(CON) FUSION OF GOODS AND SERVICES.

(By Swamy Associates)

As nuclear fusion produces energy, musical fusion produces synergy. But here comes a great "tax fusion" of goods and services, where two major taxes are going to fuse together, to produce a bout of energy, synergy as well as some "allergy"!!!

In law making, transparency is the buzzword. By tabling the draft of a very important "next-generation" tax proposal, the department has blown the shackles of age-old conservatism and in-camera nature of law making. This new outlook of the department merits resounding appreciation.

We feel, as dedicated practitioners, it is our bounden duty to clinically dissect and critically diagnose the probable allergic symptoms of this grand tax fusion. After a deep dip into the draft Rules, we have gathered both pearls and pebbles. The pebbles are :

Rule 1

1.0 The term "Cenvat" refers to the duty of excise. As per Section 3 (a) of the Central Excise Act, 1944 duty of excise is referred to as "Cenvat – Central Value Added Tax". As the new Rules seek to provide for availment of Credit, not only in respect of duty of excise, but also of Service Tax, the Rules may be rechristened either as "Credit of Duties of Excise and Service Tax Rules, 2004" or "Cenvat and Service Tax Credit Rules, 2004" or "Goods and Services Tax Credit Rules, 2004" or by any other suitable name. For the same reasons, instead of calling the credit allowed by the rules as Cenvat Credit in various places, such credit shall be called, either as "Credit of Taxes", or "Credit of Duties" or by any other suitable name.

Rule 2

2.0 The erstwhile definition of "capital goods" under the Cenvat Credit Rules, 2002 has been retained in the draft rules. The chapter specific definition of "capital goods" may not be sufficient when credit of duty of excise paid on capital goods is sought to be allowed to output service providers. The capital goods requirements of output service providers are diverse in nature, which may include, professional instruments, etc., which often may not fall under the specified chapters. As such, the entire definition of "capital goods" needs a thorough revamp to suit the requirements of Service Tax.

2.1 We would suggest that the term "capital goods" shall include all goods, the value of which is not written off as an expenditure in a single financial year, but carried forward as a capital expenditure, by the manufacturers and output service providers. In the alternative, the existing definition of capital goods may be made restrictive, by making it applicable only for manufacturers and defining the same as suggested above, for output service providers.

2.2 Curiously, we also find that the term input has been defined for output service providers as all goods, except light diesel oil, high speed diesel oil, motor spirit, commonly known as petrol and motor vehicles, used for providing any output service; and motor vehicles for providing output service as specified in sub-clauses (f), (n), (o) and (zzp) of clause (105) of section 65 of the Service Tax Act;

One may also argue that there would be no applicability of the concept of "capital goods" as far as output service providers are concerned as "all goods" can be considered as "inputs". We hope that the same would not have been the intention.

2.3 In view of the above, it would be better, the definition of "capital goods" is either revamped completely or a separate definition of "capital goods" is prescribed for output service providers.

3.0 It may be observed that inputs for the purpose of output service providers has been defined as all goods, except light diesel oil, high speed diesel oil, motor spirit, commonly known as petrol and motor vehicles for the specified services (courier, tour operator, rent a cab operator and Goods Transport Agency). When motor car themselves have been considered as input for these four services, there is no reason as to why the definition of inputs shall exclude light diesel oil, high speed diesel oil and motor spirit, for these services. The exclusion of these goods from the definition of the term input is due to the fact that these are common utilities and its use cannot be directly attributed either to the manufacture of final products or rendering of output service. But in case of the above services, if diesel and petrol cannot be the inputs, what else can be?

3.1 Hence, we suggest that for the above mentioned four services, the term input shall include light diesel oil, high speed diesel oil and motor spirit also.

4.0 The concept of "input service distributor" has been introduced whereby the head offices and corporate offices will be designated as "input service distributors" for transferring the credit of service tax, paid by them. This provision has been made as akin to the concept of "first stage dealer" for inputs and capital goods. But the concept of "input service distributor" is likely to cause more practical problems, as detailed below.

- It is not known whether such "input service distributor" shall be registered with the department.
- It is not known, as to how the service tax paid by such "input service distributor" will be distributed among various factory premises or various premises from where output services are rendered. The basis of such distribution has not been prescribed. Even if the same is prescribed, it will only lead to further practical problems in compliance.

4.1 In view of the above, we suggest that the concept of "input service distributor" may be done away with. Instead, the manufacturers or output service providers may be permitted to avail credit of service tax paid by the head offices and corporate offices. If the manufacturer of output service provider is having more than one factory / premises, the option of taking the credit in any one place, shall be vested with him.

Rule 3

5.0 Sub Rule (2) of Rule (3) provides for availment of credit in respect of the stock of inputs lying in stock, contained in work in progress and finished goods, in case if the final products ceases to be exempted goods. Sub rule (2a) is aimed at creating a parity in this regard between manufacturers and output service providers, whose final products or output service, as the case may be, has ceased to be

exempted. But, instead of providing for availment of credit on the inputs lying in stock (normally there may not any work in progress or finished goods for an output service provider), this rule allows credit only in respect of the inputs received after the date on which the service ceases to be exempted. As the main provision of Rule 3 itself would take care of availment of credit in respect of the inputs received thereafter, this provision will become otiose. Rather this sub rule shall be amended to provide for availment of credit in respect of inputs lying in stock, as on the date when the service ceases to be exempted.

5.1 If we proceed further, we may also visualise a situation which would be equivalent to the inputs contained in work in progress, with regard to input services. There may be cases where the consideration for an input service (including the service tax thereon) would have been paid already but the consumption of the said input service would be a continuous process. For example, let us assume that an annual insurance premium has been paid in April, when the output services are exempted. Subsequently when the service ceases to be exempted from 1st July, ¾th of the service tax paid on the insurance premium shall be allowed as credit.

5.2 We suggest that when a services ceases to be an exempted service, credit of specified duties shall be allowed in respect of all inputs lying in stock on the date when the service ceases to be exempted. Further, credit of service tax paid on input services, which are continued to be consumed shall also be allowed. Sub rule 2(a) shall be amended accordingly.

6.0 Rule 3 (4) provides that if the credit availed inputs are capital goods are removed as such, the credit originally availed thereon shall be reversed. While this provision can be complied with in respect of inputs, it is seen in the past that the entire credit originally availed are being sought to be reversed in respect of capital goods, though the capital goods are not removed "as such" but removed only after a considerable period of use. Earlier, in Point No.14 of the CBEC's Circular No.643/34/2002 Dated 01.07.2002, it has been clarified that if the removal is by way of sale, duty at appropriate rate has to be paid on the sale value of capital goods and if the removal is not by way of sale, adequate depreciation shall be provided to arrive at the credit to be reversed. As the entire rules relating to Credit of duties are getting a facelift, this is the right time to make the above provision in the rules.

7.0 It has been provided that credit in respect of the inputs removed outside the premises of output service provider for rendering the output services shall be allowed. In other words, no credit needs to be reversed for such removals. Similarly, removal of capital goods outside the premises of output service providers is also permitted without reversal of credit, if such removal is for rendering the output service. But a restriction of 90 days has been provided in this regard, within which the capital goods have to be brought back to the premises of the output service provider. In reality, the restriction of 90 days cannot be complied with, if the output service is continuously rendered for a period more than 90 days. This provision may be amended and removal of credit availed capital goods outside the premises of output service provider may be permitted, so long as the capital goods are required at such outside place, for rendering the output service.

8.0 A similar restriction in respect of manufacturer of final products, in bringing back the capital goods removed to the premises of job workers within 180 days, except for moulds, dies, jigs and fixtures may also be reviewed in view of the practical difficulties. This restriction is posing great problems for the industry as many of the capital goods are used continuously in the premises of job workers. Accordingly, a provision may be introduced whereby removal of credit availed capital goods to the premises of job workers shall be permitted without any time limit, so long as they are continued to be used in the manufacture of intermediate products in the premises of job workers, which are further used in the manufacture of dutiable final products. The restriction of 180 days may be retained only for the inputs.

9.0 The restriction as to utilisation of credit (i.e. utilisation of AED (TTA) credit for payment of such AED(TTA) alone on the final products) may be given in the form a table, to enable better understanding. Credit of Education CESS availed either on inputs / capital goods / input services shall be allowed to be utilised towards such Education CESS payable on the final products or on the output service.

Rule 4

10.0 Sub rule 4(a) of Rule 6 provides that credit in respect of input service shall not be allowed in respect of that part of the value of input service which represents the amount of service tax on such input services, which the manufacturer or provider of output service or input service distributor claims as deduction under the relevant provisions of the Income-tax Act, 1961. This provision is the replica of the erstwhile provision, whereby it was provided that if the duty portion has been claimed as Cenvat Credit, the same shall not be charged as a revenue expenditure in the books of accounts. Considering the irrelevance of the above provision, the same was omitted from the statute book, with retrospective effect. Without taking note of the same, the present rule has been worded. As such, the said sub-rule may be omitted.

11.0 As per sub rule (7), it has been provided that credit in respect of service tax paid on input services shall be allowed only on or after the day on which payment is made of the value of input service and the service tax paid or payable as indicated in invoice or bill or challan. It is a common practice in the industry that such bills are paid in various installments. Moreover, if due to subsequent negotiations, if a lesser amount is accepted by the input service provider, availment of credit could be denied under this provision, as the "amount indicated in the bill" has not been paid. Taking note of the above, we suggest that this rule may be amended to allow proportionate availment of service tax credit, if part payment is made against a bill.

Rule 6

12.0 The title of Rule 6 shall be "Obligation of manufacturer of dutiable and exempted goods and output service provider, rendering both taxable as well as exempted service" as the provisions of this rule is applicable to both of them.

13.0 it may be observed that the term "exempted service" has been defined in the rules as taxable services which are exempt from the whole of the service tax leviable thereon, and includes services on which no service tax is leviable under the Service Tax Act. Similarly, the term "exempted goods" has been defined as goods which are exempt from the whole of the duty of excise leviable thereon, and includes

goods which are chargeable to "Nil" rate of duty. A comparison of the above two definitions would highlight that while the "exempted goods" shall necessarily be excisable goods, first of all, the "exempted services" need not necessarily be "taxable services" but any services on which no service tax is leviable under the Service Tax Act.

13.1 It may be observed in the context of duty of excise, that the provisions of this rule will be applicable only if the manufacturer manufactures both dutiable as well as exempted final products, which are in the first instance "excisable goods". If a manufacturer manufactures a dutiable final product and a non-excisable product, the above restriction would not apply. But, this is not so in case of "exempted services". The restriction contained in this rule will apply, even if an output service provider renders a non taxable service. This is a dangerous provision. In the absence of any definition for the term "service" any sundry activities rendered by a manufacturer or output service provider, would invite the wrath of this provision. For example, if a manufacturer leases out a small part of his building, the same shall be construed as an "exempted service" and the wrath of this provision will be applied to him.

13.2 We suggest that the term "exempted service" shall be defined only with reference to the taxable service, on which no service tax is payable by way of any notification.

14.0 Rule 6(2) may be reworded as below, to ensure better clarity.

> 2) Where a manufacturer or provider of output service avails of CENVAT credit in respect of any inputs or input services, except inputs intended to be used as fuel, and manufactures such final products or provides such output services which are chargeable to duty or tax as well as exempted goods or exempted services, then, the manufacturer or the provider of output service shall maintain separate accounts for receipt, consumption and inventory of inputs and input services meant for use in the manufacture of dutiable final products or taxable output services and the quantity of inputs meant for use in the manufacture of exempted goods or exempted services and take CENVAT credit only on that quantity of inputs or input services which is intended for use in the manufacture of dutiable goods or in providing output services chargeable to service tax.

15.0 As per Rule 6 (3), a manufacturer who has opted for not maintaining separate registers, either the credit attributable to the inputs used in the manufacture of such exempted final products and the credit attributed to the input services consumed in such manufacture shall be reversed, or an amount equal to 10 % of the price of the exempted goods shall be paid, as the case may be. While quantifying the credit attributable to the inputs may not pose any difficulty, similar exercise in respect of the quantum of credit attributable to the input services used in such manufacturing activity, would be too difficult. For example, if service tax credit on telephone service is availed, the same cannot be segregated as to its utilization towards manufacture of dutiable goods and exempted goods.

15.1 In this connection, we suggest the following alternative. Presently, an amount equal to 8 % of the price of the exempted goods is payable in such cases, which is proposed to be enhanced to 10 %, which may be due to the availment of credit on input services also. In other words, the quantum of credit availed on input services has been considered to constitute 2 % of the price of the exempted goods, on average. The same logic may be applied to those cases where proportionate credit reversal is contemplated. In this regard, as far as inputs used in the manufacture of exempted goods, the present provision of proportionate reversal of credit availed on inputs may be retained. As far as the input services used in the manufacture of exempted goods, the manufacturer may be asked to pay an amount equal to 2 % of the price of the exempted goods, in addition to reversal of credit on inputs.

16.0 The provisions of this Rule 6 shall not be applicable if the exempted goods are cleared for export, etc. Similar provision may be incorporated so as to exclude the application of this rule, if the output services are exported, or are rendered to 100 % EOUs, etc.

Rule 7.

17.0 Credit of service tax can be availed on the basis of any invoice, or bill or challan issued by an input service provider. If such input service provider is required to pay any additional amount of service tax subsequently, he may issue another invoice or bill or challan for this and pass on the credit. But in the context of duty of excise, availment of credit of such additional duty is prohibited, if such additional duty is paid by reason of fraud, etc. Similar prohibition may be introduced for availing additional credit of service tax.

17.1 In rule 7 (1) (f), a challan issued under Rule 8 A has been specified as a document for availing credit. Consequent to the withdrawal of the special provisions contained in Rule 8 A, relating to the textile sector, prescribing the challan issued under this rule as a valid document, is otiose.

17.2 In rule 7 (1) (h), only an invoice issued by the input service distributor has been specified. Bills and Challans may also be included hereunder, as it is made applicable for input service providers.

Rule 8

18.0 This rule provides for transfer of credit balance lying in the books, in case of shifting of factory / premises of rendering output service, due to change in ownership, etc. In case of a manufacturer, such transfer shall be allowed, if the stock of inputs and capital goods are also transferred to the new premises. But this requirement has not been made applicable to output service providers. We suggest that sub rule (2) of this rule shall be amended to include transfer of credit under sub rule 1(a) also, within its ambit.

General.

19.0 References are made in various places to "Service Tax Act" and "Finance Act, 1994" simultaneously. We hope that a separate "Service Tax Act" will be enacted shortly and all reference will henceforth be made only to that Act.