GST AND THE EFFECTS ON PHARMACEUTICAL INDUSTRY

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GST and the Effects on Pharmaceutical Industry

Sandip Kumar De*

Department of Economics, Bankura Zilla Saradamani Mahila Mahavidyapith

Abstract – The pharmaceutical industry has been one of the engines of growth for India. In recent times, despite cost pressures and unfavorable macroeconomics, the industry has continued to show signs of growth. The introduction of Goods and Services Tax (GST) has certainly had an impact on pharmaceutical services. In this paper, RSM explores at a broad level, the impact that GST has had on the pharmaceutical industry. We believe that understanding and identifying these issues is important and industry must appreciate that GST as a law has not fully evolved.

Keywords: GST, Pharmaceutical, Industry

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INTRODUCTION

It is assumed that the general model in which a pharmaceutical industry participant operates is that the business entity imports bulk drugs and Active Pharmaceutical Ingredients (APIs). Such APIs and drugs are sent to loan licensees for further processing and then the finished goods sent either to mother warehouses or directly to clearing and forwarding agents who may thereafter supply the same to the stockists.

There may be more than one stockist in the value chain and these stockists ultimately supply to physicians / doctors or to pharmacy chains, which are the final touchpoint for the customer. The last stage i.e. sale by physician/ hospitals is the end of the value chain and represents sale to end consumer. However, it is pertinent to note that for drug manufacturers, the sale happens when goods are supplied to the stockists.

The pharmaceutical industry in India has always been unique. Different players operating in different segments and employing different business models have emerged to remain competitive in this industry. Under the prior indirect tax regime, this industry was faced with a multiplicity of taxes such as excise duty, service tax as well as different state VATs in addition to CST on inter- state transactions. Pharmaceutical as an industry had always been the subject matter of litigation in the prior indirect tax regime.

Given that GST is at its nascent stages and the law is yet to fully shape up, it is anticipated that there would be much litigation in the current indirect tax regime as well. In this segment, we have broadly analyzed the GST impact on three parameters – namely price, supply chain and operational aspects.

The pharmaceutical industry is one of the most regulated industries. The prices of most medicines are capped by the National Pharmaceutical Pricing Authority (NPPA). Further, The Drug Price Control Order 2013 (DPCO) requires mentioning the Retail Sales Price (RSP) on the outer packings of all medicaments.

The stated Retail Sales Price is to be quoted as inclusive of all taxes, including GST. Any change in the rate of tax on the medicaments as well as Active Pharmaceutical Ingredients (API) / bulk drugs would affect the manufacturer and consumers due to price restrictions.

Prices of imports must be emphasized that the basic customs duty levied in accordance with the Customs Act, 1962, has not been subsumed into the GST regime and thus forms part of the cost of imported goods. In addition to this, Social Welfare Surcharge was introduced in lieu of education cess, in the Union Budget 2018 on basic customs duty at the rate of 10% of the aggregate customs duty, which also ultimately adds to the cost of imported goods.

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Various companies in the pharmaceutical space enjoy duty drawback exemptions and rewards of duty credit scrips under the Foreign Trade Policy and as far as basic customs duty is concerned, these benefits shall continue subject to the provisions laid out in the Foreign Trade Policy, 2015 - 20.

IGST paid on import of bulk drugs and APIs is available as input tax credit. The rate of IGST on such products is generally 18% and thus, results in working capital blockages as the output on most pharmaceutical products is either 5% or 12% or nil rated. In the first two cases, this leads to an inverted duty structure.

Under the GST regime, the loan licensee charges and the commission paid by drug manufacturers to their agents and stockists come within the 18% slab. This is an increase of nearly 3% in the indirect tax incidence as opposed to the service tax regime.

Thus, blockages of working capital may arise for those drug manufacturers who are mostly operating out of a domestic market and for whom the tax paid on input services may not be allowed for purposes of computation of refund arising on account of inverted duty structure.

It must further be emphasized that there is no refund of any input tax credit arising in relation to capital goods as well as input services (due to recent amendments made to rule 89(5) of the CGST Rules, 2017) as the same do not fall within the definition of 'net input tax credit' for purpose of computation of refund arising out of inverted duty structure.

The GST rate on most formulations is falling within three categories viz. 12%, 5% and Nil. Human blood and its components, and all types of contraceptives have nil GST on them. The GST on formulations is 12% for most medicines and it is difficult to comment on revenue neutrality of this rate of tax. A few pharmaceutical products which earlier were subject to nil excise duty, like Oral Rehydration Solutions, vaccines and insulin, but had 5% VAT, now have a 5% GST incidence.

Various pharmaceutical companies were subject to area-based exemptions under the previous regime. Under the Central Excise regime as it existed prior to 1 July 2017, the units located in certain states were eligible to avail exemption from payment of Central Excise duty in terms of area-based exemption notifications. While ab-initio exemption was available to the units located in the States of Uttarakhand and Himachal Pradesh, the units located in some areas were required to pay Central Excise duty and avail exemption by way of refund of cash component of such duty paid.

The Central government has by way of grandfathering provisions and to obviate hardships faced by such units on account of withdrawal of exemptions in the GST regime, announced a scheme of Budgetary Support with effect from 1 July 2017 to all 'eligible units' operating under such exempted areas. Such budgetary support shall only be available for the unexpired period of the exemptions earlier enjoyed by these units and on making an application.

Under the GST regime, there is a tremendous scope to improve the supply chain and bring the overall costs of logistics down. Under the earlier indirect tax regime, CST on interstate transactions at the rate of 2% turned out to be a very significant cost and resulted in many companies having at least one warehouse or depot in each state or union territory where they were operating. Under the GST regime, seamless availability of input tax credit even on interstate transactions makes it possible for many companies to employ a hub and spoke model. Consolidation of warehouses and depots needs to be evaluated from the perspective of reducing cycle time and also in terms of being responsive to customer needs rather than just looking at the fiscal costs. Withdrawal of area-based exemptions may also be an inflection point in encouraging pharmaceutical companies to proactively alter their supply chain design.

E-way bills, which have been recently introduced for movement of all supplies above a value of Rs. 50,000/- may, apart from being looked at as only a documentation exercise, may provide invaluable data and analytics that may enable pharmaceutical companies to plan their outbound logistics in an efficient manner and to evaluate transporter performance on objective and well-defined metrics.

DISCUSSION

The thrust that GST gives to supply chain coincides with the move that pharmaceutical companies are making to continuous manufacturing and industrial automation. Thus, the supply chain aspects should be looked at a serious cost optimization exercise that would further enhance competitiveness of the businesses. The price considerations due to GST implementation and the supply chain related considerations may also enable the pharmaceutical companies to determine the manner in which they choose to comply with anti-profiteering guidelines. Being an industry so essential for consumers, anti – profiteering guidelines may get triggered for pharmaceutical companies and it is strongly suggested that pharmaceutical companies look at the mechanism they will employ to pass on the benefit of reduced prices, if any, to the stockists and thereafter to the end consumers, given the fact that drug prices are highly regulated.

Many pharmaceutical companies as discussed earlier are subject to inverted duty structure as the GST rate on import of APIs as well as most of the processing charges and costs is at 18% whereas the output is at the GST rate of Nil, 5% or 12%. The mechanism for inverted duty structure is beset with various challenges and is resulting in delays in obtaining refunds and has ramifications on working capital of various pharmaceutical companies.

GST law does not have any special provision for loan and licensee units. Where the contract is performance of job-work, these units can opt to follow the procedure laid down in section 143 of the CGST Act, 2017 i.e. the principal can send any inputs etc. to such units without payment of tax and the principal can clear the goods from the premises of such units if the principal declares these units as his additional place of business or where such units are themselves registered under section 25 of CGST Act, 2017. It is important to keep records of goods sent to Loan Licensee, as if the said sent goods not returned within prescribed period, then it would be taxable under GST.

As per the FAQs issued by the CBEC on pharmaceutical industry, in case of return of expired/near expiry drugs, the manufacturer may issue a credit note within the time specified in sub-section (2) of section 34 of the CGST Act, 2017 subject to the condition that the person returning the expired medicines reduces his input tax credit. Subsequently, when the expired goods are destroyed, the manufacturer has to reverse his ITC on account of goods being destroyed. Where the goods are returned after the time limit specified in section 34(2) of the CGST Act, 2017, the Government has clarified that the credit of the same should be given to stockists and should not be treated as supply.

CONCLUSION

Thus, to summarize, there is a possibility of significant loss of input tax credit in the pharmaceutical industry arising due to the inverted duty structure. There is a burnout due to non-availability of refund of input tax paid on capital goods. Further, disbursements due to budgetary support are expected to be delayed and this may result in further working capital blockages. All these blockages increase the cost of working capital and shall likely have an adverse impact on the prices of pharmaceutical products.

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Corresponding Author

Sandip Kumar De*

Department of Economics, Bankura Zilla Saradamani Mahila Mahavidyapith