

Point of Taxation Rules, 2011 could lead to severe confusion

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IT is still early days, for anybody to make some sense of the Point of Taxation Rules, 2011, ('POTR') which have effectively come into operation from July 1, 2011. Even as one tries to fathom these Rules, one could come up with various complications that would arise in common business situations.

Here is an attempt to consider some of these complications / situations.....

Situation No. 1: What is the date of completion of service in respect of the Fixed Price Projects undertaken by Software and other Services Companies?

As we know, these companies are allowed to follow the Percentage Completion Method under the accounting standards and recognize revenue, as periodical intervals, based on the costs incurred and the projected/budgeted profit margins. Taking a specific example of a software company which has contracted with its domestic client, to deliver a software project for a fixed price of Rs 50 lakhs spread over an estimated six month period starting on January 1, 2012, under the Indian GAAP, this Company is allowed to book revenue at periodic intervals based on the estimated percentage of the work completed. Thus, if 50% work has been done, let's say, as of March 31, 2012, this Company would book a revenue of Rs 25 lakhs in its books as of March 31, 2012 in its books and also book the relevant expenses and book profits. Of course, no invoice would be raised in this case, as of March 31, 2012. Assuming further that the client is liable to pay only on the completion of the project, how would the POTR work, in this case?

Can it be assumed that, the project completion would only fall on June 30, 2012 and consequently, so long as no money is received by the service provider, the service tax liability would arise only on the completion of the project, despite revenue being booked in the accounts, under Indian GAAP?

I wonder, if this view would be acceptable to the Department and one could foresee a lot of issues cropping up, in this area.

Situation No. 2: What is the date of completion of service in respect of service providers including IT companies who work on retainership basis?

A typical example would be service providers who work on a retainer basis with their clients. It is a very common feature of the consultancy business in India to work on a retainer basis. Let's assume a typical case of a tax consulting company which is retained by a corporate, on an annual basis. In this case, an invoice would be raised at the end of the financial year and the payment effected by the client accordingly. Now, let's assume that the service agreement stipulates that the service provider is to undertake a monthly review and provide monthly reports to the client.

What is the date of completion of service, in this case, Sir? Is it the month end or the year end? I have no clue and my guess would be as good as anybody's.

Situation No. 3: What is the date of completion of service, in the case of service providers who sign Annual Maintenance Contracts?

A typical example would be service providers, who maintain computer systems by entering into annual maintenance contracts. Typically, AMCs are entered into for one year, two years or three years. As we know, the requirement of an AMC service provider arises only when the client faces a problem which is to be rectified.

Assume that, a manufacturer enters into an AMC with a service provider to receive maintenance services over a one year period, for a fee of Rs 10 lakhs, payable at the end of the one year contract period. Can it be said that the service provider is rendering services on a monthly basis and consequently, the date of completion of service would be the month end? I have no clue, Sir.

Situation No. 4: What is date of completion of service for Realty Developers/Builders?

This could perhaps, the most confusing situation, from a practical point of view. As we know, construction services are treated as continuous supply of services under Rule 6. The Explanation to Rule (6) reads as follows:

Explanation 1.— For the purpose of this rule, 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.

In terms of this explanation, the date of completion of the service would be the date of completion of the event, as specified in the contract.

Let's take two examples.... One, that of a Builder, who has entered into a construction contract, as per which, the flat buyer is liable to effect payments as under :

On completion of Slab 1 on July 31, 2011 - Rs 20 lakhs

On completion of Slab 2 on September 30, 2011 - Rs 20 lakhs

On completion of the final construction on December 31, 2011 - Rs 10 lakhs

It is clear that, since the dates of the 'events' are specified in the contract, the date of completion of the service would be July 31, September 30 and December 31, respectively, for the gross amounts comprised in Rs 20 lakhs, Rs 20 lakhs and Rs 10 lakhs, respectively.

Consider the example of another Builder, whose payment terms are as under, in terms of his construction agreement:

On completion of Slab 1 - Rs 20 lakhs

On completion of Slab 2 - Rs 20 lakhs

On completion of the final construction - Rs 10 lakhs

In this case, it is clear that the deeming concept involving the date of completion of service would not get triggered.

Consider this third example, as per which, the following payment terms are mentioned in the construction agreement

On completion of Slab 1 within 3 months of date of agreement - Rs 20 lakhs

On completion of Slab 2 within 6 months of date of agreement - Rs 20 lakhs

On completion of the final construction within 9 months of date of agreement - Rs 10 lakhs

In this case, it is clear again that the deeming concept involving the date of completion of service would not get triggered, as no date of completion of the event is 'specified' in the contract.

If the Realty Developer/Builder manages not to get attracted under the Explanation to Rule (6) of the POTR, he would be treated like any other service provider, in as much as, the point of taxation would be the date of completion of the service or in a case where the invoice is issued within 14 days of the date of completion of the service, the date of issuing of the invoice or the receipt of payment, whichever is earlier. Hence, in such a case, the Realty Developer/Builder would be liable to tax on the basis of payments received by him, as is the case during the period prior to the POTR.

Situation No. 5: What is the date of completion of service for a back end IT company based in India , rendering services to its parent company, an Associated Enterprise, on an annual contract?

As per Rule 7, the date of completion of service would be determined in terms of Rule 3, if the payment is not received within the time specified by the RBI, in respect of transactions involving Associated Enterprises. It is a common practice for Indian Companies to raise invoices on fixed intervals, eg. on a quarterly/half yearly/annual basis and accordingly get their softex forms certified. However, if payments are received within the time frame specified by RBI (which is currently, 12 months), as per Rule 7, the point of taxation would be the date on which payments are received. Thus, assuming that the Indian Company receives monthly remittances from its parent Company, which is an Associated Enterprise, for meeting its expenses, the point of taxation would be the date of each of these remittances and accordingly, the Indian company would be required to raise invoices for each of its inward remittances. This could be a major procedural nightmare for Indian back end companies, as currently, the raising of invoices is governed by the terms of the contract entered into between the Associated Enterprises.

Before concluding.....

These are but, some major confusions that could crop up under the Point of Taxation Rules, 2011.

The Realty Sector would have a lot of problems in implementing these Rules. A lot would depend on the manner agreements are drafted. With a bit of planning, the Realty Players would be able to escape the mischief arising out of Rule 6 of POTR.

When the draft Point of Taxation (POT) Rules were issued in August, 2010, the stated basic purpose was to bring clarity and certainty in matter of levy and collection of service tax in certain situations. If there is anything that is missing in the POTR, 2011, it is clarity and certainty.

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