine credit eligibility, rather than rigid category-based exclusions.

Third, the GST portal's functionality needs to be significantly upgraded to support seamless reconciliation. Auto-populated and AI-supported GSTR-2B statements, combined with real-time invoice tracking, can eliminate many errors currently experienced by businesses. In addition, small businesses should be offered subsidized access to GST compliance software, accounting tools, and consultancy services. This will empower MSMEs to claim rightful credits without incurring disproportionate compliance costs.

Fourth, India should move towards a risk-based compliance framework rather than treating

all taxpayers with equal suspicion. Taxpayers with consistent filing history, no pending liabilities, and clean audit records should be categorized as “low risk” and given auto-approval for credits. The government can then concentrate its enforcement resources on high-risk profiles, identified using AI-driven analytics and transactional red flags. Such a model will not only reduce the compliance burden but also improve tax morale and voluntary compliance.

Fifth, the ITC refund process—especially for exporters and inverted duty structure cases—must be expedited. A guaranteed timeline for refunds, with automatic interest in case of delays, should be implemented. The refund application process should be made simpler and integrated with ICEGATE and other customs systems to ensure that exporters are not penalized for bureaucratic delays. Pre-validation of shipping bills, electronic Bank Realization Certificates (e-BRC), and refund calculations should be automated to the extent possible.

Sixth, the government should consider the establishment of a central ITC tribunal or fast-track dispute resolution mechanism. At present, disputes related to ITC eligibility are decided by state authorities, leading to divergent interpretations and increased litigation. A centralized adjudication body or appellate forum for ITC disputes will ensure uniformity, faster resolution, and legal clarity. Alternatively, sector-specific advance ruling benches can be established with experts from law, tax, and industry to provide binding guidance.

Seventh, taxpayer awareness must be prioritized. The GST Council, CBIC, and state tax authorities should collaborate to develop comprehensive training programs, online modules, and knowledge portals. Educational videos, webinars, and mobile apps in vernacular languages can help bridge the gap between policy and practice. Further, sectoral guides and FAQs on ITC issues should be updated regularly and promoted actively.

Eighth, long-term reforms should consider aligning the Indian GST regime closer to international standards. This may involve revisiting the concept of “negative list” of ineligible credits, replacing it with a “positive test” for credit eligibility based on business purpose. The eventual integration of direct and indirect tax systems through PAN-based credit tracking and a unified compliance dashboard can also be explored. Such reforms will improve efficiency, reduce fraud, and promote formalization of the economy.

In conclusion, the Input Tax Credit mechanism, though one of the cornerstones of the GST framework, remains a double-edged sword in its current form. While it offers the potential for seamless tax flow and reduced cascading effect, its current implementation in India is marred by excessive conditionalities, restrictive rules, and administrative bottlenecks. The evidence presented in this research clearly shows that the compliance burden is disproportionately high for businesses, especially MSMEs, and that policy measures have not adequately differentiated between honest and fraudulent taxpayers.

Yet, the silver lining lies in the growing adoption of technology, increasing tax digitization, and the government’s responsiveness to stakeholder feedback. The implementation of e-invoicing, the rollout of GSTR-2B, and the push for analytics-based monitoring are encouraging signs of systemic maturity. With appropriate reforms in law, process, and administration, India can move towards a more equitable, efficient, and business-friendly ITC regime.

Future research could focus on empirical analysis of ITC utilization patterns across states, the impact of specific amendments on sectoral compliance, or a comparative assessment of refund processing efficiency post e-invoicing rollout. Moreover, quantitative studies on the correlation between ITC restrictions and working capital constraints could offer data-driven insights to policymakers. Longitudinal studies tracking taxpayer behavior before and after the introduction of GST reforms would also enrich the policy discourse.

Ultimately, a robust ITC mechanism is indispensable for the success of any value-added tax system. By learning from global practices, embracing technological innovation, and fostering a taxpayer-centric compliance environment, India can fully realize the transformative potential of GST.

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