Deciding between ITC and Composition Scheme: A Guide for Small Businesses in the GST Era

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Businesses have the option to choose between the Input Tax Credit (ITC) and the Composition Scheme under GST. ITC allows for the offsetting of taxes paid on purchases against tax liabilities on sales, ensuring that taxes are balanced and maintain a state of tax neutrality and transparency. In contrast, the Composition Scheme provides a uniform tax rate determined by the total sales, streamlining adherence to tax regulations, particularly for small enterprises, and diminishing expenses. ITC facilitates adherence to regulations and the efficient monitoring of cash flow, while the Composition Scheme promotes economic expansion and the development of entrepreneurial activities. Small businesses should thoroughly evaluate the advantages and disadvantages of each choice and may consider consulting with tax experts to efficiently negotiate the intricacies.

Introduction

The ITC mechanism allows businesses to reduce their tax liability by claiming credit for the GST paid on purchases and inputs. Businesses have the tendency to deduct the tax they have already paid on their raw materials, services, and other business expenses from the GST they are obligated to pay on their sales. This technique is especially advantageous for organizations that have high input costs, such as manufacturers and wholesalers, who face hefty charges for raw materials, machinery, and other inputs. By utilizing ITC, these enterprises can efficiently reduce their total tax liability, resulting in cost reductions and enhanced profitability. In addition, ITC guarantees that firms involved in the supply chain do not face several layers of taxation at each stage of production and distribution. This prevents the accumulation of taxes and ultimately reduces the cost of goods and services for customers. The pass-through benefit of the ITC enables businesses to maintain their competitiveness by offering items at reduced rates as a result of tax savings.

Furthermore, the ITC process improves transparency and facilitates the maintenance of precise transaction records. Firms are required to maintain comprehensive documentation of their purchases and sales in order to be eligible for Input Tax Credit (ITC). This requirement serves as an incentive for firms to improve their record-keeping practices and exercise more financial discipline. Precise documentation is essential for audit purposes and plays a vital role in establishing confidence within stakeholders, including customers, suppliers, and tax authorities. Nevertheless, the ITC system necessitates careful documentation and consistent filing of returns, which can be burdensome for small enterprises with restricted administrative resources. Complying with the ITC regulations requires meticulous monitoring and recording of all GST payments made on purchases, comparing these amounts with suppliers' tax filings, and assuring prompt submission of monthly or quarterly GST returns. Small enterprises with a smaller workforce and insufficient knowledge of tax affairs may find this to be a substantial administrative challenge, which could possibly take away resources from their main business operations.

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Conversely, the Composition Scheme provides a streamlined tax structure designed to alleviate the administrative burden on taxpayers operating on a small scale. This scheme is suitable for enterprises that have an annual turnover of up to INR 1.5 crore in the preceding financial year. In the case of service providers (other than restaurants), this turnover threshold limit is fixed at INR 50 lakhs, whereas for restaurants, it is INR 1.5 crore. Under this program, the qualifying registered person has the option to pay a certain proportion of their revenue as tax, which is considerably lower than the regular GST rates. Manufacturers and traders generally have a tax rate of 1%, while restaurant services typically have a tax rate of 5% and 6% for service providers. The simplified approach simplifies tax calculations and eliminates the requirement for strict regulatory compliance, as enterprises under the Composition Scheme submit tax returns on a quarterly basis instead of monthly. The quarterly filing schedule reduces administrative burdens, enabling business owners to concentrate on operations instead of substantial tax compliance duties.

Nevertheless, enterprises that choose the Composition Scheme will issue a Bill of Supply in place of a Tax Invoice and are not permitted to avail ITC. This constraint implies that they are unable to transfer the advantages of GST to their business-to-business (B2B) clients, who may have a preference for suppliers that provide ITC. As a result, enterprises participating in this program may experience competition in the B2B sector, since their clients are unable to balance off tax obligations on their purchases. This could result in a potential decline in business if clients prioritize the benefits of ITC. Furthermore, the inability to generate tax invoices under the Composition Scheme presents difficulties while interacting with larger corporations that demand accurate tax paperwork to adhere to regulations and maintain proper records. (Anjaneyulu, 2024), (Kessler, 2020), (Filings, 2002), (Annapoorna, 2023)

Objective

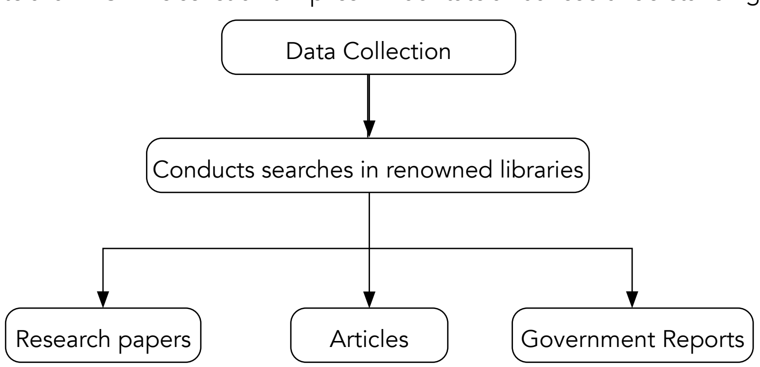
To review and provide insights into the topic "Deciding Between ITC and Composition Scheme: A Guide for Small Businesses in the GST Era".

Methodology

The researcher encountered numerous obstacles during the execution of this review. A major challenge was the extensive reliance on existing research findings related to the subject, requiring a comprehensive review of existing literature to ensure that the study was based on current and relevant research findings.

In addition to navigating the breadth of existing research, the researcher had to make critical judgments regarding which studies and data to include. This involved setting stringent review time restrictions to manage the volume of literature efficiently. The selection of publications was particularly crucial, as it needed to ensure a balanced and comprehensive perspective on the subject matter.

To address these challenges, the researcher will employ interpretive, analytical, and comparative approaches in the current research project. These methodologies will facilitate a nuanced understanding of the data and allow



for the synthesis of information from various sources.

Data collection will be conducted from several renowned libraries, which house a wealth of primary and secondary materials relevant to the study. The focus will be on thoroughly reviewing these materials to extract valuable insights and data. Additionally, websites and other online resources will be utilized as supplementary data-collecting tools, ensuring that the research encompasses a broad spectrum of information and remains up-to-date with the latest developments in the field.

Through these strategies, the researcher aims to overcome the inherent obstacles and produce a comprehensive and insightful guide for small businesses navigating the decision between ITC and the Composition Scheme under the GST regime.

Discussion

ITC is a fundamental concept within the GST framework, designed to avoid the cascading effect of taxes and enable businesses to reduce their overall tax liability. By allowing businesses to claim a credit for the GST paid on their purchases, ITC ensures a seamless flow of tax credits from manufacturers to consumers, enhancing the efficiency and fairness of the tax system. (Ainapur, 2017)

ITC is the tax paid on purchases of goods or services that a business can use to offset against the GST liability on their sales. In simpler terms, it allows businesses to deduct the tax they have paid on inputs (purchases) from the tax they are required to pay on outputs (sales). This mechanism ensures that the tax is levied only on the value addition at each stage of production and distribution, preventing the double taxation effect.

To illustrate the working of ITC, consider the following example:

- A manufacturer incurs a GST of ₹300 on purchasing raw materials and other inputs.
- The manufacturer then processes these inputs and generates a final product, which incurs a GST liability of ₹450 when sold.

In this case, the manufacturer can claim an ITC of ₹300, which has already been paid on inputs. Therefore, the net GST payable by the manufacturer would be:

ITC is instrumental in eliminating the tax-on-tax (cascading) effect, thereby reducing the overall cost of goods and services. This promotes competitiveness and efficiency in the market by ensuring that businesses are not taxed repeatedly at each stage of the supply chain.

Net GST Liability = Output GST– Input GST = ₹450 – ₹300 = ₹150

Thus, the manufacturer effectively reduces the tax burden by utilizing the ITC, ensuring that only the value addition is taxed.

For a business to claim ITC, it must meet certain conditions laid out under the GST laws. These conditions include:

Possession of a Tax Invoice: The claimant must have a valid tax invoice or debit note issued by the registered supplier of goods or services. This invoice serves as an evidence of the GST paid.

Receipt of Goods/Services: The claimant must have received the goods or services for which they are claiming ITC. This ensures that the credit is only claimed for actual purchases.

Filing of GST Returns: The claimant must file the relevant GST returns, including the details of inward supplies (purchases) and outward supplies (sales). Timely and accurate filing of returns is crucial for the reconciliation of ITC.

Payment of Tax Charged: The tax charged on the supply of goods or services must be paid to the government by the supplier. This condition ensures that the credit is claimed only when the tax has been actually remitted to the government.

Importance of ITC in the GST Framework

ITC is instrumental in eliminating the tax-on-tax (cascading) effect, thereby reducing the overall cost of goods and services. This promotes competitiveness and efficiency in the market by ensuring that businesses are not taxed repeatedly at each stage of the supply chain. Additionally, ITC improves tax compliance and revenue collection for the government by encouraging businesses to procure from registered suppliers and maintain accurate transaction records.

The GST Composition Scheme provides a customized solution for small businesses as an alternative to the conventional GST structure. Instead of following the usual GST rates and reporting procedures, businesses have the option to pay a predetermined proportion of their yearly turnover as tax under this program. This streamlined method greatly diminishes the regulatory obligations for small enterprises, enabling them to concentrate more on their fundamental activities. (Das, 2023)

Certain requirements must be met by enterprises in order to be eligible for the GST Composition Scheme. This initiative is primarily available to enterprises with an annual revenue of up to ₹1.5 crore. This cut-off point makes sure that the program aids small enterprises that might find it difficult to manage the hassles of ongoing GST compliance. Manufacturers, dealers, and eateries may participate in the program as long as they don't provide alcohol. A comparable program is also offered to service businesses with less than ₹50 lakh in annual revenue. With the help of this extension, small service providers will benefit from a more straightforward tax structure.

Small businesses find the GST Composition Scheme appealing because it provides a number of noteworthy advantages, including:

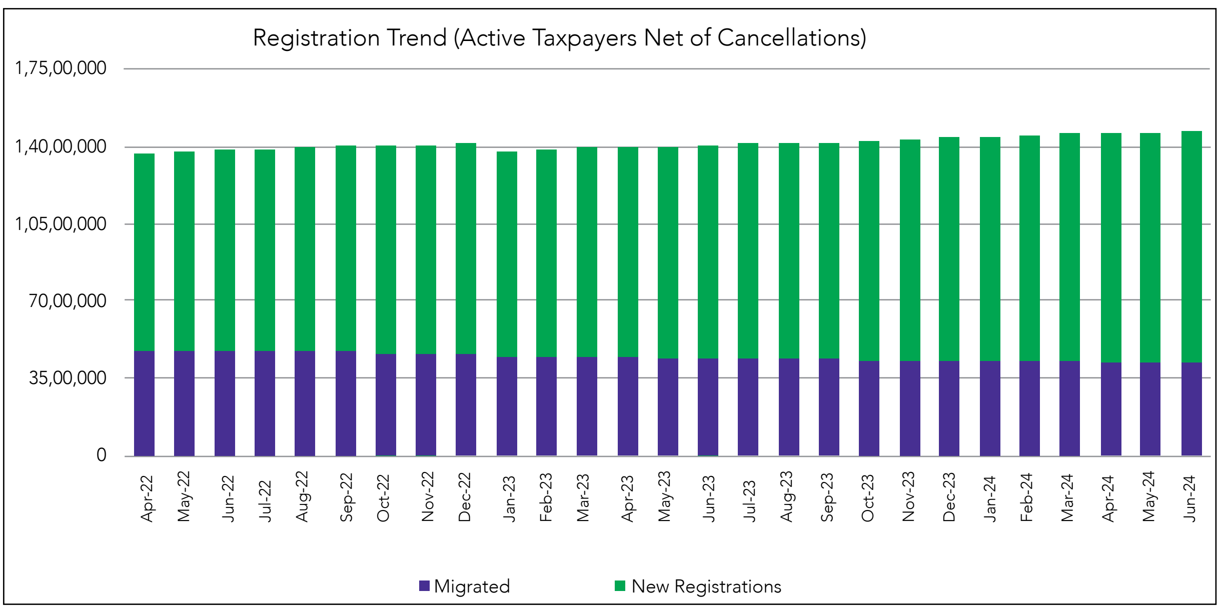
- **Simplified Tax Procedures:** The Composition Scheme's ability to simplify tax procedures is one of its biggest benefits. By choosing this plan, businesses can file quarterly returns rather than monthly ones, which greatly minimizes the administrative load.
- **Less Compliance and Record-Keeping:** Compared to the normal GST regime, the scheme necessitates less stringent bookkeeping and fewer thorough records. For small enterprises with limited resources for accounting and compliance procedures, this simplification can be especially helpful.
- **Reduced Tax Rates:** In general, the Composition Scheme's tax rates are less than the regular GST rates. For instance, the tax rate for manufacturers and traders is 1%, whereas the tax rate for restaurant owners is 5% and 6% for service providers. Because of these lower rates, small businesses will find it easier to comply with the tax laws overall.
- **Decreased Tax Liability:** Small firms can reduce their tax liability by using the Composition Scheme. Businesses with narrow profit margins especially benefit from this reduction since it allows them to have better cash flow and reinvest savings back into their operations. (India, 2024), (Narayan, 2023)

Considerations for Decision

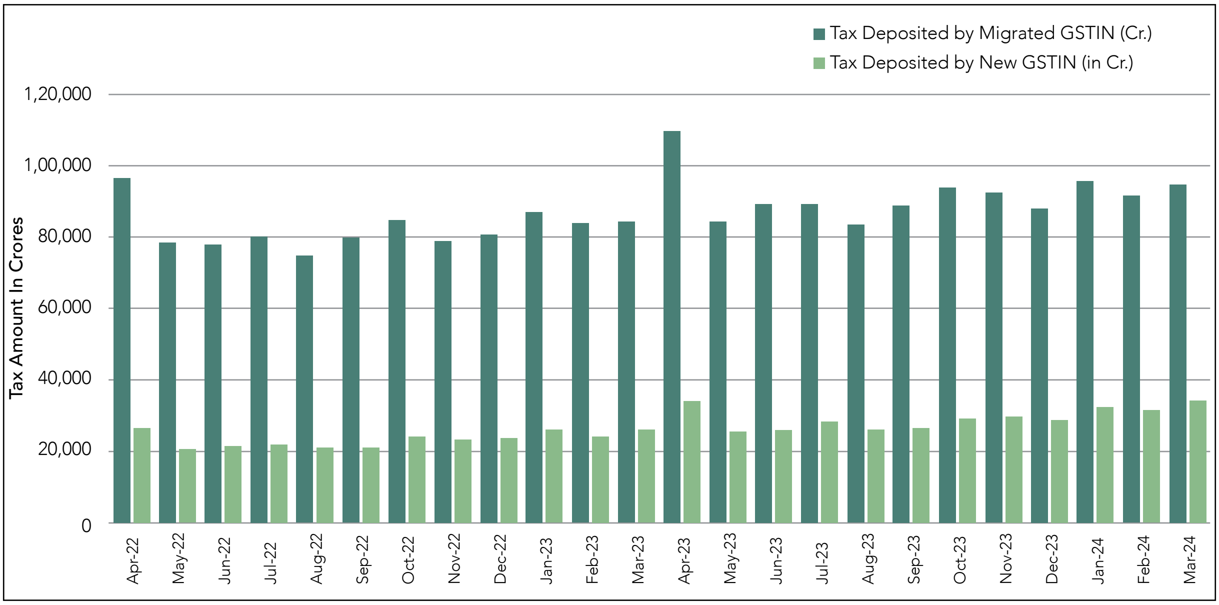
When deciding between the ITC mechanism or the Composition Scheme under the GST regime in India, it is important to carefully analyze various considerations. These issues can have a significant influence on the financial and operational elements of small enterprises.

- **Business Turnover:** A crucial factor to examine is the financial income created by a corporation. If the annual revenue is less than Rs. 1.5 crore, selecting the Composition Scheme could be a feasible option. This program provides simplified compliance requirements, and a fixed tax rate determined by turnover, which can be beneficial for smaller enterprises seeking to simplify their tax responsibilities.
- **Volume of Taxable Supplies:** It is important to assess the number of taxable supplies that the business generates. If the business engages in a large number of taxable transactions, choosing the standard scheme and taking advantage of ITC benefits may lead to substantial tax savings. Businesses can enhance their profitability by

Graph: Registration Trend (Apr – 2022 till June – 2024)



Graph: The number of active taxpayers are as follows:



efficiently reducing their overall tax bill by claiming credit for the tax paid on inputs.

- **Compliance simplicity:** The level of simplicity in adhering to regulations is a crucial factor, especially for small enterprises that have limited resources and knowledge in tax-related issues. The Composition Scheme provides a streamlined system for businesses to meet their compliance obligations. Under this scheme, firms are required to submit quarterly returns and pay taxes at a predetermined rate determined by their turnover. This efficient method can effectively reduce both time and resources, making it an appealing choice for firms aiming to decrease administrative hassles.
- **Inter-State Transactions:** When a firm participates in substantial inter-state transactions, it is essential to evaluate the consequences of this based on the decision between the normal scheme and the Composition Scheme. While the normal scheme enables firms to carry out both intra-state and inter-state transactions smoothly, the Composition Scheme is restricted to intra-state supply alone. Thus, companies that have a significant presence in numerous states may discover that the regular system is better suited to properly manage their inter-state operations. (Sagar, 2023), (Panda, 2024), (P, 2023)

Availability of Composition Scheme to Service Providers

By paying a predetermined proportion of their turnover in fees rather than regular tax liabilities, qualifying taxpayers can opt for a streamlined compliance option under the Goods and Services Tax (GST) law's composition scheme. Everyone wins with the composition scheme: producers, buyers, and users alike. The use of this system is contingent upon meeting certain requirements, however ITC is not an option under this program, as stated in the previous paragraph. A taxpayer using a reverse charge mechanism is nonetheless liable for paying taxes at the standard rate. Payers are required to show the term "Composition Taxable Person" on all notice boards and signboards at their business location, and it must also be specified in the bill of supply. However, the following individuals are not eligible to use the Composition Scheme:

- Those who supply goods across states
- Individuals who engage in e-commerce
- Casual tax-payers
- Ice cream, pan masala, and tobacco businesses
- Combine services and commodities up to a maximum of five lakhs or ten percent of the annual turnover, whichever is greater
- Provision of services more than ₹50 lakhs

The following are the other features of the Composition Scheme:

- **Eligibility:** Taxpayers who offer services and have an aggregate turnover of up to ₹50 lakhs from the previous financial year are eligible to choose the composition plan. Whether they are eligible for the program is determined by this threshold.

- **Threshold Limit:** A taxpayer is required to switch to the normal GST scheme and pay taxes at the appropriate rates if their turnover is above ₹50 lakhs in a given fiscal year. In order to lessen the difficulty of compliance, the composition system is tailored for smaller firms.

- **Applicability:** Both service providers and suppliers of goods and services are covered under the plan. It eases the burden by streamlining compliance standards and tax computations.

- **Exempt Services:** A number of services are free from taxes under the GST. This exemption applies

Table: Composition Taxpayers: Returns and Payment Trends

Return Period	No. of Returns Filed	No. of GSTINs Making Payment	Nil Filers	Tax Paid in Cr.	Avg. Tax per GSTIN/quarter
Apr to Jun-18	15,88,663	13,13,501	2,75,162	716.67	5,456.15
Jul to Sep-18	15,56,889	12,84,293	2,72,596	669.04	5,209.37
Oct to Dec-18	15,27,527	12,82,597	2,44,930	718.23	5,599.80
Jan to Mar-19	14,88,906	12,49,166	2,39,740	757.37	6,062.99
Apr to Jun-19	14,58,551	10,64,834	3,93,717	704.05	6,611.81
Jul to Sep-19	14,24,155	10,21,776	4,02,379	649.51	6,356.72
Oct to Dec-19	14,09,916	10,27,959	3,81,957	717.44	6,979.31
Jan to Mar-20	13,93,023	9,91,343	4,01,680	699.77	7,058.86
Apr to Jun-20	13,91,893	8,13,938	5,77,955	367.69	4,517.46
Jul to Sep-20	13,88,760	9,18,439	4,70,321	549.40	5,981.86
Oct to Dec-20	13,69,570	9,40,043	4,29,527	686.54	7,303.29
Jan to Mar-21	13,52,607	9,15,800	4,36,807	727.90	7,948.25
Apr to Jun-21	13,20,360	6,66,334	6,54,026	404.96	6,077.49
Jul to Sep-21	13,04,593	7,15,445	5,89,148	515.20	7,201.17
Oct to Dec-21	12,85,855	7,55,374	5,30,481	611.58	8,096.36
Jan to Mar-22	12,70,455	8,24,743	4,45,712	717.67	8,701.70
Apr to Jun-22	12,21,940	8,37,294	3,84,646	681.95	8,144.74
Jul to Sep-22	11,87,926	8,33,621	3,54,305	675.97	8,108.84
Oct to Dec-22	11,69,899	8,41,354	3,28,545	734.91	8734.86
Jan to Mar-23	11,55,109	8,54,001	3,01,108	806.17	9439.87
Apr to Jun-23	11,04,864	7,98,193	3,06,671	685.78	8591.60
Jul to Sep-23	10,63,674	7,85,754	2,77,920	667.51	8495.21
Oct to Dec-23	10,28,175	7,76,435	2,51,740	716.50	9228.10
Jan to Mar-24	9,59,553	7,37,133	2,22,420	723.56	9,815.91

*The number of taxpayers above are of those who filed returns
*Average tax payment in cash is based on non-nil returns

Source: GST portal

specifically to services that involve making deposits, loans, or advances and when payment is made in the form of interest or a discount.

- **Calculation of Aggregate Turnover:** Exempt services connected to providing loans, advances, or deposits are not included in the aggregate turnover calculation used to assess eligibility for the composition scheme. In this computation, only taxable supply is taken into account.

For qualifying taxpayers with turnovers up to ₹50 lakhs, the composition plan provides a simple tax compliance option that let them pay a fixed proportion of turnover as fees instead of ordinary GST. It eases administrative responsibilities and streamlines the tax process, which is especially helpful for smaller companies and service providers. (Rohit Pithisaria, 2021)

Composition Scheme incl. conditions to be followed:

Taxpayers may take advantage of the Composition Scheme, a straightforward GST program. Streamlined GST procedures and a flat rate of turnover payment are available to small taxpayers. Any taxpayer with a revenue of less than ₹1.5 crore is eligible to participate in this plan. A more straightforward option for taxpayers under the GST regime is the GST Composition Scheme. The following are the prerequisites to participate in this program:

- **No Input Tax Credit (ITC):** Dealers who choose the composition plan are not eligible to claim the ITC on their purchases.
- **Services Only:** Sub-section 2A Section 10 allows service providers to avail of this scheme having turnover below ₹50 lakhs in the preceding financial year.
- **Goods Excluded:** Under this program, dealers are not allowed to supply goods that are GST-free. Alcoholic beverages, for instance, are usually not allowed.
- **Normal GST Rates for the Reverse Charge Mechanism:** Taxpayers must pay taxes at the regular rates in effect if they are involved in transactions covered by the Reverse Charge Mechanism.

For qualifying enterprises, especially those that deal primarily in commodities, the GST Composition Scheme provides a streamlined tax compliance option, but it also limits their ability to claim input tax credits. (Annapoorna, 2023), (CHAWLA, 2020)

To switch from regular registration to the Composition Scheme under GST

In order to pay tax under the aforementioned provision, taxpayers who are registered as regular tax payers under GST must submit an application to opt for Composition Levy in Form GST-CMP-02 at the GST Portal before the start of the financial year.

Log in to the GST Portal

- Access the Taxpayers' Interface on the GST portal.

Navigate to the Application for Composition Levy

- Go to Services > Registration > Application to Opt for Composition Levy.

Fill the Form

- Complete the form according to the specified rules.
- Ensure you meet the eligibility criteria for the Composition Scheme.

Remember that you cannot opt for the Composition Levy if you are involved in:

- Supplying goods not liable to be taxed under GST.
- Inter-state outward supplies of goods.
- E-commerce supplies where tax collection is required by the operator.
- Manufacturing notified goods.
- Being a casual dealer, non-resident foreign taxpayer, Input Service Distributor (ISD), or TDS Deductor/Tax Collector. (Tutorial.gst, 2024)

Conclusion

The GST Composition Scheme serves as a significant mechanism for streamlining tax compliance for small firms. This scheme offers a simplified method for taxation, resulting in a substantial decrease in administrative tasks, a reduction in tax rates, and a more efficient process for filing taxes. This provides valuable assistance to businesses that are struggling with limited resources and knowledge in tax-related topics. Although the Composition Scheme has certain benefits, such as a consistent tax rate and streamlined processes, it does have several restrictions, most notably the lack of ITC. Small firms considering participation in the Composition Scheme must carefully evaluate their qualifying criteria and ensure congruence with their operational requirements. Although the program provides advantages specifically designed for small firms, such as decreased administrative work and tax obligations; businesses must evaluate if it is compatible with their future expansion plans and transaction patterns. Effectively navigating the intricacies of tax legislation necessitates making well-informed decisions, and seeking help from tax professionals becomes essential. Small firms can enhance their tax efficiency and ensure compliance with regulatory requirements by utilizing the knowledge and skills of tax consultants.

The primary objective of the Composition Scheme is to reduce the tax burden on small enterprises and streamline compliance procedures. Nevertheless, every business must carefully evaluate its advantages and disadvantages, taking into account its distinct circumstances and goals. The goal is to find a harmonious equilibrium between streamlining tax processes and making astute choices that optimize the business's long-term objectives. Considering this perspective, the Composition Scheme presents itself as a beneficial choice for small enterprises aiming to negotiate the complexities of GST rules while ensuring economic stability and expansion.

ITC is an essential element for small firms functioning under the GST framework. This approach enables firms to deduct the tax paid on their purchases from the tax payable on their sales, thus significantly decreasing their overall tax burden. ITC is crucial for small firms as it helps to maximize financial resources, improve competitiveness, and promote growth. ITC offers small firms a significant advantage by effectively preventing the domino effect of taxes. The use of ITC enables firms to offset the tax spent on inputs, ensuring that taxation is levied solely on the value added at each stage of the supply chain. This not only eradicates the imposition of taxes on the same income twice but also enhances effectiveness and equity within the tax system. ITC empowers small enterprises to enhance their ability to manage cash flow. Businesses can successfully minimize their tax liability to the government by subtracting the tax paid on purchases from their tax liability on sales. Excess funds can be reinvested in the business, utilized for expansion, or allocated to other operational costs, promoting growth and long-term viability. In addition, ITC encourages tax compliance among small firms. Businesses must comply with the conditions outlined in the GST legislation to be eligible for claiming input tax credit. These factors include having legitimate tax invoices, submitting GST reports on time, and ensuring that the tax charged by suppliers is paid to the government. This encourages firms to maintain precise transaction records, acquire goods and services from registered suppliers, and perform their tax duties conscientiously. The Input Tax Credit is a crucial resource for small firms, enabling them to effectively manage the intricacies of the GST system, minimize their tax obligations, and improve their competitive advantage. Small firms can optimize their operations, enhance their financial well-being, and facilitate sustainable expansion in the current changing business landscape by harnessing the advantages of information technology and communications.

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