CENVAT Credits - Opportunities Available to a Manufacture

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Central Excise and Service tax play an important role in a manufacturer's business considering the fact that the burden of these taxes can be passed on to the buyer/customer unlike direct taxes like Income Tax. Since the burden of these taxes can be passed on to the buyer, the manufacturer should be all the more careful in tax planning as many a time the concurrence of the customer would also be a key issue. Unlike direct taxes, any step taken would also impact directly the cost of the product/ service which would affect the interests of the customer. Where the same is detrimental to his interests, the manufacturer may very well end up losing the customer and orders. Thus proper tax planning keeping in mind the interests of the business as well as that of customers assumes significance and this is where manufacturers usually feel constrained. The concept of credit which is governed by the Cenvat Credit Rules 2004 which enables a manufacturer to avail not just credits of excise duty on inputs and capital goods but also of service tax paid on input services, is one of the most critical components of tax planning under Central Excise and Service Tax as it offers potential of reducing the costs of product/service offered by the manufacturer, to his customers. Cost reduction if ensured, would be a great boon considering the present economic scenario prevailing not just in India but even abroad.

The importance of credit stems from the fact that the availability of the same depends on the conditions prescribed under law and also the fact that the same gets added to the cost of the product or service where such credits are not available and consequently, recovered from the customer. Non availability of credits also results in cascading effect of taxes which is nothing but tax on taxes which would have the effect of increasing the cost at the customer's end. Thus, proper planning with regard to credits becomes all the more essential. In this article we shall discuss the areas which some of the manufacturers have been found to be ignoring and where planning for credits can be undertaken.

Exemption under Law and Credits

A manufacturer or a service provider would not be entitled to avail cenvat credit of excise duty on inputs and service tax paid on input service used for manufacture of exempted goods or for providing exempted services as per Rule 6(1) of Cenvat Credit Rules 2004. Even where a manufacturer or a service provider opts for the benefit of exemption on goods manufactured or in respect of output service, he is required to quantify the amount of credit in respect of inputs in stock or lying in process or contained in final product to be cleared without payment of duty or used for providing output service on which the exemption benefit is being claimed. The exemption being referred to here is the SSI exemption under Notification 8/2003 CE and exemption for small service provider under Notification 6/2005 ST. The manufacturer would have the option not to avail the benefit of the exemption being referred to here. Before taking the decision to go in for exemption benefit, the manufacturer should note the credits available on inputs, capital goods and input services. Where the credits are substantial, it could be worthwhile not to opt for exemption. This would be more so for a manufacturer as he would be entitled not only to credits on inputs but also on input services.

This decision would also be influenced by the customer profile of the manufacturer. Where for instance the customer would be in a position to avail cenvat credits of the duty of excise discharged by the manufacturer, it would make sense to discharge the duty and avail benefit of cenvat credit. This can happen if the customer himself happens to be a manufacturer of dutiable goods or a service provider providing taxable service and not the ultimate consumer who makes no value addition. Such customers would also prefer getting the goods on payment of duty as the presence of credits would go towards reducing the overall material cost. This can also act as a springboard for the manufactured to expand his customer base as most of the large scale manufacturers prefer buying or procuring materials from manufacturers who discharge duty of excise.

Another factor which should be considered is the quantum of clearances on account of exports or deemed exports. Where these clearances are substantial, it would make sense not to go in for benefit of SSI exemption as the manufacturer would anyway be entitled to export/deemed export benefits. Even where the manufacturer opts for SSI exemption benefit he should ensure that he claims export benefits on goods exported as well as the benefit of credits on capital goods which can be utilised for duty payment once the turnover crosses the exemption limit of Rs. 150 lakhs.

(Note: - Accumulation and subsequent utilisation of credits has also been supported in Bell Packaging (India) (P) Ltd (2007 (209) ELT 294 (AAR)).

Where the decision is taken to discharge duty of excise, the procurements would have to be made directly from the manufacturer or from a dealer registered under Central Excise who would be in a position to pass on the benefit of cenvat credit. An alternative to purchase would be to operate on job work basis by discussing this option with the customer. This would enable the manufacturer to cut down investment in inventories significantly as well as reduce the risks associated with such an investment.

Impact of Rule 6 of Cenvat Credit Rules 2004

Rule 6 of CCR 2004 requires a manufacturer of dutiable and exempted goods to maintain separate records showing the receipt, consumption and inventory of inputs or input services to be used for manufacturing dutiable and exempted goods (or taxable and exempted service where they are provided by a manufacturer) and avail credits only on those inputs and input services intended to be used in manufacturing dutiable goods (or taxable service where the same is provided). Where this cannot be done, the manufacturer would be required to pay 10% of the value of the exempted goods (8% of value of exempted services where the same are provided by the manufacturer). The alternative to this where separate records are not maintained would be to calculate the credits attributable to exempted clearances, proportionately by using the formula prescribed u/r 6(3A)(b) of CCR 2004. The credits here are not only on inputs or capital goods but on input services as well. There are 16 specified services u/r 6(5) of CCR 2004 where the credits would be admissible unless such services are used exclusively for manufacture of exempted goods or for providing exempted services. Moreover, in case of capital goods, the credits would be admissible fully unless used exclusively for exempted activity as aforesaid.

A common mistake committed by manufacturers is to reverse credits altogether in respect of inputs and capital goods used for manufacturing exempted goods or for providing exempted services and in respect of input services used partly for exempted activity, ignoring the credits on 16 specified input services u/r 6(5) of CCR 2004. The manufacturer can examine the option of paying 10% or 8% as the case may be where the credit balances are substantial and the margin enjoyed by the manufacturer not substantial or where the exempted clearances are not frequent. This would entitle him to full credits without having to bother about segregation. Another aspect to be noted here is the concept of “value” on which the said amount is to be paid. The value now would be in accordance with Section 4/4A of CEA 1944 as the case may be or in respect of services, as per Section 67 of Chapter V of Finance Act 1994 as amended.

Another point requiring mention here is the fact that where clearances of excisable goods are on account of exports under bond, clearances to 100% EOU/EHTP/STP or to unit in an SEZ or SEZ developer, or to United Nations for specified projects, the restrictions of this Rule would not apply and the credits on the concerned inputs or input services used in such clearances can be claimed. This relaxation does not apply to services provided to SEZ unit/developer.

Where the manufacturer opts for the formula under Rule 6, certain aspects would assume significance. These are as follows –

- The said Rule is silent regarding the treatment to be given to the opening balance of credits brought forward from the earlier year. Thus these credits can be claimed in full.

- Where the manufacturer carries on trading activity in addition to providing taxable services or manufacturing dutiable goods, the Rule is silent regarding such a scenario though the department would like to believe that trading is akin to exempted activity. The manufacturer can also distinguish trading activity from exempted activity and claim full credits unless he really has exempted clearances or exempted services being provided (an interpretation which has been followed by the Commissioner (Appeals) in Faber Heat Kraft Industries Ltd case

(2008 (12) STR 252)). To be on the safer side of the law, where inputs or input services are used exclusively for trading, the credits on the same can be segregated and the benefit

claimed only in respect of input services which are common to dutiable/taxable activity and trading.

Input service – concept includes services in relation to setting up of factory

Manufacturers of dutiable goods should also note that credit of service tax paid on input services used in relation to setting up or renovation or repairs or modernisation of factory or premises for providing output service or office in relation to such factory or premises would also be admissible. These would include services of architect, construction services, erection commissioning, maintenance or repair, interior decorator services etc. Thus manufacturers undertaking or planning to undertake construction or expansion of their factories/premises in future should ensure that the contractor is registered under service tax and collects service tax on such services. The manufacturer as stated above would then avail credit of service tax paid to provider of such services.

The contractors who are required to discharge service tax liability have generally been found to register themselves under the old categories i.e. commercial or industrial construction, erection, commissioning or installation service, construction of complexes etc. Another option is that of works contract where there is transfer of property in goods liable to sales tax during the course of execution of such contract. Though this category offers the service provider the option to go in for composition, a decision would have to be taken only after considering the nature of materials being used in the construction work/service involved. This is so especially where the materials have suffered duty of excise before the same could be procured by the contractor. Generally, materials like cement, steel, electrical switches, cables etc suffer duty of excise. In order to avail these credits, the contractor would have to charge service tax on the gross amount including the value of materials transferred. This would enable him to reduce the cost of construction to his client/customer on account of the availability of credit of excise duties on the materials used for construction.

Another option would be to have the client supply the materials required for construction, to the contractor after procuring the same. This would require the client to register himself as a dealer under Central Excise for the purpose of passing on the credits on such materials to the contractor who would claim the same. The contractor would include the value of such materials given to him by his client, in the gross amount and charge service tax. The value of such materials supplied free of cost by the client would then be deducted from the amount payable to the contractor by the client. Here, in effect what would be paid is the charge for construction plus the service tax amount. This option if exercised would also result in savings on VAT as one can avoid a scenario where the materials are sold by the contractor with his margin on the same, to the client and consequent taxing under KVAT. This could be a worthwhile option where the service receiver is himself not in the construction business as no set off on construction materials can be claimed under the KVAT Act 2003.

Where the customer is not in a position to claim cenvat credits, the contractor can examine going in for composition benefit with regard to that contract. He would however not be eligible to claim cenvat credits on materials used for construction with the exception of capital goods. Credits on input services too would be available.

Job work option-relevance

The manufacturer can also examine the option of operating as a job worker rather than purchasing the material outright. This can prove to be a good step where investment in inventories is found to be on the higher side. The job worker would be in a position to claim cenvat credits where the activity in question amounts to manufacture and clearance to principal is of dutiable goods. Even where the process in question does not amount to manufacture as defined under CEA 1944, the job worker would be advised to examine the liability under service tax especially where the principal clears the goods received from him as such without subjecting the same to any further processing. The liability would be under Business Auxiliary Service and the benefit of notification 8/2005 ST would not be available. The sub-contractor is advised to be careful in classifying the taxable service especially where certain repair work is also undertaken on goods sent by the principal. This is because, in the second scenario, the liability under service tax could be under Maintenance, Repair or Management service where the benefit of notification 8/2005 ST does not come into play at all.

For the sub-contractor to avail credits, the materials would have to be received under a duty paid document. Materials can also be received directly from the principal's supplier. Where the process amounts to manufacture and the goods are sent to the principal who clears the same as such, the valuation would have to be in line with Rule 10A of Central Excise (Determination of Price of Excisable Goods) Rules 2000. The principal would therefore have to indicate the price for charging the duty of excise, to the sub-contractor. The job worker would claim credits not only on the materials supplied by the principal but on input services used for such job work as well. This position would remain the same even if the process is liable to service tax under BAS and service tax is charged.

Sub-contractors may also be using their own material for processing and even in such cases; credit of excise duty on such materials can be claimed. Even if the job worker happens to be working under notification 214/86 CE which entitles him to clear goods manufactured, without payment of duty of excise, to the principal, credit of excise duty on materials procured by him and used partly for such job work can be claimed as the principal would be clearing the goods on payment of duty and such clearances would have to be distinguished from exempted clearances for the purpose of Rule 6 of CCR 2004. This view has been followed by the Bangalore Tribunal in South India Wire Products (P) Ltd Vs CCE Bangalore (2008 (228) ELT 290 (Tri-Bang)) and in Sterlite Industries India Ltd Vs CCE Pune (2005 (183) ELT 353 (Tri-LB)) as well as R.M. Polypack Pvt. Ltd Vs CCE Allahabad (2008 (226) ELT 591 (Tri-Del)) and National Standard India Ltd Vs CCE Mumbai III (2008 (226) ELT 431 (Tri-Mum)). This view can be followed in respect of cenvat credits on capital goods especially as the values are generally high as well as in respect of common input services.

Export - impact on credits

Where a manufacturer is engaged in exporting goods manufactured or exports taxable services outside India, he would be entitled to avail cenvat credits on the inputs and input services used for such export of goods or export of taxable services and utilise the same for paying service tax on taxable services provided within the country or for paying duty of excise on clearances within the country. Where such utilisation is not possible, the cenvat credits can be refunded under Rule 5 of CCR 2004. The procedure for refund is governed by Notification 5/2006 CE (NT) dated 06.03.2006 which can be downloaded from the websitewww.cbec.gov.in

An alternative to this would be to examine the rebate option. In case of a manufacturer exporting excisable goods manufactured, the rebate would be governed by Rule 18 of CER 2002. The rebate can be claimed of duty paid on exports or duty on materials used in processing or manufacture of goods meant for export. Similarly, he would also be entitled to rebate of service tax paid on taxable service exported or of service tax on input service and excise duty on inputs used for providing such taxable service for export. The exporter would be better off going in for rebate of excise duty paid on excisable goods exported or of service tax paid on taxable services exported as it enables him to utilise the cenvat credits for making such payment and then en-cashing the same. Where the credits are significant, the exporter can debit the duty/tax amount as the case may be against the credits balance, on export of excisable goods or taxable service and go for a rebate claim on the amounts debited. He should be careful here to remember that the goods in question should not be unconditionally exempt from the whole of duty of excise under a notification issued u/s 5A of CEA 1944. The excise duty or service tax on export of goods or taxable service should not be collected from the customer to avoid unnecessary issues. While the procedure for rebate under Central Excise is specified by Notification 19/2004 CE (NT) dated 06.09.2004 as amended, the rebate under service tax is specified by Notification 11/2005 ST dated 19.04.2005. This option would score over refunds because of the constraints imposed with regard to timing of refunds.

Where the manufacturer prefers going in for rebate of the duty paid on materials/inputs used for manufacturing or on inputs and input services used for providing the taxable service for export, the procedure is as stipulated by Notification 21/2004 CE (NT) dated 06.09.2004 and Notification 12/2005 ST dated 19.04.05

Input service credits and their distribution

The Cenvat Credit Rules 2004 also provide an option to the manufacturer to distribute the credits on input services received at an office or branch. The credits can be distributed to the factory of manufacture of dutiable goods or the premises providing output service. Credits pertaining to units engaged in exempted activity cannot be distributed. The amount distributed cannot exceed the tax paid on input services. The manufacturer opting to use this route shall have to register as an ISD and file returns under service tax. A record of the input services received at the office and distributed to the various units would have to be maintained. The distribution can be on a bill or a challan which would be used by the receiving unit to claim credits of service tax paid on such input services. This would prevent a scenario where the credits are accumulated at the office for want of utilisation or for that matter a scenario where the department denies the credits where the bills are addressed to some other location of the manufacturer and not the factory or said premises.

Transfer of credits – the option available

Rule 10 of CCR 2004 allows a manufacturer or a service provider to transfer the cenvat credits lying unutilised when there is a shifting of the said factory or premises to a new site or when there is a change in ownership on account of sale, merger, amalgamation, lease or transfer of a factory to a joint venture. The transfer would be permissible when the liabilities of the factory/premises/business are also transferred. This would be a very useful tool especially where the business is to be re-organised. Where there are balances of credits accumulating in one entity, the same can be transferred to another entity for utilisation. This can be examined where a manufacturer has more than one unit and one of those units engages in exports (taxable services or excisable goods) alone thereby resulting in accumulation of credits. An alternative to refund would be to merge the unit with another (where this can be done) so that the excess credits can be utilised. This is a safe option and involves quicker remedy rather than refund especially where the accumulated credits are substantial.

Export of goods and specified input services

The Central Government has issued a notification under Service Tax (41/2007 ST dated 06.10.07) which provides exporters of goods, the option to go in for refund of service tax paid on certain specified services used for export of goods. Even though all services have not been covered under this notification, the list of services that are covered may be expanded to cover more services in future. This notification would enable an exporter of goods to en-cash the service tax paid by him on certain services which he would have used for exporting his goods abroad. This can be used by a manufacturer where he opts to go in for refund of the service tax paid rather than claiming the same as credits. He should note that refund here is not of credits which would be under Rule 5 of CCR 2004 but of service tax paid on specified services.

Concept of deemed manufacture and opportunity when exporting

There is a concept of deemed manufacturing under Central Excise whereby certain processes can be deemed as amounting to manufacture even though the process may not satisfy the tests laid down by the Supreme Court in Delhi Cloth and General Mills Co Ltd Vs UOI case, (1962 (10) LCX 0001) in order to hold the same as manufacture under Section 2(f) of CEA 1944. The test as to whether the process amounts to manufacture or not would be determined by analyzing whether a new article having a distinctive name, character or use emerges or not from the said process. Under Section 2(f) (ii) processes mentioned in the section and chapter notes to First Schedule of CETA 1985 can be deemed to amount to manufacture. Section 2(f)(iii) deems the processes of packing or repacking in unit containers or labelling or re-labelling of containers including the declaration or alteration of Retail Sale Price or adoption of any other treatment to render the product marketable as amounting to manufacture in respect of goods specified under Third Schedule.
This concept could prove to be useful to an exporter where export of such goods is involved. This would enable him to carry out the necessary operations on the goods and to claim the benefit of cenvat credit of excise duty on inputs, capital goods and input services used for such export of goods and consequent refund where utilisation is not possible.

Recipient of service and credits

A service receiver in India who receives taxable service from abroad would be liable to pay service tax in respect of such service under a reverse charge mechanism. One saving grace here is that if the service received qualifies as an input service, cenvat credit of the service tax paid on such service by the service receiver can be claimed as credit and utilised for paying duty of excise on local clearances or for payment of service tax on services provided within the country.

Many of the service receivers though are not aware of this point. The payment of service tax on such services received would however have to be paid in cash and there is no question of utilising credits for the same as per Rule 5 of Taxation of Services (Provided from outside India and Received in India) Rules 2006.