



Udyog Whitepaper



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Cenvat credit: Demystifying options for exempted goods / services

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Introduction

The Cenvat credit scheme is devised to neutralise the cascading effect of tax on tax. Therefore it is applicable only if the final product is exigible to excise duty / service tax. However, as in real life the inputs and services used may not be neatly separable for exempted and taxable supplies, the law provides for different ways of operationalising this principle. These different ways and how to select a beneficial option in case of exempted products, are discussed in this paper.

Cascading effect / Cenvat credit not applicable to exempted supplies

Cenvat credit is a way by which the government, in effect, gives back the duties / service tax paid on inputs and input services in the form of a credit entry in a 'Cenvat account', which can be debited as a legally acceptable method of 'paying' excise duty or service tax. The condition of taking this 'Cenvat credit' entry is that the relevant input / input service is not to be used in manufacture of exempted product or provision of exempted service. The logic of this prohibition is rooted in the *raison d'être* of the scheme, which is that tax should not add to the assessable value for further duties / tax. If there is no further taxation of the product, then the Cenvat credit scheme is inapplicable. Therefore rule 6 of the Cenvat Credit Rules 2004 stipulates,

“(1) The Cenvat credit shall not be allowed on such quantity of input used in or in relation to the manufacture of exempted goods or for provision of exempted services, or input service used in or in relation to the manufacture of exempted goods and their clearance upto the place of removal or for provision of exempted services, except in the circumstances mentioned in sub-rule (2).”

Rule 6 of the Cenvat Credit Rules 2004 (hereinafter referred to as the Cenvat rules) is entitled 'Obligation of manufacturer or producer of final products and a provider of output service', and it lays down the basic obligation very clearly, as quoted above. This basic obligation is that a manufacturer or service provider is not to take credit on inputs / input services used for manufacture or exempted goods or provision of exempted service. Sub-rule (2), in turn, stipulates that the assessee must keep separate accounts of the inputs and input services to ensure compliance of this. However, there is a loophole, in the non-obstante clause of sub-rule (3).

Exceptions to prohibition on credit on inputs/services for exempted supplies

Sub-rule (3) of Rule 6 of the Cenvat rules provides an exception to the principle laid down in sub-rule (1), with the non-obstante clause, "Notwithstanding anything contained in sub-rules (1) and (2)..." It then proceeds to offer three options to a person who opts not to maintain separate accounts:

“(3) Notwithstanding anything contained in sub-rules (1) and (2), the manufacturer of goods or the provider of output service, opting not to maintain separate accounts, shall follow any one of the following options, as applicable to him, namely:-

(i) pay an amount equal to six per cent. of value of the exempted goods and exempted services;

or

(ii) pay an amount as determined under sub-rule (3A); or

(iii) maintain separate accounts for the receipt, consumption and inventory of inputs as provided for in clause (a) of sub-rule (2), take CENVAT credit only on inputs under subclauses (ii) and (iv) of said clause (a) and pay an amount as determined under sub-rule (3A) in respect of input services. The provisions of sub-clauses (i) and (ii) of clause (b) and subclauses (i) and (ii) of clause (c) of sub-rule (3A) shall not apply for such payment.”

Thus, if an assessee has both exempted and dutiable / taxable supplies, and opts not to maintain separate accounts for the inputs and services used for these, the Cenvat rules allow him to choose and follow one of three options:

- (i) pay six per cent of the value of the exempted supplies; or
- (ii) pay an amount determined under sub-rule (3A) (discussed below) for both exempted goods and exempted services; or
- (iii) pay an amount under sub-rule (3A) for only exempted services, and segregate inputs for exempted goods and not take Cenvat credit on these.

Very important: conditions that restrict the options under Rule 6(3)

There are important caveats to these options, which need to be noted.

- Firstly, no Cenvat credit is to be taken on inputs or input services that are exclusively used in exempted manufacture or exempted services.
- Secondly, whichever option is chosen remains in operation for the rest of the financial year and cannot be changed during that financial year.

Option under sub-rule (3A): formulae that are really quite simple

The option under sub-rule (3A), like the others under sub-rule (3), requires prior intimation to the Superintendent of Central Excise, and cannot be changed for the remaining part of the financial year. The option is that separate accounts are not maintained, credit is taken on inputs and input services as they are received; and an amount of Cenvat credit is reversed as per the formulae prescribed. The formulae sound so complicated that the average assessee does not even consider this option; but when decoded they are really quite simple. They stipulate the method to arrive at an amount of Cenvat credit to be reversed provisionally each month, and the method to arrive at the final figure at the close of the financial year. The formulae, which essentially approximate the actual amount of credit involved in the exempted supplies, are as follows.

For an assessee who is only a manufacturer (and is not a provider of services),

- take the total amount of Cenvat credit attributable (provisionally) to inputs used for exempted goods as 'A';
 - take the total amount of exempted goods manufactured and cleared during the previous financial year as 'E';
 - take the total amount of goods, both dutiable and exempted, manufactured and cleared during the previous financial year as 'F';
 - take the total amount of Cenvat credit taken on input services during the month as 'G';
- (i) Reverse 'A' each month towards Cenvat credit on inputs used in exempted goods;
- (ii) To arrive at the amount of Cenvat credit to be reversed each month towards input services used in exempted goods, carry out the operation $(E/F) \times G$.

At the close of the financial year, work out the quantity of inputs actually used in exempted goods, and the Cenvat credit thereon. If this is more than the total amount reversed during the year as 'A', reverse the differential amount by the end of June. (If not paid by 30 June, interest at the rate of 24% per annum will be payable from 30 June till the date of payment.) If it is less than the total amount reversed during the year as 'A', take *suo moto* credit on the differential amount.

Similarly, to arrive at the amount of credit attributable to input services used in exempted goods during the year, substitute the year's values instead of the previous year's values as 'E' and 'F', and use the year's values instead of the month's value as 'G' in the formula $(E/F) \times G$. Proceed as above for any differential amount as compared to the reversal of credit actually made.

For an assessee who is only a service provider (and is not a manufacturer),

- Take the total value of exempted services provided during the previous financial year as 'B';
 - Take the total value of services, both exempted and taxable, provided during the previous financial year as 'C';
 - Take the Cenvat credit taken on inputs during the month as 'D'.
 - take the total amount of exempted services provided during the previous financial year as 'E';
 - take the total amount of goods, both dutiable and exempted, manufactured and cleared during the previous financial year as 'F';
 - take the Cenvat credit taken on input services during the month as 'G'.
- (i) Carry out the operation $(B/C) \times D$, to arrive at the amount of Cenvat credit to be reversed for inputs each month.
- (ii) Carry out the operation $(E/F) \times G$ to arrive at the amount of Cenvat credit to be reversed for inputs each month.

At the close of the financial year, repeat the same formula by taking the figures for the year for which the reversal is being worked out. Where 'D' denoted the Cenvat credit on inputs during a month, it will be replaced by Cenvat credit taken on inputs during the year. Similarly, where 'G' denoted the Cenvat credit on input services taken during the month, it will be replaced by the figure for Cenvat credit taken during the year.

If the figure arrived at in this manner is more than the total amount reversed during the year based on the provisional formulae, reverse the differential amount by the end of June. (If not paid by 30 June, interest at the rate of 24% per annum will be payable from 30 June till the date of payment.) If it is less than the total amount provisionally reversed during the year, take *suo moto* credit on the differential amount.

For an assessee who is both a service provider and a manufacturer

An assessee who is both a service provider and manufacturer has to proceed as follows:

First work out, provisionally, the amount of Cenvat credit attributable to inputs used in exempted goods, as in 'A' above;

'B' is the same value as in the formula above, i.e. the total value of exempted services provided during the previous financial year;

'C' is the total value of dutiable goods plus total value of all services (exempted as well as taxable) during the previous financial year;

'D' is the total credit taken on inputs during the month, minus 'A'.

- (i) Provisionally reverse the Cenvat credit equal to 'A' each month, as ineligible credit on inputs;
- (ii) For provisional reversal of ineligible credit on input services, apply the formula $(B/C) \times D$.



At the close of the financial year, repeat the same formula by taking the figures for the year for which the reversal is being worked out (in place of the figures for the previous financial year). Thus,

- Where 'A' and 'D' denoted the Cenvat credit on inputs during a month, they will be replaced by Cenvat credit taken on inputs during the year.
- Where 'B' denoted the value of exempted services for the previous financial year, it will now refer to the value of exempted services during the year just closed.
- Similarly, where 'C' denoted the Cenvat credit on input services taken during the month, it will be replaced by the figure for Cenvat credit taken during the year.

If the figure arrived at in this manner is more than the total amount reversed during the year based on the provisional formulae, reverse the differential amount by the end of June. (If not paid by 30 June, interest at the rate of 24% per annum will be payable from 30 June till the date of payment.) If it is less than the total amount provisionally reversed during the year, take *suo moto* credit on the differential amount.

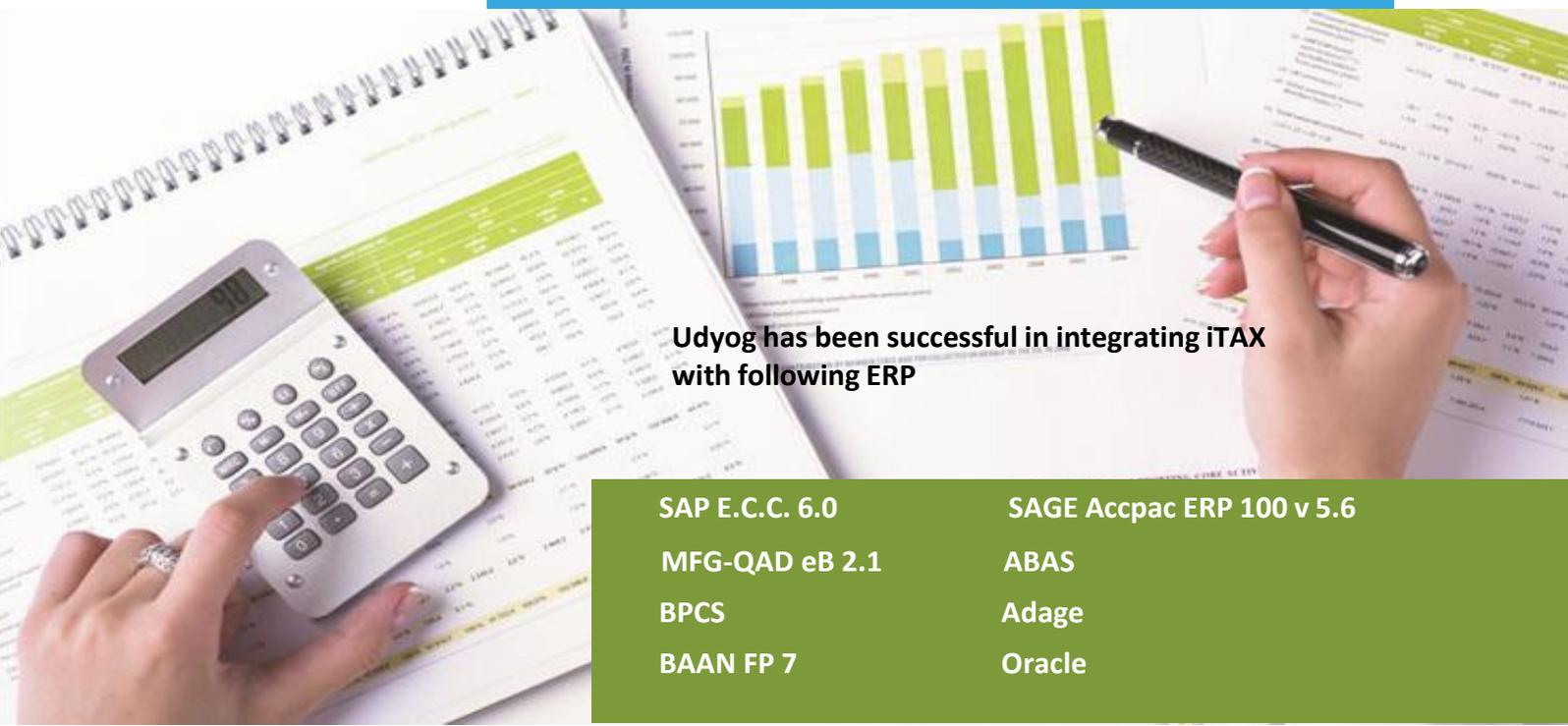
Deciding on an option under Rule 6(3) and (3A)

It can be seen that sub-rule (3A) is basically actuals. Therefore in choosing the options, one has to look at the value addition, which of the materials is duty-paid, and whether 6% will be advantageous. The option of 6% is advantageous if the Cenvat credit involved in inputs for exempted goods is more than 6% of the value of the goods. Let us take an example, in which, for simplicity, we will take it that there is no tax on services used. In our hypothetical example, if the duty structure on inputs for the product is

- duty of 10% paid on input plastic which constitutes 50% of value,
- duty of 12% paid on input fabric which constitutes 10% of value, and
- natural rubber (no excise duty), which constitutes 40% of value

then the total duty paid on inputs is 6.2% of value. In such a case it is beneficial to reverse 6% of value to comply with Rule 6(3) by selecting the option under Rule 6(3)(i).

If the duty structure on inputs is different, and the total duty paid on inputs and input services is less than 6% of the value at which the product or service is sold, then the option of Rule 6(3A) may be a better one. The hybrid option under Rule 6(3)(ii), in which the inputs for exempted supplies are segregated in the accounts and credit not taken at all on these, while input services are treated under the Rule 6(3A) methodology, may also be advantageous to some.



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