

Are Point of Taxation Rules Constitutionally Valid? – Nov 15, 2011

THE Point of Taxation Rules, 2011 ('POTR') have effectively come into operation from July 1, 2011. These Rules contain some of the harshest, obnoxious and most impracticable provisions concerning services which have been classified under 'continuous supply of services'. The three services directly concerning the Realty Sector, viz. Works Contract services, Construction of complex services and Commercial or Industrial Construction services, have been brought under the concept of 'continuous supply of services'. As per Explanation 1 to Rule 6 of the POTR, where the provision of the whole or part of the service is determined periodically on the completion of an event in terms of a contract, which requires the service receiver to make any payment to service provider, the date of completion of each such event as specified in the contract shall be deemed to be the date of completion of provision of service. With specific reference to the Realty Sector, in terms of the explanations to Rule 6 of the POTR, the implication is that, where the construction agreements entered into by the Realty Developers and Builders provide for specific dates related to the completion of the events, (for example...laying of slab is an event) requiring the customers to make payments, then, such dates would be deemed to be date of completion of each such event,irrespective of the actual date the event is completed.

Thus, for example, if a construction agreement states that, a payment of Rs20 lacs is to be made by the customer, on November 15, 2011, on the expectation/premise that the first slab would have been laid by that time, the date of completion would be deemed to be November 15, 2011 or the date of receipt of the payment, whichever is earlier, irrespective of whether the slab has been laid or not. In a hypothetical situation, assuming that, no construction activity has started in respect of this particular agreement, the date of completion of the event would still be November 15, 2011, triggering the service tax liability accordingly.

These are draconian provisions, in as much as, the service tax liability would get triggered on the basis of dates mentioned in the construction agreement, notwithstanding the fact that, no construction activity might actually have commenced. In the example that we have discussed above, the Developer/Builder would also be required to raise invoices within 14 days of the dates mentioned in the invoice. Non-raising of invoices within 14 days would trigger prosecution proceedings under Section 89 of the Finance Act, 1994. The horror story does not end here. Raising of an invoice for service tax purposes could also trigger the liability to VAT, as per most VAT laws, as raising of an invoice would be one of the situations attracting tax liability.

As per Rule 3 of the POTR, the service tax liability would arise on the earliest of the following three occurrences:

- *Raising of an invoice for service provided or to be provided, provided that where the invoice is not issued within fourteen days of the completion of the provision of the service, the point of taxation shall be date of such completion.*
- *Date of actual receipt of the money, to the extent of such receipt, if this date is earlier to the time specified in the above clause.*
- *Date of receipt of an advance, to the extent of this advance money.*

Now, it is clear that, the service tax liability would arise in a case, where an invoice is raised even when no service has actually been provided, as aforesaid.

One can see that the similarity between Rule 3 of the POTR and the provisions contained in the VAT laws. For instance, Section 7 of the Karnataka Value Added Tax Act, 2003, reads as follows:

7. Time of sale of goods.-

1. Notwithstanding anything contained in the Sale of Goods Act, 1930 (Central Act 3 of 1930), for the purpose of this Act, and subject to subsection (2), the sale of goods shall be deemed to have taken place at the time of transfer of title or possession or incorporation of the goods in the course of execution of any works contract whether or not there is receipt of payment:

provided that where a dealer issues a tax invoice in respect of such sale within fourteen days from the date of the sale, the sale shall be deemed to have taken place at the time the invoice is issued.

1. Where, before the time applicable in sub-section (1), the dealer selling the goods issues a tax invoice in respect of such sale or receives payment in respect of such sale, the sale shall, to the extent that it is covered by the invoice or payment, be deemed to have taken at the time the invoice is issued or the payment is received.

It is then clear that the service tax law is following the VAT law, in so far as the timing of the rendering of services is concerned. However, with specific reference to the services covered under 'continuous supply of services' the POTR goes several steps forward, as contrasted to the VAT law, to levy tax on the basis of agreements signed. The POTR, as they deal with provisions related to 'continuous supply of services' are largely impractical and are impossible to be followed, if the experience over the last three months is any indication. This would leave the Realty Sector, with no choice, except, perhaps, to challenge the constitutional validity of these Rules.

The Point of Taxation Rules, 2011 ('POTR') have been issued under Section 94(2)(hhh) of the Finance Act, 1994, which authorises the Government to make rules for the date for determination of rate of service tax and the place of provision of taxable service. Per se, these Rules go much beyond the mandate given to the Central Government under Section 94. Taking this discussion further.....as per Section 68 (1) of the Finance Act, 1994, the charging section, every person providing taxable service to any person shall pay service tax at the rate specified in Section 66 in such manner and within such period as may be prescribed. It is clear that the provisions contained in the POTR go much beyond the mandate given by Sections 68 .

Given the fact, as aforesaid, that the POTR goes beyond the VAT law, it would be interesting to know that the Courts have heavily come down on the provisions in the VAT laws, asking for sales tax to be paid on advance amounts received, without the transfer of property in goods having occurred. In *Consolidated Coffee Board Ltd v. Coffee Board, Bangalore (2002-TIOL-678-SC-MISC)* and *Installment Supply Ltd v. Sales Tax Officer, Ahmedabad-I (1974) 34 STC 65 (SC)*, it has been held by the Hon'ble Apex Court that under the sales tax law that, by fixing by legal fiction, the taxable event as the point of time of receipt of advance payment or issue of tax invoice, much before the goods are incorporated into the property of the contractee or ownership/possession of the goods involved in transferred to the contractee, would amount to subjecting a transaction of unfructified sale of goods or taxing an agreement to sell goods and hence, is unconstitutional. In a recent landmark case, viz. *Nagarjuna Construction Company Limited, Bangalore v. State of Karnataka and Others* reported in 2010(69) Kar.L.J. 97 (HC), the Division Bench of the Karnataka High Court has struck down Section 7 of the KVAT Act and has held that, "this Section, which creates a legal fiction that a transaction of sale is completed for the purposes of the Act when payment is received as advance is akin to bringing to tax, an agreement to sell goods, even before the property in the goods passes to the buyer". While delivering this decision, the Hon'ble Karnataka High Court had also gone into the validity of the Explanation to Section 3 of the Karnataka VAT Act, 2003, which requires the works contract to include any amount received as advance, as part of the consideration for transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract, in the month, in which in which execution of such works contract commences and has held this Explanation to be unconstitutional.

Moreover, we must bear in mind that, while Sections 7 and 3, dealing with the time and sale of goods are part of the Karnataka VAT Act itself and therefore, stand on a much firmer legal ground, as contrasted to the Point of Taxation Rules, 2011 which would seem to stand on shaky grounds, having to derive their legal sanctity from the Finance Act, 1994. This is especially so, as there is no provision under the VAT law to levy tax on the basis of agreements signed, which as we discussed, is more draconian that requiring VAT to be paid on advances received.

Before concluding ...

In my opinion, there is a very strong case for challenging the constitutional validity of the Point of Taxation Rules, 2011 before the High Courts, under Article 226 of the Constitution. The Realty Sector, especially, would be well advised to challenge these Rules, rather than trying to do the impossible. Reliance can be had on the decision of the Supreme Court in CIT v. B C Srinivasa Shetty (1981)128 ITR 294, wherein, the taxing provision (related to taxation of capital gains) was struck down on account of its impracticability.