

How Changes in Cenvat Credit Scheme will affect IT Industry – March 21, 2011

The cenvat credit scheme has seen some very major changes, in this Budget. In terms of Notification No. 3/2011-Central Excise (N.T.) dated March 1, 2011, the Government has effected some major fundamental changes in the cenvat credit scheme, which would drastically affect Industry in general and the IT sector, in particular. This paper is an attempt to look at some of the cenvat credit related issues particularly concerning the IT sector.

New Definition of “Inputs”

The existing definition of “inputs”, as contained in Rule 2(k) is being substituted with a brand new definition, which reads as follows:

(k) “input” means–

(i) all goods used in the factory by the manufacturer of the final product; or

(ii) any goods including accessories, cleared along with the final product, the value of which is included in the value of the final product and goods used for providing free warranty for final products; or

(iii) all goods used for generation of electricity or steam for captive use; or

(iv) all goods used for providing any output service; but excludes-

(A) light diesel oil, high speed diesel oil or motor spirit, commonly known as petrol;

(B) any goods used for-

(a) construction of a building or a civil structure or a part thereof; or

(b) laying of foundation or making of structures for support of capital goods, except for the provision of any taxable service specified in sub-clauses (zn), (ztl), (ztl), (zzq), (zzh) and (zzza) of clause (105) of section 65 of the Finance Act;

(C) capital goods except when used as parts or components in the manufacture of a final product;

(D) motor vehicles;

(E) any goods, such as food items, goods used in a guesthouse, residential colony, club or a recreation facility and clinical establishment, when such goods are used primarily for personal use or consumption of any employee; and

(F) any goods which have no relationship whatsoever with the manufacture of a final product.

New definition of “Input Service”

The existing definition of “Input Service”, as contained in Rule 2(l) is being replaced with a new definition, which reads as follows:

(l) “input service” means any service, -

(i) used by a provider of taxable service for providing an output service; or

(ii) used by a manufacturer, whether directly or indirectly, in or in relation to the manufacture of final products and clearance of final products upto the place of removal, and includes services used in relation to modernisation, renovation or repairs of a factory, premises of provider of output service or an office relating to such factory or premises, advertisement or sales promotion, market research, storage upto 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;

but excludes services,-

(A) specified in sub-clauses (p), (zn), (zsl), (zzm), (zzq), (zzzh) and (zzzza) of clause (105) of section 65 of the Finance Act (hereinafter referred as specified services), in so far as they are used for-

(a) construction of a building or a civil structure or a part thereof; or

(b) laying of foundation or making of structures for support of capital goods, except for the provision of one or more of the specified services; or

(B) specified in sub-clauses (d), (o), (zo) and (zzzj) of clause (105) of section 65 of the Finance Act, in so far as they relate to a motor vehicle except when used for the provision of taxable services for which the credit on motor vehicle is available as capital goods; or

(C) such as those provided in relation to outdoor catering, beauty treatment, health services, cosmetic and plastic surgery, membership of a club, health and fitness centre, life insurance, health insurance and travel benefits extended to employees on vacation such as Leave or Home Travel Concession, when such services are used primarily for personal use or consumption of any employee;”

How these changes in the definitions of “Inputs” and “Input Services” could affect IT Industry?

- The main purpose behind the new cenvat credit rules is to restrict the meaning of “inputs” and “input credits”, in order to ensure that the cenvat credit availment is restricted. This is also an attempt by the Union Government to statutorily overrule the decisions of the various High Courts and the Supreme Court, which have taken a rather broad view, in terms of allowing cenvat credit.
- Under the current cenvat credit rules, service providers can avail of cenvat credit, of the service tax paid on ‘input services’ which are used in relation to business. Moreover, the usage of the words ‘such as’ in the current definition, has led to the Courts interpreting the concept of ‘input services’ in a very broad manner, as aforesaid. For instance, the Bombay High Court, in the Coca Cola case and the Ultra Tech Cements case had taken the view that ‘input service’ would cover not only services which are directly or indirectly used in or in relation to the manufacture of the final products but also would include services used in relation to the business. Service providers were relying on these decisions, as the benefit of the expanded version of ‘input services’ is also available to services providers. Now, with the new definition of ‘input services’ not using the words ‘in relation to business’ or ‘such as’, cenvat credit would be available only for input services, which are used for providing the output service. Thus, the service provider, including the companies in the IT industry, would now have to establish the nexus between the input service and the output service. Thus, it would no longer be possible for the service provider to justify the availment of

the cenvat credit, on the basis that the input service is used for the business. The service provider would now have to justify that the input service is used for providing the output service.

- The new definition of 'input services', in its excluding part, covers services 'such as' outdoor catering, beauty treatment, health services, cosmetic and plastic surgery, membership of a club, health and fitness centre, life insurance, health insurance and travel benefits extended to employees on vacation such as Leave or Home Travel Concession, when such services are used primarily for personal use or consumption of any employee. It is now clear that, with the usage of the words 'such as' in the excluding part, cenvat credit would not be available on input services which are primarily used for employee welfare or for the consumption of the employees. Apart from the services listed in the definition, the Department would now try to deny credit even in respect of the other input services, where the Department feels that these are employee oriented. In a typical case like renting services, the Department might seek to deny credit in respect of the portion of the rent, which is attributable to the garden, gym, canteen, swimming pool, etc., being employee welfare related.
- Cenvat credit on rent-a-cab services, Sodexho passes, etc., would now be disallowed. This is rather unfortunate considering the fact that, BPO companies are statutorily required to provide cabs for their employees, under certain circumstances, including for night stay.
- The tragedy arising out of the new definition is that, the excluding part of the definition of 'input services' uses the words 'such as', while, under the existing definition of 'input services', these words are used in the inclusive part. The Courts have held that when the statute uses the words 'such as', the list that follows these words are merely illustrative. Hence, under the new dispensation, the excluding part of the definition could also include services which are not specifically mentioned.
- In terms of the new definition, IT companies cannot now avail of cenvat credit, in respect of the duty paid on inputs and the service tax paid on input services, in relation to the construction of the office premises, as against the current position that allows cenvat credit on construction of office premises.
- THESE CHANGES WOULD DRASTICALLY AFFECT THE INFORMATION TECHNOLOGY INDUSTRY, MUCH MORE THAN ANY OTHER INDUSTRY, AS THE IT INDUSTRY SPENDS SIGNIFICANT AMOUNTS ON EMPLOYEE RELATED EXPENSES

Expansion in the scope of Exempted Services would also affect IT companies

Clause 2(e) of the Cenvat Credit Rules, 2004 ('CCR'), which defines 'exempted services' has undergone a major change, under the Budget. The revised definition of 'exempted services', to take effect from April 1, 2011, reads as follows (the amendment brought about by the Budget is given in an italicized form :

"exempted services" means taxable services which are exempt from the whole of the service tax leviable thereon, and includes services on which no service tax is leviable under section 66of the Finance Act, 1994 and taxable services whose part of value is exempted on the condition that no credit of inputs and input services, used for providing such taxable service, shall be taken.

Explanation.- For the removal of doubts, it is hereby clarified that "exempted services" includes trading".

The treatment of 'trading' as 'exempted services' would affect IT companies, which trade in software licenses, including the companies which sell imported software licenses. The value of 'exempted services' would be the selling value less the purchase value. These companies would now be required to reverse cenvat credit, to the extent attributable to the exempted services, in terms of Rule 6(3) of the Cenvat Credit Rules, 2004. This new definition is clearly aimed at getting over the consequences arising out some Tribunal decisions, which have held that, 'trading' is not an exempted service. This development could drastically affect assesseees with a significant trading turnover, as, cenvat credit would now have to be reversed to the extent of the trading margin.

The new definition of 'exempted services' could also, perhaps, include companies providing annual maintenance services/contracts and where, exemption is claimed in respect of the value of the goods, under Notification No. 12/2003.

Deletion of Rule 6(5) would also affect IT sector

One of the major amendment proposed in the Budget is the deletion of Rule 6(5) of the Cenvat Credit Rules, 2004, with effect from March 1, 2011. Under Rule 6(5), there was no need to reverse the credit in respect of the 17 input services specified therein, so long as these input services were not exclusively used to provide exempt output services. This list

included Commercial or Industrial Construction services and consequently, IT companies setting up their own facilities/development centres could avail of cenvat credit of the service tax paid to their contractors. With the deletion of Rule 6(5), this is no longer possible.

Are the amendments to the cenvat credit scheme prospective or retrospective?

In terms of the language used in the Budget related statutory provisions, it is very clear that the new definitions of 'inputs', 'input services' and 'capital goods' are prospective in nature. Hence, one unintended benefit arising out of these developments is that, cenvat credit related to the employee welfare expenses/input services, cannot be denied for the period prior to April 1, 2011. This stand can be taken by the IT companies, which are fighting cases at the adjudication and appellate levels, as a strong additional ground.

The Budget does not deal with the refusal of Department to grant refunds

The Budget does not deal with the refusal of the Department to grant refund of the unutilized cenvat credit, to the services exporters. It is a very well known fact that, despite the numerous circulars and notifications and statutory amendments, the Departmental Officers are just not granting refunds of the unutilized cenvat credit. Instead of tackling this issue, head on, the Government has thought it fit to announce a duty drawback scheme, the details of which are yet to be announced. It does seem that this scheme is only for exporters of goods and not for exporters of services. This was the view which was expressed in the post Budget seminars attended by the Revenue officials. To leave out services exporters from the duty drawback scheme would be most unfair, especially, when the current scheme is just not working.

Before concluding....

It would seem that the Finance Minister has singled out the IT sector for some rough treatment in this Budget, whether it is the refusal to renew the tax holiday scheme or the drastic amendments in the cenvat credit scheme. This seems rather unfortunate and uncalled for, given the fact that the IT sector has been mightily contributing to the national cause by consistently posting impressive growth rates.