The never-ending drama related to service tax audit … : 24-12-2014

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By S Sivakumar, LLB., FCA, FCS, ACSI, MBA, Advocate

EVEN as we thought that the Department had been clean bowled by the decision of the Delhi High Court, which had struck down Rule 5A(2) of the Service tax Rules, 1994, based on which, the Service Tax Department had assumed to itself, the powers to undertake the service tax related audit of the assessee, here comes yet another valiant attempt by the 'never say die' Department aimed at overcoming this decision. TIOL's DDT has very recently reported that the Department has indeed managed to get a stay from the Hon'ble Supreme Court - **2014-TIOL-101-SC-ST-LB**, in so far as the *Travelite* decision of the Hon'ble Delhi High Court is concerned.

Before we try to understand if the recently issued Notification No. 23/2014-Service Tax dated December 5, 2014 and the clarifying Circular No. **181/7/2014-ST** dated December 10, 2014 would really help the Department to resume the service tax audits, it would do us good to understand the legal basis upon which, the Hon'ble Delhi High Court had struck down Rule 5A(2) of the Service Tax Rules 1994 as it then stood. Paras 9 and 11 of this decision, reported in **2014-TIOL-1304-HC-DEL-ST**, reproduced below, indicate the basis on which the High Court concluded that the Department cannot use Rule 5A(2) as it then stood, to conduct audits.

Quote :

> 9. Section 72A envisages an audit of an assessee's records only in special circumstances, namely, when there is a failure to declare or compute the value of the taxable service, when the utilization of CENVAT credit in excessive of the limit permissible or by fraud etc., and when the business operations of the assessee are dispersed across multiple locations. Apart from Section 94, the Revenue could not show any other substantive provision which justifies a probe into the records of the assessee, under conditions akin to those contemplated by Rule 5A(2). The Revenue was also unable to show the compulsion of arming authorities with such sweeping powers, under the Rules.
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> 11. The mere fact that a rule-making power is phrased in terms that indicates a general delegation of power,cannot lead to the inference that such power may be exercised to make rules that exceed the bounds of the statute. Rules may only give effect to the statute's provisions and intent and cannot be used to create substantive rights, obligations or liabilities that are not within the contemplation of the statute. (Ref. Kunj Behari Lal v. State of H.P, (2000) 3 SCC 40 and Global Energy Ltd. v. Central Electricity Regulatory Commission, (2009) 15 SCC 570. It is apparent that the only type of audit within the contemplation of the statute is that stipulated for in Section 74A, i.e. a special audit when only certain circumstances are fulfilled. The Parliament thus had a clear intention to provide for only a special audit. The fact that Section 72A prescribes the conditions meriting such special audit compels the necessary inference that the Parliament did not intend to provide for a general audit that "every assessee" may be subjected to, "on demand". This Court is thus of the opinion that any attempt to include provision for such a general audit through the back-door, such as through the impugned rule, is ultra-vires the rule making power conferred under Section 94(1). Rule 5A(2) must consequently be struck down.

Unquote:

It is clear from a reading of these paras, that the High Court struck down Rule 5A(2) on the basis that, there is no statutory backing in the Finance Act, 1994 to justify a general audit of assessees.

One would then have expected the Government to bring in a clear statutory provision to justify audits by the Departmental officers. Instead of doing this, in the forthcoming Budget, the Government has thought it fit to replace the existing Rule 5A(2) with a new Rule. *Per se* , this could mean that, the decision of the Delhi High Court striking down the earlier version of Rule 5A(2) would no longer hold ground. But, the legal principle laid down, in the *Travelite*decision, that the Department cannot undertake audits without the statutory backing in Section 94 of the Finance Act, 1994 is still, very much valid. The *Travelite* decision would, in my view, continue to frustrate the attempts of the Department to conduct audits under the newly substituted Rule 5A(2), which reads as under:

> "(2) Every assessee, shall, on demand make available to the officer empowered under sub-rule (1) or the audit party deputed by the Commissioner or the Comptroller and Auditor General of India, or a cost accountant or chartered accountant nominated under section 72A of the Finance Act, 1994,-
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> (i) the records maintained or prepared by him in terms of sub-rule (2) of rule 5;
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> (ii) the cost audit reports, if any, under section 148 of the Companies Act, 2013 (18 of 2013); and
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> (iii) the income-tax audit report, if any, under section 44AB of the Income-tax Act, 1961 (43 of 1961),
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> for the scrutiny of the officer or the audit party, or the cost accountant or chartered accountant, within the time limit specified by the said officer or the audit party or the cost accountant or chartered accountant, as the case may be."
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> This new Rule 5A(2) has been issued under the powers granted to the Government by Section 94(2)(k), which reads as under:
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> "(k) imposition, on persons liable to pay service tax, for the proper levy and collection of tax, of duty of furnishing information, keeping records and the manner in which such records shall be verified."

It is very clear from a reading of Section 94(2)(k) that, all that it empowers the Department is to verify the information and records that are required to be maintained by the assessees and nothing more. However, as is to be expected, the Board has taken upon itself, the onerous duty of expanding the scope of the newly introduced clause (k) of Section 94(2) and has clarified as under in paras 2 and 3 of its Circular dated December 10, 2014:

> 2. In exercise of the rule making powers under clause (k) of sub-section (2) of section 94 of the Finance Act, 1994, the Central Government has inserted a new rule 5(A)(2) in the Service Tax Rules, 1994 vide notification no. 23/2014-Service Tax dated 5 th December, 2014. This rule, interalia, provides for scrutiny of records by the audit party deputed by the Commissioner. Such scrutiny essentially constitutes audit by the audit party consisting of departmental officers.
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> 3. Verification of records mandated by the statute is necessary to check the correctness of assessment and payment of tax by the assessee in the present era of self-assessment. It may be noted that the expression "verified" used in section 94(2)(k) of the said Act is of wide import and would include within its scope, audit

by the departmental officers, as the procedure prescribed for audit is essentially a procedure for verification mandated in the statute.

Even granting for the sake of an argument that, the term 'verification' could include within its scope, a 'scrutiny' of the records of the assessee, the billion dollar question that arises now is whether, the terms 'scrutiny' and 'audit' are synonymous?By no means, Sir.

When the compulsory 'tax audit' provision was introduced in the Income tax Act,1961 thro' the insertion of Section 44AB, which stipulated audit by Chartered Accountants, the Income Tax Practitioners challenged the section on the basis that, they too were competent to undertake audit. In the celebrated case of T.S Nataraj v. Union of India reported in (1985) 155 ITR 81 (Karnataka), the SLP against which was dismissed by the Supreme Court, the Karnataka High Court has explained the term 'audit' as under, in Para 23.1:

Quote:

The term 'audit' which is not defined in the Act or the General Clauses Act, is defined in the following Dictionaries as hereunder;

"Audit 2. Official examination of accounts with verification by reference to witnesses and vouchers . . . . . ."

"Audit. 1. To make an official systematic examination of (accounts). . . . . ."

(vide : Shorter Oxford English Dictionary, Third edn., Revised with Addenda, p. 122)

"Audit, 1a: a formal or official examination and verification of books of account (as for reporting on the financial condition of a business at a given date or on the results of its operations for a given period) but a methodical examination and review of a situation or condition (as within a business enterprise) concluding with a detailed report of findings: a rendering and settling of accounts. 2. the final report following a formal examination of books of account: an account as adjusted by auditors: final statement of account. 3. archaic: a judicial examination (as in a court). 4. Audi-tale. 5. a check of publishers' records to verify claims as to the extent of publication's circulation.

Audit. 1. to examine and verify (as the books of account of a company or a treasurer's accounts)…"

(vide: Webster's Third New International Dictionary – Unabridged, Vol. 1 (AG), p. 143)

Audit, an examining of accounts. An audit may be either detailed or administrative, and is usually both. A detailed audit is a comparison of vouchers with entries of payment, in order that the party whose accounts are audited may not debit his employer with payments not in fact made. An administrative audit is a comparison of payments with authorities to pay, in order that the party whose accounts are audited may not debit his employer with payments not authorised. Exchequer and Audit Departments Act, 1866 (as amended) See Comptroller."

Unquote:

By no stretch of imagination can one take the view that, the terms 'scrutiny' and 'audit' can be treated on par. To say that the 'audit' officers of the Department can undertake 'scrutiny' which is to be equated with 'audit' reflects a total lack of understanding of the concepts involved in 'scrutiny' and 'audit'. In fact, the only bunch of professionals who are authorized and competent to do 'audit' are Chartered Accountants, to which glorious profession, I belonged to, till recently. To say that the 'scrutiny' undertaken by Superintendents is equivalent to an 'audit' by a Chartered/Cost Accountant is plain insult to the CA profession. Of course, the Courts will not buy this argument.

Be that as it may…. my view is that, the newly substituted Rule 5A(2) would still be challenged in the High Courts, for sure. Instead of undertaking this hasty and half-baked exercise of trying to equate 'scrutiny' with 'audit', the Board could have waited for the Budget and brought in statutory amendments.

Before concluding…

How does the new Rule 5A(2) deal with the powers of the CAG to undertake audit of companies which do not deploy or use public funds? My strong view is that, in the absence of an amendment to Articles 148 and 149 of the Constitution, the CAG does not have powers to audit private companies or companies which do not employ public funds.

It is rather amusing to see the Service Tax Department argue that they have powers to undertake 'audit' of assessees. We do not find a similar situation under the Income tax Act or under the State VAT laws, where, it is clearly recognized that, only CAs can undertake the tax related audit functions. Assessees do not have an objection regarding the Department's powers to verify their records. But, let the Department not get into the audit function, for Heaven's sake. By virtue of having a common and super-efficient education and training system, the CAs can be expected to bring about a near uniformity in the audit function. Is it possible to expect the same from the Departmental system?

Where was the need for the Government to take this 'Rule' route to rectify the lack of a statutory backing vis-à-vis the powers to undertake audit of assessees? Perhaps, this was unavoidable, given the fact that, the Audit Wings of the Department including the much touted and newly created Audit Commissionerates have little work to do currently.

We can now expect the invigorated Service Tax Department to resume issuing notices to assessees under the new Rule 5A(2), especially given the fact that the Hon'ble Supreme Court has stayed the *Travelite* decision.It would seem that, as things stand now, the hapless assessees would have to be prepared to meet the 'audit' challenge from the Audit Wings of the Service Tax Department and go through the 'last quarter' pressure. Since the *Travelite*decision dealt with the old version of Rule 5A(2), which is no longer in the statute, we should expect the new audit notices to be issued under the new Rule 5A(2) to be challenged in the High Courts, as well. The CAG's offices are not going to sit quiet, either. I understand that new notices for service tax audits have already started getting issued.The Apex Court's stay,*per se* , does not prevent the High Courts to take a view on audit notices issued under the new Rule 5A(2), as this was not the subject matter vis-à-vis the stay. Advocates are sure to have a busy season ahead, in the high profile and rapidly changing drama, related to service tax audits.

In so far as the legality of the adjudication and/or appellate proceedings already concluded on the basis of audits conducted by the Service Tax Departments, prior to 6-8-2014, it would seem that, assessees would find it difficult to challenge these proceedings. Under the income tax law, the Courts have held that, while the search or similar proceedings could be illegal, the evidence collected can still be used against the assessees. A similar view is possible, of proceedings including levy of substantial amounts of service tax, concluded on the basis of service tax audits, the lack of authority about which the Government itself has now conceded.