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Valuation in Service Tax

Rule 5(1) of the Valuation Rules

A recent judgment dated 30 November 2012 of the Delhi High Court in WP (C) No, 6370 of 2008, reported as Intercontinental Consultants & Technocrats Private Limited v CCE, 2013 (029) STR 0009 (Del), has made waves by striking down Rule 5(1) of the Service Tax (Determination of Value of Taxable Services) 2006 (hereinafter, the "valuation rules"). The requirements of the rule and the implications of the judgment striking it down are examined below.

Valuation Rules 5(1)

Rule 5 of the Valuation Rules

Rule 5 of the valuation rules has three parts, which can be paraphrased as follows. Sub-rule (1) requires that all expenditure or costs incurred in the course of providing a service must be treated as consideration for the service and included in the taxable value for service tax; sub-rule (2) provides for exclusion of expenses that are incurred on behalf of the client and recovered from him; the third part of the rule gives examples to illustrate the elements that must be included in taxable value. The rule can be perused under http://www.servicetax.gov.in/st-rules-home.htm

Demand on the petitioner

Against this backdrop, a show cause notice was issued to Intercontinental Consultants & Technocrats Private Limited, demanding service tax amounting to over Rs 3.5 crores on travel and hotel bills reimbursed by their clients for a period of four years. Inevitably, the allegation of suppression of facts was also made, and penalties were proposed. The noticee took the matter in writ petition to the High Court.

Delhi High Court: Rule 5(1) bad in law

The Delhi High Court seems to have had no difficulty in striking down Rule 5(1) as bad in law, being ultra vires sections 66 and 67 of the Finance Act 1994. During the period in question, section 66 was the section under which service tax was levied. Section 67 was, and continues to be, the section governing determination of taxable value.

Rule 5(1) travels beyond section 67

The High Court found two features of Rule 5(1) objectionable. Firstly and more importantly, the sub-rule was found to go beyond the scope of what was authorised by section 66 and 67. Under section 66 (and currently under section 66B), the levy of service tax is on the value of (taxable) services. Under section 67, where a service is taxed with reference to its value, such value will be the consideration received for such service. It is clear, the High Court observed, that only the value of the service provided can be subjected to service tax. The valuation rules are made to carry out the purposes of the Act, and cannot travel beyond the boundaries laid down in section 67.

Double taxation

The second flaw that the High Court found in Rule 5(1) of the valuation rules was that it resulted in double taxation, inasmuch as the items of expense being included for tax had already been subjected to service tax in the hands of the respective service providers. Here it is necessary to comment that the provisions of the Cenvat Credit Rules do not seem to have been brought to the notice of the bench.

Inconsistent treatment of recoverable expenses

There is an additional problem with Rule 5(1), which was not canvassed by the petitioners and not discussed in the judgment. This is the inconsistent and discriminatory treatment that results from the wording of the rule. The rule requires adding recoverable expenses to taxable value in cases "(w)here any expenditure or costs are incurred by the service provider in the course of providing taxable service". It follows that if these expenses are not incurred by the service provider but directly taken care of by the client, they will not be taxable. To take the example of air tickets and hotel stay, as was the issue in the case before the Delhi High Court, these become taxable if initially paid for by the service provider and recovered from his client; but are not taxable if paid for by the client at the outset without passing through the hands of the service provider. This is not a reasonable basis for creating a liability.

British law on "disbursements"

The issue of what constitutes a deductible disbursement was settled in the context of British VAT law in the High Court decision in the case of Rowe & Maw, 1975 (STC) 340 (-here STC refers to 'Simon's Tax Cases'). Deductible disbursements are essentially pass-through expenses that are identified by eight characteristics, which have since been used in Indian service tax law to identify 'pure agent' payments. Other payments / expenses, which are directly attributable to a particular client's work and are recovered from the client, are not to be treated as disbursements, and are part of taxable value.
The HM Revenue & Customs website clarifies as follows regarding disbursements:
"Directly attributable costs which are borne by the solicitor, sometimes referred to as 'taxable' disbursements, form part of the solicitor's own supply and must be standard-rated when passed on to the client."
The authority for this is cited as follows:
"In Rowe and Maw ([1975] STC 340), the High Court ruled that travelling costs incurred by a solicitor in the course of his duties for his client and recovered from the client at cost could not be treated as a disbursement. The supply of travel was to the solicitor and therefore formed part of his onward supply of legal services to the client."
It is this principle that is embodied in Rule 5(1) of the valuation rules in India.

Rationale behind Rule 5(1)

Prima facie, Rule 5(1), as also the British case cited above, are intended to preclude any attempt to artificially separate a professional's fee from his inbuilt costs like secretarial assistance and stationery charges. Particularly in the legal profession there is a convention of billing these separately, which may result in their exclusion from tax but for this provision.

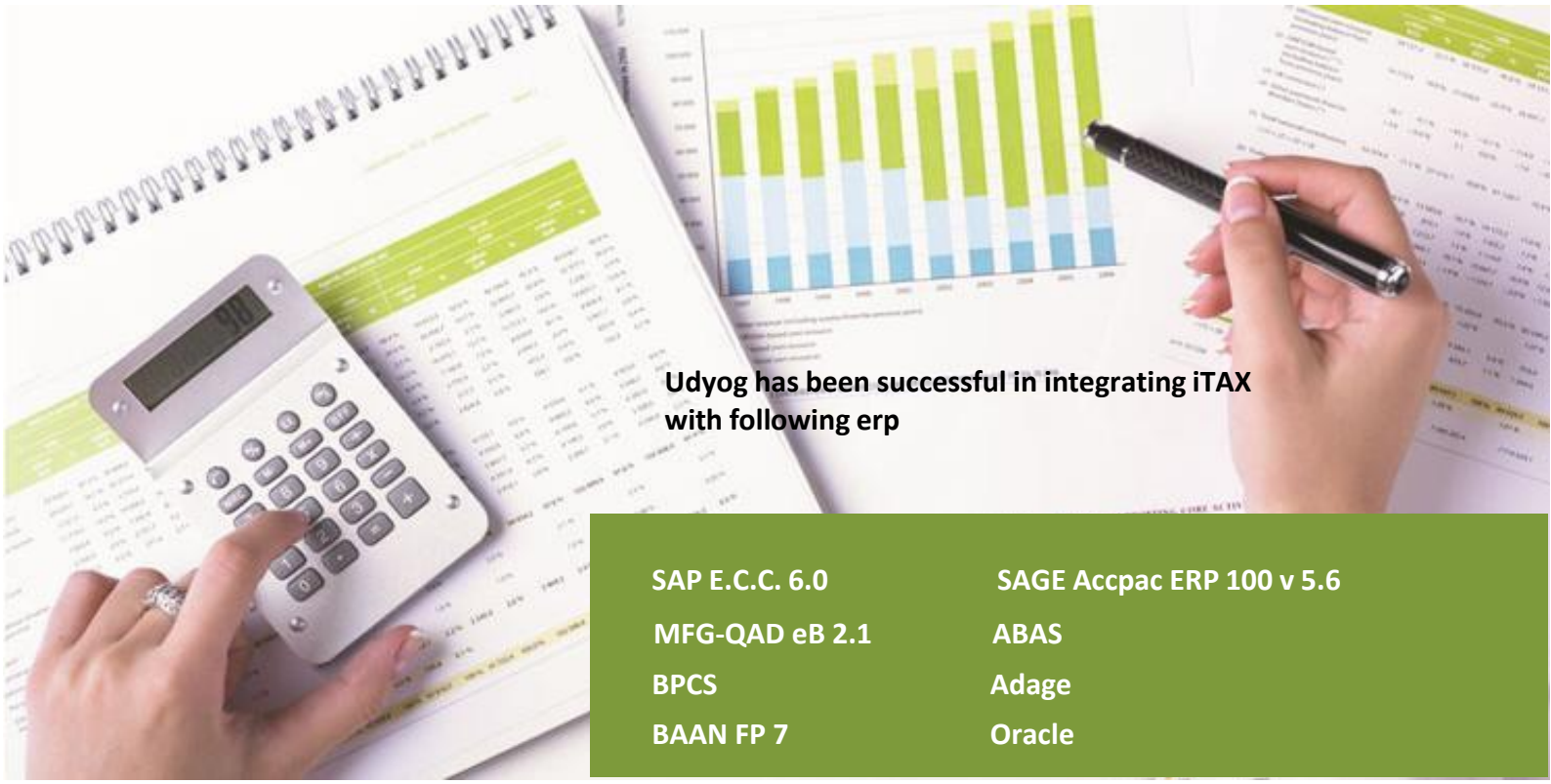
Earlier clarification regarding reimbursements

Prior to the notification of the valuation rules, the CBEC had clarified that reimbursement of out-of-pocket expenses was not part of taxable value. In paragraph C(iv) of instructions circulated by way of circulars and trade notices, the following clarification was given:
"(iv) Another concern that has been raised is whether service tax is payable on the reimbursable/out-of-pocket expenses charged to the client on actual basis. As regards charges billed to the client on account of out of pocket expenses which are reimbursable on actual basis, such as, travelling, boarding and lodging expenses is concerned, the same are not subject to service tax. In this respect, the service tax assessee may be required by the jurisdictional Commissioner of Central Excise to provide documentary evidence substantiating his claim for abatement from the gross amount received from the client for services rendered. Similar dispensation in respect of reimbursable/out-of-pocket expenses charged to the client on actual basis is also available in respect of other services." [Indore Commissionerate Trade Notice 5/98 dated 14 October 1998]

Suggestion for re-formulation of Rule 5 (1)

In the light of the Delhi High Court judgment, and against the backdrop of the intention expressed in the 1998 trade notice, the government must give attention to the different elements of cost so that the baby is not thrown out in the concern to retain the bathwater. The rule needs to be re-formulated so as to capture inbuilt costs, even if separately billed, but exclude costs that are to the account of the client. A suggestion would be to add a proviso specifically excluding costs of lodging, boarding and travel for a client.

The examples given in the rule also require revision in the light of this principle.



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