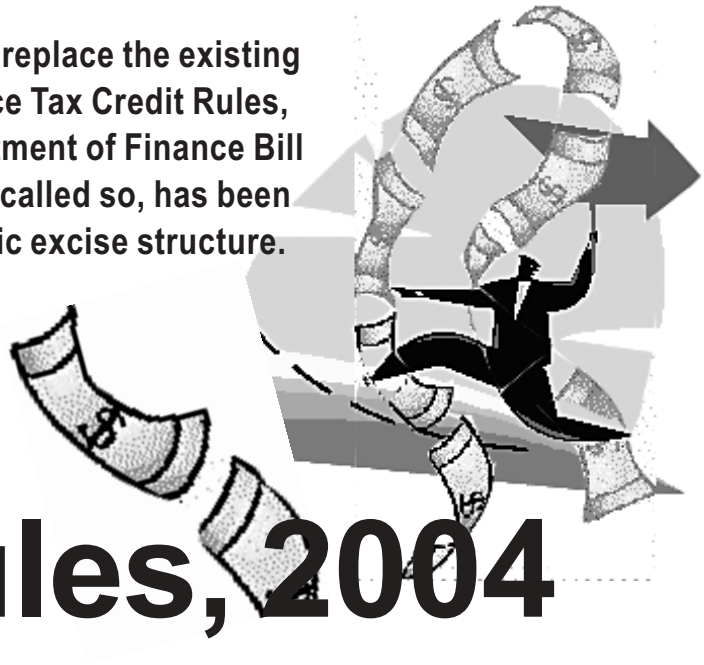
The rules released in September 2004 replace the existing CENVAT Credit Rules, 2002 and Service Tax Credit Rules, 2002 with effect from the date of enactment of Finance Bill 2004. This merger of rules, if it can be called so, has been done without much tinkering with basic excise structure.



CENVAT Credit Rules, 2004

R. Sarathy

The new CENVAT Credit Rules 2004 are a follow up of the Union Finance Minister Mr P. Chidambaram's assurances in the Parliament for taking steps to integrate the tax on goods and services.

'Cross vatability' or Inter-sectoral credit, by whatever name it is called, is a bold measure of cross pollination. A new clause (xvi aa) under Section 37 of the Central Excise Act has been inserted to provide for credit of service tax leviable under chapter V of the Finance Act, 1994 paid or payable on taxable services used in, or in relation to manufacture of excisable goods. The new rules mark a beginning towards a fully integrated 'Goods and Service tax" recommended by the Kelkar committee in July 2004. Excise duty and service tax continue to be separate levies.

Applicability

The CENVAT Credit Rules 2004 extend to the whole of India. As Service Tax law is not applicable to Jammu & Kashmir, the credit of service tax is not considered for them. The manufacturers located in J & K utilizing services from service providers outside J & K will not be entitled to avail service tax credit nor claim refund of service tax on services used in the export of final products. The rules cover all the three categories, namely manufacturers, service providers and manufacturers-cum-service providers.

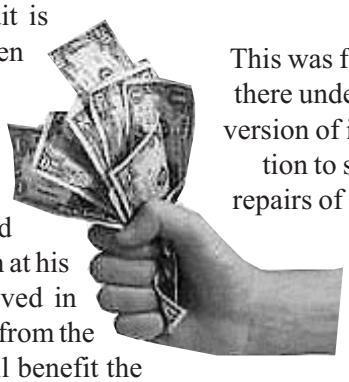
Eligibility

There is no change in the portion of definition on inputs pertaining to manufacturers. Inputs for service provider (SP) under rule 2(k) would mean goods (with similar disallowance for LDO, HSD and petrol) used for providing output service. In respect of specified input services such as management consultants, architects, consulting engineers, interior decorator, commission and installation agency, technical testing and analysis agency, technical inspection and certification agency, construction services, intellectual services with the addition of security agency, scientist and technocrat, maintenance or repair agencies, foreign exchange brokers, the full service tax paid is eligible for credit under rule 6(5) unless these are exclusively used in the manufacture of exempted goods or providing exempted services which means that even if part of the services is used for exempted goods or services the credit can still be retained.

The author is a member of the Institute. He can be reached at psarathy91@rediffmail.com

Credits in respect of capital goods (coverage same as existing) under rule 2(a) is also being allowed for service provider (SP). Capital goods will also include motor vehicles (registered in the name of SP which was not a pre-condition in the draft rules) used for providing output services by courier agency, tour operator, rent-a-cab operator, goods transport agency and also by cargo handling agency, outdoor caterer and pandal contractor. These provisions are laudable and reflect the ongoing progressive thinking of the government.

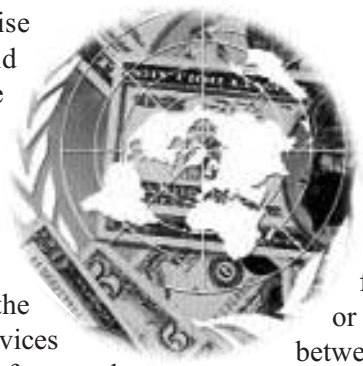
Also, a joint reading of rules 2(a)(A), 2(a)(B) and 2(k)(ii) reveals that credit is eligible on capital goods and inputs even when they are not received in the premises of SP as long as they are used for providing output services. In view of logistics and cost involved, a SP may prefer to receive and unload goods at the place of service rather than at his premises. Credit should not be deprived in such situations. An early confirmation from the government on this understanding will benefit the concerned.



In the absence of restriction, credit of service tax paid on cellular phones can become eligible.

Availability of credit up to place of removal

It is stated in the preamble to the draft rules that "in principle, credit of tax on those taxable services would be allowed that go to form a part of the assessable value on which excise duty is charged. This would include certain services which are received prior to commencement of manufacture but the value of which gets absorbed in the value of goods. As regards services received after the clearance of the goods from the factory, the credit would be extended on services received up to the stage of place of removal (as per section 4 of Central Excise Act). In addition to this, services like advertising, market research etc. which are not directly related to manufacture but are related to the sale of manufactured goods would also be permitted for credit".



A new clause (xvi aa) under Section 37 of the Central Excise Act has been inserted to provide for credit of service tax leviable under chapter V of the Finance Act, 1994 paid or payable on taxable services used in, or in relation to manufacture of excisable goods.

This was formalized in draft rule and the explanation there under. In response to the industry, the enlarged version of input service includes services used in relation to setting up, modernization, renovation or repairs of a factory, premises of SP, office, advertisement or sales promotion, market research, storage, procurement of inputs, activities relating to business such as accounting, auditing, financing, recruitment and quality control, coaching and training, computer networking, credit rating, share registry and security, inward transport and outward transport upto the place of removal. Though the benevolence of the government is evident here, yet restricting the credit up to the place of removal needs to be dispensed with. It is suggested that all services availed in the value added chain, whether pre or post place of removal, should qualify for Cenvat.

One to one correlation

In respect of input service, it means any service used by a service provider (SP) for providing output service or those used by manufacturer whether directly or indirectly in or in relation to the manufacture and clearance of final products. In no organization, whether big or small, is it possible to establish a concrete link between input service and final products. Once the manufacturer feels a need for a service and avails it for business consideration, the credit should be freely available. Further, out of the 73 services covered as on 8th July except a few services like health club and fitness centers, mandap keepers and stock brokers, most services can be debated/interpreted by advocates and

aggrieved to have some connection with manufacture of final products. The requirement of nexus is onerous and needs to be deleted to avoid litigation.

CENVAT credit on capital goods isn't permissible if depreciation u/s 32 of Income Tax Act is claimed on amount of credit. There is a draconian provision under rule 4(7) that credit on input services is allowable only on payment of value of service and service tax.

Availment

Cenvat credit is available to a manufacturer of final products and SP. This credit all pervadingly is allowed for excise duty, additional duty of customs, service tax, newly introduced education cess (EC) etc pertaining to inputs, capital goods and input services received on or after 10.09.2004. Credit allowed to SP is also termed as cenvat credit (similar to duty). It is to be noted that a restriction for use of services within the factory / premises has been prudently left out. In this wave of liberalization, the Government could have granted the R&D cess payments for availment.

Utilisation

Cenvat credit can be utilized for payment of excise duty or service tax subject to the usual restriction of month-end balance being available for payment of duty or tax relating to the month. The utilization of EC has been expanded by a newly introduced proviso under rule 3(7)(b) stating that credit of EC on excisable goods and EC on taxable services can be utilized either for payment of EC on excisable goods or for the payment of EC on taxable services. The credit has to be reversed when the inputs or capital goods are removed as such from the premises of the manufacturer or SP. The government has wisely thought out a concession here. This payment is not attracted where the inputs or capital goods are removed outside the premises for the purpose of providing output service (proviso to 3(5)). There is however a condition that capital goods are to be brought back within 180 days (originally 90 days) plus extension of 180 days with the permission of AC/ DC. This is a practical provision since delays are part and parcel of the real world and in most cases, the service provider renders services not at his terms but on the terms of service recipient. This rule has to be distinguished from rule 4(5)(a) (the latter dealing with job work) which requires reversal of credit if the items are not returned to the manufacturer within 180 days with re-credit facility when they are received back in the factory or premises of SP.

Conditions for allowing CENVAT credit

Credit is allowed as per existing rules on inputs immediately upon receipt in the factory / premises and on capital goods at 50% in year of receipt & the balance in any subsequent year. The credit on capital goods is not permissible if depreciation under section 32 of the Income tax Act is claimed on the amount of credit. The provisions of rule 3(1) of the existing Service Tax Credit Rules, 2002 have been carried forward under new Rule 4(7) which allows credit on input services only upon payment of value of service and service tax.

Within the realm of indirect tax, central excise and service tax are proposed to be treated on different platforms. While under rule 4(1), Cenvat credit in respect of inputs is available immediately to the manufacturer / SP, the same rationale has not been extended to Cenvat Credit in respect of input services under rule 4(7). The payment linked credits could perhaps be justified that under rule 6(1) of Service Tax Rules, 1994 realization of revenue by the Government from output service providers is on quarterly basis. But this facility of quarterly payment is limited to individuals and partnership firms and not to corporates, who revenue-wise could form the bulk of service providers. Fortunately, there is no time limit to take credit.

With in the organization from the accounting point of view, the availment of credit upon payment poses problems as it is difficult to keep track whether all credits have been availed of. ERP system and standalone market packages may not have this in-built linking facility. Coordination between bills section (which is generally responsible for payment to service providers) and excise section. (which is entrusted with the task of timely availment) would be a hard issue even in situations where they form part of one department, namely accounts. At best, an interested accountant will debit the service tax payments to a separate "Service tax credit

suspense a/c" to have some control. Extracting the break-up of this ledger balance on a reporting date and the reconciliation of 'paid vs availment" will be a time consuming exercise. Experts opine that there is failure of matching concept. While the Service bills may be booked on accrual basis in general ledger, the availment gets deferred to the next period/ year upon payment.

Refund of CENVAT credit on export services

In existing service tax rules, there is no provision for refund of service tax credit even though input service received and consumed to provide output service has been exported. This is now set right under proposed rule 5 which allows refund subject to fulfillment of certain conditions.

Obligations cast on the manufacturer

Under rule 6, cenvat credit is not allowed on inputs or input services that are used in manufacture of exempted goods or exempted services. Under rule 2(e), exempted services means taxable services which are exempt from the whole of service tax leviable thereon, and includes services on which no service tax is leviable. If he is engaged in chargeable as well as exempted goods / services, a separate account for receipt, consumption and inventory of inputs / input services is required. If the manufacturer opts not to maintain separate account, then in respect of exempted products the proportionate credit has to be expunged and for non-exempted products 10% of the price (raised from 8% as credit of service tax is now being allowed) charged by him has to be paid at the time of removal. A service provider (SP) not opting to maintain can utilize credit upto 20% of the service tax payable on taxable output service, this being similar to the erstwhile rule 3(5) which provided a cap of 35%.

Currently voluntary payment of duty or tax on exempted goods / services is not permitted. In a sense, it cuts the cenvat chain. It is suggested that the manufacturer/ SP may be given an option to forego the exemption, backed up by credit facility.

Another issue is the crucial expression used in sub rule (2) namely "intended for use". There is a view in the professional world that the mandate on the liability to the service tax has to be seen strictly in terms of the rule at the time of receipt of input service and not later. As availment of credit is not deferred till the payment of tax on output service, this point needs to be clarified.

It would be left to the assessee to decide as to how he distributes the credit, only ensuring that the total credit allowed does not exceed the eligible credit amount and such offices who distribute the credit would have to obtain service tax registration.

Interestingly, the anomaly in sub-rule (6) about the non-applicability of rule 6 has been corrected by substitution of " excisable goods" for "exempted goods" in respect of certain removals without payment of duty.

Concept of input service distributor

There is a blessing in the offing. In real life situations, many a time the bill / invoice is raised in the name of head office/regional office etc. for services which are actually received in the factory (or factories) or premises of service provider. In addition, the bill for services which are not specific for any factory/premises, such as advertising, market research, management consultancy etc. would also be received only in these offices. The availment in such situations has been a matter of never ending talk. The issue has been sorted out by allowing distribution of credit of tax. Rule 2(m) read with rule 7 defines an "input service distributor" means an office of manufacturer or provider of out put service which receives invoices towards purchase of input services and issues invoice, bill or challan for the purpose of distributing the credit of service tax paid on the services to its manufacturing units or units providing output service. It has been left to the assessee to decide as to how he distributes the credit only ensuring that the credit distributed does not exceed the tax paid. Thus the distributor is comparable to dealers under the CENVAT scheme of inputs and capital goods. The document issued by him is being accepted under law as a eligible document under rule 9(1)(g) for availing credit. To pass on the credit, he has to obtain service tax registration, comply with new rule 4A of service tax rules and file half-yearly statement with the Superintendent under rule 9(10) of cenvat rules 2004.