

## **GST Compensation - A New Crisis & Solutions**

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GST which is the biggest tax reform in independent India would not have happened without the cooperation of the States. Multiple rounds of discussions; give and take; diplomacy; statesmanship were all at play but the swinging factor was the compensation. Major manufacturing States anticipated significant loss of revenue on account of loss of certain existing powers of taxation including the collections from Central Sales Tax Act.

When VAT was to be implemented across the country by States the very same issue of compensation was the key factor and losses on account of CST revenues due to implementation of VAT was agreed to be compensated by the Centre. This did not happen within the time as promised and the States remained unhappy on this aspect for a long time. As a master stroke the Central Government not only paid out this compensation but in order to bring the States into the GST fold, gave compensation a very different colour by incorporating it as part of the Constitutional Amendment.

### **Constitution (122<sup>nd</sup> Amendment) Bill, 2014**

Section 18 of the 122<sup>nd</sup> Constitution Amendment Bill, 2014 provided for an *additional tax on supply of goods not exceeding 1% in the course of inter-State trade or commerce shall, notwithstanding anything contained in clause (1) of article 269A to be levied and collected by the Government of India for a period of two years or such other period as the Goods and Services Tax Council may recommend, and such tax shall be assigned to the State in the manner provided in clause (2).*

Section 19 of the 122<sup>nd</sup> Amendment Bill, 2014 provided that *Parliament may, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States for loss of revenue on account of implementation of the goods and services tax for such period which may extend to five years.*

The 2014 Bill which was passed by the Lok Sabha was referred to the Select Committee of the Rajya Sabha. The Committee after considering the views of the stakeholders recommended that the provision of 1% additional tax in its present form is likely to lead to cascading of taxes. Having regard to the concerns expressed by various States and some of the members of the Committee in their submissions, the Committee recommended amendment in clause 19 to provide that the *Parliament may, by law, on the recommendation of the Goods and Services Tax Council, provide for compensation to the States for the loss of revenue arising on account of implementation of Goods and Services Tax for a period of five years.*

### **Constitution (101<sup>st</sup> Amendment) Act, 2016**

The recommendations of the Committee was accepted and Section 19 of the Constitution (101<sup>st</sup> Amendment) Act is the same as proposed by the Select Committee. There are two key changes from the Bill to the Act. The first being the term 'arising' getting incorporated whereby the *compensation is clearly linked to the loss of revenue arising on account of implementation of GST.* The second is that, the period is clearly identified as five years.

The entire bonhomie between the Centre and the States was on account of the assured constitutional guarantee of compensation. Co-operative federalism, which is an often used phrase to indicate the Centre and States joint approach towards GST, rests on the solemn guarantee of the States being compensated for loss of revenue.

While assuring compensation was critical for States to come on board, finding sources of revenue to make

such payment became an issue and the time tested solution of generating revenue through additional levies in the form of a compensation cess was envisaged.

### **Minutes of GST Council Meetings**

The minutes of the Third GST Council Meeting held on 18<sup>th</sup> and 19<sup>th</sup> of October 2016, indicate the following:

- (i) Some of the State Ministers had raised questions on whether cess would be constitutionally permitted after introduction of GST.
- (ii) The Minister from Odisha did not support the proposal as GST was meant to reduce multiple taxes and suggested cess on direct tax.
- (iii) The Minister from Punjab supported an independent mechanism and observed that after five years whatever was collected from cess should be shared between Centre and State.
- (iv) The Minister from Rajasthan felt that a separate higher rate of tax on demerit goods would be better than cess.
- (v) The Minister from UP felt that in principle cess should be collected by all States especially in cases of natural disasters.
- (vi) The Minister from Kerala was of the view that compensation should be funded by Central Government from corporate tax, customs duty, sale of spectrum or increasing tax on petroleum products.

The issue was ultimately deferred and the minutes of the Eighth GST Council Meeting dated 3<sup>d</sup> and 4<sup>th</sup> January 2017 shows interesting insights:

- (i) The Minister from Karnataka stated that he was very uncomfortable with a new definition of compensation fund under Section 2(4) which provided that if the cess amount fell short, the Council would decide as to how to raise resources. *The Hon'ble Chairperson assured that compensation to States shall be paid for five years in full within the stipulated period of five years and in case the amount in GST compensation fund fell short of the compensation payable in any bimonthly period, the GST Council shall decide the mode of raising additional resources including borrowing from the market which could be repaid by collection of cess in the 6<sup>th</sup> year or further subsequent years.*
- (ii) The Revised Draft GST Compensation Law was approved with certain modifications.

The 10<sup>th</sup> GST Council Meeting on 18.02.2017 debated the issue further and the Draft Compensation Law with changes suggested by the Union Ministry of Law was approved. However, in the 12<sup>th</sup> GST Council Meeting held on 16.03.2017 further changes were made. Section 10 was modified whereby the proceeds of cess leviable under Section 8 and such other *amounts* as may be recommended by the Council shall be credited to the non-lapsable fund known as 'GST Compensation Fund'.

The GST Council in its 27<sup>th</sup> meeting held on 04.05.2018 considered imposition of cess on sugar. Cess was proposed by the Union at Rs.3 per kg. over and above 5% GST on sugar in order to create a separate fund for Government intervention in the interest of farmers. The minutes indicate that

- (i) Minister from Tamil Nadu stated that it was against the underlying principle of GST that is one nation one tax and it would also increase the non-sharable tax revenue of the Centre leading to a situation wherein State would also be tempted to impose cess in future for one or other cause.
- (ii) Bihar, Uttar Pradesh, Tripura supported the proposal.
- (iii) The Secretary clarified that it was wrong to say that cess was distorting GST and reminded that when cess mechanism for compensation was discussed, the counsel debated at length whether it was better to have cess or additional GST. *Thus cess imposition was not a distortion when it benefited States, but in this situation all were advising that Government of India should bear the cost.*
- (iv) The issue remained unresolved and a Committee was formed to give recommendations.

The 28<sup>th</sup> GST Council Meeting on 21.07.2018 considered the interim report by the group of Ministers on imposition of cess where the group had recommended that since the matter is sub-judice in the Supreme Court it will be advisable to wait till the final judgement of the Supreme Court on the Constitutional validity of the imposition of compensation cess under GST. The issue was kept under abeyance.

## **Kerala Flood Cess**

The 30<sup>th</sup> GST Council Meeting on 28.09.2018 debated the levy of additional cess proposed by Kerala and the minutes indicate that

- The Minister from Tamil Nadu supporting the proposal of the Kerala Government to impose cess in the State of Kerala and not supporting the proposal to create a separate disaster fund at national level by imposing levy of cess on all States.
- Some Ministers supported the levy of cess while others suggested a surcharge by the Union while all of them agreed that there has to be a mechanism for helping the State of Kerala.

A Seven Member Committee of Ministers was formed and in the 32<sup>nd</sup> GST Council Meeting on 10.01.2019 the levy of cess on intra-State supply of goods and services within the State of Kerala at a rate not exceeding 1% for the period not exceeding 2 years was cleared.

## **Non-availability of Funds in the Compensation Fund**

Recent press reports suggest that the compensation fund does not have sufficient amounts for payment of compensation; compensation claim of States not being fully settled; compensation claims arising from non-manufacturing States; views of the Attorney General on the issue of compensation; apprehension by States on the delay; fall in tax revenues for both Centre and States on account of the business coming to a standstill due to Covid 19.

Covid-19 as well as the slump in economy as perceived before the pandemic and as estimated and anticipated on account of the pandemic is likely to throw a huge challenge on the issue of compensation. With the tax collections plummeting, calculation of compensation based on a 14% growth would throw serious challenges for the Centre which is also suffering from fall in its own tax collections.

The next few GST Council meetings will be critical and the compensation issue is likely to dominate the agenda. An interesting aspect is that alternate sources for compensation have been debated in the council meetings as well as discussed before the select committee.

## **Key Questions**

- Will the Centre pay the compensation based on the promise given and in the true spirit of co-operative federalism, even though the Centre is starved of funds?
- If the Centre has to live up to the constitutional guarantee and ensure that the commitments given before the Select Committee; the Parliament; and the promise made to the States, whether borrowing money exclusively for this purpose is the solution?
- In case the Centre has challenges in borrowing funds for paying compensation, given the impact of COVID on its own revenues; the huge expenditure outlay that is required to battle the pandemic; the high interest burdens; the importance of defence funding; what would be the alternative sources of revenue?
- Will the Centre re-negotiate the method of calculation of compensation and convince the States to reduce the growth percentage from 14% taking into account the impact of COVID?
- Will the Centre retain the calculation but convince the States for extension of time and also provide for a levy of compensation cess beyond the period of 5 years?
- Will the Council recommend increase in the coverage of goods and services that are subject to compensation cess?
- Will the Council recommend increase in tax rates or restructuring of tax rates in a Covid environment?
- Will the Centre prefer the States to borrow on the strength of future compensation cess?

## **Claim of Compensation**

The States are unlikely to give up their claim for compensation given the fact that this was the critical negotiation point and there is a Constitutional guarantee. The mode of payment of compensation was left to the Council but the compensation was the responsibility of the Union. The Centre should not renege from the commitment made to the States given the fact that this commitment was the turning point in the entire negotiation and the States willingly gave up their powers of taxation based on the solemn promise that there would be assured compensation if there is loss of revenue.

The Centre is unlikely to take a position that it would not pay compensation even though press reports indicate the possibility of difference of opinion. However, the Centre would be keen to negotiate with the States to bring down the quantum of compensation by renegotiating the projected growth rate or identify loss of revenue on account of implementation of GST as against loss of revenue on account of Covid.

The other view would be that, having agreed upon 14% growth as the basis for calculation of compensation, the Centre should not hide behind hyper technical legal arguments such as force majeure; revenue challenges; etc. Assuming, there are contracting parties who had entered into a contract where the consideration was identified and fixed and there is no force majeure clause, it would be difficult to avoid payment obligations by referring to the pandemic. While there are cases where parties have been sympathetic and brought down prices or provided for waivers, the same involves negotiation and co-operation. Even assuming, commercial contracts may enjoy different treatment based on provisions of contract law or based on doctrine of frustration, the same should not be used or attempted to be used when it becomes to a Constitutional guarantee given by the Union to the States in a federal democracy.

### **Down Memory Lane**

Retrospective amendments to nullify precedents are regularly deployed to protect revenue. However, it has eroded the confidence of business and industries apart from investors. One cannot forget the *Vodafone* decision and the amendment that followed. Lapsing credits; changing conditions after the investment is made have all been different tools and the underlying objective has been the protection of revenue or to retain the tax collected. While industry would remain an unhappy victim, States are not likely to remain mute spectators and would be clear and focussed on the fact that compensation is payable being a constitutional commitment.

The past should not be repeated. The Privy Purse issue remains a blot in an otherwise clean record of compliance of contractual commitments. When the number of Indian rulers agreed to surrender and give up all their properties and wealth and be part of India, the Government of India had guaranteed payment of a certain fixed sum to the rulers known as 'Privy Purses'. Article 291 originally provided for payment of sums guaranteed or assured by the Government of India to any rulers out of the consolidated fund. Article 362 provided that while making laws due regard shall be had to guarantee or assurance given under any covenant or agreement referred to in Article 291.

Mrs. Indira Gandhi led Government wanted to abolish Privy Purses and the Constitution (24<sup>th</sup> Amendment) Bill, 1970 was tabled to abolish the Privy Purses. The Bill was passed by the Lok Sabha but defeated in the Rajya Sabha. The President of India under Article 366(22) de-recognised all the rulers. This order was challenged and the Eleven Member Bench of the Supreme Court<sup>[1]</sup> held that

- Assurances given and covenants and agreements were not to be treated as an exercise in futility. The contention that the arrangements were to be temporary and could be nullified by a unilateral act of Union of India was rejected.
- Under Article 291, there was an obligation on the Union to pay Privy Purses and an implied right vested with the ex-rulers to receive the amount. The charge on the Consolidated Fund and the subsequent appropriation and the logical payment were an integrated process of the constitutional mechanism.
- The obligation to pay Privy Purses is imposed on the Union not by virtue of it being a successor to the Dominion of India but under the mandate in Article 291.
- The Rulers were entitled to all pre-existing rights and privileges including that to the Privy Purse.

Unfortunately, the then Government which was intent on abolishing the Privy Purse chose to amend the Constitution. The Constitution (26<sup>th</sup> Amendment) Act, 1971 was passed repealing Article 291 and Article 362; inserting Article 363 and amending Article 366(22). Article 363 sought to oust the jurisdiction of Courts in respect of disputes arising out of treaties and agreements entered or executed before the commencement of the Constitution by the ruler of an Indian State and to which the Government of the Dominion of India or any of its predecessor Governments was a party. Article 366(22) amended the definition of 'ruler' to abolish the concept of rulership and the Privy Purse. The Constitution (26<sup>th</sup> Amendment) Act, 1971 was upheld by the Supreme Court<sup>[2]</sup> where the Court held that the amendment had put an end to the distinction between the erstwhile rulers and others.

### **Privy Purse and the Current Context**

The Privy Purse story is very much relevant in the current context and the Centre must take care to ensure that history is not repeated. Article 291 was a constitutional guarantee and Section 18 of the Constitution (101<sup>st</sup> Amendment) Act is equally a constitutional guarantee. The rulers gave up their property and rights when they agreed to form part of the Dominion of India and were promised a Privy Purse. The States had agreed to a truncated Entry 54 of the List-II, deletion of powers to levy tax on entry of goods; advertisement; surrendered the power to levy entertainment tax to the municipality; gave up the revenues arising out of central sales tax and in the bargain obtained the right to tax services.

Since the States were of the view that the grand bargain may or may not result in growth in revenue and

anticipated loss of revenue, the claim of compensation arose and the Centre agreed to pay the compensation for a specified time period. It is now morally, legally and ethically the responsibility of the Centre to show a high degree of statesmanship and honour the constitutional guarantee given to the States. If there is any dilution of this, then the entire reform aspect of GST would slowly get defeated with States having significant loss of revenue choosing the route of some cess or other over and above SGST relying upon the decision of the Supreme Court<sup>[3]</sup> which held that power to levy compensation cess flows from Article 246A.

### **Way Forward**

The Centre and the States which were suffering from sluggish growth in revenues are now seeing a serious fall on account of Covid. The solution is both short-term and long-term. The short term solution would be to re-guarantee the compensation; release all pending amounts as a measure of goodwill and then negotiate in good faith on reduction of percentage of growth. The funding can be through a package of initiatives which can include

- (i) Borrowing by the Centre;
- (ii) Increasing the coverage of items that attract compensation cess keeping into account the potential for revenue and the impact on inflation;
  - Restructuring existing rates of taxes to make it simple and effective.

The long term solution lies in keeping the five trillion dollar economy goal alive and taking all such steps that are required to boost growth of the economy and increase demand. This would automatically reflect in buoyancy in revenues which would in turn reduce the quantum of compensation. Major reforms would be required in export related provisions; input tax credit apart from other provisions.

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<sup>[1]</sup> *Madhav Rao Jivaji Rao Scindia Bhadur Vs. Uol (1971) 1 SCC 85*

<sup>[2]</sup> *Raghunathrao Ganpatrao Vs. Uol (1994-Supp.(1) SCC 191)*

<sup>[3]</sup> *Union of India Vs. Mohit Minerals Pvt. Ltd. (2019) 2 SCC 599 (SC)*