

Impact of Negative List on Credit Mechanism



With introduction of tax on services, in 1994, the service tax credit mechanism was introduced in the year 2002. Cenvat Credit Rules, 2004 was introduced vide notification No. 23/2004-C.E. dated 10-09-2004. Now, the scheme of taxation of services has undergone a sea change and a new scheme of taxation of services based on negative list (Negative list scheme) is made effective from 1st July 2012. Under this scheme, any activity for consideration becomes a service unless specified in the negative list. Later, as expected, along with various other Notifications relating to negative list scheme, amendment to Cenvat Credit Rules, 2004 was also brought in. If one sees the recent amendments made in June 2012, one can only say that the credit mechanism has not been brought up to date. Read on...

Background

Cenvat scheme (earlier known as Modvat scheme) was introduced in the year 1986 to provide for instant credit on inputs to the manufacturers thereby avoiding the cascading effect of taxation of inputs used in the manufacture of the final products. Prior to this scheme, a more restrictive proforma credit scheme was in vogue. Subsequently, from the year 1994, the scheme of credit was extended to capital goods also. These Rules were issued with an objective to streamline the process of payment of duty and to prevent the cascading effect, where duty is levied both on the inputs or capital goods and also on the finished goods. The apex court in *Ichalkaranji Machine Centre's* case¹ observed that credit mechanism is basically a duty-collecting procedure, which aims at allowing relief to a manufacturer on the duty element borne by him in respect of the inputs used by him.

With introduction of tax on services, in 1994, the service tax credit mechanism was introduced in the year 2002. Though this scheme was similar to that of



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¹ 2004 (174) E.L.T. 417 (S.C.)

Cenvat scheme, it was limited only to credit on input service used in providing taxable output services.

Cenvat Credit Rules, 2004 was introduced vide notification No. 23/2004-C.E. dated 10-09-2004 by superseding the earlier credit rules and merging the provisions of earlier separate rules for manufacturers and service providers, to allow cross sectoral credit. Manufacturer and service providers were allowed to avail and utilise credit on inputs, inputs services and capital goods.

Concept of Cenvat Credit

Under the present Cenvat scheme (herein after referred to as Credit Rules) credit of duty paid on inputs and capital goods and service tax paid on input services can be availed by a person who is either a manufacturer or a taxable service provider or engaged in both activities. The credit so availed can be utilised towards payment of duty of excise on goods or service tax on taxable services.

Credit Rules define 'Inputs' to include all materials used in or in relation to manufacture of goods or used for generating electricity for use in manufacture or used for provision of services. However, the definition excludes those goods from the ambit of inputs which are used for construction of factory or laying foundation or structural support to machinery and goods used for personal consumption of employees.

Capital Goods is defined to mean as goods which fall under the chapters 82, 84, 85, 90, and headings 6805, grinding wheels and the like, and parts thereof falling under heading 6804 of the First Schedule to the Excise Tariff Act. Apart from this, pollution control equipments, spares, parts or accessories of the above goods, tubes and fitting, storage tank are also specifically included. Motor vehicle credit is allowed only on a few vehicles and credit on cars, etc. is available for service providers who use such vehicles like GTA, courier, etc.

Inputs service means services which are used in or in relation to manufacture of final goods or used for provision of service. The definition specifically includes certain services like services used in relation to modernisation, renovation or repairs of a factory or office, advertisement or sales promotion, market research, storage up to the place of removal, procurement of inputs, accounting, auditing, financing,

recruitment and quality control, coaching and training, computer networking, credit rating, share registry, security, business exhibition, legal services, inward transportation of inputs or capital goods and outward transportation upto the place of removal. Further, services such as construction of building or a factory, services relating to insurance, rent a cab services or servicing of motor vehicles and certain services used for personal consumption of employees are kept out of the ambit of input service.

The Rules prescribe guidelines and conditions on the aspects of availment, utilisation and transfer of credit, documentation on the basis of which credit could be availed. Further, rules also provide for a mechanism to avail and utilise the credit where assessee has both taxable and non taxable activities and where the services/goods are received at a place other than factory or registered premises. Apart from this the Rules provide for mechanism to avail refund of credit on goods/services used for export of goods or services and adjustment of credit in the event when goods are manufactured on job work basis.

Disputes on Cenvat Credit

Due to frequent amendments to the provisions of Cenvat rules and also lack of clarity and simplicity in the language employed, these rules have always been a centre of dispute ranging from eligibility of credit on particular type of goods or services to procedural issues relating to documentation on which credit could be availed.

On the aspect of inputs, in numerous cases, the Supreme Court had taken a broader view on the eligibility of credit on the goods as inputs. However, from recent decisions of Supreme Court² it appears that still there is no clarity on the aspect of what constitutes input. Similarly, on the aspect of inputs service, the High Court and Tribunal have interpreted the definition of input service broadly and have

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² Maruti Suzuki case- 2009 (240) E.L.T. 641 (S.C.) and Ramala Sahkari Chini Mills Ltd- 2010 (260) E.L.T. 321 (S.C.)

extended the benefit of input credit on services such as catering, transportation to employee, health insurance to employees, and certain employee welfare activities. On the capital goods front also, wide play has been allowed.

However, in the year 2011, the Government made amendments to restrict the scope of input services and take away credit relating to employee welfare activities. In the light of the move towards the negative list and broad basing service tax, smooth flow of tax credit is an absolute necessity which should not be curtailed by restrictive definitions. However, the amendments made to Cenvat Credit Rules recently on 20-6-2012 fail to achieve the desired objective of having seamless credit.

Cenvat Credit and Impact on Negative List

The concept of negative list: Scheme of taxation of services has undergone a sea change and a new scheme of taxation of services based on negative list (Negative list scheme) is made effective from 1st July, 2012. Under this scheme, any activity for consideration becomes a service unless specified in the negative list. Also, certain activities which are merely a transfer of title in goods or immovable property and transactions in money

would not be liable to service tax. Therefore, now each and every activity which qualifies to be service would be liable to service tax unlike the erstwhile positive list scheme where only certain specific services were taxed.

It is interesting to note that the introduction of negative list scheme is seen as a step towards implementation of Goods and Services Tax (GST) under which tax is proposed to be levied on the value addition at each stage by way of set off through a tax credit mechanism. The seamless credit system would definitely play a vital role in implementing effective GST system.

With the negative list scheme already in place, it would be interesting to analyse whether the present set of definitions of input services would be sufficient to allow the business to keep the Cenvat chain moving.

Amendments to Cenvat provisions in light of negative list scheme: As expected, along with various other Notifications relating to negative list scheme, amendment to Cenvat Credit Rules, 2004 was also brought in. Gist of the important amendment is tabled below:

Amendment to	Summary/impact of amendment								
Capital Goods	<p>Motor vehicle/chassis of motor vehicle would qualify as capital goods for following service providers:</p> <table border="1"> <thead> <tr> <th>Goods transport vehicle</th> <th>Passenger transport vehicle</th> </tr> </thead> <tbody> <tr> <td>a) renting of motor vehicles</td> <td>a) renting of motor vehicles</td> </tr> <tr> <td>b) transportation of inputs and capital goods for provision of taxable services</td> <td>b) Transportation of passengers</td> </tr> <tr> <td>c) Courier agency services</td> <td>c) services of imparting motor driving skills</td> </tr> </tbody> </table> <p>The old scheme of restricting credit on motor vehicles to specified service providers continued. Error in earlier amendment rectified by including dumpers and tippers.</p>	Goods transport vehicle	Passenger transport vehicle	a) renting of motor vehicles	a) renting of motor vehicles	b) transportation of inputs and capital goods for provision of taxable services	b) Transportation of passengers	c) Courier agency services	c) services of imparting motor driving skills
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Inputs	<p>The old scheme of restriction on credit on goods used for construction activity other than by construction/works contract service provider has been continued. The present rule provide as given below:</p> <ul style="list-style-type: none"> ▶ Goods used for construction or execution of works contract of a building or a civil structure or a part thereof. ▶ Goods used for laying of foundation or making of structures for support of capital goods, <p>In other words, goods used for construction of structure other than civil structure which is not used as support structure for capital goods would qualify as inputs.</p>								

³ Stanzen Toyotetsu India (P) Ltd- 2011 (23) S.T.R. 444 (Kar.), Toyota Kirloskar Motor Pvt. Ltd- 2011 (24) S.T.R. 645 (Kar.), Ultratech Cement Ltd. - 2010 (20) S.T.R. 577 (Bom.)z

⁴ Refer Notification No.28/2012 CE NT dt. 20.06.2012

Amendment to	Summary/impact of amendment
Input service	<p>Earlier restriction on restriction relating to credit on construction related activities continued. The amended rules provide that, service portion in the activity of :</p> <ul style="list-style-type: none"> ▶ construction services or service portion in execution of works contract of a building or a civil structure or part of such building or civil structure or in laying of foundation or making of structures for support of capital goods, would not qualify to be input service except for the service provider providing such services. Only relief is that services in relation to construction such as (architect, valuator etc.) are not covered under the restriction. <p>Restriction on availment of credit on renting of motor vehicle, insurance/repair/servicing of motor vehicles, other than by manufacturer or specified service provider continued.</p>
Output service	<ul style="list-style-type: none"> ▶ Any service provided by a provider of service located in the taxable territory but shall not include a service, <ul style="list-style-type: none"> ■ services specified in negative list (section 66D), ■ where the whole of service tax is liable to be paid by the recipient of service
Exempted service	<ul style="list-style-type: none"> ▶ Non taxable services. Means services covered under negative list or services on which no tax could be levied. ▶ taxable services exempted fully or exempted portion of partially exempt services ▶ but does not include service which qualify to be export in terms of Rule 6A of Service Tax Rules, 1994
Utilisation of credit [Rule 3(4)]	Cenvat credit cannot be utilised for payment of service tax as on reverse charge as a recipient of service.
Refund of credit	New rule 5B introduced to allow refund of credit on inputs and inputs service to provider of service(s) on which the recipient of service would be liable to pay service tax.

If one sees the recent amendments made in June 2012 as set out above, one can only say that it is unfortunate that the credit mechanism has not been brought up to date.

Restrictive definitions in credit mechanism: After its amendment in the year 2011 wherein the phrase ‘activities relating to business such as’ was removed, the present definition of input service, appears to be more restrictive. Apart from the services used for providing output service or in relation to manufacture, certain specific services are covered under inclusive part and a list of services is placed in exclusion part. In the backdrop of introduction of negative list to tax each and every activity which qualifies as service, the cascading effect of taxation would certainly go up, where definition of input service is not broad based.

It must be understood that a dynamic business environment does not wait for credit mechanisms to be put into place post facto, a proactive step is needed from the Government. Similarly, government officials

determining what is an input service or input or capital goods should make way for the businessman to define what his necessities are. Therefore, it is essential that the wordings “activities relating to business” should be brought back.

Take for instance, where the company provides accommodation to their staff in a guest house or undertakes air travel for official purposes, whether such services would be eligible as input services is being hotly contested. Credit on such services is being denied on the ground that the same neither has any

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nexus with manufacturing activity nor is specified in the inclusion list. If such is the case, tax paid on these services would definitely get added to the cost of the final product or services, thereby defeating the very purpose of credit mechanism. The above instance is only a simple example and the assessee are facing numerous instances on a day to day basis.

The discussion paper which was issued prior to introduction of negative list, mentioned with examples about breakage of credit chain resulting in increase in cost of the product under the erstwhile scheme of service tax. However, introduction of negative list, without amending the credit provisions to expand the scope definition of input service/inputs or capital goods, would go against the concept and the basis on which this scheme was issued. The new scheme would only be revenue multiplying tool rather than an economic policy moving towards implementation of GST.

Impact of exemptions, abatement and reverse charge mechanism on credit scheme: Similar to the erstwhile scheme, under negative list scheme also, exemption and abatements (partial exemption) are provided to certain category of services. Abatements are provided in respect of services such as supply of food by hotel, transport of passenger, renting of hotels or inns, etc. Some of the abatements are with conditions of not availing credit on inputs, input services and capital goods. However, in certain cases, the exemption is subject to non availment of credit on inputs and capital goods.

Similar to exemption, under first type of abatement scheme (where no credit is allowed), there is complete breakage of credit chain. Under second set of abatement scheme, where credit is allowed only on input services, the assessee availing credit, cannot avail entire amount of service tax paid on input service but would be allowed to avail credit only to the extent of taxable portion based on the service. This is because, exempt services has been defined to include the exempt portion of the services which are partially exempt and applying Rule 6, credit is restricted on proportionate basis.

Because of the abatements/exemption, there is a breakdown in Cenvat chain resulting in cascading effect on the prices of goods and services used by the ultimate consumers.

Artificial barriers which are created under present set of provisions: The present set of provisions is being

interpreted to create artificial barriers on availment or utilisation of credit. For instance on one hand construction activities get taxed but on the other hand the recipient of such services is not able to avail credit of huge taxes paid on such construction activities.

Similarly, in case of credit availed by branch offices and transfer of such credit in terms of Rule 7, recent amendment restricts the transfer of credit either on the basis of utilisation of service or on turnover basis.

It is time that the executive realised that Cenvat is nothing but excise duty. That is how it has been defined under Section 2A of the Central Excise Act, 1944.

Utilisation of Cenvat is nothing but payment of duty. Till recently there was a specific provision, restricting payment of service tax on GTA services by way of utilisation of credit. Now, provisions of rules are amended not to allow utilisation of credit for payment of service tax as a recipient. Though, this amendment would certainly help to contest the past periods, it again restricts the scope of credit. In the case of *Arvind Fashions Ltd*⁵, the High Court has already held that utilisation of credit for payment of import of service is permissible in a case prior to 19-4-2006 when the import rules came on the statute book. There is no reason why the same argument cannot be used for the period after 19-4-2006 also. Realising this, the government should have allowed credit. Unfortunately, the amendment made on 20-6-2012 effective 1-7-2012, debars credit from being utilised for payment of service tax on imported services and the government announces another refund mechanism. As a whole, it appears that the introduction of negative list scheme sans the amendments in the CENVAT Credit Rules to broaden the scope of the credit may not achieve the desired objective of rationalising the tax system.

Conclusion

These are but a few issues and only when the negative list is operationalised would the trade and industry know how it would work. Frequent tinkering with the rules has already lead the Supreme Court to frown upon this practice (*see Maruti Suzuki Ltd Vs. CCE 2009 (240) ELT 641*). It is hoped that the Government stops making unnecessary amendments and focuses on putting in place a credit mechanism which is transparent, simple and without artificial barriers and which allows smooth flow of credit chain along with smooth transition to GST regime. ■

⁵ 2011 TIOL 748 HC