ACHILLES HEEL

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It is more than two decades since the introduction of the Modvat Scheme in the Indirect taxes domain, which is now rechristened as the Cenvat Scheme. This scheme is intended to offset the cascading effect of taxes / duties. If 10th September 2004 is a "D- day" in the annals of Cenvat scheme, when cross sectoral credit between duties of excise and service tax was allowed to manufacturers and service providers, 1st March 2006 shall be the "Black day" in the Cenvat history, when the basic intention of offsetting the cascading effect is given a jolt by the Budget dynamite "Notification 1/2006". In a salutary proposition, all and sundry Notifications providing for such abatements for different categories of taxable services, have now been placed under one single Notification, 1/2006 Dated 01.03.2006. Though, it is the first Notification of the year, it doesn't seem to be the best!

Considering the peculiar nature and content of the various taxable services provided, certain abatements have been prescribed by the Government, by way of exemption Notifications, so as to arrive at the value of taxable services. The basic idea behind such provision is to exclude from the amount received by the service provider, of such amounts, which are not attributable for the services rendered. As the value of taxable service can only be the value received for rendering such service, any amount received for any other purpose, has to be excluded from the value of taxable service and these Notifications provided for the same.

As already stated, the logic of providing for such abatements is an attempt to levy service tax only on the consideration attributable to the service, after excluding the consideration meant for any other purpose. Such exclusions may be either on the basis of prescribed percentages fixed by the Government as per various Notifications, or on the basis of actuals, as per Notification 12/2003 ST Dated 20.6.2003 (which excludes the value of materials and goods sold during the course of service for the purposes of payment of service tax). It is also relevant to note that the availment of Notification 12/2003 or other Notifications prescribing abatements is **mutually exclusive.** In other words, the benefits sought to be conferred by these two types of Notifications are akin and they intend to provide the same result. As such, it can be safely concluded that the exclusion from gross amount is only towards the value of materials used / sold during the course of service.

For the sake of this article, let us take the case of a "construction service" provider, be it commercial construction or construction of a residential complex. It is a common fact that the amount charged by a construction service provider also includes the value of cement, steel, etc. used by him, apart from his "service charges". Notification 12/2003, the applicability of which is universal, provides for exclusion of the value of goods sold during the course of providing the service, from the value of taxable service. But, it would be highly impracticable for a construction service provider, to separately indicate the sale value of cement, steel and other goods used by him, while constructing for his client. Accordingly, a notional 67 % abatement has been provided for in respect of such construction services, by way of Notification 15/2004 ST Dated 10.09.2004 (commercial construction) and Notification 18/2005 ST Dated 07.06.05 (residential construction).

When the value of goods sold during the course of provision of service are thus excluded from the value of taxable service, either at actuals (Notification 12/2003) or on the basis of prescribed percentage (67% - Notifications 15/2004 or 18/2005), the said excluded value would not at all attract the levy of service tax. As already stated, the excluded value

represents only the value of goods and materials used while providing the service. Hence, there is no reason to allow Cenvat credit of duties of excise paid on such goods/materials, as there could be **no cascading effect,** in such cases. Accordingly, all the above Notifications contained a condition to the effect that the benefit of Cenvat credit shall not be claimed in respect of the goods and materials sold during the course of providing the service, when the benefit of any of these notifications (supra), are claimed. **But, none of the above Notifications, prohibited the availment of Cenvat credit on input services**.

Now comes the dynamite! While consolidating the abatements under one roof, the Government has either intentionally or inadvertently, has now introduced a prohibition in respect of the availment of Cenvat credit on input services also! This silent prohibition has come as a rude shock to the entire construction industry and all their tax planning has become topsy turvy.

In this connection, the following complications are foreseen for the construction industry. In construction industry, sub contracting (Back-to-Back out sourcing) is a common phenomenon. If a construction contract is awarded to "A" for Rs. 100 Crores, "A" would sub contract the entire contract to "B", for say, Rs.90 Crores. As the taxable service in case of construction activities is the services rendered **by any person to any other person**, both "A" and "B" would be liable to pay service tax under the same head of "construction services". Hitherto, in such cases of back-to-back contracts, "A" would avail the Cenvat credit of the service tax paid by "B" (as an input service), eventhough "A" opts to claim 67% abatement. With the advent of Notification 1/2006, a chaotic situation emerges. Now, when "A" opts to pay service tax on 33 % of his gross amount, as per Notification 1/2006, the service tax paid by "B", cannot be availed as Cenvat credit by "A". The resultant anomaly can be better portrayed in the following table, with reference to the above example:

Details.	**If "B" chooses to avail Cenvat Credit and pay service tax on total amount.**	**If "B" chooses not to avail Cenvat credit and claim 67 % abatement.**
Value of taxable service for "B"	Rs.90 Crores.	Rs.29.7 Crores.
Service Tax payable by "B" (10.2%)	Rs.9.18 Crores.	Rs.3.03 Crores.
Let us assume that "A" opts to claim 67 % abatement. Hence, he cannot avail Cenvat credit of the service tax charged by "B".		
Value of Taxable service for "A"	Rs. 33 Crores.	Rs.33 Crores.
Service Tax payable by "A" (10.2%)	Rs.3.37 Crores.	Rs.3.37 Crores.
Total amount for which service tax is paid in the given transaction.	**Rs.123 Crores.** (Rs. 90 Crores + Rs. 33 Crores)	**Rs.62.7 Crores.** (Rs.29.7 Crores + Rs.33 Crores)
Total service tax in the given transaction.	**Rs.12.55 Crores.** (Rs.9.18 Crores + Rs.3.37 Crores)	**Rs.6.4 Crores.** (Rs.3.03 Crores + Rs.3.37 Crores)

It may be observed from the above, though the contract value itself is only Rs.100 Crores, in the first case, service tax is charged on Rs.123 Crores and in the second case, as against Rs.33 Crores (33 % of Rs.100 Crores), service tax is being charged on Rs.62.7 Crores. Is it not double taxation? What will happen if "B" further sub contracts to "C" once again on back-to-back basis for Rs.80 crores? (In this connection, we pause to add that the CBEC clarification that sub contractor need not pay service tax if the main contractor pays service tax, would apply only in those cases where the taxable service is the service provided to the "client". Moreover, the services rendered by "B" in this case would be classified only under "Construction service" and not under "Business Auxiliary Service", as per Section 65 A of the Finance Act, 1994).

Notification 1/2006 is effective from 01.03.2006. In other words, whenever the benefit of 67 % abatement is sought for the services rendered after 01.03.2006, it shall be ensured that no Cenvat credit is taken in respect of the input services consumed, while rendering such service. This can be complied with no difficulty, in respect of those input services, which are going to be consumed after 01.03.2006. In other words, the service provider may stop availing Cenvat credit on his input services, completely, w.e.f 1/3/06. But, there are several cases, where the input services are of continuous nature. For example, the construction service provider might have availed the services of an Architect, who would have charged service tax. The services rendered by the Architect are for the entire construction. The service provider might have availed Cenvat credit of the service tax charged by the Architect and might have even already used it against payment of his service tax liabilities. When, the construction is only partly complete, as on 01.03.2006, in respect of the bills to be raised by him after 01.03.2006, as per the conditions of Notification 1/2006, he should not have availed Cenvat credit of input services used by him for rendering his service. In the instant case, Cenvat credit on the input service, viz., Architect has already been availed. Such input service also pertains to the construction done after 01.03.2006. In such cases, we feel that the department would insist for reversal / re-payment of proportionate credit, already availed on Architect Services. This is just only the tip of the iceberg and imagine the host of other services, credit in respect of which would have been availed already and the benefit of the same would continue till the completion of the construction.

To conclude, the innocuous amendment in the Notification is nothing short of dynamite, in terms of its effects and consequences.

Before parting….

The restriction imposed vide Notification 1/2006, is only to the effect that no Cenvat credit shall be availed, in respect of the input services consumed for rendering the output service. In other words, the credit availed and available as a balance, in respect of the input services already consumed (which has already been used and hence would not be used after 01.03.2006, for example, credit in respect of the telephone bill for the month of January 2006), is not subject to the restriction and such Cenvat credit can be used to discharge the liability, pertaining to the period after 01.03.2006. But, the moot question is, as to how, the Cenvat credit balance as on 01.03.2006 can be segregated into two, viz., which is liable to be reversed (Cenvat credit attributable to the input services, which will be consumed after 01.03.2006, for which payment has already been made and credit availed) and which is eligible for utilization against service tax liability (Cenvat credit attributable to the input services which are already consumed and will not be consumed after 01.03.2006).