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Fake Invoicing and Availment of Input Tax Credit

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GST System has brought one of the most important benefits, viz., the availment of Input Tax Credit (ITC) to overcome the Cascading Effect of Taxes that existed in the old regime of Indirect Taxation. The paper attempts to shed light on the practice of Fake Invoicing and how it exploits the benefit of ITC. The paper goes on to explain various ways adopted by traders under Fake Invoicing. The paper highlights the solution adopted by the Tax Department through the Finance Act to tackle the problem of Tax Evasion by means of Fake Invoicing. It further discusses the mandate brought about under Section 16[1] *of the CGST Act, read with Section 41*[2] *of the CGST Act, along with its merits and demerits. Further, the paper highlights the effect of such a mandate and, thus, concludes it is a useful tool to plug in the revenue leakage in the department.*

Keywords: *fake invoices, availment, mandate, section 16, section 41, rule 37.*

[1] Central Goods and Services Tax Act 2017, s 16
[2] Central Goods and Services Tax Act 2017, s 41

INTRODUCTION

Section 16 of the CGST Act[3] regulates the Availment of ITC in GST. Availment of ITC is when the recipient of goods or services or both uses the goods and/or services for further business and adds a certain value to the goods and services then, they are required to pay the GST on the value addition only. As a result of this, they avail the credit of the taxes already paid by the supplier as the buyer had to pay the full amount of tax while purchasing the goods and services initially from the supplier. The availment of Input Tax Credit (ITC) has been extensively abused by traders through the generation of counterfeit invoices, a practice known as Fake Invoicing. This contemporary issue results in revenue loss for the Revenue Department.

FAKE INVOICING AND PRACTICES

It has been observed that trade associations obtain fake GST registrations, taking advantage of the limited human interaction in the process. By utilising fake registrations, traders create fraudulent GST firms to produce Fake Invoices, portraying fictitious transactions of goods and services. The rationale behind acquiring fake registrations is to designate the fake firms as suppliers in the invoices, allowing the actual operational firm to claim the role of the recipient to avail ITC unlawfully. Consequently, the transactions depicted in these invoices represent fictitious supplies. The Fake Invoices are utilised to falsely document purchases of goods and services, which are then portrayed as essential for business operations. Through this deceptive practice, traders exploit the opportunity to claim Input Tax Credit on illegitimate transactions. The counterfeit invoices enable traders to fraudulently claim ITC, which was non-existent and utilise it to fulfil GST payments for exported goods, leading to unjustified claims for GST refunds on exports.[4]

As previously stated, counterfeit invoices present fictitious transactions of goods and services, irrespective of whether the transportation of goods falls within the specified distance limitations set by individual state exemptions. Consequently, to circumvent any potential issues with law

[3] Central Goods and Services Tax Act 2017, s 16

[4] Annapoorna, 'Circular on ITC claims on fake invoices' (*Clear Tax*, 23 December 2024) <https://cleartax.in/s/circular-itc-claims-on-fake-invoices> accessed 15 March 2024

enforcement authorities, namely Mobile Squad, the fabricated movement of goods must be substantiated by spurious e-Waybills. This implies that certain traders resort to a series of fraudulent actions, ranging from falsifying GST registrations to generating counterfeit e-Way Bills solely to obtain Input Tax Credit illicitly.

STATUTORY POSITION AND CHANGES

The Availment of Input Tax Credit (ITC) is governed by Section 16 of the Central Goods and Services Tax (CGST) Act. The issue mentioned above pertains to the concept of Tax Evasion. Section 16 stipulates that sub-section (1)[5] permits the utilisation of ITC, while sub-section (2)[6] outlines the necessary conditions for its availment. According to Section 16(2)(c)[7] of the CGST Act, the availment of ITC must be in conjunction with Section 41[8] and Section 43A (now omitted) of the same Act. Until the enactment of the Finance Act 2022, Section 41[9] did not impose any restrictions on ITC availment and allowed registered individuals to claim input tax credit provisionally. Nevertheless, this legislative gap led to the exploitation of the law by registered entities, resulting in the emergence of Fake Invoicing malpractices.

To forestall traders from participating in the malpractices of Fake Invoicing, a Circular was issued by the GST Council delineating the Standard Operating Procedure (SOP) for State GST Authorities to address the issue of Fake Invoicing.[10] The Circular also elucidated various potential reasons that lead traders to partake in the practice of Fake Invoicing. These reasons encompass converting Input Tax Credit (ITC) into cash by transferring it to those capable of utilising it, inflating the business turnover to secure bank loans or achieve better valuation in Initial Public Offerings (IPOs), and evading GST on taxable outward supplies. Despite the GST

[5] Central Goods and Services Tax Act 2017, s 16(1)
[6] Central Goods and Services Tax Act 2017, s 16(2)
[7] Central Goods and Services Tax Act 2017, ss 38-41
[8] Central Goods and Services Tax Act 2017, s 41
[9] '[Opinion] Why Reversal of ITC for the Tax Period from 01-07-2017 to 01-10-2022, When Supplier Has Not Paid to Government' (*Taxmann*, 28 November 2023) <https://www.taxmann.com/post/blog/opinion-why-reversal-of-itc-for-the-tax-period-when-supplier-has-not-paid-to-government#:~:text=GST%20Section%2041%20(2)%20The,manner%20as%20may%20be%20prescribed%3A%20> accessed 15 November 2024
[10] 'SOP for utilising fake invoice Issuers dataset by SGST authorities' (*Tax Guru*, 12 May 2020) <https://taxguru.in/goods-and-service-tax/sop-utilising-fake-invoice-issuers-dataset-sgst-authorities.html> accessed 15 November 2024

system's provision of an accountable and foolproof mechanism through which each buyer and seller are interconnected, Fake Invoicing has been employed in a manner that eludes detection by the GST system, resulting in tax evasion. Notably, data from January 2024 revealed that more than 29,000 fictitious firms were implicated in suspected ITC evasion amounting to Rs. 44,000 crores over 7.5 months.[11] The traders used to undertake GST registration and subsequently engaged in the creation of counterfeit invoices. Those who purchased goods as per such fraudulent invoices would then claim Input Tax Credit (ITC), while the suppliers neglected to submit their GST returns. In these scenarios, the traders would allow their debts to accumulate and offer bribes to their jurisdictional officers to evade their responsibilities. Consequently, this resulted in the Revenue Department not receiving the GST payments from the supplier and having to provide ITC claims to the buyers of these goods and services.

MANIPULATION OF ACCOUNTS

Despite the robust technological framework governing GST, instances of fraudulent activities persist considerably. Manipulation in accounts plays a significant role in fabricating documents, further emboldening traders to generate fake invoices unabashedly. Traders operate multiple firms to engage in the practice of issuing Fake Invoices. For example, they may avail the ITC of Rs.100 but produce an undervalued bill for subsequent sale, indicating a reduced taxable value that leads to a diminished tax liability of Rs. 85. This decreased liability, achieved through undervaluation of bills or presenting goods as sold at a loss, generates profits for the firm by accumulating more ITC than the liability on outward supplies. Nonetheless, this process necessitates the involvement of multiple firms, as undervaluing invoices continuously would cause losses to the firm in the books of account, prompting the utilisation of another firm owned by the trader to offset this deficit. The manoeuvring of invoices and manipulation of accounts across various firms to balance profits and losses and evade detection while engaging in Fake Invoicing is facilitated by those who exploit the loopholes in legislation in the form of Tax Avoidance, whether intentional or unintentional by lawmakers.

[11] Shishir Sinha, '29,000 firms, Rs. 44,000 cr GST evasion exposed in fake invoice crackdown' *The Hindu Businessline* (08 January 2024) <https://www.thehindubusinessline.com/economy/nationwide-drive-uncovers-29000-firms-44000-cr-gst-evasion-in-fake-invoice-crackdown/article67716175.ece> accessed 15 November 2024

Another fraudulent practice within Invoicing involves the sale of such invoices. Traders make Invoices and proceed to sell them. In this scenario, the supplier selling the invoices requests the buyer to cover a portion of the GST, with the remainder being borne by the supplier himself. This arrangement benefits the supplier by partially offsetting their outstanding GST liability on outward supplies through the buyer of these invoices. Consequently, the Input Tax Credit (ITC) availed by the supplier who sold the invoice yields a higher sum than the GST paid on outward supplies to the tax department.

SOLUTION TO AVAILMENT OF INELIGIBLE ITC

Section 106 of the Finance Act of 2022[12] was introduced to combat tax evasion stemming from Fake Invoicing. This section brought about a significant alteration to Section 41 of the CGST Act. Section 41 of the CGST Act outlined the prerequisites for the availment of ITC under Section 16 of the CGST Act. The revised Section 41, in conjunction with Section 16(2)(c)[13], established a Mandate for ITC to be claimed according to the guidelines specified in Section 16 of the CGST Act. Additionally, under subsection (2) of Section 16[14], suppliers are now mandated to pay taxes to the government in relation to the sale of goods and services, thereby enabling buyers to claim ITC on their purchases. Specifically, Section 41(2)[15] stipulated that any credit obtained under subsection (1)[16] must be reversed, along with applicable interest, if the taxes due on the supply of goods and services are not paid by the supplier to the government. This underscores the necessity for the buyer to be able to avail ITC only if the supplier has fulfilled their tax obligations on the sale, which is further ensured by the interconnected chain between supplier and buyer over the GST Portal.

There might be instances where the supplier has genuine intentions while the buyer has malafide intentions to avail ITC and not pay the supplier the invoice amount. Thus, along with this mandate, the Legislature has kept in mind to not be biased towards the suppliers by

[12] Finance Act 2022, s 106
[13] Central Goods and Services Tax Act 2017, s 16(2)(c)
[14] Central Goods and Services Tax Act 2017, s 16(2)
[15] Central Goods and Services Tax Act 2017, s 41(2)
[16] Central Goods and Services Tax Act 2017, s 41(1)

imposing a strict mandate to pay to the government. The legislature substituted sub-rule (1)[17] under Rule 37, CGST Rules, to ensure that suppliers are not defrauded by the buyers. It says that if the buyer defaults in paying the supplier wholly or partially along with the tax payable, then the ITC availed by the buyer along with the interest as under Section 50, CGST Act[18] would be paid by the buyer while furnishing GSTR-3B for the tax period immediately following the period of 180 days from the date of invoice.

Prior to this requirement under the Mandate, fictitious firms operated for extended periods without filing returns, as the jurisdictional officer turned a blind eye due to bribery. These fraudulent entities would delay their tax payments before eventually shutting down, while buyers continued to claim ITC. It is worth noting that these deceptive businesses were often established by the traders themselves to exploit ITC benefits through their other entities acting as buyers/sellers, with the transactions being managed internally. However, to avoid prosecution, these sham firms were established under someone else's name for GST registration purposes, yet they were controlled by the same individual.

MERITS OF MANDATE

It is essential to acknowledge that the mandate offers certain advantages. The mandate did not eliminate the practice of Fake Invoicing entirely; however, it has undeniably impacted the practice. This impact arises from the fact that the supplier, specifically the potential fictitious firm created by the trader (buyer) to benefit from Input Tax Credit (ITC) without paying taxes, is now unable to avail of the ITC. This situation occurs because when the bogus firm, acting as the supplier, fails to pay taxes to the government, the ITC cannot be claimed by the trader, rendering the purpose of the fictitious firm futile. Although instances of Fake Invoicing and Tax Evasion persist, they now manifest in a manner where the fictitious firm can only operate for a brief period of 1-2 months before being detected by Artificial Intelligence (AI) due to non-filing of returns, thereby preventing the buyer from accessing ITC. This scenario can also be viewed from an alternative perspective, highlighting that the primary objective of fictitious firms, which

[17] Central Goods and Services Tax Act 2017, r 37(1)
[18] Central Goods and Services Tax Act 2017, s 50

involved evading taxes by not paying taxes and enabling other entities to wrongfully claim unnecessary ITC, is thwarted.

It serves as a deterrent against the illicit activities of sham entities seeking to evade taxes, as the absence of ITC availability discourages the circulation of invoices among multiple fictitious firms to exploit ITC benefits and reduce tax liabilities. Additionally, the mandate facilitates the prompt identification of defaulting suppliers, compelling buyers to enforce adherence to GST regulations to access ITC legitimately. Furthermore, under Section 16 of the Central Goods and Services Tax (CGST) Act[19], this mandate provides the Revenue Department with a degree of certainty regarding revenue collection. By necessitating suppliers to comply with tax obligations, the mandate mitigates the risk of non-compliance, thereby safeguarding the interests of buyers and preventing potential revenue losses. Failure to comply could erode the buyers' trust in suppliers, resulting in diminished future revenues for the latter. The mandate carries both advantages and disadvantages, underscoring the importance for taxpayers to adhere to regulatory requirements. The Tax Department cannot afford to allow tax evasion or revenue loss solely due to increased compliance costs, as such losses would constrain the government's ability to offer exemptions or relief measures to taxpayers in need, thereby emphasising the critical role of compliance in sustaining revenue streams.

Another benefit of the mandate may be that with less loss of revenue to the revenue department, the government can reduce the tax burden on the taxpayers by either reducing the direct tax rates or reducing the number of tax slabs. Reducing the number of tax slabs in India is one of the most important tasks for the tax department and can be achieved by plugging the leaks into the revenue collection.

DE-MERITS OF MANDATE

The fundamental question is whether the mandate stipulated in Section 16 of the Central Goods and Services Tax (CGST) Act proves advantageous in an absolute sense or has disadvantages too.

[19] Central Goods and Services Tax Act 2017, s 16

Often perceived as a drawback for the buyer, this mandate necessitates that the buyer must await the supplier's payment of taxes. Consequently, from the buyer's standpoint, they face delays in availing ITC. Moreover, if the supplier neglects or overlooks payment of taxes, the buyer is once again deprived of accessing their entitled ITC. Furthermore, another issue that buyers may confront pertains to transactions involving fictitious firms designed solely for defrauding buyers and tax evasion through non-filing of returns while selling goods and services. In such scenarios, genuine buyers with no malicious intentions are unable to claim ITC. This deprivation prevents legitimate buyers from reaping the benefits of the GST system, which includes paying taxes solely on value addition and mitigating the cascading effect of taxes by reimbursing previously paid taxes to buyers for further business use. Determining whether the supplier has remitted taxes to the government poses a significant challenge for the claimant (recipient). This situation compels the buyer to verify the supplier's tax compliance. It imposes interest liabilities on the buyer/claimant due to the supplier's failure to fulfil tax obligations to the government.

This mandate restricts the Input Tax Credit (ITC) availability to the legitimate buyer solely based on the non-payment of taxes by the supplier. Such a provision also has significant implications for businesses with a lengthy working capital cycle, particularly those dependent on ITC for their financial operations. The absence of ITC accessibility could profoundly impact their functionality, given their reliance on it for sustaining their working capital requirements. Consequently, buyers are compelled to exercise increased vigilance in distinguishing between legitimate and fraudulent suppliers to prevent delays in ITC receipt and the incurring of interest payment obligations. Such a practice necessitates buyers to engage in additional verification measures and incur supplementary expenses to ensure that suppliers have fulfilled their tax obligations to the authorities. This leads to heightened intricacies and burdens in adhering to regulatory stipulations (Cost of Compliance). This escalation in costs and complexities contradicts the fundamental principles of the Goods and Services Tax (GST) framework, which aims to streamline compliance procedures. Therefore, it is imperative to conduct a thorough evaluation to ascertain whether the mandate has caused more harm than the anticipated benefits to the Revenue Department.

CONCLUSION

It can be inferred from the above facts that the practice of Fake Invoicing poses a great threat to the integrity of the tax system. As a response, the Tax Department issued an SOP and even brought amendments through the Finance Acts to address this issue of tax evasion, which has been discussed above. It is essential to understand the problems that may arise in the functioning of the government due to the continuance of such malpractices. From the above arguments for and against the mandate under Section 16, CGST Act, it is imperative to say that despite the mandate having more disadvantages prima facie than advantages, it is important to understand the rationale and the far-fetched idea behind bringing such a mandate. The mandate seeks to foster compliance, enhance transparency, and protect ITC mechanisms from exploitation. Thus, the mandate must not be criticised and must be supported because it might not have achieved the far-fetched idea yet but has surely gained success in the short run by reducing the bogus firms' tax evasion and plugging in the revenue leaks. By adhering to and supporting the measures brought in by the tax department, the long-term benefits of the Input Tax Credit and a streamlined tax framework can be safeguarded, which in turn would contribute to a broader goal of a transparent and efficient tax system.