

## Point of Taxation Rules – Pain of Taxation? Part - I

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### Introduction

- 1.0 In the arena of Central Excise (CE) and Value Added Tax (VAT), principles regarding levy of tax has been settled since long. This has been due to subject of taxation being the commodities dealt with which is tangible. However, in the case of Service Tax (ST) it is not so easy. This is for the reason that the process of providing service is not tangible. Throughout the world it has been posing a challenge to the tax authorities in terms of determining the time element. Till date, in India, this has not been a major source of problem as the payment of tax was linked with receipt of payment. The event of receipt of consideration, being easily identifiable, did not raise any issue. However, it is in deviation to the principles applied in the case of CE and VAT. Since all the taxes levied under indirect taxation viz. CE, VAT and ST are proposed to be brought under single umbrella of Goods and Service Tax (GST), it has become necessary to have the common base for levy and collection of tax in respect of all the cases. This requires formulation of rules regarding determination of point of time when a service can be said to have been provided.

### Levy of Tax and Point of taxation

- 2.0 Before making an attempt to understand provisions of Point of Taxation Rules, 2011 (PoTR), it will be necessary to explore the meaning of certain terminology used. In the process of taxation, the first step is levy of tax. Levy is linked with certain event. On triggering of the certain event, the transaction becomes taxable. It is known as Taxable Event. In the second stage, once an event has become taxable, the question of collection of tax will arise. The statute will provide for the event or time whereat it will become point of taxation. In the third step, the statute will provide for the time period or another event on occurring of which tax will have to be paid. Thus, as can be seen, the concept of levy, collection and payment of tax are fundamental aspects of any fiscal law. For example, in case of CE, under the Central Excise Act, 1944 duty is levied on excisable goods produced or manufactured in India. Under Central Excise Rule, 2002 CE duty is required to be paid on removal of goods from factory or warehouse. Thus, levy of duty is on manufacture or production of goods which is the taxable event and point of taxation is the removal of goods. Actual payment of duty is governed by the Excise Rules which is generally the 5th or 6th date of the month following the month in which goods are removed.
- 2.1 Section 66 of the Finance Act (FA) provides for levy of ST on provision of various services. Section 65(105) defines various services which are subject to tax. However, unlike in the case of CE, the FA does not provide for point of taxation. Since, the payment of tax was linked with receipt of payment; it did not pose any problem. However, as it is proposed to be aligned with the provisions of CE and VAT, the question of determining Point of taxation (PoT) has arisen.

### **Background of POTR, 2011**

3.0 During August, 2010, the Central Board of Excise and Customs (CBEC), published draft rules in this respect for comments from the tax payers. Originally, it was proposed to be implemented from January, 2011. However, it was postponed and has been proposed in the Budget, 2011 under the name and style of "Point of Taxation Rules, 2011" to be effective from 1<sup>st</sup> April, 2011. This is a major change in the area of Service Tax (ST) as it amends the very basis of determining taxable event.

3.1 The objectives of the whole exercise, as set out in the draft published by the CBEC in August, 2010, reads as follow:

*The Government of India proposes to issue Point of Taxation (for Services Provided or Received in India) Rules, 2010 in exercise of the powers conferred on it under Sec. 94 (2)(hh) of the Finance Act, 1994.*

*The purpose of these rules is to introduce clarity and certainty in the matter of levy and collection of Service Tax particularly in situations of change of rate of service tax or imposition of service tax on new services. At present there is lack of clarity as to the date from which the changed rate or a new levy of service tax become payable and tax payers as well as tax officials face uncertainty in this regard as the provisions are not explicit. Similar uncertainty prevails in regard to cases of continuous supply of services. So far these issues have been addressed by CBEC through clarificatory circulars that accompany such changes. A need has been felt to put the regulatory frame work on a transparent, clear and durable basis and hence these rules.*

*The other major change proposed to be brought about through these rules is to link the payment of tax to provision of service, raising of the invoice or payment for service provided or to be provided, whichever is the earliest. Currently the payment of service tax is linked to receipt of payment for the service, which is at odds with regime in force in Central Excise and VAT laws implemented by the states. In both Central Excise and VAT, tax payment is required on accrual basis - upon manufacture and clearance of goods in the former and issue of invoice in the latter. In neither case is the tax payment linked actual receipt of payment for the goods. The GST regime is likely to follow this practice and it is necessary to align the service tax regime with it so that transition to GST will be smooth. The change in the point of payment of tax will also simplify accounting for the taxpayers.*

*The proposed changes are broadly on lines of best international practices.*

*(emphasis supplied)*

To what extent the objectives have been achieved, and the hardship that will be caused to the tax payers, shall be examined at the end of this analysis.

### **Consequential Amendments in ST Rules**

4.0 In consequence of applicability of PoTR, certain amendments have been carried out in Service Tax Rules (STR) as well. Notification No. 3/2011 dt. 1-3-2011 proposes major amendments in the following Rules.

4.1 In Rule 4A i.e. Issue of Invoice, the words "*completion of*" in Rule 4A(1) has been replaced with the words "*provision of*". As the PoT is proposed to be linked with various events which are not based on completion of service, it becomes necessary to amend the provisions relating to issue of invoice based on such events. Insertion of the words "*provision of*" takes care of provision of service and deeming provisions as well. It means that, in the case of deeming provisions, the SP will be required to issue invoice within 14 days of the services which have been deemed to be provided. Amended Rule 4A, after amendment, will look like as follow:

**4A.** (1) Every person providing taxable service, not later than fourteen days from the date of ~~completion of~~ *provision of* such taxable service or receipt of any payment towards the value of such taxable service, whichever is earlier, shall issue an invoice, a bill or, as the case may be, a challan signed by such person or a person authorized by him in respect of such taxable service provided or to be provided and such invoice, bill or, as the case may be, challan shall be serially numbered and shall contain the following, namely:—

- (i) the name, address and the registration number of such person;
- (ii) the name and address of the person receiving taxable service;
- (iii) description, classification and value of taxable service provided or to be provided; and
- (iv) the service tax payable thereon :

**Provided** that in case the provider of taxable service is a banking company or a financial institution including a non-banking financial company, or any other body corporate or any other person, providing service to a customer, in relation to banking and other financial services, an invoice, a bill or, as the case may be, challan shall include any document, by whatever name called, whether or not serially numbered, and whether or not containing address of the person receiving taxable service but containing other information in such documents as required under this sub-rule :

**Provided further** that in case the provider of taxable service is a goods transport agency, providing service to a customer, in relation to transport of goods by road in a goods carriage, an invoice, a bill or, as the case may be, a challan shall include any document, by

whatever name called, which shall contain the details of the consignment note number and date, gross weight of the consignment and also contain other information as required under this sub-rule:

~~Provided also that where any payment towards the value of taxable service is not received and such taxable service is provided continuously for successive periods of time and the value of such taxable service is determined or payable periodically, an invoice, a bill, or as the case may be, a challan shall be issued by a person providing such taxable service, not later than fourteen days from the last day of the said period.~~

Another amendment is deletion of third proviso in Rule 4A. In view of separate provision for determining PoT in the case of CSoS, it is not required.

#### **Insertion of Rule 5B**

4.2 Another major amendment is insertion of clause 5B. It reads as follow:

#### **Date for determination of rate.-**

The rate of tax in case of services provided, or to be provided, shall be the rate prevailing at the time when the services are deemed to have been provided under the rules made in this regard.

4.3 This Rule provides for the rate as prevailing on the date on which the services were provided or deemed to have been provided. This put an end to controversy regarding the applicability of the rate of tax.

#### **Amendments in Rule 6**

4.4 Rule 6 regarding payment of tax is also proposed to be amended. A Table showing comparative position is given here below.

<b>Existing Provision of Service Tax Rules (STR)</b>	<b>Proposed Amendments in ST Rules</b>
<b>Payment of service tax</b>	<b>Payment of service tax</b>
6. (1) The service tax shall be paid to the credit of the Central Government, –	6. (1) The service tax shall be paid to the credit of the Central Government, –
(i) by the 6th day of the month, if the duty is deposited electronically through internet banking; and	(i) by the 6th day of the month, if the duty is deposited electronically through internet banking; and
(ii) by the 5th day of the month, in any other case,	(ii) by the 5th day of the month, in any other case,
immediately following the calendar month in which the <i>payments are</i>	immediately following the calendar month in which the <i>service is deemed</i>

Existing Provision of Service Tax Rules (STR)	Proposed Amendments in ST Rules
Payment of service tax <u>received, towards the value of taxable services:</u>	Payment of service tax <u>to be provided as per the rules framed in this regard</u>

<b>Provided</b> that where the assessee is an individual or proprietary firm or partnership firm, the service tax shall be paid to the credit of the Central Government by the 6th day of the month if the duty is deposited electronically through internet banking, or, in any other case, the 5th day of the month, as the case may be, immediately following the quarter in which the <u>payments are received, towards the value of taxable services</u> :	<b>Provided</b> that where the assessee is an individual or proprietary firm or partnership firm, the service tax shall be paid to the credit of the Central Government by the 6th day of the month if the duty is deposited electronically through internet banking, or, in any other case, the 5th day of the month, as the case may be, immediately following the quarter in which the <u>service is deemed to be provided as per the rules framed in this regard</u>
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Amendments, as highlighted above, are consequent to PoTR under which tax liability will be determined with reference to deeming provisions.

<b>Provided further</b> that notwithstanding the time of receipt of payment towards the value of services, no service tax shall be payable for the part or whole of the value of services, which is attributable to services provided during the period when such services were not taxable :	<i>Proposed to be omitted</i>
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In view of Rule 5 of PoTR this clause is not relevant and, hence, proposed to be omitted.

<b>Provided</b> also that the service tax on the <u>value of taxable services received</u> during the month of March, or the quarter ending in March, as the case may be, shall be paid to the credit of the Central Government by the 31st day of March of the calendar year.	<b>Provided</b> also that the service tax on the <u>services deemed to be provided</u> in the month of March, or the quarter ending in March, as the case may be, shall be paid to the credit of the Central Government by the 31st day of March of the calendar year.
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Amendments in this clause take care of payment of tax liability which is deemed to arise in the month of March.

Explanation. – For the removal of doubts, it is hereby declared that where the transaction of taxable service is with any associated enterprise, any payment received towards the value of taxable service, in such case shall include any amount credited or debited, as the case may be, to any account, whether called ‘Suspense account’ or by any other name, in the books of account of a person liable to pay service tax.	<i>Proposed to be omitted</i>
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In view of Rule 7 of PoTR, this clause is proposed to be omitted.

### **Events Occurring in the Process of Provision of Service**

- 5.0 Before understanding the PoTR, it will be necessary to understand various events which occur in the process of provision of service. Let us see the whole process as it occurs.

Sr.	Event
1	SR approaches SP for provision of services
2	SP provides details of services to be provided
3	SP and SR negotiates and finalises terms of services to be provided, amount of consideration, time of payment and other conditions
4	SP and SR enters in to a contract
5.1	If so required in the contract, SP issues invoice for services to be provided as agreed upon in the contract.
5.2	If so required in the contract, SR makes payment of advance as provided in the contract, if any
6	SP commences providing of services
7.1	On a specified date as agreed upon, SP completes providing of services either fully or in part.
7.2	It may so happen that SP may not be in a position to provide the services fully as agreed upon
7.3	It may also happen that the SP might not have commenced rendering of services at all.
8	SP issues invoice for services provided
9	SR makes the payment to SP against the bill received after deducting certain amount as retention money or deposit as provided in the contract
10	On completion of the time period laid down, SR makes the payment of retention money
11	SP writes off balance amount of the invoice raised which has not been received.

Sr.	Event
12	In the eventuality of failure of provision of services and non-recoverability of advance paid, SR writes off the amount of advance paid.

5.1 It should be noted that all the transactions may not have the sequence of events as indicated above. However, generally, it follows the above said sequence. Essentially, the question is - at what point of time tax should be levied i.e. 4, 5, 5.1, 5.2, 7.1, 7.2, 7.3 or 8? PoTR attempts, though not stated specifically in the Rules, to determine taxable event with reference to earliest occurrence of some of the events as indicated above. PoTR also attempts to determine taxability of the transactions when there is a change in rate of tax. The issue becomes complex as the rate of tax also get changed periodically. Moreover, at times some of the services become taxable when certain events as shown above have already taken place.

5.2 Primarily there are three situations as follow:

- a) Static Level i.e. where there is neither the change in rate or no levy of tax for the first time
- b) Where there is a change in rate of tax
- c) Where the tax is being levied for the first time

As proposed, the system of levy of service tax will revolve around three events as follow:

- a) Provision of Service
- b) Issue of Invoice
- c) Receipt of Payment

### Structure of PoTR

5.4 PoTR tries to make provision for various eventualities. It can be tabulated as follow

Rule 2	Definitions
Rule 3	Determination of PoT in the cases where there is no change in rate or the service is not falling into Continuous Supply of Service (CSoS)
Rule 3(a)	Determination of PoT where invoice has not been issued nor payment has been received before provision of service
Rule 3(b)	Determination of PoT where Invoice has been issued or payment has been received before provision of service
Rule 4(a)	Determination of PoT where service has been provided <i>before</i> the change of rate of tax
Rule 4(b)	Determination of PoT where service has been provided <i>after</i> the change of rate of tax
Rule 5:	Determination of PoT where tax is being <i>levied on the service for the first time</i>
Rule 6:	Determination of PoT where service is being provided <i>continuously</i> beyond specified period

Rule 7:	Determination of PoT where service has been provided to <i>Associated Enterprise</i>
Rule 8:	Determination of PoT where service in the case of <i>copyright, trademarks, designs or patents</i>

## Definitions

### Continuous Supply of service

6.0 Clause 2(c) defines it as follow:

*“continuous supply of service” means any service which is provided, or to be provided continuously, under a contract, for a period exceeding three months, or where the Central Government, by a notification in the Official Gazette, prescribes provision of a particular service to be a continuous supply of service, whether or not subject to any condition;*

6.1 Draft rules of August, 2010 in this respect read as follow:

*“continuous supply of service” means any service which is provided, or to be provided, under a contract, for a period exceeding six months, or where the Central Government, by a notification, prescribes provision of a particular service to be a continuous supply of service, whether or not subject to any condition;*

6.2 There are two major changes here viz. insertion of the word “*continuously*” and reducing the period of contract from six months to three months. Under the proposed draft emphasis was on the period of a contract. However, it has been restricted to the cases wherein the services are provided *continuously*. Thus, the cases of provisions of services intermittently have been excluded as only the cases wherein the service is provided continuously will be governed by this definition.

6.3 As far as period of three months is concerned, it has been reduced from six months to three months. This will bring in its ambit large numbers of cases under Rule 6 preponing the liability to pay the tax.

6.4 Some of the features of the above clause are as under:

- a) Rendering of services will be divided into two broad categories viz. one-time and Continuous Supply Service.
- b) The definition is based on terms of the contract *rather than nature of service to be provided*. It means that each contract has to be evaluated separately on the basis of period laid down in the contract.

- c) If, as per the agreement, time-frame for providing of service is less than three months, it will fall into the category of One-Time. However, if it extends to more than three months, it will fall into the category of CSoS.
- d) This rule will have tax implication in the sense that in the case of One-time service it will be governed by Rule 3 while CSoS will be governed by Rule 6.
- e) It should be noted that the differentiation is based on the terms of the contract. It is not clear what will happen if there is no written contract.
- f) It is also not clear what will happen if provision of service, as against the original contract, extends beyond the period of three months.
- g) PoTR has inserted the word "*continuously*". This is going to be a controversial issue as no definition is available about norms for determining continuity.
- h) At times, the parties enter into the agreement wherein various terms and conditions are laid down. Period for providing of service may be, say, two or three years. Services are provided as and when requisitioned. Such cases will pose problems.

### **Invoice**

7.0 Clause 2(d) defines the word "Invoice" as follow:

*"invoice" means the invoice referred to in rule 4A of the Service Tax Rules, 1994 and shall include any document as referred to in the said rule;*

7.1 Draft rules of August, 2010 in this respect read as follow:

*"Invoice" shall have the meaning assigned to it in Rule 4A of the Service Tax Rules, 1994 and shall include any bill or challan as prescribed therein;*

7.2 Draft Rules had kept the definition restricted to the provisions of Rule 4A. However, the provision in PoTR encompasses wide variety of cases as it refers to "*any document*". In view of the above provisions, issue of "Pro-forma" invoice / bill will also get covered leading to creating the liability for payment of tax.

7.3 Neither the Service Tax Rules (STR) nor CENVAT Credit Rules define the term "Invoice". Rule 9 of CENVAT Credit Rules lists various kinds of documents on the basis of which CENVAT Credit can be claimed. Definition of PoTR goes far beyond the provisions contained in CENVAT Rules. Here, there will be conflict. The Service Provider (SP) will have to pay tax based on, say, contract under which the service has become taxable. However, it will not be possible for the Service Recipient (SR) to

claim CENVAT Credit as there is no proposal to carry out corresponding amendments in CENVAT Credit Rules.

7.4 It should be remembered that the objective of having this clause is to ensure that any document showing commitment by the SP for rendering of service be considered for invoking the deeming provision. However, the said document cannot be the base for claiming CENVAT Credit by the SR. If that is the case, the SP having entered into a contract for rendering of service should immediately issue invoice so that he can collect the value of service and discharge the tax liability. Otherwise, the SR cannot claim CENVAT Credit. It is true that the Government is not concerned whether the ST is collected by the SP or not. It should be appreciated that such type of provisions can play havoc as both the SP and SR will have to keep records for the following types of transactions.

- a) Deemed Services without issue of invoice
- b) Issue of Invoice without providing of Services
- c) Actual provision of Services
- d) Receipt of consideration as advance
- e) Receipt of consideration after providing of services in part
- f) Receipt of consideration after providing of services fully
- g) Writing off of value of services for non-receipt of consideration

7.5 It appears that the objective here is to plug the loopholes by issue of "Pro-forma" invoice, hence, an extensive definition of the term "invoice" has been provided.

**Point of Taxation:**

8.0 Clause 2(e) defines the term PoT as follow:

***"point of taxation" means the point in time when a service shall be deemed to have been provided;***

8.1 Draft rules of August, 2010 in this respect read as follow:

***"Point of taxation" means the point of time when the **tax becomes payable** to the Government;***

8.2 This is a major change in the definition. The definition in the Draft went far ahead as it tried to determine the period of time when the liability to pay the tax arises as it refers to "tax becoming payable" rather than determining the point of time when the services has been or deemed to have been provided. As we know, Rule 6 of ST Rules lays down the period during which ST is required to be paid. Had this provision been continued, it would have created havoc. In fact, it would have been a clear case of overriding the provisions of Rule 6 of ST Rules. Mark the following important aspects of this definition:

- a) It is a deeming provision - it is not necessary that the SP should have provided the service.
- b) It gets invoked the moment event as provided for in Rule 3, 4, 5 and 6 occurs.
- c) It refers to the end point of provision of service and consequences thereof.
- d) Point of time when the provision of service commenced is not important.

### **Taxable Service**

9.0 Clause 2(f) reads as follow:

*“taxable service” means a service which is subjected to service tax, whether or not the same is fully exempt by the Central Government under Section 93 of the Act;*

9.1 Draft rules of August, 2010 in this respect read as follow:

*“taxable service” means a service which is subjected to service tax, whether or not the same is fully exempt by the Central Government vide powers conferred under Section 93 of the Act;*

9.2 Section 93 of the Finance Act gives power to the Central Government for exempting a particular service. Therefore, reference to these three words was not warranted.

9.3 S. 65(105) of the Finance Act defines the term “taxable service” as “any service provided or to be provided .....” and lists various services which have been brought within the net of taxation. Section 66 levying charge of ST provides “there shall be levied a tax .....on the value of taxable service referred to in sub-clause .....”. Thus, it keeps out of levy the services which have not been made subject to charge. Broadly speaking there are two types of services viz. (1) the one which has been subject to ST and (2) the one which has not been subject to tax. In the first type of case, it is not necessary that tax will have to be paid on such services. The Government has been empowered to make certain services exempt i.e. the cases wherein tax will not be required to be paid. In such cases, though tax is not required to be paid, still it will be called “taxable service”. It means that all the services as listed under section 65(105) of the Finance Act are taxable even though the same may be exempt for any reason.

### **Taxable Event:**

10.0 PoTR has dropped the definition in this respect. Draft rules of August, 2010 in this respect read as follow:

*“taxable event” means an event which causes the tax liability to arise, namely, the provision of service, issuance of invoice or the receipt of payment.*

10.1 In any statute levying tax, provision of taxable event is important. For example, in the case of Income Tax, tax is levied on income which has been accrued or received by the assessee. In the same manner, in the case of Sales Tax or VAT, taxable event is transfer of property in the goods. In the case of Service Tax, the Finance Act does not provide so explicitly. Section 66 provides for levy of ST on provision of various services and provision of section 65(105) defines various services. Draft Rules of August, 2010 proposed the same. However, clause in this respect has been deleted in the PoTR. Instead, clause 2(e), while defining the term "Point of taxation", does so partially as it refers to the cases of deeming services only. Hence, even after the PoTR, there is no clarity about taxable event in the normal course of transaction.

### **Determination of Provision of Service in the normal course**

11.0 Rule 3 of PoTR provides for the rule which has to be applied for determining the timing of occurrence when services is said to have been provided.

#### ***3. 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***

11.1 Draft rules of August, 2010 in this respect read as follow:

*For the purposes of these rules, - A provision of service shall be treated as having taken place at the time when service is provided, or is to be provided.*

11.2 The most controversial issue will arise on account of these three words viz. "to be provided". As we shall see during the course of clause by clause analysis, it will be a major source of nuisance to the service providers. ***This is for the reason that even a promise to render service has been made taxable event making the SP liable to pay the tax.*** For confirmation in this respect, refer to Explanatory Notes provided under Rule 3 of the Draft Rules.

11.3 Following points be noted here:

- 1) It is a deeming provision. It gets invoked even if the service has not been provided.
- 2) The villain here is the words "***to be provided***".
- 3) There can be two interpretations of this clause. It implies that the SP will be liable to tax at the point of time when he enters into a contract. This is irrespective of the fact when milestones laid down have been achieved or not.

- 4) One can read it another way as well. It gets invoked only when the point of time at which the service should have been provided. If we read this clause with clause (b), this interpretation sounds plausible.
- 5) In either of the case, for the purpose of taxation, actual provisioning of the service is not required.
- 6) An interesting issue arises here. What will happen if the SP has received an advance which will be after entering into a contract? If the provision of Rule 3(b) has to be applied can be it be treated as another point of taxation?

### ***“To be provided”***

11.4 The most confusing, and perhaps going to be most controversial as well, are the words “to be provided”. Let us, first of all examine it from the time aspect. How should one read these words? Does it refer to a case wherein even a mere promise has been made to perform a service or to a case wherein both the parties have laid down certain milestones for completion of work? A logical view will support the latter view. However, in the Draft Rule of August, 2010 the Explanatory note read as follow:

*Rule 3 provides that the taxable event shall be the provision of service, including future provision. This would mean that the service, even though promised to be provided at a future date, shall be taxable. The rule also lays down that, if the service provider issues an invoice or receives any payment before providing service, the service, to the extent of the amount mentioned in the invoice, or the amount of payment, shall be deemed to have been provided. It means that the service provider shall be liable to pay the tax to the extent of amount mentioned in invoice, or the payment received, even if the service has not been provided at that point of time.*

11.5 Mark the words underlined. These words are sufficient enough for any layman to understand the consequences of such provisions. Having not satisfied with the statutory provisions of taxing the transactions which have taken place, an attempt is being made to levy tax on something which has not happened at all. Is it not the case of levying tax on notional events?

### **Rationale for PoT on service “to be provided”**

11.6 Similar provision can be found under Canadian GST. Therein, it is provided that the entering into an agreement itself is a supply of service, with the performance of the agreement being part of that supply rather than a separate supply. Such provision over-rides the ordinary meaning of “provision of service”. Here it is presumed that

there is a supply of a contractual right to acquire something, the consideration for which is the payment or the promise to pay; when the contract is later performed, there is no additional consideration, and, therefore, no additional taxing point. Thus, where there is a payment of advance and performance of service is in future, the time of supply is the time at which the contractual rights are created. Provision of service in future might be a supply, but it is made for no consideration and, therefore, of no consequences. Looking to the Indian structure of taxation, it is a moot point to consider whether such a characterisation rule is valid.

### **Implications for Business**

- 11.7 How one should read the words “*to be provided*”. Should one read it being applicable the moment a contract is entered into? Or should one read it as on achieving a milestone of completion of provisioning of service as laid down in the contract? A reasonable view can be that it will be applicable only when the milestone with reference to the time as laid down in the terms of the contract are achieved. Here, the possibility is that, for various reasons, the SP might not have commenced provision of service or having commenced it might not have been completed. These three words make such cases also liable to tax something which has not happened. To an extent, it can be said that it is an attempt to levy tax on a hypothetical provision of service. One can understand “deeming” provision of tax but a provision laying down tax on notional basis defies logic.
- 11.8 Another practical difficulty here is cancellation of contract after the date of completion as laid down originally. If the SP has to pay the tax on hypothetical basis, a question will arise as to how to recover the tax paid when such a contract is cancelled.
- 11.9 This rule will require the assessee to track the Basic Tax Points for transactions. The assessee generally recognises revenue based on rendering of services, invoice or payment dates. This means that for transactions where the Basic Tax Points do not coincide with the invoice or payment date, the assessee will have to incur additional costs in order to fully comply with PoTR.
- 11.10 On plain reading it appears that a Master Agreement laying down certain terms and conditions for performance of service without reference to any milestones will also get covered. This is absurd for the reason that it will not be possible to quantify the value of service. If it is not possible to quantify the value of service, it will not be possible to compute tax liability.

### **PoT on the Basis of Issue of Invoice or Payment Received**

- 12.0 Rule 3 also provides for the contingency wherein invoice is issued or payment is received before providing of service. Clause 3(b) reads as follow:

*(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.*

12.1 Here it is not necessary that both the events should take place at the same time. Occurrence of either of the event i.e. issue of invoice or receipt of payment will trigger this clause. This is for the reason that the word used here is “or” and not “and”.

12.2 In the case of certain services, the SP is required to issue Pro-forma Invoice for obtaining advance. In the case of construction industry, it is known as Mobilisation Advance. In view of this clause, it will be taxable the moment such a document is issued.

#### **Quantification of Value of Service**

12.3 The clause provide for quantification of value of service in such cases as well. Value of service for tax purposes will be to the extent covered by the invoice or payment. Therefore, payment received for part of a pro-forma invoice will make total amount of pro-forma invoice taxable.

#### **Payment of Deposit**

12.4 At times, the SR is required to make payment of security deposit. Although it is not part of the consideration for services to be provided, its valuation has raised disputes. Explanation to Rule 3 provides for such cases.

*Explanation.-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.*

12.5 Clause 3(b) refers to the term “payment”. It is a vague term. It is not clear whether it refers to payment for services to be rendered or rendered. The ST Department has taken a view that payment made by SR as security deposit to the SP is the payment and, therefore, is subject to tax. In order to avoid legal issues arising in this respect, the Draft Rules contained following provision:

*Provided that no tax shall be payable on an interest free refundable deposit.*

12.6 However, the above provision has been dropped in PoTR. It means the dispute in this respect will survive. Clause (a) and (b) read together following scenario emerges:

	Event	Taxable at the point of
1	Services is provided	provision of service
2	Point of time when the service <i>should have been</i> provided	time when service should have been provided
3	Issue of Invoice <i>before</i> provision of service	Issue of invoice
4	Receipt of payment <i>before</i> provision of service	Receipt of payment
5	Issue of invoice <i>before</i> the time agreed upon for provision of service	Issue of invoice
6	Receipt of payment <i>before</i> the time agreed upon for provision of service	Receipt of payment

### **Import of services**

12.7 Section 65A of FA provides for taxation of import of services. Explanation 2 to rule 3 provides for such cases as well. It reads as follow:

*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.*

12.8 The provisions in this respect can create problem with respect to import of service. In the case of import of service invoice is being issued by a foreign company or person who is not subject to tax. In view of this, separate provision is required to be made. Explanation 2 takes care of the said situation. Clause 66A of the Finance Act provides for levy of tax in the case of import of services. As per the PoTR, in such cases, date of receipt of invoice is proposed to be considered the point of time when service is deemed to be provided. In the case of payment of advance, it is the point of remittance of money when the service is deemed to be provided.

12.9 As we know, in these days, in the case of import of services, negotiation takes place through e-mail. In view of extended definition of the term "invoice", even a confirmation in the e-mail will make it subject to tax. One can imagine the hassles involved particularly in the case of Information Technology Services wherein the Value Added Dealers enters into hundreds of transactions in a month on e-mail. Keeping track of each of it, determining the deemed date of provisions of service and paying tax thereon will be Herculean task. Apart from that it will involve cash-flow problem as payment of tax will be preponed.

Various scenarios emerging out of the above can be summarised as follow:

**Point of taxation where there is no change of rate of tax**

Provision of Service	Issue of Invoice	Payment	Point of Taxation
<b>Yes - 3(a)</b>	After provision of service	After provision of service	<b>When service is provided</b>
<b>Time at which service was promised to be provided - 3(a)</b>	Might not have been issued	Might not have been made	<b>At the point of time when service was promised to be provided</b>
After issue of Invoice	<b>Before providing of service-3(b)</b>	After issue of Invoice	<b>At the time of issue of invoice</b>
After payment	After payment	<b>Before providing of service-3(b)</b>	<b>At the time of receipt of payment</b>

**Change in Rate of tax**

13.0 Frequent changes in the rate of tax, has caused lots of hardship. Draft Rule of August, 2010 has following to say about its justification.

*Rule 5 determines the point of taxation where there is a change in rate of tax. In other words, it prescribes the applicable of rate of tax in the cases where the tax rate changes between the occurrence of different events, viz., provision of service, issuance of invoice, and receipt of payment. This Rule only covers the change in rate of tax, **including any service which was exempt and becomes taxable**, and does not cover the services which become taxable for the first time. The provisions of this rule can be summarized in tabular form as shown below (Please note that the words 'Before' and 'After' mean "before the change in tax rates" or "after the change in tax rates", as the case may be).*

[Note: PoTR does not contain the words highlighted]

13.1 Rule 4 of PoTR lays down rules for such cases.

***4. Determination of point of taxation in case of change of rate of tax.***

***Notwithstanding anything contained in rule 3, the point of taxation in cases where there is a change of rate of tax in respect of a service, shall be determined in the following manner, namely:***

13.2 There has been considerable controversy regarding rate of tax to be applied when it is changed. This is particularly for the reason that, in large number of cases, the process of provisioning of service is going on when the rate of tax is changed. There may also be the cases wherein advance was already paid and the SP has paid the tax thereon. However, at the time of rendering of the service, the rate of tax is changed. In order to avoid such controversies, clause 4 of the PoTR provides for various contingencies. Provisions in this respect have been classified keeping the focus point of provision of service. Clause (a) deals with the cases wherein the service has been provided before the rate has been changed while clause (b) deals with the cases wherein the service has been provided after the change of rate. The problem becomes complex as there are three events viz. providing of service, issue of invoice and receipt of payment which affect the point of taxation depending upon the time of its occurrence.

**Provision of service before change in rate of tax**

13.3 Clause (a) provides for the cases wherein service has been provided before the change in rate of tax. It reads as follow:

***in case a taxable service has been provided before the change of rate,***

13.4 However, the question that will arise is whether the provision of service should have been completed at the point of time? What will happen if the providing of service is going on at the time of change in rate of tax? Such questions remain unanswered.

***Scenario- I***

13.5 First scenario takes care of issue of invoice and receipt of payment after change of rate of tax. It reads as follow:

***(i) where the invoice for the same has been issued and the payment received after the change of rate, the point of taxation shall be date of payment or issuing of invoice, whichever is earlier; or***

13.6 Clause (i) shifts the focus for levy of tax from providing of service to issue of invoice and payment which takes place after the change in rate. It should be remembered that under this clause both the events viz. issue of invoice and payment should be

after the date of change in rate of tax. A question that will arise what will happen if invoice has been issued before the change in the rate of tax and payment has been received thereafter. Since, in this clause, both the events have been linked together with the word “and”, this clause will not apply. It will be governed by clause (ii).

**Scenario - II**

13.7 Second scenario covers the cases where invoice has been issued earlier but payment has been received subsequently. It reads as follow:

*(ii) where the invoice has also been issued prior to change in tax rate but the payment is received after the change of rate, the point of taxation shall be the date of issuing of invoice; or*

13.8 Under this clause, focus shifts to providing of service and issue of invoice with reference to payment received subsequently. Since, out of three events two events take place before the change of rate, point of taxation get shifted to the point that is before the change of rate.

**Scenario - III**

13.9 Under the third scenario payment has been received before but the invoice has been issued after the change of rate of tax. It reads as follow:

*(iii) where the payment is also received before the change of rate, but the invoice for the same has been issued after the change of rate, the point of taxation shall be the date of payment;*

13.10 Under this clause, provision of service has been linked with payment which takes place before the change in rate of tax. Here, two events takes place before the change in rate of tax, hence, PoT will be before the change in rate of tax.

**Point of taxation where there service is provided before change in rate of tax**

Sr.	Provision of Service	Issue of Invoice	Payment	Point of Taxation
1	Before - 4(a)(i)	After - 4(a)(i)	After - 4(a)(i)	Date of issue of invoice or payment, whichever is earlier
2	Before - 4(a)(ii)	Before - 4(a)(ii)	After-4(a)(ii)	Date of issue of invoice
3	Before -4(a)(iii)	After - 4(a)(iii)	Before - 4(a)(iii)	Date of Payment

### **Increase / Reduction in Rate of Tax**

13.11 Rule 4 refers to change in rate of tax. Hence, it is applicable to both the types of cases viz. increase in rate of tax and reduction in it.

### **Exemption / Withdrawal of Exemption**

13.12 There is no clarity about exemption or withdrawal of exemption of services from taxation. Draft Rules of August, 2010 contained the provision which read as follow:

*change in tax rate includes withdrawal of exemption*

However, PoTR does not contain such provision. Therefore, issues arising in this respect will remain unresolved.

### **Provision of Service after the Change of Rate of Tax**

14.0 Clause (b) of Rule 4 takes care of the cases wherein service has been provided after the change of rate of tax. It reads as follow:

*(b) in case a taxable service has been provided after the change of rate,*

14.1 As in the clause (a), the principle followed are the same. PoT is determined with reference to other two events viz. issue of invoice and payment.

### **Scenario - I**

*(i) where the payment for the invoice is also made after the change in tax rate but the invoice has been issued prior to the change of tax rate, the point of taxation shall be the date of payment; or*

Here two events viz. provision of service and payment takes place after the change in rate, hence, PoT arises after the change of rate.

### **Scenario - II**

It reads as follow:

*(ii) where the invoice has been issued and the payment for the invoice received before the change of tax rate, the point of taxation shall be the date of receipt of payment or date of issuance of invoice, whichever is earlier; or*

### Scenario - III

It reads as follow:

*(iii) where the invoice has also been raised after the change of rate but the payment has been received before the change of rate, the point of taxation shall be date of issuing of invoice.*

14.2 As in the case of (i) above, the principles followed in the case of (ii) and (iii) are the same. The above analysis may sound confusing. However, it can be better understood in tabular form.

#### Point of taxation where service is provided after change of rate of tax

Provision of Service	Issue of Invoice	Payment	Point of Taxation
After - 4(b)(i)	Before - 4(b)(i)	After - 4(b)(i)	Date of Payment
After - 4(b)(ii)	Before - 4(b)(ii)	Before-4(b)(ii)	Date of receipt of Payment or issue of invoice whichever is earlier
After -4(b)(iii)	After - 4(b)(iii)	Before - 4(b)(iii)	Date of Issue of Invoice

#### Payment of tax in cases of new services

15.0 Extension of coverage of services has raised disputes regarding its applicability particularly where services were continuing at the point when it is brought under the taxation. Before reading the provision let us see what the Explanatory Note circulated in August, 2010 has to say in this respect.

*Rule 6 is specifically provided for conditions where a service (which is not a continuous supply of service) is charged to tax for the first time i.e. becomes taxable for the first time. The rule provides that:-*

*(a) If an invoice has been issued and payment received before a service becomes taxable, no tax would be charged even if the service is provided after the same has become taxable. This provision is consistent with the other similar provisions in these rules, and ensures that a financial transaction which has achieved finality before a service was taxable shall not be reopened for collection of tax.*

*(b) If any payment has been received prior to a service being chargeable to tax, no tax shall be chargeable if an invoice has been issued within 14 days*

*of receipt of payment. The period of 14 days is the period also prescribed in Rule 4A of Service Tax Rules, 1994 and ensures that a payment is not shown as having been made earlier than it was actually made.*

*(c)The rule also clearly lays down that any service, which is a not a continuous supply of service, if provided before the service becomes chargeable to tax, shall not be subjected to tax.*

15.1 Rule 5 in this respect reads as follow:

*Where a service, not being a service covered by rule 6, is taxed for the first time, then,-*

*(a) no tax shall be payable to the extent the invoice has been issued and the payment received against such invoice before such service became taxable;*

15.2 As per this clause, provision of service after it becomes taxable will not be subject to tax provided invoice has been issued and payment has been received.

*(b) no tax shall be payable if the payment has been received before the service becomes taxable and invoice has been issued within the period referred to in rule 4A of the Service Tax Rules, 1994.*

15.3 Under this clause if the payment has been received in the first step but invoice has been issued after the service became taxable and service has been provided subsequent thereto, no tax will be payable provided invoice has been issued within the time as laid down under Rule 4A of ST Rules. As we have seen under 4.1, amended Rule 4A provides for issue of invoice within 14 days of provision of service or deeming service. It is interesting here to note that there is no reference to provision of service. In the case of Rule 4, the determining criteria are provision of service before and after change in rate of tax.

**Point of taxation in the case of new services**

Issue of Invoice	Payment	Point of Taxation
Before - 5(a)	Before - 5(a)	No tax to the extent of invoice issued <u>and</u> payment received
Within the period provided in Rule 4A - 5(b)	Before-5(b)	No tax payable

## **Continuous Supply of Service**

16.0 There are certain services which by its nature are such that it takes considerable time in its completion. In such cases, SP raises invoice or payment is made on an ad hoc basis. Generally, a provision of services is on a progressive basis when the contract or agreement provides for stages of its provision. A supply may also be a progressive supply where, under a contract, services are to be supplied on an ongoing basis. However, Rule 6 differs from the traditional concept and defines continuous supply with reference to length of service to be provided. Before understanding the provisions of Rule 6, it will be interesting to read the Explanation which was provided with the Draft Rules of August, 2010. It read as follow:

*Rule 7 deals with the continuous supply of services (e.g., construction services, maintenance and repair services etc.), According to the proposed definition in rule 2 of these rules, 'continuous supply of service' refers to services that are supplied continuously for a period exceeding six months or services that are specified by the Govt. as continuous supply of services, subject to prescribed conditions, if any.*

*The proposed rule essentially prescribes that the rate of tax will be the rate applicable on the date the payment becomes due as per the contract, or, if the payment is linked to completion of certain events (milestones), when those milestones are completed. If none of the above two conditions is specified in a long term contract, then the service provider is required to pay the service tax at the time of raising of invoice, or receipt of payment, whichever is earlier.*

*This rule also provides that if any payment has been received in respect of non-taxable service, before it becomes taxable, the same would not be charged to tax, even if the service is provided subsequently*

*The only exception in this case pertains to the services in continuous supply of service a part of which is being provided before the service becomes taxable, (i.e the service becomes taxable during the currency of provision of service but payment for which is received after the service becomes taxable).*

*Certain examples of this are*

- (a) The payment for construction services is made before the tax becomes applicable but the construction is started after the service becomes taxable.*
- (b) Part of the construction is done before the service becomes taxable but payment for the same is received after the service becomes taxable*
- (c) Water supply has been made in the month of March & April, the bill is raised in month of May, but the service has become taxable in the month of April*

*Similar situations can be interpolated in other services which are supplied continuously.*

*In such cases, tax is liable to be paid on the basis of raising of invoice or the date provided for payment in the contract or the actual payment, as the case may be.. This Rule is drafted keeping in view the fact that the extent of service provided during a particular period of time in continuous supply of the service is difficult to determine.*

*Further, alternatively, payment received in respect of payments received prior to service becoming taxable, but where the service may be provided subsequently, will also not be taxable.*

*It has been prescribed that the clauses of the rule shall be read sequentially. Thus, if there is a date of payment prescribed in the contract, the tax becomes due on that day irrespective of the fact if the payment has been received or not. In case, the date of payment is not prescribed in the contract, but payment is linked to achievement of milestones, then the tax becomes payable even if no payment has been received by the service provider. However, if no date of payment is prescribed in the contract, or if the payment is not linked to achievement of any milestones, then the tax would be payable whenever the service provider issues an invoice, or receives a payment (whichever is earlier).*

16.1 Rule 6 reads as follow:

***Determination of point of taxation in case of continuous supply of service.-***

***(1) In case of continuous supply of service, the whole or part of which is determined or payable periodically or from time to time, shall be treated as separately provided at the date on which the payment is liable to be made by the service receiver, if such date is specified in the contract.***

16.2 As we have seen, in the case of Rule 3(a) service is subject to tax even in the case where promise has been made to provide it. The same principle has been applied here in a different manner. In case of CSoS, it is extremely difficult to judge the extent of services provided. Hence, PoT has been linked with milestones which have been achieved or should have been achieved as per the time schedule laid down. Clause (1) is provides for two contingencies viz.

- a) Due date of provision of service; and
- b) Due date of payment

- 16.3 Under CSoS tax liability will be triggered the moment the date as agreed upon is reached. It is not necessary that the quantum of service as determined to be provided by the said date has been completed or not. It will cover the case where, for any reason, provisioning of service has not commenced at all.
- 16.4 Another event which can trigger the liability is the date on which the payment is falling due as per the contract. Under this clause ST is leviable if, as per the date of payment laid down in the contract whether or not payment is actually received. This will cause hardship for the assesseees in case the payment is not received or a reduced amount is received.
- 16.5 An implication of this will be that the SP will have to keep accounts of targets reached independently and correlate it with accounts maintained for financial transactions. A major issue will be treatment of tax paid under this clause. How to keep track of it? Assessing Officer will ask the SP to reconcile the amount of services provided with financial records i.e. Profit & Loss Account. It will be an almost impossible job. Imagine the plight of SP who will have to maintain a database for the targets achieved, ST paid, consideration received, amount of ST recovered, consideration received in part etc.

#### **Issue of Invoice or Receipt of Payment under CSoS**

- 16.6 Clause (1) provides for taxing the service when it was falling due. Clause (2) provides for the cases where issue of invoice or receipt of payment. It reads as follow:

*(2) If, before the time specified in sub-rule (1), 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.*

#### **Quantification of Value of Service**

- 16.7 Value of service for tax purposes have been restricted to the amount covered in the invoice or payment received.

#### **Payment of Advance under CSoS**

- 16.8 As in the case of service in the normal course, under CSoS also, provisions have been made for taxation of advance received. It reads as follow:

*Explanation.-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.*

### **Import of Services and CSoS**

- 16.9 Explanation 2 to Rule 3 contains the provision for import of services. In the same manner, Explanation 2 of CSoS contains taxation of services under CSoS. It reads as follow:

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

### **Associated Enterprises:**

- 17.0 Explanation to Rule 6 of ST Rules contains provisions for levy of tax in the case of AE. Rule 7 of PoTR contains similar provisions. It reads as under:

*7. Determination of point of taxation in case of associated enterprises.*

*The point of taxation in respect of associated enterprises shall be the date on which the payment has been made, or invoice under rule 4A of the Service Tax Rules, 1994 has been issued, or the date of debit or credit in books of accounts of the person liable to pay service tax, whichever is earlier.*

- 17.1 The concept of AE was introduced into Finance Act during the year 2008. Accordingly, mere book entries between the associated enterprises are taxable. It extends levy of service tax on the date which is earliest of the following three dates:-

1. Date of payment, or
2. Date of debit or credit entry, or
3. Date of issue of debit or credit notes.

- 17.2 In view of expanded meaning assigned to the word "Invoice" Debit or Credit Note also will get covered. As per Rule 4(7) of the Cenvat Credit Rules, 2004, credit in respect of input service is allowed after the date of payment of consideration. However, it should be noted that, in such cases also, under CENVAT credit Rules, the credit for tax is based on the payment by SR and not on the date of payment of service tax by the service provider.

### **Provisions with respect to Intellectual Property Rights**

18.0 Permitting use of Intellectual Property Rights (IPR) are taxable. By its nature, they belong to different category. Hence, provisions have been made in Rule 8. It reads as follow:

*8. Determination of point of taxation in case of copyrights etc.*

*In respect of royalties and payments pertaining to copyrights, trademarks, designs or patents, where the whole amount of the consideration for the provision of service is not ascertainable at the time when service was performed, and subsequently the use or the benefit of these services by a person other than the provider gives rise to any payment of consideration, the service shall be treated as having been provided each time when a payment in respect of such use or the benefit is received by the provider in respect thereof, or an invoice is issued by the provider, whichever is earlier.*

18.1 A typical nature of such service is that at the time of entering into the contract value of service is not ascertainable. Secondly, value of service gets determined by the act of a person who is not SP. For such cases, two events have been provided for as follow:

- a) Payment in respect of IPR
- b) Issue of invoice by the service provider

18.2 For example, in the case of use of trademark value of service may be linked with sales. Contract entered into in this respect will lay down the rate at which royalty will have to be paid. Sales giving rise to right to payment will be made by SR and thus value of service will depend on act of SR and not SP.

### **Transition Provision**

19.0 Providing of service is an ongoing activity. A change in determining tax liability in between is bound to create serious issues. Rule 9 of PoTR tries to provide partial relief in this respect. It reads as follow:

*9. Savings.- Nothing contained in these rules shall be applicable in case of invoices issued prior to the date from which these rules become effective.*

It means that invoices issued before 1<sup>st</sup> April, 2011 will not be governed by these rules. It also covers the cases wherein invoices have been issued before providing of services. As we have seen there are three events which can trigger the liability. However, Rule recognises only one event out of it. Issue of invoice is generally governed by the terms of the contract entered into. Therefore, it may not be possible to issue invoice and get out of rigours of PoTR.

**Conclusion:**

20.0 The PoTR proposes significant change in the tax legislation. The Rule will require changes in accounting systems, invoicing, input and output service records, credit registers, tax payment records, tax computation reports etc. These changes will require businesses to reengineer their entire processes and systems pertaining to tax payment and compliances.

20.1 The above analysis is only a plain reading of the Rule as proposed. There are various issues remaining unanswered viz. taxation of receipt of deposit and credit for refund thereof, bad debts written off, claiming of CENVAT Credit etc. And the most important aspect is how these changes will impact different types of services? At present there are more than 100 services which are subject to tax. Each one is having its different characteristics. These rules will have different implications for all of them. As can be seen from the length of the analysis, it is humanly impossible to deal with such complexities. It is time for oneself to get refresh physically and mentally. Let us keep these issues for the second part of the analysis.

*(to be concluded)*