

## Service Tax on Accrual Basis might create chaos – Mar 5, 2011

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THE Finance Bill 2011, as we know, has proposed to revamp the entire service tax regime by proposing a changeover to the accrual system, from the currently followed, cash system. This is a very major change in the service tax law and brings along, certain major complications. This proposed changeover is contained in Notification No 3/2011, which seems to amend Rule 6 of Service Tax Rules 1994 and substitute the words “payments are received, towards the value of taxable services”, **with the words** “service is deemed to be provided as per the rules framed in this regard”.

#### The text of the new rules, is reproduced below:

**Determination of point of taxation** – For the purposes of these rules, unless otherwise stated, “point of taxation” shall be determined in the following manner, namely:-

*(a) a provision of service shall be treated as having taken place at the time when service is*

*provided or to be provided; and*

*(b) if, before the time specified in clause (a), the person providing the service issues an invoice or receives a payment, the service shall, to the extent covered by the invoice or the payment made thereof, be deemed to have been provided at the time the invoice was issued or the payment was received, as the case may be, whichever is earlier.*

**Explanation 1:** *For the purposes of this rule, wherever any advance, by whatever name known, is received by the service provider towards the provision of taxable service, the point of taxation shall be the date of receipt of each such advance.*

**Explanation 2:** *For the purposes of this rule, in respect of services taxable under section 66A of the Act, the point of taxation under clause (b) shall be the date on which the invoice is received, or the payment is made, as the case may be, whichever is earlier.*

Clause (a) says that the provision of service shall be treated as having taken place at the time when service is provided or to be provided. This is a very obnoxious development that, a service provider can be asked to pay service tax, even when he has not actually rendered the services. Being a guy with a defective knowledge of the beautiful English language, I am not able to interpret this clause, in any other manner.

Let's discuss the havoc that this requirement will create, with some examples. Let's assume that, I, as a Chartered Accountant, have contracted with a certain client, Mr A, for delivering a valuation report, and have agreed to deliver this report on June 30, 2011, and the kind client, has agreed to pay me Rs 50,00,000/- for this report (Sir-this is only a hypothetical situation. No client has ever paid me or will ever pay me, Rs 50,00,000/- for a valuation report, as a matter of fact). Due to certain issues, I am not able to deliver this report on June 30, 2012, let's assume. As per the new rules, I become liable to pay the service tax of Rs 5,15,000/- on July 5, 2011, as I am deemed to have rendered the service on June 30, 2011, notwithstanding that I haven't done anything on this assignment. Assume further that, I start re-negotiating with this great client start from September 1, 2011 and get a one year extension, starting from October 1, 2011. Let's assume that, due to certain issues, I am not able to deliver the valuation report and the assignment is called off on December 31, 2012.

Even assuming that I maintain my books on the accrual basis, I still don't recognize this transaction in my books, for the financial year 2011-12. However, I have already paid service tax on July 5, 2011 and Government says, that I can either go for the self-adjustment (the limit for which has now been increased to Rs 2 lakhs), or, go for a refund, when the amount is more than Rs 2 lakhs. In the instant case, when I file a refund in January 2013, the Department would reject my refund claim, on the basis that, the refund claim is filed beyond the one year period, stipulated in Section 11B of the Central Excise Act. How fair then, is this requirement that I am asked to pay service tax, even when I have not actually rendered any service and worse, I cannot even file a refund claim for the service tax that I have paid.

Let's take this logic forward. As a Chartered Accountant, I am allowed to maintain books on cash basis of accounting. In fact, most CAs follow the cash basis of accounting. Take the case of our billings for statutory audit of companies. If the proposed reasoning that I am liable to pay service tax on the date on which services 'is to be provided' then, I am, in all probability, to be deemed as having provided the services on March 31, 2012 and pay service tax on April 5, 2011, in respect of the financial year 2011-12. After all, even the client recognizes that I have rendered him the statutory audit related service and makes a provision, in his books. The unfortunate fact would remain, in this case, I would pay service tax even before commencing the services.

It is a normal practice amongst professionals that we raise proforma invoices, before starting an assignment. Without the proforma invoice getting approved, we don't start working on an assignment. In many cases, assignments get dropped mid way and in some cases, we simply don't proceed. In all of these cases, we would be liable for service tax on the basis that, an invoice has been raised for provision of service.

TIOL's Netizens might think that I am exaggerating the implications arising out of this development. Not at all, Sir. Take the case of the Realty Developers, who are into development of residential complexes. They had no issues paying service tax on the basis of payments or invoices, whichever is earlier. As we know, Developers do enter into construction agreements with their flat buyers which specify milestones for completion of the projects and also specify the associated instalment payments. Let's assume that, notwithstanding that the milestones have been fulfilled, the flat buyer still does not pay the instalment (s). The Developer would be liable to pay service tax, on the basis of the actual work done by him, notwithstanding that, the flat buyer has not paid him. Take this logic further. Assume that the Developer has not started the construction activity at all. He would still be liable for paying service tax, based on the agreements entered into by him, as he is deemed to have rendered the service, on the date the said service was to have been provided. Imagine the chaos that this new rule would create, in the case of a Developer constructing a huge residential complex with, let's say, 1000 flats?

**As per the new Point of Taxation Rules, 2011 which have been framed vide Notification 18/2011-ST and made effective from 01.04.2011, the point in time when the services shall be deemed to be provided shall be the earliest of the following three:**

Date on which service is provided or to be provided

Date of invoice

Date of payment

**It is clear that the new dispensation will play havoc... where is the need to drastically change a system which is working well over the years?**

**Before parting...**

Notwithstanding the fact that the Government is not justified in shifting to the accrual basis for levy of service tax, why is it that it is not prepared to allow cenvat credit unless the payment for the input service has been effected. Is this not a double standard?

In my view, the requirement that a service provider has to pay service tax even without having rendered the service, is not legally sustainable and is likely to be struck down by the Courts. Some High Courts have struck down the provision in the VAT law that, a dealer can be asked to pay VAT on an advance amount received, even without having concluded a 'sale' transaction. A similar fate awaits the Point of Taxation Rules, at least, in so far as the provision related to the levy of service tax on services to be provided without receipt of the consideration.

This new dispensation is bound to create a lot of litigation, if the Government goes ahead with the new amendments. Such a drastic change in the basic scheme of the levy of service tax is not warranted now, with the Government seriously trying to implement GST in the immediate future.