Navigating GST Reforms: A Strategic Framework for Microfinance Operations and Compliance

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ABSTRACT:
The introduction of the Goods and Services Tax (GST) in India represents a significant transformation for the microfinance industry, shifting it from a disjointed tax structure to a consolidated, technology-driven system. Although primary lending activities—where interest forms the sole consideration—continue to be exempt under the CGST Act, supplementary financial services such as processing charges and administrative fees are subject to a standard GST rate of 18%. This dual classification of "exempt" and "taxable" supplies generates considerable challenges in tax compliance and cost efficiency.
This study analyzes the diverse effects of GST on Microfinance Institutions (MFIs), emphasizing the shift from centralized registration to state-wise compliance, which has raised operational expenditures and administrative complexities. A central focus of the research is the evaluation of Input Tax Credit (ITC) mechanisms—particularly comparing the proportional approach under Section 17(2) with the fixed 50% method under Section 17(4). The findings indicate that while the fixed approach ensures administrative convenience, the proportional method can deliver greater financial advantages for specific operational structures.
Additionally, the paper examines the strategic consequences of the "GST 2.0" reforms (2025–2026), which introduced automated refund mechanisms, compulsory e-invoicing at lower thresholds, and rationalized tax slabs. Through both qualitative and quantitative assessment of recent regulatory developments, the research proposes a comprehensive navigation framework for MFIs. Core strategies include adopting cloud-based compliance systems, implementing rigorous vendor validation to safeguard ITC claims, and utilizing standardized GST data to improve credit evaluation processes..

KEYWORDS:
Goods and Services Tax (GST), Microfinance Institutions (MFIs), Input Tax Credit (ITC), Tax Compliance and Digitalization, Financial Inclusion and Formalization.

INTRODUCTION :

Microfinance functions as a vital pillar of financial inclusion in India, offering essential credit and financial solutions to unbanked and underbanked populations, particularly within rural and semi-urban regions. Traditionally, the sector operated under a fragmented indirect taxation system, where Service Tax alongside multiple state-level Value Added Taxes (VAT) led to a “cascading effect,” thereby increasing operational costs. The implementation of the Goods and Services Tax (GST) in 2017—and its later progression into the “GST 2.0” framework of 2025–26—signified a structural shift aimed at establishing a unified “One Nation, One Tax” regime.

However, for Microfinance Institutions (MFIs) and NBFC-MFIs, this transition presents both opportunities and challenges. On one side, GST enhances transparency, promotes digital formalization, and enables a smoother flow of Input Tax Credit (ITC). Conversely, it introduces a distinctive “dual-taxation” complexity. While the fundamental activity of microfinance—interest earned on loans—remains exempt from GST under the CGST Act, associated services such as loan processing fees, documentation charges, and technical inspection fees are taxed at a standard rate of 18%.

This distinction between exempt and taxable supplies creates a substantial compliance challenge. MFIs are required to manage multiple state-wise registrations, adhere to mandatory e-invoicing for reduced turnover thresholds (effective April 2025), and comply with intricate ITC reversal provisions under Section 17(4). Moreover, the expense associated with maintaining GST-compliant infrastructure often passes through to borrowers, potentially affecting the objective of affordable financial inclusion.

LITERATURE REVIEW:

Sanjay Garyali (2025) highlights that contemporary studies on “GST 2.0” indicate a transition toward AI-enabled compliance systems and real-time invoice reconciliation. Scholars such as Sanjay Garyali (2025) assert that these reforms are “people-centric,” as reduced tax rates on essential goods enhance the repayment ability of micro-borrowers, thereby reinforcing the MFI ecosystem. Nevertheless, existing literature cautions that the 30-day deadline for e-invoice registration (effective April 2025) may create liquidity constraints for MFIs that have not fully digitized their operational infrastructure.

Bhalla, Sharma, and Gupta (2023) emphasize that although GST promotes formalization, it has simultaneously imposed “regressive compliance costs” on smaller enterprises. Their research indicates that micro and small firms frequently lack adequate technological capabilities to cope with continuous regulatory updates, including mandatory e-invoicing. In the context of MFIs, this suggests that clients—primarily low-income entrepreneurs—may face increased financial pressure as institutions transfer rising compliance and administrative expenses.

PricewaterhouseCoopers (2022) identifies Section 17 of the CGST Act as a focal point of academic discourse, as it offers two distinct alternatives for claiming Input Tax Credit. The proportional method under Section 17(2) allows credit claims only for inputs linked to taxable services, whereas the fixed 50% method under Section 17(4) permits a uniform claim of half of the eligible ITC while the remaining portion lapses. Studies suggest that although the fixed method simplifies large-scale operations with high transaction volumes, it may lead to substantial loss of eligible credits when taxable income components are relatively high.

Deloitte (2020) explains that prior to GST implementation, India's financial sector operated within a complex framework of Service Tax and multiple state-level levies. The introduction of GST represented a significant reform aimed at eliminating cascading taxation and establishing a unified market structure. Early analyses revealed that although GST streamlined taxation for most industries, it created distinct operational challenges for financial institutions, particularly due to the requirement of state-wise registrations, which significantly increased return filing volumes.

OBJECTIVES OF THE STUDY:

This study pursues the following specific objectives:

1. To evaluate the overall impact of GST and GST 2.0 reforms on the operational, financial, and compliance structure of Microfinance Institutions (MFIs).
2. To analyze the implications of dual taxation (exempt vs taxable supplies) and Input Tax Credit (ITC) mechanisms on cost efficiency and profitability of MFIs.
3. To develop a strategic framework for enhancing compliance efficiency, digital adaptation, and sustainable growth of MFIs in the evolving GST regime.

HYPOTHESES

• H1: AI adoption in medicine leads to significantly improved diagnostic accuracy and workflow efficiency as perceived by healthcare professionals.

• H2: The main barriers for AI adoption are regulatory concerns and lack of skilled personnel.

• H3: Stakeholders perceive positive impact of AI on patient outcomes, but express apprehension regarding transparency and data privacy

RESEARCH METHODOLOGY:

Despite extensive literature on GST's impact on large banking institutions and the MSME sector, limited research specifically addresses rural-oriented MFIs, which often function in regions with inadequate digital infrastructure. These institutions encounter unique challenges in managing high-frequency compliance requirements under GST 2.0. This study aims to bridge this gap by proposing context-specific strategies to support digital adaptation and operational efficiency.

This research adopts a descriptive and analytical design to evaluate the implications of GST reforms on the microfinance sector, focusing on both regulatory structures and financial outcomes.

Data Collection

The study relies on both secondary and qualitative primary insights. Secondary data includes an extensive review of the CGST Act (2017), subsequent amendments up to the 2025–26 Union Budget, and official GST Council circulars. Additionally, annual reports of leading NBFC-MFIs, such as CreditAccess Grameen and Fusion Microfinance, were examined to assess trends in tax-related expenditures. Qualitative insights were obtained through informal consultations with tax professionals and MFI operations managers to understand practical challenges in compliance and implementation.

Comparative Analysis Framework

The study employs a comparative model to evaluate the effectiveness of ITC mechanisms:

1. The proportional method (Rule 42/43), which allocates ITC based on the ratio of taxable to exempt supplies.
2. The fixed 50% method (Section 17(4)), which allows a standardized claim of half the eligible ITC.

Impact Indicators

Key performance indicators include:

- Compliance Cost Index
- ITC Utilization Ratio
- Turnaround Time (TAT) for invoice processing and reporting

Scope and Limitations

The research primarily focuses on NBFC-MFIs in India. A key limitation is the limited availability of granular GST filing data for smaller NGO-MFIs, which may face higher proportional compliance challenges.

FINDINGS:

Dual-Supply Complexity

The findings indicate that MFIs face significant challenges due to the bifurcation between exempt and taxable services. While interest income remains exempt, fee-based services attract GST. Institutions with higher reliance on such fees experience greater tax liabilities, which may indirectly increase borrowing costs.

ITC Strategy Comparison

Feature	Fixed 50% Method	Proportional Method
Ease of Use	High	Low
Audit Risk	Low	High
Financial Efficiency	Moderate	Potentially High
Suitability	Large MFIs	Fee-driven MFIs

GST 2.0 Impact

The reforms have introduced mandatory e-invoicing and stricter compliance timelines. While compliance costs have increased, improved transparency has enhanced institutional credibility and access to funding.

Strategic Framework

- The study proposes three core strategies:
- Technology-driven compliance systems
- Vendor compliance verification
- Decentralized regional compliance management.

DISCUSSION/SUGGESTIONS:

The findings of this study highlight that the implementation of GST has introduced a structural transformation in the functioning of Microfinance Institutions (MFIs), particularly through the coexistence of exempt and taxable supplies. This dual nature creates operational and financial complexities, especially in determining tax liability and Input Tax Credit (ITC) eligibility. The exemption of interest income, combined with taxation on ancillary services, leads to partial ITC utilization, thereby increasing the effective cost of operations.

A critical observation from the analysis is the trade-off between administrative simplicity and financial optimization in selecting ITC methods. The Fixed 50% method under Section 17(4) provides ease of compliance and reduces the risk of audit disputes, making it suitable for large MFIs with high transaction volumes. In contrast, the Proportional Method under Rule 42/43 offers greater financial efficiency in cases where taxable income components are relatively higher, although it requires complex calculations and careful documentation.

Furthermore, the transition to the GST 2.0 framework has reinforced a “digital-first” compliance environment. The introduction of mandatory e-invoicing and the 30-day reporting rule has increased operational pressure, particularly for MFIs operating in rural and semi-urban regions with limited technological infrastructure. Delays in invoice reporting can lead to denial or loss of ITC, thereby directly impacting cash flow and profitability.

Another significant implication is the rise in compliance-related costs, including investments in software systems, consultancy services, and staff training. While these costs have increased in the short term, the enhanced transparency and standardized reporting mechanisms have improved the credibility of MFIs in the eyes of financial institutions and regulators. This, in turn, facilitates better access to formal credit and investment opportunities.

The study also underscores the importance of strategic adaptation. The adoption of technology-driven compliance systems, strict vendor verification processes, and decentralized compliance management can significantly reduce operational inefficiencies. Moreover, leveraging GST data for credit assessment can improve risk evaluation and reduce default rates among borrowers.

Overall, the discussion indicates that although GST introduces compliance challenges, it also acts as a catalyst for formalization, efficiency, and long-term sustainability in the microfinance sector. The ability of MFIs to strategically adapt to this evolving tax environment will determine their competitiveness and contribution to financial inclusion.

CONCLUSION:

The evolution of GST represents a transition toward a formalized and digitally integrated financial system. While short-term challenges persist, long-term benefits include improved transparency, enhanced credit assessment, and reduced financial risk. The choice between ITC methods plays a critical role in maintaining financial efficiency.

CONFLICT OF INTEREST:

This paper is based on a conceptual review of published literature and does not involve direct funding or collaboration with commercial biotechnology entities. The author declares no financial or personal conflicts of interest related to the subject matter discussed.

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