Services under Full Reverse Charge - All Stick and no Carrot?

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THE year 2012 witnessed a paradigm shift in taxation of services from the selective to the comprehensive regime with the introduction of the Negative List under the Service Tax legislation ('the Finance Act, 1994'). The year also witnessed a series of radical re-engineering of the compliances under the Service Tax law with the introduction of a Joint Charge (Partial forward charge and Partial reverse charge) Mechanism and the addition of new services to the list of services that attracted Service Tax under the Full Reverse Charge Mechanism.

It is generally presumed that the Reverse Charge Mechanism not only offers an opportunity to the small and unorganized service providers to get away from costly and unwieldly compliance but at the same time acts as a catalyst in the enhanced tax payment process instituted by the Government for widening the Service Tax base.

However, after the lapse of about four years since the expansion of the ambit of Full Reverse Charge Mechanism, the shortcomings of this mechanism are threatening to undermine the benefits it holds for the respective service providers.

Reverse Charge Mechanism at a glance

The ambit of the 'Full Reverse Charge Mechanism', where entire Service Tax is payable by an identified person other than the service provider (typically, the Receiver of Service), was radically expanded vide Notification 30/2012-ST dated 20 June 2012, as amended from time to time. The following services have been notified till date under Full Reverse Charge Mechanism:

1. Insurance Agent's Service
2. Bank Recovery Agent's Service
3. Goods Transport Agency Service
4. Sponsorship Service
5. Legal Services by individual advocate or firm of advocates
6. Arbitral Tribunal Service
7. Services by Directors of the company or body corporate to the company or body corporate
8. Any Services provided by Government/Local Authority to a Business Entity
9. Rent-a-Cab Service
10. Manpower Supply Service/Manpower Recruitment Agency (subjected to Full Reverse Charge with effect from 1 st April, 2015)
11. Security/ Detective Service (subjected to Full Reverse Charge with effect from 1

st April, 2015)

12. Service portion in execution of Works Contract

13. Taxable services provided by a person located in a non-taxable territory received by any person located in the taxable territory

Why should refund of Cenvat Creditbe available only to Providers of Services under Partial Reverse Charge under Rule 5B?

Simultaneously with the introduction of the Joint Charge, Rule 5B was inserted in the Cenvat Credit Rules, 2004 ('CCR') providing for a mechanism for claiming refund of unutilized Cenvat Credit by Services Providers under the Reverse Charge Mechanism. It was only in 2014 that three services covered under the Partial Reverse Charge Mechanism were notified vide **Notification No. 12/2014â€"CE (NT)** dated 3 March 2014. It is pertinent to note that none of the services that were notified under Full Reverse Charge were mentioned therein.

The fact that services under Full Reverse Charge were not notified for the purpose of refund under Rule 5B was no surprise as a close reading of Rule 5B (introduced in 2012) itself made it amply clear that the Government holds no intention to extend the refund facility to service providers covered under Full Reverse Charge Mechanism.

Rule 5B reads as follows:

> *"A provider of service providing services notified under sub-section (2) of section 68 of the Finance Act and being unable to utilize the Cenvat Credit availed on inputs and input services for payment of Service Tax on **such output services**, shall be allowed refund of such unutilized Cenvat Credit subject to procedure, safeguards, conditions and limitations, as may be specified by the Board by notification in the Official Gazette."*

Further, the term 'Input Service' has been defined as a service used by a provider of taxable service for providing an 'Output Service'.

In this context, it becomes imperative to understand the meaning of 'Output Service'.

The term 'Output Service' defined under Rule 2(p) of the Cenvat Credit Rules, 2004, was amended concurrently with the introduction of Rule 5B, to exclude from its ambit, services where the entire tax is liable to be paid by the recipient of service, that is, services under Full Reverse Charge Mechanism.

Thus, it becomes amply clear that refund under Rule 5B would be restricted to Services under Partial Reverse Charge Mechanism with no hopes for any of the services attracting Full Reverse Charge of getting notified for claiming refund of unutilized Cenvat Credit.

What prompted the change in Definition of 'Output Service'?

It may be argued that the intention of the Government in excluding services under the Reverse Charge Mechanism may have been to end the legal battle over whether payment of Service Tax by Service Receivers under Reverse Charge can be made from the Cenvat Credit pool instead of cash.

The earlier definition of Output Service included an Explanation which created a legal fiction deeming the Service under Reverse Charge Mechanism as an Output Service. This position was time and again, relied upon by the persons liable to pay Service Tax so as to contend that since Rule 3 of Cenvat Credit Rules, 2004 provides that Cenvat Credit can be used to pay tax on Output Service, liability of Service Tax under Reverse Charge, being an output service, can be discharged through cenvat. This went against the position adopted by the Department that liability of Reverse Charge must necessarily be discharged in cash. However numerous rulings were issued in favor of the assessee, which ultimately prompted the lawmakers to revise the definition of Output Service to its current form. The resultant denial of refund to providers of

services under Full Reverse Charge may have been unintentional but nevertheless, the financial implications of this amendment have been quite serious for the affected parties.

Interestingly, the argument made by Revenue in most of these disputes over the issue, was that Service Receivers were only deemed 'service providers' but not 'Actual service providers' and cenvat should, therefore, not be available to them for payment of Service Tax.

> *[Refer CCE v. Nahar Industrial Enterprises Ltd. - **2010-TIOL-868-HC-P&H**;*
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> *CST v. Hero Honda Motors Ltd - **2012-TIOL-1104-HC-DEL-ST***
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> *Commissioner of Service Tax, Chennai v. Royal Enfield - **2014-TIOL-1220-CESTAT-MAD***

Applying this very argument adopted by the Department in a reverse way, it would not be incorrect to argue that Cenvat Credit should then be available to the 'actual service provider'. Taking this argument a step further, it can be further argued that since these actual service providers do not have any output Service Tax liability (since they are not the 'persons liable to pay Service Tax'), they should be allowed to claim the refund of unutilized Cenvat Credit and pursuant to the same, services under Full Reverse Charge should also be notified under Rule 5B of the CCR.

Parity needs to be restored:

Interestingly, service providers under Full Reverse Charge Mechanism are faced with a greater likelihood of having unutilized Cenvat Credit since the output liability is nil. They are further restricted to even avail Cenvat Credit by means of the definition of Output Service. If Cenvat Credit would have been allowed to be availed, the same could have been utilized towards the other output Service Tax liabilities that the Provider may have incurred. Prohibition on availment of Cenvat Credit by such service providers not only bars them from claiming refund of accumulated Cenvat Credit but also effectively rules out any possibility of utilization of the credit.

As against this, a service provider under Partial Reverse Charge is not only allowed to avail such Cenvat Credit which allows adjustment towards the output liability of the same service and even other services, but is also offered the option to claim a refund for any unutilized credit.

This bias creates a cascading effect of Input taxes as the provider of service under Full Reverse Charge would presumably recover the cost of accumulated Cenvat Credit on the Input Services, from the customer by loading the same in the value of service.

Is GST the solution to this dichotomy?

On 6 October 2015, the Ministry of Finance released three Reports of the Joint Committee on Business Processes for GST with respect to registration, payment and refund process in the public domain for inviting views and comments from stakeholders.

The GST Business Processes report on Refunds envisages various situations in which a refund may arise under the proposed legislation. Among the situations listed therein, is featured a situation of *"Credit accumulation due to inverted duty structure i.e. due to tax rate differential between output and inputs.â€ OR "Carry forward Input Creditâ€*

An extract of the same is produced below:

> "(H) REFUND OF CARRY FORWARD INPUT TAX CREDIT:
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> > *i) As stated earlier, **ITC is allowed to remove cascading and under modern VAT laws, tax is charged on value addition only and tax is not charged on tax** . It is for this reason that the ultimate consumer is liable to bear the tax burden.*
> >
> > *ii) It is noted that the ITC may accumulate on account of the following reasons:*

a) Inverted Duty Structure i.e. GST on output supplies is less than the GST on the input supplies;

b) Stock accumulation;

c) Capital goods; and

d) Partial Reverse charge mechanism for certain services."

It is revealed from the above that while on one hand GST is purported to be a tax only on value addition and no tax will be charged on tax,whereas by listing only 'Services under Partial Reverse Charge Mechanism 'for entitlement to refund of the accumulated input credit, the malaise of tax cascading for services under Full Reverse Charge seemingly appears to exist even in the GST regime.

While there is no denying the fact that GST Business Processes put in the public domain may be only preliminary guiding factors and do not have any legal authority,one cannot entirely disregard the propositions laid down therein. They offer precious glimpses into the legislation that may materialize eventually. However, in the light of the detailed analysis offered above, it is necessary that it be brought to the immediate notice of the Government that future would not be bright for providers of services under Full Reverse Charge Mechanism unless the anomaly is promptly set right.

Eureka

A few solutions that can be thought of to resolve this problem is as discussed below:

A non-obstante clause under Rule 5B to provide for refund to Services under Full Reverse Charge Mechanism may do the trick. Alternatively, inclusion of Services under Full Reverse Charge Mechanism from the definition of Output Service may prove to be the universal solution to put an end to this protracted litigation. A suitable distribution mechanism to ensure seamless passage of credit to the Service Receiver would be an option less cumbersome than claiming a refund.

(Views discussed above are strictly personal)