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GST - Impact of GST on working capital for SMES

Working capital is the lifeline of a business to carry out day-to-day operations. Managing working capital efficiently is a problem that plagues both small and large businesses. Inability to manage working capital may have adverse effects, including premature closure of businesses.

GST, a comprehensive indirect tax system, is a few months away from rollout. Businesses need to understand the implications of GST on various day to day operations.
Therefore, let us take a look at the ways in which GST impacts the working capital for SMEs and understand how you can use GST to your advantage.

Introduction of "Furtherance of Business" as a concept for Input Tax Credit

Under the current regime, input tax credit is available only on inputs which are used or linked to your taxable output. For example, as a trader, input VAT paid on purchase of goods will be available as credit only on making a taxable sale. However, any tax paid on business overheads is not allowed as credit. For example, service tax paid by a trader on advertising services for business purposes is not allowed as credit, and should be treated as business expenses.

In GST, the concept of input tax credit is broadened to include any input or services "used or intended to be used in the course of or for furtherance of business. Therefore, businesses will be allowed to claim input tax credit on all such inputs and input services. In the example used above, a trader can claim credit for tax paid on advertising services.

Let us understand this further with a working calculation.

Particulars	Current Regime		GST	
Gross Profit		10,00,000		10,00,000
Indirect Expenses				
Repair and Maintenance *#	1,15,000		1,00,000	
Advertising Expenses *#	1,15,000		1,00,000	
Printing and Stationery**	1,15,000	3,45,000	1,00,000	3,00,000
Net Profit	**6,55,000**		**7,00,000**	
% of Enhanced Profitability			**7%**	

(*Tax Rate considered @ 15% under current regime. #Tax rate considered @ 18% under GST- **GST Rate @ 12%)
If you observe, in the current regime, business expenses including the taxes are debited to Profit & Loss A/c. This is because, input tax credit is not allowed on business overheads. Broadly, only on those input services or goods which are directly linked to taxable output, Input tax credits are allowed.
Under GST, businesses will be allowed to claim input tax credit on business expenses which are 'used or intended to be used in the course of or furtherance of businesses'. As a result, in the above table, only the actual expenses excluding taxes are debited to Profit & Loss A/c.
This concept of "furtherance of business" will reduce your cost of operation, and directly increase the net margins of your business, thereby, strengthening your working capital.
In order to leverage this, businesses need to procure goods or services from registered businesses, and account for the tax paid on business overheads.

Impact on Input Tax Credit

Under the current regime, the value of input credit availed by you is not dependent on the 'real time' acceptance of the tax liability by the supplier.

However, under GST, input tax credit will be dependent on your supplier's compliance i.e. your supplier should file the return declaring the outward supplies along with the tax payment.

If your supplier does not comply, it will cause a major dent to your cash outflow. For some reason, if your supplier fails to furnish the valid return, the input tax credit claimed by you will be reversed and you will be asked discharge it along with interest. There will be a twin blow to your cash outflow:

- You have already paid your supplier.
- Since ITC claim is reversed, you have to pay the tax along with interest.

However, there will be some breathing space since the draft law provides a window of 2 months to ratify the discrepancies before reversing the ITC claim.

Therefore, vendor management under GST is very crucial. It will be one of the enabling factors for timely claim of input tax credit on your inward supplies, where the supplier has on-time compliance credibility. You need to re-look at your current vendors, and review and identify vendors who are compliant. GST compliance rating will help you choose suppliers who are better compliant.

What does all this mean?

If you are not disciplined about being compliant, you might lose your customers. Similarly, if your supplier is not compliant, he might lose you.
Under GST, businesses must ensure that they do not default because they might lose their rating, and this might eventually kill the business.

Taxability of advances

Under GST, on receipt of advance against supply of goods or service at a later date, tax needs to be paid on the date of receipt of advance. Currently, the concept of paying tax on advance receipt exists only in Service Tax. This extended provision on goods in GST will impact the cash outflow of businesses engaged in supply of goods. This is because, all this while, as a manufacturer or trader of goods, there was no obligation to pay a part of advance as tax, but in GST, you have to pay.

Secondly, though the tax is paid by the supplier on advance receipt, the recipient will not be able to claim it as input tax credit immediately. This is because ITC will be available only on the receipt of tax invoice and once the said goods or services are received by him.

As a result, due care has to be taken with regard to ‘Advance Clause’ in contracts. Please take help in structuring contracts. If invoices can be raised based on percentage completion methods, they should be evaluated.

Impact of stock transfer to branches

Under Central Excise, a registered manufacturer making a stock transfer of excisable goods, should pay excise duty on 100% +10 % of cost of production, and under VAT, on furnishing Form F, stock transfers are not taxable.

Under GST, ‘Supply’ includes transfers. The taxability of certain specific supplies without consideration and the concept of distinct persons, implies that stock transfer under GST is taxable. The taxability of stock transfers under GST will have an impact on cash flow. This is because, tax is paid on the date of stock transfer, and ITC is effectively used when stock is liquidated by the receiving branch.

Due to tax instances, the need for additional working capital arises and it will be a challenge for SMEs who operate with thin working capital. Examining the need for branches, effective planning of branches, and leveraging of cross branch transfers can reduce the impact on working capital.

So, ensure that an impact analysis is done on all different locations from where your business operates.

Also, a clear understanding of the kinds of taxes you need to pay whether IGST (which is inter operable) against a CGST and an SGST will help.

SMEs in service sector

Currently under Service Tax, registration is centralized and it is pan India. As a result, the input service tax availed on input services procured across the nation can be utilized to set off the Service Tax liability without any restriction. Under GST, registrations are state-wise. A service provider has to register in a state in which he makes outward supply of services. There is restriction to set off CGST + SGST of a state with another state. This may create a situation where input tax credit is held at a branch and cannot be utilized to set-off the tax liabilities of another branch in a different state. This will have an impact on the cash outflow of the business.

Though the concept of Input Service Distributor (ISD) is available under GST, it will not be helpful in the above situation.

Secondly, with the finalization of the tax rate structure of 5%, 12%, 18% and 28%, and if services are included under the 18% tax bracket, service will be expensive by 3% compared to 15% of Service Tax under the current regime. Due to this additional increase in outflow, the need to increase the working capital will arise.

Inverted duty structure

Inverted duty structure is a situation where tax on inputs are higher than the tax on outputs. For example, rate of excise duty on raw materials is 12.5% and the excise duty on finished goods is 6%. Usually, this exists in the pharma industry and in the case of import of raw materials. This situation leads to accumulation of unutilized credit. As per the example, the excess of 6% over 12.5% i.e. 6.5 will always be unutilized and gets accumulated.

Under central excise, refund is allowed only in the case of exports, and for the credit accumulated due to inverted duty structure, refund is not admissible. This has led to blockage of funds.

Under GST, the benefit of inverted duty structure allows for better cash flow. In GST, businesses are allowed to claim the unutilized input tax credit accumulated due to inverted duty structure. This is a major relief to businesses, coupled with a simplified process of refund claim, and fast processing of refund – 90% of refund claim will be disbursed on provisional basis and 10 % after verification.

Input Tax Credit on transitioning to GST

On the date of transitioning to GST, the closing balance of CENVAT and Input VAT reflected in the last return (prior to GST) will be carried forward as CGST and SGST input tax credit. Therefore, it is very important for businesses to account for all purchases, so that the eligible input tax credit is completely captured in the returns, and transition to GST happens without any loss of input tax credit.

In the current regime, businesses are not allowed to take credit on certain duties and taxes such as excise duty and entry tax paid. This may be due to various reasons:

- You may be currently engaged in the manufacture and sale of exempted goods or provision of exempted service. On transition to GST, these goods or services may be taxable.
- You may be an unregistered manufacturer as your aggregate clearance value is below 1.5 crores. Under GST, you may become liable to register based on a threshold limit of Rs 10 lakhs for Special Category States (Arunachal Pradesh, Assam, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh and Uttarakhand) and Rs 20 Lakhs for the rest of India.
- You may be trader paying excise duty. This is not currently available for input credit.

The good news is that the duties and taxes paid on the closing stock held on the date of transitioning to GST will be allowed as input tax credit on meeting specific conditions laid down by the law.

This eliminates the cascading effect and double taxation, and will help SMEs in filling the additional working capital needs of the business.

Therefore, it becomes imperative for businesses to prepare themselves so that they can take the benefit of the eligible input credit under GST. Some suggestions include:

- Ensure that all purchases made against Rule 11 or tax invoice are accounted for in your books.
- Carry out a periodic review of transactions to identify any instances of missed out credit
- Ensure that debit notes/credit notes are settled in order to ascertain the correct carry forward of balance.

Conclusion

Working capital is the fuel for any business, and for SMEs, the impact of GST on working capital will be a great challenge while adopting the new indirect tax system. Preparedness for smoother transition to GST without any loss of input tax credit, availing of input tax credit on business overheads, and effective vendor management, will all play a key role in mitigating the risks on working capital.