Reimbursements in Service Tax – Ramification of Delhi HC Decision – Dec 14, 2012

DECEMBER 14, 2012

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THE decision of the Delhi Court, in the case of *Intercontinental Consultants and Technocrats Pvt Ltd v. Union of India and Anr*, reported in ***2012-TIOL-966-HC-DEL-ST,*** is a truly landmark judgment.

As reported, the Delhi High Court has unequivocally held and reiterated the well accepted principle that the Rules cannot override the statutory provisions contained in the Act and that Rule 5(1) of the Service Tax (Determination of Valuation of Services) Rules, 2006 is*ultra vires* Sections 66 and 67 of the Finance Act, 1994. The relevant extract of the decision is reproduced below…

Quote :

11. In the aforesaid backdrop of the basic features of any legislation on tax, we have no hesitation in ruling that Rule 5 (1) which provides for inclusion of the expenditure or costs incurred by the service provider in the course of providing the taxable service in the value for the purpose of charging service tax is ultra vires Section 66 and 67 and travels much beyond the scope of those sections. To that extent it has to be struck down as bad in law. The expenditure or costs incurred by the service provider in the course of providing the taxable service can never be considered as the gross amount charged by the service provider "for such service" provided by him. The illustration 3 given below the Rule amplifies what is meant by sub-rule (1). In the illustration given, the architect who renders the service incurs expenses such as telephone charges, air travel tickets, hotel accommodation, etc. to enable him to effectively perform the services. The illustration, therefore, says that these expenses are to be included in the value of the taxable service. The illustration clearly shows how the boundaries of Section 67 are breached by the Rule. Apart from travelling beyond the scope and mandate of the Section, the Rule may also result in double taxation. If the expenses on air travel tickets are already subject to service tax and is included in the bill, to charge service tax again on the expense would certainly amount to double taxation. It is true that there can be double taxation, but it is equally true that it should be clearly provided for and intended; at any rate, double taxation cannot be enforced by implication….

***Unquote*:**

Now… in the aftermath of this important judicial development, several questions could arise. This piece is an attempt to quickly address some of these…

Any possibility of refunds?

Most assessees have been collecting service tax on reimbursements and have been remitting the service tax so collected to the account of the Government. Is there a possibility for such assessees to claim a refund of the service tax paid on such reimbursements? If the service tax burden has already been passed on to the service recipients, the service providers would not be allowed to file the refund claims. Of course, the service recipient, assuming that he has not passed on the service tax burden to his own customers/service receivers, is entitled to file a refund claim, subject to the time limit specified in Section 11B of the Central Excise Act, made applicable to service tax related refunds.

From a purely legal perspective since the amounts paid by the assessees cannot be treated as 'service tax' in the first place a view can be taken that the provisions of Section 11B cannot be invoked in respect of these refund claims.

Economic Impact of this decision on current cases being litigated

Several appeals have been filed before the CESTAT, on the levy of service tax on expenses reimbursed by the service receiver to the service provider. Orders passed by Commissioners confirming several crores of rupees of service tax liability on the levy of service tax on reimbursements such as electricity supplied by Developers of commercial complexes, amounts charged by Advertising Agencies, etc. are currently being litigated before the various CESTAT benches. The CESTAT, as we know, is not authorized to go into the legality of Rule 5(1) vis-à-vis Section 67. Having said so, the CESTAT Benches would now be duty bound to follow the law laid down by the Delhi High Court and the

Government could end up losing these cases resulting in a significant loss of revenue.

Can the Government amend Section 67?

This would be a very interesting development that we would need to wait and see. Given the stakes involved, one would not be surprised to see the Government taking the most predictable route of amending Section 67, albeit, retrospectively, apart from challenging the Delhi High Court decision, in the Supreme Court.

We must bear in mind the fact that the methodology for valuation of services derives its legal sanctity from Section 67 of the Finance Act, 1994 even under the new service tax law. Hence, the pain arising out of this decision will affect the Government, under the new service tax, as well.

One should definitely expect some kind of a legislative action in the coming Budget to overcome the effects arising out of this decision.

Inter-Group billings for reimbursements at actuals will now come out of tax net

Thanks to this decision corporates recovering costs or expenses, at actuals, from sister companies, etc. will no longer be required to discharge service tax on the reimbursement of expenses. Charging sister companies for reimbursements, at actuals, is a practice, widely practiced, even between companies in India and their associated enterprises. Most of these transactions including import transactions could get out of the service tax net.

Income tax angle?

It is a well-recognized principle under the Income tax law that, only 'income' can be subjected to tax, especially, in the case of provisions related to tax deduction at source. Thus, an importer, who is only reimbursing the expenses incurred by his parent company, let's say, is not required to deduct tax at source under Section 195 of the Income tax Act. One is happy that this principle has got indirectly confirmed, in the decision of the Delhi High Court, inasmuch as, service tax can be levied only on the value of 'services' rendered and not on claims of 'reimbursements', which cannot be treated as services rendered. So far so good.

"Pure Agent" concept – no longer a pre-requisite for exemption of service tax on reimbursements

In terms of Rule 5, at it has stood from 19-4-2006, reimbursements are exempted only if the eight golden conditions laid down therein, are fulfilled, cumulatively. In most practical situations, it would be impossible to fulfil all the eight conditions laid down, with the result, that, most reimbursements are now being subjected to service tax. In terms of this decision, the concept of 'pure agent' being a pre-requisite for claiming exemption from levy of service tax on reimbursements would no longer be valid.

Implications on valuation of free supply of materials by service receiver

As we know, practice of the service receiver providing materials for use by the service provider, is a widely used concept, especially, in the Realty Sector. There have been judicial decisions for and against the value of the materials supplied free of cost, by the service receiver (popularly known as FOC materials). While the Madras High Court in the *L & T* case ***[2007-TIOL-176-HC-MAD-ST],*** the Delhi High Court in the *Era Infra Engg Ltd's* case ***[2008-TIOL-386-HC-Del-ST]*** and the Calcutta High Court in the *Simplex Infrastructures Ltd's* case ***[2010-TIOL-899-HC-KOL-ST]*** have taken a *prima facie* view that, the value of the FOC materials cannot be included under the 'gross amount charged', we also have the final decision of the CESTAT in the *Jaihind Projects Ltd's* case ***[2010-TIOL-124-CESTAT-Ahm],*** taking the view that service tax has to be paid on the free supply of materials. It would seem that the validity of Rule 5(1) has not been considered in these cases. With the Delhi High Court now striking down Rule 5(1), the whole question of taxability of FOC materials would need to be looked into afresh. It is felt that there is a possibility to take the view that the FOC materials are nothing but a 'cost' in terms of the project being executed and consequently cannot form part of the 'gross amount charged', so long as adequate documentation is maintained by both the service provider as well as the service receiver.

Any planning possible, post this decision

There can be little doubt that, this decision gives rise to a number of legally sustainable planning possibilities for Industry. It would now make sense for service providers to keep documentation to clearly show the different categories of costs and expenses and bill these separately on service receivers, under claims of 'reimbursement' and raise separate bills for services charging service tax at the full rates.

Before concluding…

The ramifications arising out of this decision could be far and wide. In the Realty sector, as I know, flat buyers are charged service tax by Developers/Builders on a host of 'reimbursements' and with no mechanism to avail of cenvat credit, the overall cost of buying an apartment goes up significantly. Hopefully, post this decision, apartment buyers can get flats at lesser overall prices.

Similarly, the recoveries made by employers from employees of expenses would no longer be taxable as it can be said that the employer is only claiming a reimbursement from the employee of these expenses. In fact, post this decision, the reach of 'Reverse Charge Mechanism' would seem to get limited.

The Department, on the basis of Rule 5(1) has been taking the view that all the money that flows, whether related to the services or not, from the service receiver to the service provider is to be included under 'gross amount charged'. This decision comes as a huge relief in these cases also and the whole concept of 'gross amount charged' is bound to undergo a sea change to the advantage of the service provider.

As mentioned a retrospective amendment cannot be ruled out…which, when it happens, would give rise to a fresh round of litigation.