Making sense of expanded definition of Exempted Services – AUG 16, 2011

IF there is one area which has seen a lot of negative changes in the FY 2011-12 Budget, it is the cenvat credit scheme, without a doubt. Of particular interest in the changes brought about in the concept of 'exempted services'.

Clause 2(e) of the Cenvat Credit Rules, 2004 ('CCR'), which defines 'exempted services' has undergone a major change with effect from April 1, 2011. The revised definition, 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 66 of 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 concept involving 'exempted services' assumes a great significance, from the point of view of cenvat credit, as, under Rule 6(3) of the Cenvat Credit Rules, 2004, the cenvat credit attributable to the value of 'exempted services' would need to be reversed, in cases where the assessee has not maintained separate books of accounts. Alternatively, the assessee is required to pay service tax at the prescribed rates, on the value of the exempted services, if he does not want to reverse the proportionate cenvat credit.

The Government would seem to believe that, with the value of a taxable transaction, on which, service tax is not levied, wholly or partially, would need to get treated as 'exempted services'.

Be that as it may…. this is what, the Board Circular D.O.F. NO. 334/3/2011-TRU, DATED 28-2-2011 has to say, about the expanded definition of 'exempted services', in Paras 1.12 and 1.14:

1.12 Similarly the definition of exempted services shall include taxable services which are partially exempted with the condition that no credit of input and input service shall be availed. Moreover it has been clarified that exempted service will include trading service.

1.14 The amount payable under rule 6(3)(i) in respect of services has been reduced from 6% to 5%. Moreover in the case of exempted services (that are partially taxed with no facility of credits) this amount shall be 5% of the exempted value of the service. Thus if the exemption on a certain service is 60%, the amount required to be paid shall be 3% (60×5%) of the full value of the service.

It seems that all services in respect of which, abatement is claimed (in terms of Notification No. 1/2006-ST dated March 1, 2006, as amended from time to time) would now get treated as 'exempted services', as per the expanded definition. Thus, Mandap Keeper's services, Construction of Complex services, Commercial or Industrial Construction services, Rent a cab services, Transport of goods by road in a goods carriage services, Catering services, etc. where abatement is allowed subject to the condition that cenvat credit is not availed, would all be now treated as 'exempt services'. It is ironical that, when cenvat credit cannot be availed by service providers who have opted for the benefit of Notification No. 1/2006, there is a further need to reverse cenvat credit even on the common services to the extent of the value of the exempted services (in this case, 67%).

But, the more important question is, whether, service providers who avail of the benefit of Notification No. 12/2003-ST dated June 20, 2003, be treated as providing 'exempted services'? My strong response is a stronger 'No'.

Firstly, there is no stipulation under Notification No.12/2003 that, cenvat credit should not be taken on input services. This is clear from the Proviso to Notification No. 12/2003 which reads as follows:

"Provided that the said exemption shall apply only in such cases where-
(a) no credit of duty paid on such goods and materials sold, has been taken under the provisions of the Cenvat Credit Rules, 2004; or
(b) where such credit has been taken by the service provider on such goods and materials, such service provider has paid the amount equal to such credit availed before the sale of such goods and materials.".
Secondly, can a transaction which is a sale or a deemed sale (like transfer of right to use goods) on which, sales tax/VAT is paid/payable, be treated as an 'exempted service' in respect of which, there is a part exemption from the levy of service tax on the value of the 'taxable service' represented by the value of goods? The Government would indeed seem tothink so, in terms of the expanded definition of exempted services. But, is this view legally sustainable? My response is again, a strong 'No'.

The Apex Court has repeatedly held, in many cases, that, the words 'goods' would have to be understood in contra-distinction to the word ' services', including in All India Tax Practitioners Association v. Union of India ***(2007-TIOL-149-SC-ST)***
Even the Board has accepted this position of law in its Master Circular No. 96/1/2007-ST dated August 23, 2007, wherein, it is stated, in Reference Code No. 036.03 that, service tax is not leviable on a transaction treated as sale of goods and subjected to the levy of service tax/VAT. Though this view has been given in the context of sale of spare parts by a service station, the benefit of this view is applicable to all cases involving sale of goods by a service provider.

Will the Explanation that 'exempted services' includes trading, brought about by the amendment effective from April 1, 2011, be legally sustainable? Here again, my response is a strong 'No'. A transaction in goods cannot be treated as a service, by any stretch of imagination. And, if a transaction is not a service at all, there is no logic to treat it as an 'exempted service'.

It would seem that, the including of trading as an exempted service, has been prompted by the decisions of the Tribunals in *Orion Appliances Ltd v. CST* ***(2010-TIOL-752-CESTAT-AHM)*** and certain other decisions.
Another interesting issue, which has not been addressed by the expanded definition of 'exempted services', is whether, a service can be treated as an exempted service, prior to the date of introduction of the service tax levy on that service. The Department would seem to have diagonally contradicting views, on this subject matter. I've seen the Department taking a view, from the stand point of denial of cenvat credit, that a taxable service is to be treated as an exempted service, prior to the date of the commencement of the service tax levy. In some cases, especially in respect of the periods prior to April 1, 2008 when the new Rule 6(3) came into effect in the Cenvat Credit Rules, 2004, the Department has taken a view that, a service can be treated as an exempted service only when it is exempted by a Notification. Well…. my view is that, a transaction becomes a 'service' only when it is notified to be a taxable service and hence, there is no logic to hold that, all transactions are exempted services, till such time, they are notified to be taxable services.

Lastly, will 'exempted services' cover works contractors, who have opted for the 'Composition Scheme'? By no stretch of imagination, Sir. T he Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007, notified vide Notification No. 32 of 2007-ST, dated May 22, 2007, made effective from June 1, 2007, provides for an option whereby the service provider can opt to pay service tax equivalent to 4 per cent of the total value of the works contract instead of paying service tax at the rate specified in Section 66. There is no prohibition on availment of cenvat credit under the Composition Scheme and consequently, the concept of 'exempted services' cannot expand its tentacles to works contractors who have opted for the Composition Scheme.

Before parting…

Despite the obvious intentions of the Government to bring in sales transactions into the concept of 'exempted services' and thereby deny cenvat credit or alternatively extract service tax on these sale transactions by treating them as 'exempted services', the expanded definition is likely to meet a lot of challenges on the judicial front. How can the value of the goods sold/transferred in a composite transaction like a works contract, which is a subject matter of levy under the sales tax/VAT law, be treated as a transaction involving a service and how can the Central Government assume powers to tax/exempt this value of the transaction which falls under the purview of the States to levy taxes? Will this not be a case of the Centre stepping into the shoes of the States?

Service providers who opt for the Composition Scheme under the Works Contract services are safely outside of the mischief of the expanded definition of 'exempted services'. Similarly, service providers who opt for the benefit of Notification No. 12/2003 would also seem to be safe, but the Department is unlikely to take a pro-industry view, vis-à-vis Notification No. 12/2003.

Developers and Builders, who continue to go under Notification No. 1/2006 would have to forego large chunks of cenvat credit on the common input services post April 1, 2011. They would be well advised to opt for the benefit of Notification No. 12/2003, as there is no bar on them to shift to a better scheme.