Associated enterprises' provisions open up pandora's box! – May 27, 2008

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IN terms of the very recent amendment carried out to Section 67 of the Finance Act, 1994 through the Finance Act 2008, service tax is now required to be paid by the person liable to pay service tax on the taxable services provided even if the consideration for the taxable services provided is not actually received by him. In such cases, service tax is required to be paid immediately after crediting/debiting of the amount in the books of accounts of the service provider or receipt of payment, whichever is earlier. Thankfully, this provision is restricted to transactions between 'associated enterprises' and has come into force with effect from 10th May, 2008, in terms of Notification No. 19/2008-Service Tax dated 10.05.2008. Explanation (c) to Rule 6(1) of the Service Tax Rules, 1994 introduced thro' Notification No. 19/2008 reads as follows:

"For the removal of doubts, it is hereby declared that where the transaction of taxable service is with any associated enterprise, any payment received towards the value of taxable service, in such case shall include any amount credited or debited, as the case may be, to any account, whether called 'Suspense account' or by any other name, in the books of account of a person liable to pay service tax.";

After this insertion of the above wordings the definition for "gross amount" reads as follows:

"gross amount charged" includes payment by cheque, credit card, deduction from account and any form of payment by issue of credit notes or debit notes and book adjustment, and any amount credited or debited, as the case may be, to any account, whether called "Suspense account" or by any other name, in the books of account of a person liable to pay service tax, where the transaction of taxable service is with any associated enterprise.

As is known, the concept of 'associated enterprise' has been borrowed from Section 92A of the Income tax Act, 1961 where the term has been used in connection with international transactions. Of course, it would have been better if this term had been defined in the Finance Act 1994 in the context of the service tax law.

It's clear that this concept has been brought in to check evasion of service tax by associated enterprises, who render/receive taxable services between themselves and settle dues arising there from, thro' debit/credit notes and other accounting transaction, as has clearly been brought out, in the Finance Ministry's Letter D.O.F. No. 334/1/208-TRU dated February 29, 2008. Perhaps, the Government justifiably feels that some of these companies are avoiding payment of service tax on the basis that no receipt/payment gets effected in respect of these inter-Group transactions despite that the service provider and the service receiver recognize these transactions in their accounting statements as services provided and services receives, respectively and the concept of 'Suspense Accounts', as is well known, is a practice widely followed between Associated Enterprises.

There has been no corresponding amendment in the Export of Services Rules, 2005 vis-à-vis exported services, in respect of transactions between Associated Enterprises. Given the fact that the provisions of Section 67 of the Finance Act 1994, as amended, incorporating the provisions related to Associated Enterprises would prevail over the Export of Services Rules, 2005. Hence, the AE concept would cover export transactions, as well.

Perhaps, as an example of a classical and perhaps unintended drafting error, the amendment to Section 67 talks of "any amount" rather than "any amount towards the value of the taxable service" which have been used in the Notification No. 19/2008. Surely, the language used in the Act would prevail and one can look forward to a lot of trouble in this area as the Department is bound to levy tax on any inter-Group transactions between Associated Enterprises, despite that no taxable services have been provided.

While one completely understands the mind of the Government on this issue, in the process of removing an anomaly, it would seem that a lot of other unconnected issues will come out of the proverbial Pandora's box I've tried to highlight some of these potential bombshells waiting to explode by analyzing a bunch of typical transactions between Company 'A' and Company 'B', Associated Enterprises.

Example 1 : Company 'B' had given a loan of Rs 1 crore to Company 'A' in 2006. Company 'A' renders taxable services to Company 'B' in 2008 for Rs 1.5 Crores, let's say, on May 31, 2008. Company 'A' passes an entry debiting Company 'B' for Rs 1.5 Crores on May 31, 2008 towards the taxable services rendered. Courtesy the new amendment Company 'A' would be liable to pay service tax on Rs 1.5 Crores on May 31, 2008.

Example 2 : Company 'A' is the Indian Subsidiary of its parent Company 'B'. Company 'A' exports software services to Company 'B' on an agreed payment term involving a 6 month credit and the export transaction fulfils all the conditions laid down by the Export of Services Rules, 2005, making these software services exports, exempted services. On the assumption that Company 'A' raises monthly invoices on Company 'B' for its software services exports, in my opinion, Company 'A' would be liable to pay up service tax as of the date of its invoices despite that service tax is not to be paid on exported services. Perhaps, Company 'A' can take recourse to the refund provisions as and when it receives payments from Company 'B'. A daunting prospect indeed for Indian Subsidiaries of MNCs.

Example 3 : Company 'A' and Company 'B' transfer funds between themselves, as part of the corporate financing strategy of the Group they belong to. Accordingly, Company 'A' lends Rs 1 crore to Company 'B' on May 31, 2008, which is returned by Company 'B' on September 30, 2008. Though, the lending of funds would be an exempted service within the meaning of the service tax law, in terms of the existing methodology, Company 'A' would be liable for service tax on Rs 1 crore on May 31, 2008 with Company 'B' becoming liable for service in respect of the same amount of Rs 1 crore returned to Company 'A' on September 30, 2008.

To part with ……

• *The Government could save a lot of heartburn if it amends Section 67 on the lines of the language used in its Notification No. 19/2008 to include only taxable services. This would save a lot of time for the assessees, the Department and the Tribunals.*

• *Industrial Groups would have to come out with ingenious plans to beat the levy of service tax in respect of transactions between their Group concerns. Perhaps, the fact that it is only the accounting entries in the books of account of the service provider and not those of the service receiver which determine the leviability of service tax should throw up some guesses.*

• *With service tax being levied on the service providing Associated Enterprise, the service receiving Associated Enterprise would have to look at availing of cenvat credit as the provisions of the Cenvat Credit Rules, 2004 do not allow cenvat credit availment unless the prescribed documents are issued. Perhaps, one plan would be to have the service providing AE to use a separate GAR-7 challan which can be used by the service receiving AE to avail cenvat credit.*