

# **CENVAT AND ITS IMPLICATIONS**

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With Immense pleasure I would like to present this report on “CENVAT AND ITS APPLICATIONS”

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## CERTIFICATE FROM THE GUIDE

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# INTRODUCTION

CENVAT (Central Value Added Tax) has its origin in the System of VAT (Value Added Tax). The Concept of VAT was developed to avoid cascading effect of taxes.

In order to mitigate the cascading effect of taxes the Central Government introduced Proforma Credit under Rule 56A of the erstwhile Central Excise Rule 1944, which provided credit of duty paid on inputs used in the manufacture of final products. However this scheme was limited to a few inputs only. Prior to introduction of Proforma Credit under Rule 56A, there existed set off procedure which only allowed set off of duty paid on raw material in some cases. (for example set off under Notification 201/79). Modified system of Value added tax called "MODVAT" was introduced in 1986 Budget. Initially the modvat scheme was restricted to 38 chapters of Central Excise Tariff Act 1985. Its scope was enlarged to many other chapters later on.

When compared to Proforma credit scheme under "Rule 56A", Modvat covered a large number of inputs falling under different chapters for manufacture of final products, as the proforma credit procedure envisaged that inputs and finished goods should fall under the same chapter. In order to avail Rule 56 A procedure, a manufacturer had to take prior permission from the Assistant collector of Central Excise, give intimation in form D-3 regarding receipt of inputs with the Central Excise authority within 24 hours of receipt of inputs. However under Modvat Scheme such stringent requirements were dispensed with and a simple intimation regarding input and final product was to be made to Assistant Collector of Central Excise under dated acknowledgement.

Modvat came into existence as a result of the report submitted by Technical Study Group appointed by the Central Government to Study Value Added Tax (VAT) prevailing in European countries and to suggest adopting VAT in India to mitigate the cascading effect of indirect taxes. Modvat also faced many teething problems when implemented.

Initially Modvat Scheme was applicable only to raw material used as inputs in the manufacture of final products. However in 1994, the Scheme was extended to capital goods also by the introduction of Rule 57Q to Rule 57U of the Central Excise Rules. Modvat was renamed as Cenvat w.e.f 1.4.2000 Vide Notfn No. 11/2000 CE (N.T) dated 1.3.2000, which introduced new Cenvat Credit Rules. Full-fledged Cenvat Credit Rules 2001 were introduced w.e.f 1.7.2001.

These Rules seek to introduce simplified Cenvat provisions and procedures for allowing Credit of duty paid on specified inputs and Capital goods used in or in relation to manufacture of specified final products. The credit of duty so allowed can be utilized for payment of duty leviable as final products subject to conditions laid down in the Rules.

Cenvat Credit Rules 2002 was introduced w.e.f 1.3.2002 vide Notification No. 5/2002 C.E (N.T) dated 1.3.2002. The new rules contained full-fledged provisions for taking credit of duty paid on inputs and capital goods.

Central Government formed a task force under the chairmanship of Shri. Vijay Kelkar on implementation of Fiscal Responsibility and Budget Management Act. The Kelkar committee submitted its report to the Central Government in July 2004 which strongly recommended “Goods and Service Tax” (G.S.T).

To give effect to the proposal of integrating the tax on goods and services, Cenvat Credit Rules 2004 was introduced w.e.f 10.9.2004. Earlier to the introduction of Cenvat Credit Rules 2004, there existed separate set of Rules for taking credit in respect of Central Excise duty (Cenvat Credit Rules 2002) and Service Tax (Service Tax Credit Rules 2002). Cenvat Credit Rules 2004 has been issued by superceding Cenvat Credit rules 2002 and Service Tax Credit Rules 2002.

As already discussed CENVAT has got its origin in VAT (Value Added Tax). The concept of VAT was developed in European countries to avoid the cascading effect of taxes. Before going into the details of CENVAT system, let us examine what is cascading effect.

## **Cascading effect**

If a tax is based on selling price of a product, the tax burden goes on increasing as input and final product passes from one stage to other. For example, Let us assume that tax on a product is 10% of selling price. Manufacture ‘A’ supplies his output to ‘B’ at Rs. 100. Thus, ‘B’ gets the material at Rs. 110, inclusive of tax @ 10%. He carries out further processing and sells his output to ‘C’ at Rs 150. While he calculates his cost, ‘B’ has considered his purchase cost of material as Rs. 110 and added Rs. 40 as his conversion charge. While selling product to C, B will charge tax again @ 10%. Thus C will get the item at Rs 165 (150 + 10% tax). In fact, ‘Value added’ by B is only Rs 40 (150-110), tax on which would have been only Rs. 4, while the tax

paid was Rs. 15. As stages of production and sales continue, each subsequent purchaser has to pay tax again and again on the material which has already suffered tax. This is called cascading effect.

Tax system based on tax on gross selling price distorts tax structure. VAT removes these defects by tax credit system. Under this system, credit is given at each stage of tax paid at earlier stage.

The 'Tax Credit Method' has following advantages-

- a) Audit control is much better, which helps in controlling tax evasion. It acts as a self-policing mechanism
- b) Flexibility in applying varying tax rates to different commodities
- c) Useful in giving tax benefits on exports or other preferred end uses like uses by common man etc.

Most of the countries have adopted 'tax credit' method for implementation of VAT.

In the example illustrated above, 'B' will purchase goods from 'A' @ Rs. 110, which is inclusive of duty of Rs. 10. Since 'B' is going to get credit of duty of Rs. 10, he will not consider this amount for his costing. He will charge conversion charges of Rs. 40 and sell his goods at Rs. 140. He will charge 10% tax and raise invoice of Rs. 154 to 'C' (140 plus tax @10%). In the Invoice prepared by 'B', the duty shown will be Rs. 14. However, 'B' will get credit of Rs. 10 paid on the raw material purchased by him from 'A'. Thus, effective duty paid by 'B' will be on Rs 4. 'C' will get the goods at Rs.154 and not at Rs. 165 which he would have been the price in absence of VAT. Thus, in effect, 'B' has to pay duty only on Rs.40, which is the value added by him

Following example will illustrate the tax credit method of VAT

Details	Transaction with VAT		Transaction without VAT	
	A	B	A	B
<b>Purchases</b>	-	110	-	100
<b>Value Added</b>	100	40	100	40
<b>Sub - Total</b>	100	150	100	140
<b>Add Tax 10%</b>	10	15	10	14
<b>Total</b>	110	165	110	154

**Note:** - 'B' is purchasing goods from 'A'. In second case, his purchase price is Rs 100/- as he is entitled to Cenvat credit of Rs 10/- i.e. tax paid on purchases. His invoice shows tax paid as Rs 14. However, since he has got credit of Rs. 10/-, is paying in effect only Rs 4/- as tax, which is 10% of Rs 40/-, i.e. 10% of 'value added' by him.

The 'Value added' is difference between selling price and purchase price. In the above example, 'value' added by B is Rs 40 and hence, by tax credit system he is paying duty only on Rs 40. At each stage the manufacturer pays duty only on the 'value' added by him. Thus, it does not make any difference even if a product passes through a number of stages.

VAT was developed in West European Countries to avoid the cascading effect of taxes.

CENVAT was developed in India based on VAT.

#### **Advantages of VAT:-**

- Exports are freed from domestic taxes.
- It acts as an instrument of taxing consumption of goods and services.
- Aids tax enforcement by providing audit of different stages of production and sale. It acts as a self policing mechanism.

However it increases paper work considerably.



## **Concept relating to Central Excise Duty and Service Tax:-**

For a proper understanding what is CENVAT, some basic knowledge about Central Excise duty, Service Tax etc, is necessary.

### **Central Excise Duty: -**

Central Excise duty is a duty on goods manufactured or produced in India at the rates specified in Central Excise Tariff Act 1985. Central Excise duty is collected as per Section 3 of the Central Excise Act 1944.

Section 3 of the Central Excise Act, 1944 is reproduced as under: -

“3 (1) There shall be levied and collected in such manner as may be prescribed

(a) a duty of excise, to be called Central Value Added Tax (CENVAT) on all excisable goods ( excluding goods produced or manufactured in Special Economic Zones ) Which are produced or manufactured in India as, and at the rates, set forth in the First Schedule to the Central Excise Tariff Act, 1985 (5 of 1986);

(b) a Special Duty of excise, in addition to the duty of excise specified in clause (a) above, on excisable goods (excluding goods produced or manufactured in Special Economic Zone) specified in the second schedule to the Central Excise Tariff Act, 1985 (5 of 1986) which are produced or manufactured in India, as and at the rates, set forth in the said second schedule”

Basically the duty liability is on the manufacturer. Since it is an indirect tax the duty paid by the manufacturer is passed on to the customer.

In addition to the Basic Excise Duty (CENVAT), there are other duties viz, Special Excise Duty, National Calamity Contingent Duty, Additional Duty on Goods of Special Importance, Additional Duty on Textiles and Textile Articles, Educational Cess, Secondary and Higher Educational Cess etc. which are payable on manufactured goods, In addition to this, Educational Cess and Secondary and Higher Education Cess are payable @ 2 % and 1 % respectively of the Basic Excise Duty..

**Service Tax:-**

Taxable services are described in clause (105) of Section 65 of Finance Act, 1994.

As per Section 66, there shall be levied a tax (hereinafter referred to as the Service Tax) at the rate of twelve percent of the value of Taxable Services. In addition to service Tax @ 12 %, Education Cess and Secondary and Higher Education Cess at the rate 2 % and 1 % of Service tax respectively is also payable on Taxable services.

**Factory: -**

The term 'Factory' is defined in Section 2(e) of the Central Excise Act which reads as under:

'Factory' means any premises, including the precincts thereof, wherein or in any part of which excisable goods other than salt are manufactured, or wherein or in any part of which any manufacturing process connected with the production of these goods is being carried on or is ordinarily carried on.

**Manufacture:-**

The word 'Manufacture' is defined in Section 2(f) of the Central Excise Act which is reproduced below:-

Section 2(f) - 'Manufacture' includes any process-

- (i) incidental or ancillary to the completion of manufactured product or
- (ii) which is specified in relation to any goods in the section or Chapter Notes of the first Schedule to the Central Excise Tariff Act, 1985 as amounting to manufacture, or (iii) which, in relation to goods specified in Third Schedule to the C.E T.A, involves packing and repacking of such goods in a unit container or labeling or re-labelling of containers or declaration or alteration of retail sale price or any other treatment to render the product marketable to consumer.

## **CENVAT Scheme:-**

Section 37 of Central Excise Act gives power to Central Government to make rules to :

- (i) provide for the credit of duty paid or deemed to have been paid on goods used in, or in relations to manufacture of excisable goods (sub clause (x vi a))
- (ii) provide for the giving of credit of sums of money with respect to raw materials used in the manufacture of excisable goods (sub clause (x vi b))
- (iii) provide for credit of service tax leviable under Chapter V of the Finance Act, 1994.paid or payable or taxable services used in, or in relation to, the manufacture of excisable goods. (sub clause (x vi a a))

In exercise of the powers, under Sec. 37 of the Central Excise Act, 1944, Modvat Credit Scheme was introduced w.e.f from 1.3.1986. Modvat was substituted with Cenvat w.e.f 01.04.2000. Separate Cenvat Credit Rules were introduced w.e.f 1.7.2001, which were replaced by Cenvat Credit Rules, 2002 w.e.f 1.3.2002.

Section 94 (2) (e e) of the Finance Act, 1994 provides for the credit of Service tax paid on services consumed for providing a taxable service in case where the services consumed and the services provided fall in the same category of taxable service. In order to overcome the cascading effect, Service Tax Credit Rules, 2002 were issued w.e.f 16.8.2002.

## **Cenvat Credit Rule, 2004:-**

### **Integration of Credit of Excise Duty on inputs, capital goods and Service Tax on input services**

W.e.f. 10.09.2004, New Cenvat Credit Rules 2004 was introduced which provided for credit of duty paid on inputs, Capital goods and service tax paid on input services used in or in relation to manufacture of excisable goods. A service provider is entitled to credit of excise duty paid on inputs and Capital goods and service tax paid on input services used by him for providing the output service.

A manufacturer or service provider will be entitled to credit of Service Tax paid by him used in or in relation to manufacture of final products or for providing out put services.Credit is available

even on services which are received prior to commencement of manufacture or providing Output Services. Input Services relating to setting up of a factory is also eligible for taking Cenvat Credit. Services like advertising, business related activities like, accounting, auditing, and storage, transport etc are also permitted for taking credit. Credit of service tax paid on services such as telephone, security, construction, advertising, market research etc are also permitted.

Goods used for providing output services are treated as inputs in respect of service provider. Service provider is entitled to the credit of excise duty paid on raw materials used by him for providing out put services.

Services received at the office of the manufacturer / service provider are eligible for Cenvat Credit.

Cenvat Credit Rules, 2004 was issued w.e.f 10.9.2004 by merging Cenvat Credit Rules 2002 and Service Tax Credit Rules 2002. Important terms used in the Rules, i.e., inputs, final products, Capital goods, input service etc are defined in Rule 2 of the Cenvat Credit Rules, 2004.

Definitions of some important words used in Cenvat Credit Rules 2004 are reproduced below:-

**Capital Goods:-**

“Capital goods” means:-

- (a) the following goods, namely :-
  - (i) all goods falling under Chapter 82, Chapter 84, Chapter 90, heading No 68.02 and sub-heading No. 6801.10 of the first Schedule to the Excise Tariff Act;
  - (ii) pollution control equipment;
  - (iii) components, spares and accessories of the goods specified at (i) and (ii);

- (iv) moulds and dies, jigs and fixtures;
- (v) refractories and refractory materials;
- (vi) tubes and pipes and fitting thereof; and
- (vii) storage tanks,

Used-

- (1) in the factory of the manufacturer of the final product, but does not include any equipment or appliance used in an office; or
  - (2) for providing output services;
- (b) motor vehicle registered in the name of provider of output service for providing taxable service as specified in sub-clauses(f), (n), (o), (zr), (zzp), (zzt) and (zzw) of clause (105) of section 65 of the Finance Act; **(Rule 2(a))**.

An item can be treated as 'Capital goods only if it satisfies the following requirements given in the definition of Capital goods:-

1. The goods must fall under one of the specified chapters or heading / Sub heading of the Central Excise Tariff, or the goods must be spare parts / components / accessories of the goods mentioned above.
2. The goods must be used in the factory of the manufacturer of final products.
3. The use can be for any purpose in relation to the manufacture or production of final products.
4. In case of a manufacturer of final products, equipment/appliances used in offices of manufacturer are excluded for taking credit.

Air conditioners, refrigerating equipment and computers would be eligible for credit as Capital goods, provided the manufacturer uses them in the manufacture of final product. The only condition is that the manufacturer should use them in the manufacture of final product. For example, an Air-Conditioner used in the office premises or a computer used in the office premises of the factory shall not be eligible for Cenvat Credit. The spare parts / Components / accessories may fall under any chapter but they should be components, spare and accessories of Capital goods.

### **Exempted Goods:-**

“exempted goods” means excisable goods which are exempt from the whole of the duty of excise leviable thereon, and includes goods which are chargeable to “Nil” rate of duty; **(Rule 2(d))**.

### **Exempted Services:-**

“exempted services” means taxable services which are exempt from the whole of the service tax leviable thereon, and include services on which no service tax is leviable under section 66 of the Finance Act; **(Rule 2(e))**.

### **First Stage Dealer:-**

“first stage dealer” means a dealer, who purchases the goods directly from,-

- (i) the manufacturer under the cover of an invoice issued in terms of the provisions of Central Excise Rules, 2002 or from the depot of the said manufacturer, or from premises of the consignment agent of the said manufacturer or from any other premises from where the goods are sold by or on behalf of the said manufacturer, under cover of an invoice; or
- (ii) an importer or from the depot of an importer or from the premises of the consignment agent of the importer, under cover of an invoice; **(Rule 2(ij))**.

### **Input:-**

“input” means-

- (i) all goods, except light diesel oil, high speed diesel oil and motor spirit, commonly known as petrol, used in or in relation to the manufacture of final products whether directly or indirectly and whether contained in the final product or not and includes lubricating oil, greases, cutting oils, coolants, accessories of the final products cleared along with the final product, goods used as paint, or as packing material or as fuel, or for generation of electricity or steam used in or in relation to manufacture of final products or for any other purpose, within the factory of production;

- (ii) (ii) all goods, except light diesel oil, high speed diesel oil, motor spirit, commonly known as petrol and motor vehicles, used for providing any output services.

**Explanation 1:-** The light diesel oil, high speed diesel oil or motor spirit, commonly known as petrol, shall not be treated as an input for any purpose whatsoever.

**Explanation 2:-** Input include goods used in the manufacture of capital goods which are further used in the factory of the manufacturer. **(Rule 2(k)).**

The term “input” is defined to mean all goods except Light Diesel Oil (L.D.O), High Speed Diesel Oil (HSD) and Motor Sprit (Petrol) which satisfy the crucial requirement of ‘used in or in relation to the manufacture of final products’.

The definition of input also includes the following items:-

1. Lubricating oils, greases, cutting oil and coolants.
2. Accessories of final products.
3. Paints.
4. Packing materials.
5. Input used as fuel.
6. Input used in generation of steam or electricity.

The definition further provides that the inputs must be used within the factory of production. In view of the settled position that manufacture of final products become complete only at the stage at which it attains marketability and it leaves the factory gate, inputs used after the completion of manufacture of final products but before it is cleared from the factory are also treated as input used in or in relation to the manufacture of final products.

An output service provider is required to use the inputs for providing any output service. The concept of ‘in or in relation to’ will not apply to an output service provider.

### **Input Services:-**

“input service” means any service,-

- (i) used by a provider of taxable service for providing an output service; or

- (ii) used by the manufacturer, whether directly or indirectly, in or in relation to the manufacture of final products and clearance of final products, up to the place of removal,

and include services used in relation to setting up, modernization, renovation or repairs of a factory, premises of provider of output service or an office relating to such factory or premises, advertisement or sale promotion, market research, storage upto the place of removal, procurement of inputs, activities relating to business, such as accounting, auditing, financing, recruitment and quality control, coaching and training, computer networking, credit rating, share registry, and security, inward transportation of inputs or capital goods and outward transportation upto the place of removal; **(Rule 2(I))**.

In so far as service provider is concerned, 'input service' means any service used by a provider of taxable service for providing output service. If the provider of taxable service avails services of another service provider, the services provided by the 'other service provider' will fall under 'input service' definition provided by the said services were availed by the provider of Taxable service for the purpose of providing output service to the ultimate consumers.

In so far as manufacturer is concerned, 'input service' means any service used by the manufacturer, whether directly or indirectly, in or in relation to the manufacture and clearance of final products. The use of any service is not restricted to manufacturing only. Services used in the pre-manufacturing stage, and post manufacturing stage are also covered. The following services are specifically included in the definition of 'input services'

Services used in relation to:

1. Setting up, modernization, renovation or repairs of factory, premises of provider of
2. output service or an office relating to such factory or premises.
3. Advertisement or sales promotion,
4. Market research,
5. Storage upto place of removal,
6. Procurement of inputs,
7. Activities relating to business, such as accounting, auditing, financing, recruitment
8. and quality control.
9. Coaching and training,
10. Computer networking,



11. Credit rating,
12. Share registry,
13. Security,
14. Inward transportation of inputs and capital goods and
15. Outward transportation up to the place of removal.

The following services may be relevant in respect of above items included in the definition of input services.

**Item 1:-** may include, Architect's Service, Consulting Engineer's Service, Erection, Commissioning or Installation Service, Construction Service, Interior Decorator's Service, Maintenance or Repair Service etc.,

**Item 2:-** may include Advertising Services, Business auxiliary Services, Business exhibition Services etc.

**Item 3:-** includes Market research Agency's Service,

**Item 4:-** includes Storage and Warehousing Service,

**Item 5:-** includes Business auxiliary Service,

**Item 6:-** may include Chartered Accountant's Service, Banking and Financial Services, Manpower, recruitment services, Technical testing & Analysis Service,

**Item 7:-** includes commercial coaching and training Services,

**Item 8:-** includes computer network service,

**Item 9:-**included credit rating agency's services,

**Item 10:-**included stock broker's or under writer's service.

**Item 11:-**include security agency's service.

**Item 12 & 13:-**include Transport of goods by road service.

### **Input Service Distributor:-**

“input service distributor” means an office of the manufacturer or producer of final products or provider of output service, which receives invoices issued under Rule 4A of the Service Tax Rules, 1994 towards purchase of input services and issues invoice, bill or, as the case may be, challan for the purposes of distributing the credit of service tax paid on the said service to such manufacturer or producer or provider, as the case may be; **(Rule 2(m))**.

If a manufacturer is having multiple manufacturing units in different parts of the country, Invoices/ Bills in respect of input services are raised in the name of Head Office/ Regional Offices. The services are actually received by the different manufacturing units or factories or different premises of the service provider. In the case of services which are not specific to a particular factory or premises of a service provider, the Bills are raised in the name of Head Office/ Regional Office. In order to provide for a mechanism to pass on the service tax credit in such cases, such offices of the manufacturer/ service provider are designated as “Input Service Distributor” Rule 7 of the Cenvat Credit Rules prescribes the manner in which an input service distributor can distribute the service tax credit.

### **Output Service:-**

“output service” means any taxable service, excluding the taxable service referred to in sub clause ( zzp) of clause (105) of section 65 of Finance Act, provided by the provider of taxable service, to a customer, client, subscriber, policy holder, or any other person, as the case may be, and the expressions ‘provider’ and ‘provided’ shall be construed accordingly’ **Explanation-** For the removal of doubts it is hereby clarified that if a person liable for paying service tax does not provide any taxable service or does not manufacture final products, the service for which he is liable to pay service tax shall be deemed to be the output service; **(Rule 2(p))**.

Requirement for being an Output Service:-

1. It must be a taxable service as defined in section 65 (105) of Financial Act, 1994. The service must fall under the category of one of the specified taxable service, except the

services rendered by a goods transport agency in relation to transport of goods by road in a goods carriage.

2. It must be rendered by the provider of taxable service, to a customer for final consumption.

### **Procedural aspects of Cenvat:-**

Cenvat credit is allowed under Rule 3 of Cenvat Credit Rules 2004. Rule 3 of Cenvat Credit Rules 2004 is reproduced as under:-

“3(1) A manufacturer or producer of final products or provider of taxable service shall be allowed to take credit (hereinafter referred to as the CENVAT credit) of-

- (i) the duty of excise specified in the first Schedule to the Excise Tariff Act, leviable under the Excise Act;
- (ii) the duty of excise specified in the Second Schedule to the Excise Tariff Act, leviable under the Excise Act,
- (iii) the additional duty of excise leviable under section 3 of the Additional Duties of Excise (Textile and Textile Articles) Act, 1978 (40 of 1978),
- (iv) the additional duty of excise leviable under section 3 of the Additional Duties of Excise (Goods of Special Importance) Act, 1957 (58 of 1957),
- (v) the National Calamity Contingent duty leviable under section 136 of the Finance Act, 2001 (14 of 2001);
- (vi) the Education Cess on excisable goods leviable under section 91 read with section 93 of the Finance (No. 2) Act, 2004 (23 of 2004);  
(via) the Secondary and Higher Education Cess on excisable goods leviable under clause (126) read with clause (128) of Finance Bill 2007, which by virtue of the declaration made in the said Finance Bill under the Provisional Collection of Taxes Act, 1931(16 of 1931) has the force of law;
- (vii) the additional duty leviable under section 3 of the Customs Tariff Act, equivalent to the duty of excise specified under clauses (i), (ii), (iii),(iv), (v) and (vi) and (via); the additional duty leviable under sub-section (5) of section 3 of the Customs Tariff Act: provided that a provider of taxable service shall not be eligible to take credit of such additional duty;

- (viii) the additional duty of excise, leviable under section 157 of the Finance Act, 2003 (32 of 2003);
- (ix) the service tax leviable under section 66 of Finance Act;
- (x) the Education Cess on taxable services leviable under section 91 read with section 95 of Finance (No. 2) Act, 2004 (23 of 2004); and
- (xi) the additional duty of excise leviable under [section 85 of Finance Act, 2005 (18 of 2005)].;

Paid on –

- (i) Any input or capital goods received in the factory of manufacture of final product or premises of the provider of output service on or after the 10th day of September, 2004; and
- (ii) Any input service received by the manufacturer of final product or by the provider of output services on or after the 10th day of September, 2004,

Including the said duties, or tax, or cess paid on any input or input service, as the case may be, used in the manufacture of intermediate products, by a job-worker availing the benefit of exemption specified in the notification of Government of India in the Ministry of Finance (Department of Revenue), No. 214/86-Central Excise, dated the 25th March, 1986, published in the Gazette of India vide number G.S.R. 547(E), dated the 25th march, 1986, and received by the manufacturer for use in, or in relation to, the manufacturer of final product, on or after 10th day of September 2004.

#### **Basic requirements for allowing duty credit / service tax credit:-**

Rule 3 lays down that the following basic requirements to be satisfied in order to allow duty credit.

- 1) The person must be a “manufacturer” or “producer” or “a provider of taxable service.”
- 2) The person must be manufacturing or producing final products or providing out put services.

- 3) The inputs, capital goods or input services must be received in the factory/premises of output service provider on or after 10-09-2004
- 4) The specified duties/ service tax in respect of which credit is allowable must have been paid.

### **Types of duties eligible for credit**

Rule 3(1) of Cenvat Credit Rules stipulates that credit of duty is admissible only in respect of following duties:-

- 1) Basic Excise Duty (Cenvat):- Credit is allowable on the basic excise duty (Cenvat) as specified in the First Schedule to the Central Excise Tariff Act, 1985.
- 2) Special Excise Duty: - Credit of Special Excise Duty specified to the Central Excise Tariff Act 1985 is Allowable.
- 3) Other duties allowable: - The additional duty leviable under
  - (i) Section 3 of the Additional Duties of Excise (Textile and Textile Articles) Act and
  - (ii) Section 3 of additional Duties of Excise (Goods of Special Importance) Act are allowable as credit. In addition, w.e.f. 1.3.2005, credit is allowable on the additional duty of excise leviable under clause 85 of Finance Bill 2005, relating to levy of additional duty on Pan Masala and Specified tobacco products.
- 4) National Calamity Contingent duty: - Credit is allowable on the National Calamity Contingent duty paid on the goods specified in the seventh schedule to Finance Act 2001 as amended, i.e. Petroleum oils, certain varieties of polyester yarn & motor vehicles.
- 5) Education Cess: - Credit is allowable on Education Cess paid on excisable goods.
- 6) Secondary and Higher Education Cess: - Credit is allowable on Secondary and Higher Education Cess paid on excisable goods.
- 7) Countervailing Duty: - The Additional duty under Section 3 of the Customs Tariff Act equivalent to duties mentioned at (1) to (6) above is allowable as credit.
- 8) Additional Duty levied under Finance Act 2003: - The additional duty leviable under Finance Act 2003 on Tea and Tea waste is allowable as credit.

### **Basic requirements for allowing Service Tax Credit to the Manufacturer: -**

The following are the basic requirements for allowing credit of Service Tax paid on input services to the manufacturer of final products:-

1. The person should be a “manufacturer or producer” of the final products.
2. He should have received input service on or after 10.9.2004.
3. He should have used the input service in or in relation to manufacture of final products on or after 10-9-2004.
4. Service tax on the input service is paid by him.

### **Basic requirement for allowing duty credit to Output Service provider: -**

1. The person availing duty credit must be “a provider of output service”.
2. He should have received inputs or capital goods in his premises on or after 10-09-2004.
3. The input or capital goods were received for the purpose of using them in or in relation to providing an output service.
4. Only specified duties are eligible for credit.
5. Duties in respect of such inputs or Capital goods have been paid.

### **Basic requirements for allowing Service Tax Credit to Output Service provider: -**

1. The person must be a provider of output service.
2. He should have received the input service on or after 10-09-2004.
3. The input service was used in or in relation to providing output service.
4. Service Tax on the input service is paid.

### **Utilisation of Cenvat Credit**

Cenvat Credit can be utilized by a manufacturer or provider of output service for payment of the following duties:

- Any excise duty on final product (i.e. Basic Excise Duty, Special Excise Duty, Additional Duty under Goods of Special Importance Act or Textile and Textile Article Act, National Calamity Contingent Duty, Education Cess, Secondary and Higher Education Cess etc.)
- Duty on inputs or Capital goods if such inputs or capital goods are removed as such.
- Amount paid while returning rejected goods under Rule 16 of Central Excise Rules, 2002.
- Service Tax, Education Cess or Secondary and Higher Education Cess on Taxable Service.

### **Cenvat for Service Provider and Manufacturer – Comparison**

Many of the Cenvat provisions are applicable to both manufacturer as well as service provider.

However, there are some distinctions.

Following provisions are applicable to Manufacturer and Service provider:-

- a) Credit available for inputs, capital goods and input services.
- b) Wide definition of 'input services'. Services relating to setting up unit, marketing and activities relating to business covered.
- c) Credit of inputs and capital goods is available as soon as goods are received in factory or in premises of service provider.
- d) Credit of input service only after payment made to service provider.
- e) Credit of basic duty, Special duty, CVD, AED (GSI), NCCD, Education Cess, Service Tax available.
- f) Invoice of manufacturer or service provider, Bill of Entry, Supplementary Invoice, Dealer's Invoice, Invoice of Input Service Distributors are duty paying documents.
- g) Services received at Head Office / Regional offices can be availed through issue of Invoice by the Head office/ Regional Office as 'Input Service Distributor'
- h) Cenvat credit can be utilized for payment of duty on any final product / service tax on any taxable service.
- i) Credit of Education Cess, Secondary and Higher Education Cess, NCCD and AED (T&TA), etc, can be utilized only for respective duty/ tax paid on final product or final services.

- j) One to one correlation is not required
- k) Cenvat on capital goods can be availed in two stages – upto 50% in first year and balance in any subsequent year.
- l) Capital goods obtained on lease or hire purchase or loan are eligible for Cenvat.
- m) Depreciation cannot be claimed on excise duty portion of value of capital goods.
- n) No duty or no service tax is payable on exported goods or services.
- o) Cenvat of inputs and input services used in exported final product can be utilized for payment of duty on other final product / taxable output services, or refund can be obtained but in case of service provider no provision for refund.
- p) No credit if inputs, capital goods and input services used exclusively for exempted final products or output services,
- q) If common inputs/ input services used, 10% 'amount' is payable on the value of the exempted final products. In case of service provider if common inputs/ input services used, the provider of output service shall pay 8% of the value of exempted services.
- r) Credit transfer in case of amalgamation / merger permissible.
- s) Burden of proof on person availing Cenvat credit to show tat he has availed it correctly.
- t) Penalty provisions are same.

Following table attempts to compare distinctions.

<b>Manufacturer</b>	<b>Service Provider</b>
Wide definition of inputs, Input includes goods used directly or indirectly, used in relation to manufacture sufficient.	Narrow definition. Only goods used for providing output services eligible. Indirect use is not permitted.
Capital goods should be used in factory. Purpose not relevant. Inputs can be sent out for job work, even if it is 'manufacture'. The inputs can also be sent for processing, testing, repairs, reconditioning etc.	Capital goods should be used for provision of output services. Input can be sent out only for processing, testing, repair, reconditioning etc. but not for 'manufacture'.
Capital goods can be sent out for processing, testing, repairs, reconditioning etc., to be brought back in 180 days.	Capital goods can be sent out for processing, testing, repairs, reconditioning etc., to be brought back in 180 days. In addition, these can be sent out for providing output service, to be brought back in 180days.
SSI units can opt out of Cenvat at year end then again come back when they cross exemption limit turnover.	No such provision in case of Service Tax.



## **High lights of Cenvat Scheme:-**

### **Credit of duty paid on Input {except High Speed Diesel (HSD), Light Diesel Oil (LDO) and Motor Spirit} and input services:-**

Cenvat Scheme grants credit of duty paid on inputs, capital goods and input services used in / or in relation to the manufacture of final products. A manufacturer has to pay central excise duty on the final products manufactured by him as per the transaction value or assessable value (selling price) of the goods. Similarly a service provider has to pay Service Tax on the services provided by him. Under the Cenvat Scheme, the manufacturer and the Service provider gets credit of duty paid on inputs / capital goods and service tax paid on input services.

### **Inputs may be used directly or indirectly:-**

The inputs may be used directly or indirectly in the manufacture of final products. The inputs need not be present in the final product.

### **Input goods eligible for Cenvat to Service providers:-**

Cenvat credit of Central Excise duty paid on inputs used for providing output services, except High Speed Diesel (HSD), Light Diesel oil (LDO) and Motor Spirit (petrol) is available to a provider of output services.

### **Input credit is not admissible if Final product/Output service is exempt from Central Excise Duty/ Service Tax:-**

No credit of duty paid on inputs / Service Tax paid on input services is available if final products are exempt from central excise duty or service provided is exempt from Service Tax. If a manufacturer manufactures both dutiable and exempted products, or a service provider provides both taxable and exempted services, he should maintain separate records for inputs / input services used for manufacture of exempted final products and should not avail Cenvat credit in respect such inputs / input services used exclusively in the manufacture of exempted products or for providing exempted services.. However if he does not maintain separate records

and inventories of inputs / input services used in exempted final products / exempted services, a manufacturer of final products has to pay an amount of 10% of price of exempted goods, where as a provider of taxable services has to pay 8% of the value of exempted services (as provided in Rule 6 of the Cenvat Credit Rules).

**Credit on the basis of Specified documents:-**

Cenvat credit is to be availed on the basis of specified documents, i.e, an invoice issued by an manufacturer of input or capital goods or inputs or capital goods cleared as such from his factory / Depot etc., an invoice issued by an importer, an invoice issued by a 1st stage dealer or a second stage dealer, a supplementary invoice, challan or similar document evidencing payment of duty issued by a manufacturer or importer, a Bill of entry, or a Certificate issued by an appraiser of customs in respect of goods imported through a Foreign Post Office.

**Burden of proof is on the manufacturer:-**

The burden of proof regarding the admissibility of Cenvat credit is on the manufacturer/ provider of output service. The admissibility of Cenvat credit should be established by valid supporting documents. It is the responsibility of the person availing the Cenvat credit to prove that the inputs, capital goods / input services have actually suffered central excise duty/ service tax.

**Credit to be availed immediately:-**

Credit of duty on inputs can be taken immediately after the inputs are received in the factory. In the case of Capital goods 50% of the credit can be taken in the financial year in which the Capital goods are received in the factory and the balance credit can be taken in the subsequent financial year. In the case of input services credit is available only after the amount of Bill is paid to the Service provider.

**One to One Co-relation is not required:-**

Cenvat Credit Rules do not require input – output co-relation to be established.

**Cenvat Credit is available only if there is manufacture:-**

Cenvat Credit on inputs and input services are available to the manufacturer only if the process carried out amounts to manufacture or if they are used for providing output service.

#### **Transitional credit:-**

Where input credit was not taken at the time of receipt of the inputs on or after 10.09.2004, because at that point of time, the goods manufactured were either exempted goods or non excisable goods, if such goods cease to be exempted goods or non excisable goods from a later date, Cenvat credit can be taken in respect of inputs lying in stock or in process or inputs contained in final products lying in stock on the date on which the goods ceases to be exempted goods or becomes excisable. This relaxation applies to inputs only and not to capital goods.( Rule 3(2) of Cenvat Credit Rules)

#### **Cenvat credit and depreciation on capital goods:-**

Cenvat credit is not allowable on capital goods if depreciation is claimed on the central excise duty element. Rule 4(4) of the Cenvat Credit Rules imposes the condition that if depreciation is claimed under Section 32 of the Income Tax Act, on that part of the value of the capital goods which represents the element of duty on such goods, credit will not be allowed.

#### **Maintenance of Records & filing of Returns:-**

The manufacturer/ service provider is required to maintain registers showing the receipt of inputs, capital goods/ input service , the credit taken on the said inputs, capital goods /input services and the utilization of the Cenvat credit at the time of clearance of final products/ out put service. Under earlier modvat scheme, there were prescribed registers for this purpose viz, RG23 Pat I and RG 23 Part II Registers. How ever, at present, there are no such prescribed registers. The private records of the assessee will suffice provided they contain all the required details. The manufacture/ service provider is also required to file monthly / yearly returns prescribed under the Cenvat Credit Rules.

### **Refund of Cenvat credit:-**

Rule 5 of the Cenvat Credit Rules provides for refund of Cenvat credit in a case where final products are exported under bond, or under letter of under taking with out payment of duty. The Cenvat credit in respect of input so used can be utilised by the manufacturer for payment of excise duty on any other final product. If the Cenvat credit can not be used for payment of duty, the same can be refunded to the manufacturer subject to the conditions prescribed under Notification No.49/2003 CE (N.T) dated 17.5.2003. issued under Rule 5 of the Cenvat Credit Rules.

### **Restriction on the quantum of credit utilised for payment of duty:-**

Under Rule 8 of the Central Excise Rule, 2002 the manufacturer of excisable goods are required to pay duty on a monthly basis by 5th of the succeeding month, except in the month of March, where duty is to be paid by 31st March. In respect of clearances made during the month, duty can be paid through debit in Cenvat account by 5th of succeeding month, (except for month of March). First proviso to Rule 3 (4) of Cenvat Credit Rules stipulates that the debits so made should not be in excess of the credit available in the Cenvat account. on the last day of the month. In other words, the credit available on 5th of succeeding month should not be considered for the purpose of duty payment for the previous month.

### **Availability of Cenvat credit in certain situations:-**

#### **Inputs destroyed prior to use:-**

The credit of duty paid on inputs is allowable only if the inputs are actually used in or in relation to manufacture of final products. No credit is allowable on inputs destroyed prior to its use in the manufacture

#### **Inputs destroyed in transit:-**

If the inputs are damaged in transit, and they become unfit to be used in manufacture, no credit is allowable.

#### **Inputs destroyed at intermediate stage:-**

If the inputs are put in to the manufacturing stream but were destroyed at an intermediate stage, credit on the inputs can not be denied..

### **Inputs lost in storage:-**

If inputs are lost in storage, before being put to use in the manufacture, credit is not admissible.

### **Clearance of inputs / Capital goods as such:**

Rule 3 (5) of the Cenvat Credit Rules 2004 deals with the situation where Cenvated inputs or capital goods are cleared as such from the factory of manufacturer or premises of a service provider. In the case of clearance of inputs or capital goods, as such, a manufacturer shall pay an amount equal to the credit availed in respect of such inputs or capital goods, and such removal shall be made under the cover of an Invoice referred in Rule 11 of the Central Excise Rules..

In the case of service provider also if he clears the inputs or capital goods on which Cenvat Credit is availed, as such, from his premises he shall pay an amount equal to Cenvat Credit availed, except in the following situation:

1. When inputs are removed outside the premises of service provider for providing output service
2. When Capital goods are removed outside the premises of service provider for providing output service and the Capital goods are brought back to the premises of the service provider within 180 days of their removal or such extended period not exceeding 180 days as may be permitted by the Asst / Deputy Commissioner of Central Excise, as the case may be. In situation (1) and (2) above, the service providers need not pay back the Cenvat credit availed by him.
3. Rule 3(5) of the Cenvat Credit Rules was amended vide Notification No.39/2007 C.E (N.T) dated 13.11.2007. As per the newly inserted third proviso to Rule 3(5) duty on used capital goods shall be paid reducing 2.5% per quarter of Cenvat taken on particular capital goods.

### **Admissibility of credit on input or capital goods written off:-**

Input / Capital goods are written off or partially written off in the books of accounts of the manufacturer, as being obsolete. The admissibility of Cenvat Credit in such situation is under:

1. In case where unused inputs are fully written off, the credit availed must be paid back.
2. In case where the value of inputs is partially written off / reduced in the accounts of the company, but the inputs are still capable of and available for use in the manufacture of finished goods, there would be no question of payment of Cenvat Credit availed.
3. In respect of Capital goods, viz, Components, Spare parts etc, which are written off before use and hence are not proposed to be used, Cenvat Credit availed will have to be paid back on the same lines as applicable to “inputs” as mentioned at 1 above. (as clarified in CBEC Circular No. 645/36/2002. CX dated 16.7.2002)

### **Recovery of Cenvat credit wrongly availed and penal provisions:-**

Cenvat provisions are subject to wide spread misuse by unscrupulous elements. Stringent provisions for recovery of Cenvat credit wrongly availed, confiscation and penalty are also incorporated in the Cenvat Credit Rules. Rule 14 of the Cenvat Credit Rules provides for recovery of wrongly availed Cenvat credit and for recovery of interest on the wrongly availed credit. Rule 15 of the Cenvat Credit Rules provides for confiscation of offending goods and penalty for wrong availment of Cenvat credit.

## BACKGROUND

Cenvat Credit Rules, 2004 were issued with the sole intention to avoid the cascading effect of taxes. It is a pre runner to Goods and Service Tax (G.S.T) proposed to be introduced w.e.f. 2010. In Cenvat Credit Rules 2004 earlier Cenvat Credit Rules 2002 and Service Tax Credit Rules 2002 were merged. Cenvat Credit Rules, 2004, allows credit of duty paid on inputs, capital goods and service tax paid on input services used in or in relation to the manufacture of final products/ for providing output services. Though the Cenvat Credit Rules appears to be simple it can not be considered as hassle free. More over the Rules are amended every now and then. A number of disputes arose due to differences in interpretation of the Rules by manufacturer/ provider of output service and the law enforcing agencies. Some of these disputes reach appellate forums like Tribunals, the High Court/ Supreme Court for the correct interpretation of the Rules.

One such area of dispute which is likely to have effect on most of the manufacturers/output service providers is attempted to be discussed below. The problem discussed below is not pertaining to a particular organization. It is of a general nature and is likely to be of common interest.

Cenvat credit is availed on inputs immediately after their receipt in the factory/ in the premises of the output service provider. In the case of capital goods 50% of the duty paid is taken as Cenvat credit in the financial year of receipt and the remaining 50% in the subsequent financial year. There are cases where the manufacturer / provider of output service want to clear the inputs/ capital goods with out carrying out any manufacturing activity i.e, as such. Rule 3 (5) of the Cenvat Credit Rules 2004 provides for such an eventuality.

A manufacturer is manufacturing both dutiable and exempted final products. He is also an output service provider providing both taxable and exempted services. The manufacturer / output service provider is availing Cenvat credit of duty paid on common inputs and service tax paid on input services. In this case Rule 6 of Cenvat Credit Rules is attracted. Though Rule 6 is very comprehensive in nature it has got several grey areas. This Rule was vastly amended in budget 2008 to stream line the existing procedures.

**PROBLEM: -**

A manufacturer “A” takes credit of central excise duty paid on inputs, capital goods and service tax paid on input services including services for procurement of inputs and in respect of storage services for storage of inputs outside his factory in tanks and godowns as he does not have proper facility to store the inputs inside his factory. The said manufacturer is engaged in the manufacture of dutiable and exempted final products. He is also a provider of both taxable and exempted output services. He is not maintaining separate accounts and inventory in respect of inputs/ input services used in the manufacture of exempted final products/ exempted output services.

**Situation A: -**

After availing Cenvat credit on inputs and input services,

- (i) the manufacturer clears the inputs as such to his own sister unit at another location,
- (ii) clears inputs as such to another manufacturer “B”

**Questions arising:-**

- a) What is the quantum of Cenvat credit the manufacturer “A” is required to pay back in respect of inputs cleared as such?
- b) Is he required to reverse the Cenvat credit availed on the input services also? If so what is the Quantum of credit he is required to reverse?

**Situation B: -**

After availing Cenvat credit on common inputs/ input services the manufacture clears the exempted final products / provides exempted output service to his customer “C”.

**Questions arising:-**

- a) What are his options while clearing exempted final products/ while providing exempted output services?
- b) What is the quantum of Cenvat credit he is supposed to pay back / reverse while clearing exempted final products/ while providing exempted services?



## METHODOLOGY

Cenvat Credit Rules 2002 dealt with credit of duty paid in inputs and Capital goods. Cenvat Credit Rules 2004 added one more item i.e. Service Tax paid on input services received by the manufacturer for availing credit. Service Tax has been included in the Cenvat Credit Rules with the prospective plan for introducing Goods and Service Tax (G.S.T)

### **Review of Literature:-**

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The problems arising in the Cenvat Credit Rules are due to the difference in interpretation of the Rules by the manufacturer/ service provider and the Central Excise / Service Tax Authorities. The issues are decided by the concerned authorities after following proper procedures and if such decision is not mutually agreeable, appeal is filed with appellate forum, i.e, the Tribunal/ High Court / Supreme Court etc. The decisions of these authorities if the same is accepted by the manufacturer / Service provider and the Central Excise / Service Tax Department they become part of the law on the subject matter (precedents). Cenvat Credit Rules, 2004, and the problem discussed below are very recent developments. Though, there are a number of case law on earlier rules, none of these are exactly applicable to the problem discussed below. Some of these case laws are discussed below at the time of discussion.

**The problem taken for discussion is of general nature applicable to a Manufacturer / Service provider who takes credit of duty on inputs, Capital goods and Service tax paid on input services.**

### **PROBLEM UNDER STUDY**

**A manufacturer “A” takes credit of central excise duty paid on inputs, capital goods and service tax paid on input services including services for procurement of inputs and in respect of storage services for storage of inputs outside his factory in tanks and godowns as he does not have proper facility to store the inputs inside his factory. The said manufacturer is engaged in the manufacture of dutiable and exempted final products. He is also a provider of both taxable and exempted output services. He is not**

**maintaining separate accounts and inventory in respect of inputs/ input services used in the manufacture of exempted final products/ exempted output services.**

**Situation A:-**

**After availing Cenvat credit on inputs and input services,**

- (i) the manufacturer clears the inputs as such to his own sister unit at another location,**
- (ii) clears inputs as such to another manufacturer “B”**

**Questions arising:-**

**c) What is the quantum of Cenvat credit the manufacturer “A” is required to pay back in respect of inputs cleared as such?**

**d) Is he required to reverse the Cenvat credit availed on the input services also? If so what is the Quantum of credit he is required to reverse?**

**DISCUSSION:-**

A manufacturer can take immediate credit of the duty paid by the supplier on the inputs / Capital goods. The manufacturer uses the inputs and Capital goods in the manufacture of his final products. However in some cases the manufacturer may have to remove the inputs from his factory for:-

- a) for sale or disposal if the said goods are not required by him,
- b) may remove the said goods to his sister concern due to some strategic reason.
- c) for job work / processing in another factory and return.
- d) the inputs may have been rejected and sent to the original manufacturer for repair / rework and return.

Since the manufacturer has already taken credit of duty paid on inputs, it is necessary to have proper control over their removal. If the manufacturer wants to remove / clear the inputs on which he has availed Cenvat Credit for any reason like rejection, quality problems, excess

supply, change in production plan etc. He can clear the input as such from his factory after payment of an amount prescribed under Rule 3 (5) of the Cenvat Credit Rule 2004.

**Rule 3(5) of Cenvat Credit Rules 2004 is reproduced below:-**

“(5) when inputs or Capital Goods, on which CENVAT Credit has been taken, are removed as such from the factory, or premises of the provider of output services, the manufacturer of final products or provider of output services, as the case may be, shall pay an amount equal to the credit availed in respect of such inputs or Capital goods and such removal shall be made under the cover of an invoice referred to in Rule 9:

Provided that such payment shall not be required to be made where any inputs or capital goods are removed outside the premises of the provider of output service for providing output service.

Provided also that if the capital goods, on which credit has been taken, are removed after being used, the manufacturer or provider of output service shall pay an amount equal to the amount of Cenvat credit taken on the said capital goods reduced by 2.5% for each quarter of a year or part thereof from the date of taking Cenvat credit. Rule 3(5) of Cenvat Credit Rules, 2004 clearly provides that inputs of capital goods can be removed from the factory of the manufacturer or premises of output service provider on payment of an amount equal to the Cenvat Credit availed on the said inputs or Capital goods. The inputs or Capital goods can be removed by reversing the Cenvat credit taken. Rule 3 (4) (b) of Cenvat Credit Rules states that Cenvat Credit can be utilised for payment of “amount” on inputs cleared as such or after being partially processed, or on capital goods cleared as such. In view Rule 3(4) (b), partially processed inputs can be cleared on payment “amount” equal to Cenvat Credit availed. However for the goods to be covered as partially processed input the processes carried out should not amount to “manufacture”. If the processing amounted to manufacture central excise duty will be payable on the said goods at the time of clearance / removal from the factory of inputs / capital goods as such should be under cover of an invoice. An invoice under Rule 11 of the central Excise Rules should be prepared showing the amount payable on the inputs / capital goods cleared as such.

On the above issue there are a number of judgments regarding 8% (now 10%) amount and interest can not be recovered by applying Sections 11 A and 11AB of the Central Excise Act.

(1) Pushpman Forgings Vs, Commissioner, 2002 (149) E.L.T (Tri- Mum)-The Tribunal held that the amount of 8% which is required to be reversed in terms of Rule 57 CC is neither “Modvat credit nor a duty of Excise” There fore it was held that the amount can not be recovered in terms of Section 11 A or Rule 57 I. It was further held that there was no mechanism to recover such duties and the same can not be enforced. This judgment was upheld by the Supreme Court.

(2) The Supreme Court in the case of Chandrapur Magnets Vs. Commissioner Central Excise, Nagpur, reported in 1996 (81) E.L.T. 3(S.C), has held that Modvat credit can not be denied for failure to maintain register. The relevant portion of the said judgment is reproduced below:-

“In view of the clarification by the Deptt, we see no reason why the assessee can not make a debit entry in the credit account before the removal of the exempted final products. In such a situation, it can not be said that the assessee has taken credit for the duty paid on the inputs utilised in the manufacture of the final exempted products under Rule 56 A. In other words the claim for exemption of duty on the disputed goods can not be denied on the plea that the assessee has taken credit of the duty paid on the inputs used in the manufacture of these goods”.

The Supreme Court has not observed any thing about the constitutional validity of the provision under Rule 14 of Cenvat Credit Rules, 2004, so far.

An Output Service provider is also required to pay an amount equal to the Cenvat credit availed on inputs /Capital goods “cleared as such” and clear the said goods under an invoice except in the following situations:-

1. when any inputs are removed outside the premises of the Service provider for providing output service.
2. when Capital goods are removed outside the premises of the Service provider for providing output service and the Capital goods are brought back to the premises of the said output service provider within 180 days of their removal, or such extended time not exceeding 180 days as may be permitted by the jurisdictional Deputy / Asst. Commissioner of Central Excise.

In the above 2 cases no payment of amount is required to be made.

In the context of inputs, the word “as such” can only mean ‘before being put in to use’. However the same meaning cannot be assigned in respect of capital goods, since capital goods can also be removed after use also. In the case of capital goods, the word “as such” has to be interpreted to cover both removal before use and removal after use.

There was no provision for depreciation in respect of used capital goods cleared from the factory prior to 13.11.2007 in Rule 3 of Cenvat Credit Rules 2004. Earlier Rule 57S of Central Excise Rules, 1944 in the Modvat Scheme provided for depreciation which provided for deduction of @ 2.5% of credit for each quarter of the year from the date of availment of the credit. A similar provision was introduced in Rule 3 of Cenvat Credit Rules vide amendment made by Notification no.39/2007 C.E.(N.T) dated 13.11.2007.

As per Rule 3(5) of the Cenvat Credit Rules, the amount equal to the Cenvat Credit availed is required to be paid on the date of removal of inputs or Capital goods as such. By a recent amendment brought out in Budget 2007, the amount debited under Rule 3(5) has been treated as Central Excise duty, hence there appears to be no irregularity in monthly payment of the “said amount” along with Central Excise duty as provided under Rule 8 of the Central Excise Rules.

#### **Amount paid under Rule 3(5) is admissible as credit:-**

Rule 3(b) of the Cenvat Credit Rules provides that the amount paid under Rule 3(5) shall be eligible as credit as if it was a duty paid by the person who removed the goods as such under Rule 3(5) of the Cenvat Credit Rules.

On going through Cenvat Credit Rules, it appears that credit in respect of inputs and capital goods is specific to factory of manufacture. That is once input and capital goods are removed out of the factory, the manufacturer is no more entitled for Cenvat Credit in respect of these goods and the Cenvat Credit availed is required to be paid back or reversed. As far as credit on input service is considered, Cenvat Credit is with respect to the manufacturer and not restricted to the factory of manufacture. The definition of input service is very wide. As far as a manufacturer is concerned input service means any service used by the manufacturer, whether directly or indirectly, in or in relation to the manufacture and clearance of final products from the place of removal. Input Services includes services used in relation to setting up, modernisation,

renovation and repairs of a factory, or an office relating to such factory, advertisement or sales promotion, market research, storage up to the place of removal, procurement of inputs, activities relating to business such as accounting, auditing, financing, recruitment and quality control, coaching and training, computer networking, credit rating, share registry, security, inward transportation of inputs or capital goods and outward transportation up to the place of removal.

Further specific provision has been made for distribution of credit of service tax paid on input services to different manufacturing units of the same manufacturer through “input service distributor”.

“**Input service distributor**” is defined in Rule 2(m) of Cenvat Credit Rule 2004, which read as:

“(m) “**input service distributor**” means an office of manufacturer or producer of final products or provider of output services, which receives invoices issued under Rule 4A of the Service Tax Rules, 1994 towards purchases of input services and issues invoice, bill or, as the case may be challan for the purposes of distributing credit of service tax paid on the said services to such manufacturer or producer or provider as the case may be”

An input service distributor is required to take Registration under Service Tax (Registration of Special Category of Persons) Rules, 2005. The input service distributor will receive the invoices in respect of input services received by manufacturer's factories and offices and issue invoices for distributing the input Service Tax to its different factories in the proportion decided by them.

From the above, it can be seen that Cenvat Credit can be availed on different business auxiliary services which are not directly related to the factory or the manufacturing activity carried out in the factory. The Cenvat Credit on input service is therefore in respect of the manufacturer and not specific to a particular factory of the manufacturer. Further Rule 3(5) of Cenvat Credit Rules 2004 provides that credit availed on inputs and capital goods “cleared as such” have to be paid back or reversed. There is no such provision of reversal of Cenvat Credit in respect of input services involved in procuring or storage of inputs or capital goods in Rule 3 (5) of the Cenvat Credit Rules 2004.

### **Findings:-**

From the above discussion, it is clear that the manufacturer is required to pay back or reverse the Cenvat Credit availed on inputs or Capital goods cleared as such. But he needs not reverse the Cenvat Credit availed in respect of input services for procuring or storage of inputs or Capital goods as there is no specific provision for reversal of credit on input services given in Rule 3(5) of Cenvat Credit Rules.

### **Situation B: -**

**After availing Cenvat credit on common inputs/ input services the manufacture clears the exempted final products / provides exempted output service to his customer “C”.**

### **Questions arising:-**

- c) What are his options while clearing exempted final products/ while providing exempted output services?**
- d) What is the quantum of Cenvat credit he is supposed to pay back / reverse while clearing exempted final products/ while providing exempted services?**

### **DISCUSSION:-**

The above problem is faced by most of the manufacturers availing Cenvat Credit as some products manufactured fall under the exempted category. To have a clear idea let us examine the legal aspect of this problem.

Rule 6 of the Cenvat Credit Rules, 2004 deals with the obligation of manufacturer of dutiable and exempted final products and provider of taxable and exempted output services. Rule 6 has been amended to bring about changes with effect from 1st April 2008..

Rule 6 of Cenvat Credit Rules is applicable to a manufacturer of final products and to a provider of taxable services. Sub Rule (1) of Rule 6 states that Cenvat Credit shall not be exempted goods or provision of exempted services except in the circumstances given under Sub Rule (2).

Rule 2(d) of the Cenvat Credit Rules defines “exempted goods”. According to the said definition, “exempted goods” means excisable goods which are exempt from the whole of the duty of excise leviable thereon, and includes goods which are chargeable to “Nil” rate of duty.

The provisions of Sub Rule (1) of Rule 6 is attracted only when inputs , Capital goods or input services are used only in the manufacture of exempted goods or for providing exempted services. Sub Rule (2) of Rule 6 is attracted when the manufacturer is manufacturing both dutiable and exempted final products or both taxable and exempted services. Sub Rule (2) states that if a manufacturer is manufacturing both dutiable and exempted products or if the service provider is providing both taxable and exempted services, then the manufacturer or the service provider shall maintain separate accounts for receipt, consumption and inventory of inputs and input service meant for use in the manufacture of dutiable final products or in providing taxable output service and the quantity of input meant for use in the manufacture of exempted final products or exempted output services and take Cenvat credit only on the quantity of input or input service which is intended for use in the dutiable final product or for providing taxable output service.

In case the manufacturer of final products or provider of output service is not maintaining separate accounts for receipt, consumption and inventory of inputs and input services as envisaged under Sub Rule (2) of Rule 6, the manufacturer shall pay an amount equal to ten percent of the total price, excluding Sales Tax and other taxes, if any, paid on such goods, of the exempted final product charged by the manufacturer for sale of such goods at the time of clearance from the factory (Sub Rule 6(3) (b) ),

Rule 6 of Cenvat Credit Rules, 2004 is not applicable to the following cases:-

a) Final products cleared to:-

- a) Units in Special Economic Zones
- b) 100% Export Oriented Under takings
- c) Units in Electronic Hardware Technology parks.
- d) Units in Software Technology parks

b) Final products supplied to the United Nations or an International Organisation or projects funded by them which are exempted under Notification 108/95 CE dated 28-8-1995.



- c) Final products are exported under Bond.
- d) Gold, silver falling under Chapter 71, arising during the course of Copper or Zinc smelting.
- e) All goods exempt from duties of Customs leviable under the First Schedule to the Custom Tariff Act 1975 and the Addl.. duty leviable under Sec. 3 of the Custom Tariff Act, when imported into India and supplied against International Competitive Bidding in terms of Notification No. 6/2002 CE dated 1.3.2002 or Notification No. 6/2006 dated 1-3-2006 as the case may be.

All inputs, with the exception of inputs used as fuel, which are used in or in relation to manufacture of both dutiable and exempted final products, are covered under Rule 6 of the Cenvat Credit Rules.

Sub Rule (2) and (3) of Rule 6 provide an option to the manufacturer or provider of output service to adopt one of the following alternatives:

To maintain separate accounts for the receipt / consumption and inventory of inputs and input services in respect of those used in the manufacture of dutiable final products and those used in exempted final products.

- 1) If such separate account is not maintained to avail credit on common inputs and input services initially but to make the following payments at the time of clearance of exempted final products.

<b>Final Product</b>	<b>Payment to be made</b>
1. Goods falling within heading No. 22.04, viz, Ethyl alcohol of any strength whether denatured or not, but not including alcoholic liquor for human consumption; 2. Low Sulphur Heavy Stock (LSHS) falling with Chapter 27 used in the generation of electricity; 3. Naphtha (R.N) falling within Chapter 27 used in the manufacture of fertilizer;	Amount equal to CENVAT credit attributable to the inputs and input services used in, or in relation to, manufacture of such final products at the time of their clearance from the factory.

<ol style="list-style-type: none"> <li>4. Newsprint, in rolls or sheets, falling within heading No. 48.01;</li> <li>5. Final products falling within Chapters 50 to 63.</li> <li>6. Naphtha ( R.N) falling within Chapter 27 used for generation of electricity;</li> <li>7. Goods supplied to defence personnel or for defence projects or to the Ministry of Defence for official purpose, under any of the following notifications , namely :-  (1)Notification No. 70/92-Central Excise dated the 17th June, 1992 (2)  Notification No. 62/95- Central Excise dated the 16<sup>th</sup> March, 1995 (3)  Notification No. 63/95- Central Excise dated the 16th March, 1995 (4)  Notification No. 64/95- Central Excise dated the 16th March, 1995 ;</li> </ol>	
Other final products	10 percent of 'total price' of the exempted final products

#### **No Cenvat credit if final product/ output service is exempted**

Cenvat credit is not available if inputs or input services are used for manufacture of exempted goods or for providing exempted output services.

As per Rule 6(1) of Cenvat Credit Rules, Cenvat credit is not admissible on such quantity of input or input service which is used in manufacture of exempted goods or provision of exempted services.

If inputs and input services are partly used in the manufacture of exempted final product / providing exempted output service, Cenvat credit of that portion of input / input service will not be available.

When inputs or input services are used in the manufacture of both dutiable and exempted final product, Cenvat credit of inputs and input services is not available if final product/output service is exempt from excise duty/service tax. In case of manufacturer manufacturing both exempted and dutiable final products (or service provider providing taxable as well as exempted services), and if common inputs/input services are used for manufacture of dutiable goods/ providing

taxable services and for manufacture exempted goods/ providing exempted services, in such cases, the manufacturer/service provider has following options :-

- a) Maintain separate accounts and inventory of receipt and use of inputs and input services used for exempted final products/exempted output services – Rule 6(2) of Cenvat Credit Rules.
- b) Pay an amount equal to 10% of value of exempted final products (in the case of a 'manufacturer) and/or 8% of value of exempted services (in the case of service provider) if he does not maintain separate Accounts and inventory.– Rule 6(3)(i) w.e.f. 1-4-2008.
- c) Pay an 'amount' equal to proportionate Cenvat credit attributable to exempted final product/ exempted output services – Rule 6(3)(ii)

**Cenvat credit on capital goods** – If capital goods are used for manufacture of both exempted final products and dutiable final products, entire duty paid on capital goods is available as Cenvat Credit. Cenvat credit of duty on capital goods is not admissible when it is *exclusively* used for manufacture of exempted final products [rule 6(4)]

**No reversal or payment of amount in certain cases** – If excisable goods are removed to SEZ, EOU, EHTP, STP, and UN agencies or for exports or removal of gold or silver arising in manufacture of copper or zinc by smelting, payment of 10% 'amount' is not required [rule 6(6)].

### **Options available to manufacturer manufacturing both dutiable and exempted final product and service provider providing taxable as well as exempted services**

The manufacturer/service provider has three options –

**Maintain separate inventory and accounts** - Maintain separate accounts and inventory of receipt and use of inputs and input services used for manufacture of exempted final product/ providing exempted output services. In such cases, he should not avail Cenvat credit of the inputs used in or in relation to manufacture of exempted final product and input services which are used in providing exempted services at all – Rule 6(2) of Cenvat Credit Rules.

**Pay 10% 'amount' on value of exempted goods or 8% 'amount' on value of exempted services if separate inventory and records are not maintained** - If the manufacturer / service provider opts not to maintain such separate accounts and inventory of receipt and use of inputs and input services, he has to pay an amount equal to 10% of the 'value' of such exempted final products or 8% of the value of 'exempted services' [Rule 6(3)(i) w.e.f. 1-4-2008 ( Such payment can be made by debit to Cenvat credit account or PLA [ explanation II to rule 6(3A)].

The manufacturer cannot utilise Cenvat credit of inputs/input services utilised exclusively for manufacture of exempted final product or exempted output services, as clarified in Explanation II to rule 6(3) inserted w.e.f. 1-4-2008.

The manufacturer cannot utilise Cenvat credit in respect of inputs/input services utilised exclusively for manufacture of exempted final products or for providing exempted taxable services. He has to pay an amount equal to 10% of the value of the exempted final products/ an amount equal to 8% of the value of the exempted output services, if he uses common inputs/input services.

The manufacturer/ provider of services has to exercise such option in respect of all exempted goods manufactured and all exempted output services provided by him. The option once exercised shall not be changed in remaining part of financial year – *Explanation I* to Rule 6(3) inserted w.e.f. 1-4-2008]

**Pay proportionate amount attributable to Cenvat credit utilised for exempted final product/ for providing exempted output services** – The manufacturer/service provider can opt to pay an 'amount' which is proportional to Cenvat credit availed in respect of inputs used in or in relation to manufacture of the exempted final product/ inputs and input services used for providing exempted output services [rule 6(3)(ii)]

He cannot utilise Cenvat credit of inputs/input services utilised exclusively for manufacture of exempted final product or for providing exempted output services, as clarified in *Explanation II* to rule 6(3)

The manufacturer cannot utilise Cenvat credit in respect of inputs/input services utilized exclusively for manufacture of exempted final products or for providing exempted taxable services. He has to pay back or reverse proportionate amount of credit relating to the credit availed on the inputs/ input services used in or in relation to the manufacture exempted final products/ for providing exempted output services.

The reasonable interpretation is that he should also exclude Cenvat credit relating to inputs/input services used exclusively for taxable goods [as provided in rule 6(2)] and then apply formula for proportionate reversal to common inputs/input services.

If interpreted this way, this option seems to be much better than payment of 10%/8% amount where quantum is substantial. For small service providers and small manufacturers, it may be difficult to maintain elaborate accounts records and make calculations.

If manufacturer/service provider wants to exercise the option, he has to inform details as prescribed in rule 6(3A) of Cenvat Credit Rules to the Superintendent of Central Excise.

The option has to be exercised in respect of all exempted goods manufactured and all exempted output services provided. The option once exercised shall not be changed in remaining part of financial year – *Explanation I* to Rule 6(3) inserted w.e.f. 1-4-2008.

### **Option is to person availing Cenvat credit**

Rule 6(3) uses the words 'if manufacturer or provider of output service opts not to maintain separate accounts'. Thus, whether to maintain separate accounts or not is at the option of person availing Cenvat credit. He cannot be compelled to maintain or not maintain separate accounts.

### **Meaning of exempted goods**

As per Rule 2(d) of Cenvat Credit Rules, 'exempted goods' means goods which are exempt from whole of duty of excise leviable thereon and includes goods which are chargeable to 'Nil' rate of duty. Thus, 'exempted goods' for purpose of Cenvat cover (a) Goods chargeable to 'Nil' duty as per Central Excise Tariff Act , and (b) Goods which are exempted by a notification issued under section 5A of the Central Excise act..

**Exempted goods do not mean non-excisable goods** - Goods which are not mentioned in Tariff are not 'exempted goods' as they are neither 'goods chargeable to 'Nil' duty as per Tariff' nor 'goods which are exempted by a notification issued under section 5A'.

'Exempted goods' do not cover goods which are not excisable at all and goods which are not included in Central Excise Tariff. Such goods are not 'exempted goods'. Similarly, goods not specified in tariff are not goods 'chargeable to 'Nil' rate of duty'. Thus, rule 6(2) applies only if all the final products are 'excisable goods'. The rule does not apply if one of the products is not 'excisable goods'. Goods which are not 'excisable goods' cannot be said to be exempt from duty or chargeable to Nil rate of duty.

### **Meaning of 'exempted services'**

As per rule 2(e) of Cenvat Credit Rules, "exempted services" means taxable services which are exempt from the whole of the service tax leviable thereon, and includes services on which no service tax is leviable under section 66 of Finance Act.

According to definition of 'exempted services', services on which no service tax is leviable are also 'exempted services'. If a particular service is not taxable under present provisions of Finance Act, 1994, it will be 'exempted service' for purpose of Rule 6.

It has been clarified by the Central Board of Excise & Customs vide its Circular that export of service will not be treated as exempted service - Para 6 of CBE&C Circular No. 868/6/2008-CX dated 9-5-2008.

**Services utilised for own use, not connected with manufacture or provision of services is not 'exempted service'** – An assessee may utilise part of the input services for his own use, which may be unconnected with his manufacturing activities or activities pertaining to provision of output services. For example, he may be engaged in exports or trading of goods. These cannot be termed as 'exempted services', as 'service' can be given only to another person. One cannot give service to oneself. This is 'captive consumption' of input services and not provision of services to another person.

## **Exceptions to provisions of payment of amount**

Following are the exceptions to provision of proportionate payment of Cenvat credit or payment of an amount of 10% of the value of exempted final products/ payment of an amount of 8% of the value of exempted output services.

### **Dis-allowance of Cenvat of capital goods only if used exclusively for exempted final product/services**

Capital goods used exclusively for manufacture of exempted goods or providing exempt service are not eligible for Cenvat credit . If capital goods are partly used for taxable services or dutiable final products, Cenvat credit will be available.

Some manufacturers are entitled to exemption based on turnover or quantity (e.g. SSI units). They will be entitled to Cenvat on capital goods. They can take Cenvat on capital goods and utilise it for payment of duty when their exemption limit is crossed.

### **Some services eligible even if partly used for manufacture of exempted goods/output services**

Rule 6(5) of Cenvat Credit Rules provides that in case of specified services, full Cenvat credit of input service is available even if these services are partly used in manufacture of exempted final product/ for providing exempted output services.

The services are –

1. Consulting Engineer [section 65(105)(g)]
2. Architect [section 65(105)(p)]
3. Interior decorator [section 65(105)(q)]
4. Management consultant [section 65(105)(r)]
5. Real Estate Agent [section 65(105)(v)]
6. Security Agency Services [section 65(105)(w)]

7. Scientific or technical consultancy [section 65(105)(za)]
8. Banking and Financial Services [section 65(105)(zm)]
9. Insurance Auxiliary Services concerning life insurance business [section 65(105)(zy)]
10. Erection, commissioning and Installation [section 65(105)(zzd)]
11. Maintenance or repair [section 65(105)(zzg)]
12. Technical testing and analysis [section 65(105)(zzh)]
13. Technical inspection and certification [section 65(105)(zzi)]
14. Foreign Exchange Broker [section 65(105)(zzk)]
15. Construction Service [section 65(105)(zzq)]
16. Intellectual property services [section 65(105)(zzr)]

In case of these services, reversal of Cenvat or payment of 'amount' is not required, if these services are even partly used for providing output service or manufacture of dutiable final product. Cenvat credit will be dis-allowed only when these services are used *exclusively* in manufacture of exempted final product or exempted output service. Rule 6(5) has been given overriding effect over rule 6(1), 6(2) and 6(3).

This rule has not been amended even though rule 6(3) of Cenvat Credit Rules has been recast w.e.f. 1-4-2008. Hence, the effect is that in respect of these specified services, proportionate reversal is not required – as confirmed in Para 8 of CBE&C Circular No. 868/6/2008-CX dated 9-5-2008.

#### **Supply to EOU/SEZ, export of goods, deemed exports or gold manufacture etc,**

Rule 6(6) of Cenvat Credit Rule states that provisions of rules 6(1), 6(2), 6(3) and 6(4) are not applicable , if excisable final product is dispatched without payment of duty, in following cases –

- a) Final product is dispatched to SEZ, EOU, EHTP or STP
- b) Final product is supplied to United Nations or an International Organization for their official use or supplied to projects funded by them, which are exempt from duty.
- c) Final product is exported under bond without payment of duty



- d) Gold or silver arising in course of manufacture of copper or zinc by smelting.
- e) Goods supplied against International Competitive Bidding in terms of Notification No. 6/2006-CE dated 1-3-2006 or earlier Notification No. 6/2002-CE dated 1-3-2002, if such goods are exempt from customs duty when imported in India

In the above cases, assessee need not reverse Cenvat credit or pay any 'amount'.

**International competitive bidding** - The last clause has been added w.e.f. 28-1-2005, with intention to exempt goods supplied against International Competitive Bidding as specified in Notification No. 6/2006-CE dated 1-3-2006 (Earlier Notification No. 6/2002-CE dated 1-3-2002).

#### **Payment of 'amount' on exempted final product/ exempted services**

The manufacturer / Service provider can opt to pay 'amount' of 10% of 'value of exempted final product or 8% of 'value of exempted services [rule 6(3)(i) w.e.f. 1-4-2008].

Option of payment of 10% 'amount' on exempted goods was also available, but in case of service tax, the provision upto 31-3-2008 was that tax Cenvat credit was restricted to 20% of service tax payable on taxable output services.

**Nature of the payment of 'amount'** - The payment of 'amount' is really in nature of reversal of Cenvat credit availed on inputs/input services which have been used for manufacture of exempted goods or for providing of output services.

#### **Cenvat credit is not admissible on the 'amount' paid**

The 'amount' paid on the exempted final product is not in the nature of excise duty. Hence, department has clarified that buyer of such exempted goods will not be allowed to avail Cenvat credit of 'amount' paid by the manufacturer/service provider. - MF(DR) circular No B- 42/1/96-TRU dated 27.9.1996.

The view has been confirmed in *Malviya Chem v. CCE* 2001(127) ELT 274 (CEGAT), where it has been held that 'Nil duty' and 'exemption' cannot co-exist with duty payment.

It has been clarified that the invoice prepared should indicate duty paid as 'Nil'. However, the amount @ 8% (now 10%) debited should be indicated separately as 'amount debited under rule 6(3)(b)'.

### **When to pay the 'amount'**

By issue of Notification No. 8/2007 CE (N.T) dated 01.03.2007 an explanation has been inserted in Rule 8 to provide that for the purposes of this rule, the expressions 'duty' or 'duty of excise' shall also include the 'amount' payable in terms of the CENVAT Credit Rules, 2004. Therefore, amount payable under Rule 6 (3) of the CENVAT Credit Rules, 2004, can be paid along with duty payable by 5th of the next month and the same need not be paid at the time of removal of exempted goods itself.

### **Reversal of credit or payment of 'amount' means Cenvat credit not availed**

Sometimes, the manufacturer/ service provider may take Cenvat credit because he cannot identify the material to be used for exempted final products. This does not mean that he must pay 10% 'amount'. He can rectify by reversing Cenvat credit.

In *CCE v. Bombay Dyeing Ltd.* (2007) 10 STT 286 = 215 ELT 3 (SC), it was held that even when Cenvat credit is taken, if it is reversed before utilization, it would mean that Cenvat credit has not been taken. CBE&C vide its circular No. 858/16/2007-CX dated 8-11-2007, has clarified that if Cenvat credit is reversed before utilisation, it would mean that no credit having been taken.

In *Chandrapur Magnet Wire v. CCE* reported in 1996(81) ELT 3 (SC), the Supreme Court held that reversal of Modvat credit is permissible to avail exemption when common inputs are used in the manufacture of dutiable as well as exempted products. Amount of Modvat credit taken on inputs utilised in the manufacture of final products can be debited in the Modvat account. On reversal of such Modvat credit the assessee can not be said to have taken credit on the inputs utilised in the manufacture of exempted final product. Consequently exemption from duty is not deniable to final product even if exemption Notification No 69/86- C.E. (as amended) stipulates a condition that exemption on final product is not available. .

In *Punjab Tractors Ltd. v. CCE* 2005 (181) ELT 380 (SC 3 member bench), assessee paid duty on exempted parts, availed Cenvat and reversed it when utilising it for exempted final product. It was held that the procedure followed was revenue neutral and hence duty is not payable. However, penalty was held valid for violation of rules.

In *Life Long Appliances Ltd. v. CCE* 2006 (196) ELT 1110 (CEGAT), it has been held that payment of 10% 'amount' means Cenvat credit has not been taken – view upheld by SC – 196 ELT A144 (In this case, assessee's produce was exempt if Cenvat was not taken. It was held that if 'amount' is paid, it means that Cenvat has not been taken).

### **Proportionate reversal of Cenvat Credit w.e.f. 1-4-2008**

If the manufacturer/ service provider intends to pay amount on proportionate basis as provided in rule 6(3)(ii), the 'amount' is to be calculated as provided in rule 6(3A) of Cenvat Credit Rules. He has to pay 'amount' provisionally on monthly basis. At the year end, he has to calculate exact amount and pay difference if any or adjust excess amount paid.

### **Inform option to Superintendent**

The manufacturer/ service provider should inform following details to Superintendent, while exercising the option of proportionate reversal [Rule 6(3A)(a) inserted w.e.f. 1-4-2008] –

- (i) name, address and registration No. of the manufacturer of goods or provider of output service.
- (ii) date from which the option under this clause is exercised or proposed to be exercised.
- (iii) (iii)description of dutiable goods or taxable services.
- (iv) (iv)description of exempted goods or exempted services.
- (v) CENVAT credit of inputs and input services lying in balance as on the date of exercising the option under this condition.

Such option has to be exercised in respect of all exempted goods manufactured and all exempted output services provided. The option once exercised shall not be changed in remaining part of financial year – *Explanation I* to Rule 6(3) inserted w.e.f. 1-4-2008.

If the manufacturer/ service provider intends to pay 10%/8% 'amount' on exempted final products/exempted output services, such intimation is not required.

### Mode of calculations of proportionate reversal

The mode of calculation of the amount to be reversed is as follows – the manufacturer/ service provider should first take entire Cenvat credit of inputs and input services used in exempted as well as taxable final products and exempted as well as taxable services.

**Calculation of amount to be reversed** - At the end of month the manufacturer/ service provider should calculate Cenvat credit attributable to exempted final products and exempted services on provisional basis, as follows –

Amount to be reversed at end of month		
(1)	Rule 6(3A)(b)(i)	Inputs used for exempted final products
(2)	Rule 6(A)(b)(ii)	Inputs used for exempted services (On proportionate basis, based on ratio of previous year)
(3)	Rule 6(3A)(b)(iii)	Input services used for exempted final products and exempted services (On proportionate basis based on ratio of previous year).
	Total	1+2+3 = amount to be reversed every month on provisional basis

**Calculations at the end of the year** - At end of the year, the manufacturer/ service provider should calculate the ratios on actual basis and make fresh calculations and pay difference, if any, before 30th June. If it is found that he had paid excess amount based on provisional ratio, he can adjust the difference himself by taking credit.

**Reversal in first year of production or service only at the end of year** - In the first year of production or provision of services, ratios of previous year will not be available. In that case, the calculations need not be made for the whole year. However, calculations should be made after the year is over and amount attributable to Cenvat credit on exempted final products and exempted services should be calculated and paid.

The basic idea behind the mode of calculations is sound and correct as per Vat principles. However, calculations are not easy and are prone to litigation.

There is no provision to calculate input services used exclusively for exempted services. This has to be done on ratio basis only.

### Calculation of 'amount' on provisional basis every month

The manufacturer of goods or the provider of output service shall determine and pay, provisionally, for every month –

**Inputs used for exempted final products** - The amount equivalent to CENVAT credit attributable to inputs used in or in relation to manufacture of exempted goods during the month, denoted as A.

This has to be done on basis of input-output ratio or on basis of formula similar to the one applicable in case of inputs for exempted services on provisional basis.

Let us see the following illustration

Previous year total value of exempted goods: - Rs.15, 50,000(B)

Previous year total value of clearance: - Rs. 5, 50, 75,000(C)

Month	Cenvat taken under CE In Rs.	Input Credit under ST In Rs.	Total Credit during the Month i.e. both CE & ST In Rs.	Assumed exempted credit CE In Rs.	Assumed input credit involved in exempted goods / service In Rs.
Apr	2,50,000	50,000	3,00,000	42,000	4,000
May	3,00,000	1,00,000	4,00,000	48,000	8,000
June	4,00,000	Nil	4,00,000	50,000	Nil
July	3,00,000	50,000	3,50,000	Nil	2,000
August	3,50,000	50,000	4,00,000	48,000	3,500
Sept	4,00,000	Nil	4,00,000	50,000	Nil
Oct	2,00,000	1,00,000	3,00,000	45,000	9,000
Nov	3,50,000	50,000	4,00,000	Nil	1,500
Dec	4,00,000	Nil	4,00,000	Nil	Nil
Jan	4,15,000	35,000	4,40,000	70,000	4,000

Feb	3,00,000	1,50,000	4,50,000	42,000	15,000
Mar	2,50,000	1,00,000	3,50,000	1,00,000	7,500

Arrival of provisional payment for the month of May

- (i) Cenvat credit-  $15.50/550.75 \times (4,00,000 \text{ minus } 48,000)$
- (ii) Input services-  $15.50/550.75 \times (\text{Assumed exempted credit let us say}) 8,000$

Month	Provisional credit of CE $15.50/550.75=0.03$	Provisional credit of ST
Apr	$0.03 \times 2,58,000 = 7740$	$0.03 \times 4,000 = 120$
May	$0.03 \times 3,52,000 = 10560$	$0.03 \times 3,000 = 105$
June	$0.03 \times 3,50,000 = 10500$	$0.03 \times 0 = 0$
July	$0.03 \times 0 = 0$	$0.03 \times 2,000 = 60$
Aug	$0.03 \times 3,52,000 = 10560$	$0.03 \times 3,000 = 105$
Sep	$0.03 \times 3,50,000 = 10500$	$0.03 \times 0 = 0$
Oct	$0.03 \times 2,55,000 = 7650$	$0.03 \times 9,000 = 270$
Nov	$0.03 \times 0 = 0$	$0.03 \times 1,500 = 45$
Dec	$0.03 \times 0 = 0$	$0.03 \times 0 = 0$
Jan	$0.03 \times 3,70,000 = 11100$	$0.03 \times 4,000 = 120$
Feb	$0.03 \times 4,08,000 = 12240$	$0.03 \times 15,000 = 450$
Mar	$0.03 \times 2,50,000 = 7500$	$0.03 \times 7,500 = 225$

**Inputs used for exempted services** - The amount of CENVAT credit attributable to inputs used for provision of exempted services (provisional) is to be calculated as follows –

B	Total value of exempted services provided during the preceding financial year
C	Total value of dutiable goods manufactured and removed plus the total value of taxable services provided plus the total value of exempted services provided, during the preceding financial year
D	Total CENVAT credit taken on inputs during the month minus A (i.e. credit taken on inputs for manufactured final products)
(B/C) x D	Amount to be reversed every month on provisional basis as per rule 6(3A)(b)(ii)

**Input services used in or in relation to manufacture of exempted goods or provision of exempted services** - The amount attributable to input services used in or in relation to manufacture of exempted goods or provision of exempted services (provisional) is calculated as follows –

E	Total value of exempted services provided plus the total value of exempted goods manufactured and removed during the preceding financial year
F	Total value of taxable and exempted services provided, and total value of dutiable and exempted goods manufactured and removed, during the preceding financial year

G	CENVAT credit taken on input services during the month
(E/F) x G	Amount to be reversed every month on provisional basis as per rule 6(3A)(b)(iii)

### Calculation of 'final amount' after year end

The manufacturer of goods or the provider of output service, shall determine finally the amount of CENVAT credit attributable to exempted goods and exempted services for the whole financial year in the following manner [Rule 6(3A)(c) inserted w.e.f. 1-4-2008] –

**Inputs used for exempted final products** - The amount of CENVAT credit attributable to inputs used in or in relation to manufacture of exempted goods, on the basis of total quantity of inputs used in or in relation to manufacture of said exempted goods during the financial year, denoted as H [Rule 6(3A)(c)(i)].

This has to be done on basis of input-output ratio and/or on basis of formula similar to the one applicable in case of inputs for exempted services on actual basis.

**Inputs used for exempted services** - The amount of CENVAT credit attributable to inputs used for provision of exempted services is to be calculated finally on actual basis as follows:-

J	Total value of exempted services provided during the financial year.
K	Total value of dutiable goods manufactured and removed plus the total value of taxable services provided plus the total value of exempted services provided, during the financial year
L	Total CENVAT credit taken on inputs during the financial year minus H (i.e. credit taken on inputs for manufactured final products)
(J/K) x L	Amount to be reversed finally as per rule 6(3A)(c)(ii)

**Input services used in or in relation to manufacture of exempted goods or provision of exempted services** - The amount attributable to input services used in or in relation to manufacture of exempted goods or provision of exempted services is to be calculated on actual basis as follows -

M	Total value of exempted services provided plus the total value of exempted goods manufactured and removed during the financial year
N	Total value of taxable and exempted services provided, and total value of dutiable and exempted goods manufactured and removed, during the financial year

P	CENVAT credit taken on input services during the financial year
(M/N) x P	Amount to be reversed finally at end of year as per rule 6(3A)(c)(iii)

**Amount of Cenvat credit to be reversed for whole year** - Amount of Cenvat credit attributable to exempted goods and exempted services is to be determined at the end of financial year. The amount is to be calculated as follows

(1)	Rule 6(3A)(c)(i)	Cenvat on Inputs used for exempted final products.
(2)	Rule 6(3A)(c)(ii)	Cenvat Credit on Inputs used for exempted services (On proportionate basis, based on actual ratio of financial year)
(3)	Rule 6(3A)(b)(iii)	Cenvat Credit on input services used for exempted final products and exempted services (On proportionate basis based on actual ratio of financial year).
(4)	Rule 6(5)	Cenvat credit on services specified in rule 6(5), which are exclusively used for exempted goods or exempted services
	Total	1+2+3+4 = Total amount attributable to exempted final products and exempted services

#### **Payment of difference if short payment was made**

At the year end, the manufacturer of goods or the provider of output service, shall pay an amount equal to the difference between the aggregate amount determined as per rule 6(3A)(c) and the aggregate amount determined and paid as per Rule 6(3A)(b), on or before the 30th June of the succeeding financial year, if the amount provisionally paid was lower than the amount finally determined at the year end [Rule 6(3A)(d) inserted w.e.f. 1-4-2008].

**Interest payable if amount was short paid** - In addition to the amount short-paid, the assessee will be liable to pay interest at the rate of twenty-four per cent per annum from the due date, i.e., 30th June till the date of payment, where the amount short-paid is not paid within the said due date.

Thus, no interest is payable if difference is paid by 30th June of the following year [Rule 6(3A)(e) inserted w.e.f. 1-4-2008].



### **Intimation of details to Range Superintendent**

The manufacturer of goods or the provider of output service shall intimate to the jurisdictional Superintendent of Central Excise, within a period of fifteen days from the date of payment or adjustment, the following particulars –

- (i) details of CENVAT credit attributable to exempted goods and exempted services, monthwise, for the whole financial year, determined provisionally
- (ii) CENVAT credit attributable to exempted goods and exempted service for the whole financial year, finally determined
- (iii) amount short paid determined along with the date of payment of the amount short-paid
- (iv) interest payable and paid, if any, on the amount short-paid [Rule 6(3A)(g) inserted w.e.f. 1-4-2008].

### **Self adjustment of excess amount paid**

If at the year end, it is found that the amount provisionally paid was more than the amount finally determined, the manufacturer of goods or the provider of output service may adjust the excess amount on his own, by taking credit of such amount [Rule 6(3A)(f) inserted w.e.f. 1-4-2008].

**Intimation of details to Range Superintendent** - The manufacturer of final products or the provider of output service shall intimate to the jurisdictional Superintendent of Central Excise, within a period of fifteen days from the date of payment or adjustment, the following particulars –

- (i) details of CENVAT credit attributable to exempted goods and exempted services, month wise, for the whole financial year, determined provisionally
- (ii) CENVAT credit attributable to exempted goods and exempted service for the whole financial year, finally determined

- (iii) amount excess paid
- (iv) credit taken on account of excess payment, if any [Rule 6(3A)(g) inserted w.e.f. 1-4-2008].

**If the manufacturer/ service provider does not manufacture dutiable goods or does not render taxable services**

If manufacturer of final products or the provider of output service does not manufacture dutiable final products or taxable output service, he can take credit but is not required to pay proportionate amount on provisional basis as provided in rule 6(3A)(b). However, at year end, he should pay amount on proportionate before 30th June [Rule 6(3A)(h) inserted w.e.f. 1-4-2008].

The provision applies in case of production in first year when ratios of the previous year are not available to calculate Cenvat attributable to exempted products and exempted services.

If the amount is not paid by 30th June, interest is payable @ 24% after 1st July [Rule 6(3A)(i) inserted w.e.f. 1-4-2008].

**Calculation of 'Value' of exempted goods or exempted services**

“Value” for the purpose of rules 6(3) and 6(3A) shall have the same meaning assigned to it under section 67 of the Finance Act, 1994 read with rules made there under or, as the case may be, the value determined under section 4 or 4A of the Central Excise Act, 1944 read with rules made there under [*Explanation I* to rule 6(3A)]

Thus, value is to be calculated as per provisions of Central Excise Act (in case of manufactured products) and Finance Act, 1994 (in case of service tax).

In case of goods chargeable to specific rate of duty, value shall be determined under section 4. In case of (partially) exempted services, value shall be gross amount charged for providing exempted services, without abatement - Para 3 CBE&C Circular No. 868/6/2008-CX dated 9-5-2008.

## **Recovery of the 'amount'**

If the manufacturer of final products / output service provider does not pay the 'amount' as provided in rule 6(3) or rule 6(3A), it can be recovered along with interest under rule 14 of Cenvat Credit Rules, as if it is a credit wrongly taken – *Explanation III to rule 6(3A) inserted w.e.f. 1-4-2008.*

## **Rule 6(2) and 6(3) should be taken as complimentary and not mutually exclusive**

The words used in rule 6(3) are 'notwithstanding anything contained in rule 6(1) and 6(2), the manufacturer of goods or provider of output service, opting not to maintain separate accounts, shall follow either of the following options as applicable to him'.

At first glance, it appears that rule 6(2) and 6(3) are mutually exclusive. However, this rule can be interpreted to mean that rule 6(3) is applicable in respect of inputs and input services for which assessee opts not to maintain separate accounts. Rule 6(3) should apply in cases of common inputs and common input services where assessee is not in a position to maintain separate accounts.

In costing, there is concept of 'allocation' and 'apportionment'. The costs which can be allocated directly to a particular product should be so allocated, while costs which cannot be directly allocated to any particular product/service should be apportioned on a reasonable basis.

This principle can be applied here also.. The input goods/services which can be directly allocated to taxable goods/services and exempt goods/services should be allocated under rule 6(2). Full credit should be allowed of Cenvat credit allocable to taxable goods/services and no credit should be allowed for Cenvat credit allocable to exempt goods/services.

The remaining input credit/input services should be apportioned between taxable goods/services and exempt goods/services on the basis of formulae given in rule 6(3A). This should give best possible and most fair results.

### **Cenvat credit in case of export of manufactured goods**

As per rule 5 of Cenvat Credit Rules, if the final products are exported, the Cenvat credit is not required to be reversed. The manufacturer of final products/ output service provider can utilize credit for payment of duty on other products. If this is not possible, he can get refund. The issue is where the value of exported goods will appear while making calculations as per rule 6(3A)?

Goods are cleared for export 'without payment of duty'. They are not 'exempt' goods. Ministry of Law Advice dated 29.10.1974 - confirmed and circulated vide CBE&C circular No 278/112/96-CX dated 11.12.1996,

Thus, exported goods are not 'exempt goods'. Hence, value of export of goods should be taken in denominator i.e. below the line to give correct and fair results. If these are ignored or taken in numerator (above the line), it will amount to reversal of Cenvat credit attributable to these goods, which certainly is illogical.

**Supplies to SEZ are 'exports'** - Supplies to SEZ are 'exports' as per section 2(m)(ii) of SEZ Act. Section 51 of SEZ Act provides that provisions of SEZ Act have overriding effect. Hence, irrespective of provisions of rule 6(6) of Cenvat Credit Rules, supplies to SEZ unit or developer are to be treated as 'exports'.

### **Cenvat credit in case of export of services**

As per rule 5 of Cenvat Credit Rules, if the output services are exported, the Cenvat credit is not required to be reversed. The manufacturer can utilise credit for payment of duty on other products or service tax on other services. If it is not possible for him to utilise the said credit, he can get refund by following the procedure prescribed under Rule 5 of Cenvat Credit Rules, 'output services which are exported' means any output service exported in accordance with the Export of Services Rules, 2005.

The issue is where the value of exported services will appear while making calculations as per Rule 6(3A)?

As per Rule 2(e) of Cenvat Credit Rules, service on which no tax is payable is also 'exempt service'. Thus, exported service is also exempt service. However, as per rule 5, Cenvat credit on exported service is not required to be reversed.

Hence, applying principle of harmonious construction, export of services should be taken in denominator i.e. below the line to give correct and fair results. If these are taken in numerator (above the line), it will amount to reversal of Cenvat credit attributable to the exported services, which certainly is illogical.

CBE&C vide Para 6 of Circular No. 868/6/2008-CX dated 9-5-2008, has confirmed that export of service without payment of service tax are not to be treated as exempted services.

### **Calculation of value of common inputs in case of exempted final products**

The formulae as given in rule 6(3A) are only in respect of Cenvat credit attributable to (a) inputs used for provision of exempted services and (b) input services used in or in relation to manufacture of exempted goods or provision of exempted services.

There is no formula to calculate Cenvat credit attributable to value of inputs used in manufacture of exempted final product, when inputs are common. In any case, consumables, fuel, dies, tooling etc. will be 'common inputs' in most of the cases.

In absence of any formula, the only option with assessee is to calculate the same either on basis of input-output ratio, or on the basis of formula similar to the one applicable for calculation of inputs used for provision of exempted services.

The principle of allocation and apportionment as applied in costing should apply i.e. credit of inputs directly allocable to exempt final products should be excluded fully and credit of inputs allocable directly to taxable goods should be allocated fully. In case of balance common inputs, the Cenvat credit to be reversed may be calculated on basis of formulae given in rule 6(3A).

**Certificate of Cost/Chartered Accountant** - As per Para 7 of CBE&C Circular No. 868/6/2008-CX dated 9-5-2008, calculation of Cenvat credit attributable to inputs used in relation to manufacture of exempted final products shall be made on basis of stores/production records

maintained by the manufacturer. A certificate from Cost/Chartered Accountant giving details of quantity of inputs used in the manufacture of exempted goods, value thereof and Cenvat credit taken on these inputs is to be submitted by the manufacturer at the end of the year.

### **Manufacturer / Service provider having multi-locations of factories and service stations**

The problems will multiply in case of manufacturer having multiple factories and/or service provider providing service from multiple locations.

The principles discussed above should apply here also.

### **Findings:-**

#### **Options to a manufacturer:-**

In case of a manufacturer of final products, using common inputs or input services for manufacture of dutiable as well as exempted final products and opts to not to maintain separate accounts, the manufacturer can either reverse the credit attributable ( to be worked out in the manner prescribed in the Rule 6) to the inputs and the input services used in the manufacture of exempted final products or pay 10% amount of the value ( to be determined in accordance with the provisions of Section 4 / Section 4A of the Central Excise Act) of the exempted goods.

#### **Options to the provider of output services:-**

In case of a provider of output service, using common inputs or input services for taxable as well as exempted services opts not to maintain separate accounts, the provider of output services can either reverse the credit attributable (to be worked out in the manner prescribed in Rule 6) to the inputs and input services used for providing exempted service; or pay 8% amount of the value (determined in terms of Section 67 of Finance Act, 1994) of the exempted services.

## CONCLUSION

### Situation A:-

- a) The manufacturer is required to pay back or reverse the Cenvat credit availed on the inputs or capital goods cleared as such.
- b) He need not reverse the Cenvat credit availed on input services for procuring or storage of inputs or capital goods as there is no specific provision for the same under Rule 3 (5) of the Cenvat Credit Rules.

### Situation B:-

#### Options to a manufacturer:-

In case of a manufacturer, using common inputs or input services for manufacture of dutiable as well as exempted final products and opts to not to maintain separate accounts, the manufacturer can either reverse the credit attributable ( to be worked out in the manner prescribed in the Rule 6) to the inputs and the input services used in the manufacture of exempted final products or pay 10% amount of the value ( to be determined in accordance with the provisions of Section 4 / Section 4A of the Central Excise Act) of the exempted goods.

#### Options to the provider of output services:-

In case of a provider of output service, using common inputs or input services for taxable as well as exempted services opts not to maintain separate accounts, the provider of output services can either reverse the credit attributable (to be worked out in the manner prescribed in Rule 6) to the inputs and input services used for providing exempted service; or pay 8% amount of the value (determined in terms of Section 67 of Finance Act, 1994) of the exempted services.

## RECOMMENDATION

In the case of the problem discussed in Situation A, divergent views are expressed by the manufacturers and the officers of Central Excise department. Hence C.B.E.C should give a clear picture by issuing a Circular clarifying the matter.

In the case of the problem discussed at Situation B, the following aspects of Rule 6 of Cenvat Credit rules needs clarification:-

- 1) Should the option be exercised before the first clearance/ before providing output service? Or any time during the year, if so what happens to the previous transactions?
- 2) Is the credit balance lying on the date of exercising the option available?
- 3) Are job workers, goods under specific rate, input service distributor, abatement enjoying services included?
- 4) Are non taxable services also covered under exempted services?

C.B.E.C may clarify the matter by issuing a Circular.



## LIMITATIONS

In case of dispute, the Rules are interpreted by higher legal forums like The Tribunal, the High Courts and the Supreme Courts.

Cenvat Credit Rules 2004 is very recent and most of its legal aspects are yet to be decided by the higher legal Forums. The conclusion arrived in problems discussed above are purely based on the rules and not supported judgments / decisions of tribunal / courts.

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### WEB SITES:

- [www.dateyvs.com](http://www.dateyvs.com)
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