CHAPTER -1

PREAMBLE

Introduction

Taxation is a fiscal tool in the hands of the Government to raise revenue for the country and indirect taxes like excise duty, customs duty, value added tax, service tax, proposed goods and service tax, etc. are some of the taxes which contribute majorly to raise this revenue. The proposed move to GST by the Indian Government which would combine most of these indirect taxes and be introduced as one common tax on both goods and services, is a step in this direction.

Background of Indirect Taxes in India

Broadly there are two types of taxes - ‘Direct taxes and indirect taxes’. Direct taxes are called as such because they are a tax on income earned by an individual/entity and are directly paid by the individual/entity earning the income to the government. Thus the entity or individual earning income pays tax on its taxable income determined as per the provisions of law to the Government. The slab rates of the income tax are progressive i.e. they increase with the increase in income. Hence direct taxes are considered as progressive since they rise with a rise in income and are directly proportional to the income.

However, in the case of indirect taxes, these are imbedded in the costs of goods and services (like excise, customs duty, service tax etc.) and are collected by the seller/provider of such goods/services from the final consumer of the goods/services and paid to the government. Thus though the tax is borne by the consumer, it is paid to the government by the seller of goods or provider of services. Hence the tax is an indirect tax borne by one and paid by another. Further these taxes being included in the cost of the product, are paid by all irrespective of the income level. Hence indirect taxes are considered as regressive in nature.
Excise duty, customs duty, Central Sales Tax, Value Added Tax, Luxury Tax, Entertainment tax, Service Tax etc. are the various types of indirect taxes.

Historically in India, indirect taxes were applicable only on goods and there were various indirect taxes operating in India. The main ones were Customs duty on imports, excise duty on manufacture and Sales Tax on sale of goods which later became Value Added Tax or VAT. Thus goods which were tangible in nature were covered under the indirect tax net. Further, there was no concept of availability of input tax credit or ITC set off against the output tax liability other than under excise i.e. in the form of Cenvat credit on manufacture of goods. Thus the cost of goods sold was higher due to tax being charged on tax.

Further for interstate movement of goods, Central Sales Tax or CST is charged. CST is payable to the state where the transaction originates. It is paid by the buyer of the goods in the destination state. This is contrary to the model of IGST proposed in the coming GST where the IGST is payable to the destination state and not the origination state.

**Introduction of Service Tax - 1994**

Services which were intangible in nature remained out of the indirect tax net. To correct this, in 1994, Government of India decided to bring services under the indirect tax net and service tax was born. Ironically, services are made liable to service tax under the parent act Chapter V of the Finance Act and there is till date is no separate act for service tax. At the start, in 1994, there were 3 categories of services liable to service tax. By 2012, the law went on to cover almost 129 categories of services.

Input credit of service tax paid on input services was available to service providers from 2002 if the input service was in the same category as the output service under the Service Tax Credit Rules 2002. General Service tax paid on all input services was allowed from May 2003 under the same rules. From September 2004, Input credit or ITC of excise duty, service tax etc. paid
on inputs/input services/capital goods used for providing the output services was also allowed under the Cenvat Credit Rules, 2004.

**Introduction of VAT- 2005**

Parallely in April 2005, sales tax was replaced with VAT. Not all states adopted Vat simultaneously leading to ground level issues. Around 8 states at the beginning were out of VAT and continued with sales tax. The other states had the common or standard VAT rates all over India.

Further the ITC became available in VAT resulting in slight reduction in final prices. With the introduction of concept of ITC, the compliances also automatically improved. This was because for a registered dealer to avail credit of VAT paid on his purchases, he needed a valid invoice from a registered dealer. Hence registered dealers started preferring to purchase goods from VAT compliant dealers rather than from the unregistered market.

Thus ITC was available of excise duty and service tax against service tax output or excise duty and ITC of VAT was available against VAT output. Central Sales tax or CST paid was a cost not available for set off. Also cross availability of VAT and excise /service tax ITC against the output of either was not available.

**Negative List system of Taxation introduced - 2012**

In 2012 the Government introduced the “Negative List of Taxation”. This was a shift in the concept of taxation of services under service tax. The idea was of shifting the tax base from a positive list of categories of services to “negative list of taxation”. Under the concept of “negative list” all services not covered under the “negative list” are liable to service tax. Thus “negative list” is the list of services or activities not liable to service tax, and thus the “Negative list of taxation regime” began on 1st July 2012. By implication it means that all services not covered under the negative list are liable to service tax – unless specifically covered
by exemption notification or if not provided in India as per the Place of Provision of Services Rules, 2012.

**The term Service defined for the first time**

With the introduction of “negative list” for the first time the term “service” was defined. This definition is pretty broad and covers almost any activity under its net. The definition starts with the words ‘service means any activity carried out by a person for another for consideration and includes a declared service, but does not include .....’ Thus the definition encompasses all activities for consideration except for few things like service by employee to employer etc.

**The negative list of services** is listed in Section 66D. Thus all services not covered under section 66D are liable to service tax. **Declared services** were listed under section 66E certain services were listed as ‘declared services’. These declared services are services liable to service tax specifically. This list mainly contains those services which were under litigation prior to 1st July, 2012 due to ambiguity in the earlier provision on the applicability of service tax. With this list becoming specifically liable to service tax the litigation on the same subjects is expected to reduce in future – for eg service tax on renting of immovable property a contentious issue was explicitly brought under the service tax net.

**Banking Services – Negative List**

The “Negative List” of services includes Banking services. The entry covering Banking reads as

..services by way of

*Extending deposits, loans or advances so far as .... by way of interest or discount*

*Inter se sale or purchase of foreign currency among Banks .....and such dealers*..

Prior to 2012, Banking as a service was taxable under section 65(105)(zm) and credit card services which is a part of Banking was covered under another entry under section 65(105)(zzzw). Banking services covered a wide range of activities like financing, leasing, asset management, portfolio management, advisory services, lending, foreign exchange broking,
issuing demand drafts, transfer of money, operating of Bank accounts, etc. These services were provided by Banks, financial companies or investment Bankers also.

**Taxability of income received by Banks**

The income received by Banks was in the form of interest on lending, discount on invoice etc. discounting, fees for advisory services or any other services, rent of lockers etc., charges for operating accounts, issuing drafts, commission for sale and purchase of foreign currency etc. and so on.

Of the said incomes broadly interest and discount were not liable to service tax. Income which was in the form of interest and/or discount income on facilities like overdraft, bill or cheque discounting and cash credit was exempt due to Notification 29/2004 dated 22 Sept. 2004. Interest on loans was not considered in the value of taxable services as per Rule 6(2)(iv) of the Service Tax (Determination of Value) Rules, 2006. Thus effectively income of Banks in the form of fees, charges, commission etc. was liable to service tax and interest and discount was not liable to service tax.

Effective 1st July, 2012, interest and discount income of Banks were covered under the negative list and were out of the purview of service tax.

However, there are certain incomes received by Banks like income from factoring services, collateral borrowing and lending operations, income on investments, trading income on securities etc. which do not clearly fall in the negative list now. Earlier they were not clearly covered either by the Notification 29/2004 or by the Valuation Rules, 2006. Hence, though going by the nature of these incomes they are not liable to service tax, due to lack of clear cut provisions in law, many of these incomes form a reason for litigation with the authorities.

Further the classification of these incomes was also not clear and continues to be unclear currently. This has another impact which is currently not an issue. Prior to 1 April, 2011 when the flat reversal of 50% for banks was introduced, banks were required to reverse out Cenvat credit proportionate to their exempt income. Thus credit in relation to non taxable income and
taxable income was not required to be reversed. However, there was ambiguity on whether incomes like factoring, Collateral borrowing and lending are ‘exempt’ or ‘non taxable’. This classification was hugely impact the credit to be reversed.

Further, if fees were charged for services like overdraft, it was unclear whether the service was exempt or taxable as per definition. This led to lot of litigation on the amount of credit to be reversed.

Though currently, the reversal is flat 50% irrespective of the proportion of exempt/taxable/non taxable income, there is a possibility that in GST, the proportionate credit method gets reintroduced. Hence it is imperative that before the introduction of GST, the legislation is clear on the meaning and inclusions in taxable/nontaxable/exempt services.

**Place of provision of services by Banks**

Prior to 1st July 2012, there were no Place of Provision Rules which defined where services were being provided. For determining import and export, there were a different set of Rules. However with the introduction of Place of Provision of Service Rules, 2012 the rules in relation to imports and exports were rescinded. Further these rules helped determine whether the service was being provided in the “taxable territory”. If the service as per the Rules was not provided in the taxable territory then it was not liable to service tax. Thus clear understanding of these rules was important to determine the taxability of the income received for services.

Inherently, services provided by Banks, are intangible and hence it is very difficult to decide where the service originated and where it was consumed. Hence, lucid and unambiguous provisions are required in law to decide where the service is being provided to decide whether it is liable to tax.

Going forward, in the scenario of the oncoming GST, this assumes more importance because the rules will determine not only the taxability of the service in case of service provided within/outside India but also the state where service is provided in the case of interstate services. Thus the rules will help decide the place where the service is being provided, and this in turn
would decide the state which would earn the revenue from service tax. Thus unclear provisions in this would result in fructuous litigation for assesses with States fighting for the revenue. This is more so in case of Banks who provide intangible services.

Other issues in relation to Banks

In addition to the above, there are various lacunas in the current provisions in relation to services provided by Banks. If these are not addressed then under the GST set-up these would cause tremendous issues to Banks. Some of these areas are:

- Valuation of services liable to service tax for foreign exchange conversion
- Eligibility of Cenvat credit on certain services
- Eligibility to avail Cenvat credit on service tax paid on input services – whether complete credit available, proportion to be reversed etc.
- Exemptions to be given to customers located in SEZ/STP areas
- Point of time when services become liable to service tax
- Taxability of interchange income received by issuing banks
- Valuation of services in relation to money changing
- Place of provision of services in case of branch operations
- Reverse charge liability in case of domestic service providers

Problem on hand

Banking Services – Negative List

As mentioned earlier, the provisions of law as exists currently for financial services, are subject to multiple interpretations. This leads to unnecessary confusion and litigation for the financial services industry which will only increase with the launch of GST.
Further the financial service industry is one of the big contributors to the exchequer in terms of generating revenue. Hence any adverse effect on the industry can have an adverse impact on the economy and its development.

Primarily the definition of banking services as included in the negative list is very crisp and short. However, there are multiple activities that a Bank does and earns income from. Taxability of these incomes is not mentioned in the law. The education guide released by the CBEC does have discussions on the various incomes and their taxability but it also has a disclaimer that the guide is not binding on the authorities or the assesses as it is not law.

Thus the primary income for a Bank received from the main activity of lending funds in the form of interest and/or discount is covered under the negative list and is hence not liable to service tax. However, there are numerous ancillary services to the main activity and various types of interest/discount incomes received by Banks.

For eg – Currently discount income earned under the ‘invoice discounting’ is not directly covered under the negative list. This income is discussed in the education guide. However on a practical level since the said income is not directly covered in the negative list and earlier was not directly mentioned in the Notification 29/2004 which covered incomes in the form of interest and/or discount income on facilities like overdraft, bill or cheque discounting and cash credit, the industry is involved in defending its discount income from the business of factoring as not liable to service tax since it is essentially discount income though not directly covered.

Another example is of the income from collateral borrowing and lending. Under this income, the Banks maintain securities on a common platform provided by Clearing Corporation of India Ltd. CBLO is a money market instrument approved by Reserve Bank of India backed by securities. The borrower pays interest along with principal to lender however it is represented in the form of discount on the face price of the instrument. Hence the authorities do not consider the income as interest and demand service tax on it. Thus such kinds of instruments need to get squarely covered under the law instead of in the education guide.
This kind of frivolous litigation is completely avoidable if the provisions in the guide were given the backing of law or the law itself is clear and explicit.

Given the above it is desirable that the law in relation to financial service industry be clear and unambiguous as we proceed to the era of GST.

Further provision for issues like the taxability of interchange income received by issuing banks should be abundantly clear and fair to avoid cascading of taxes.

**Place of provision of services by Banks**

The Place of Provision of Services Rules, 2012 as amended from time to time are not clear and unambiguous as to the place where the service is being provided. Specially for an intangible service like a Bank, it is very difficult to determine the place where the service is being provided.

This currently only creates confusion and leads to litigation on issues regarding import/export of services or on services being rendered in a SEZ zone by Banks. It leads to denial of export status or SEZ exemption since there is a dispute on whether the service is provided within India or outside India or within SEZ or outside the SEZ respectively.

However, with GST, the Rules would need to be relied upon to determine not only the provision of service within/outside India or a SEZ but also to decide which state the service is being provided. Unless the rules are very clear and unambiguous on this the confusion and litigation will be manifold with 29 states and additional union territories vying to establish that the service is being provided in their state/union territory. The assesses will get unnecessarily involved not only in compliances across states but also litigation across states.

To avoid this it is imperative that the provisions of law/rules be very clear on the rules to decide where a service is provided and whether the GST thereon is to be paid in the origination state or
destination state. Thus there has to be clarity on the different types of services provided by the banking industry, and the place where each of such services would become taxable.

For eg – currently the normal banking services provided to account holders are taxable at the place of the service provider. Thus the service tax is payable based on where the service originated. However if the services are not provided in the ordinary course of business or are not provided to an account holder then the service is said to be provided at the location of the service recipient. Thus in these cases the service tax is payable based on where the service destination or consumption is.

However, the POPS do not define what is a “service provided in ordinary course of business”. Even with no states/union territories involved as on date, these rules are subject to different interpretations especially in case of export/import or SEZ transactions. This is because provisions on what are the “services provided in normal course of business” is not clear. Thus there is confusion on the rule to be applied for deciding the place where the service is provided.

If similar confusion carries to the GST regime then deciding the state of compliance for interstate transactions for Banks would be a huge task. Hence it is necessary to have clear provisions on each type of service provided by Banks and whether the same are taxable at place of service provider i.e. origination based or at place of service recipient i.e. destination.

Without this clarity the industry will face tremendous issues not only in compliance but also in litigation. Further based on the clear provisions the industry will need to develop their IT systems to track the status of the customer/service to decide the place where the tax needs to be paid.

Currently, Banks are required to reverse 50% of the eligible Cenvat credit availed by them since they provide both taxable and exempted services. This is a fixed ratio irrespective of the proportion of the actual exempt income of the Banks.
Under the proposed GST regime, there is a possibility that the earlier method of proportionate reversal of eligible Cenvat credit could be brought back. Under that method it becomes necessary for Banks to classify their incomes into various baskets like taxable, non taxable, export, exempt etc. The reversal of Cenvat credit is then calculated as a proportion of the income from exempted and/or non taxable services provided to the income from total services provided.

Under this method appropriate understanding of law to determine where the service is provided is imperative to decide whether it would be exempt/export. Any wrong classification would either mean loss to the assessee or the authorities. Thus based on current POPS, a service provided by the Bank, which is not in the ordinary course of business or is not to an account holder could qualify as export or exempt depending on whether the service recipient is branch/unrelated party and whether the income is received in convertible foreign exchange. Thus such income if classified as exempt would increase the reversal ratio under the proportionate method. If the income is classified as export the ratio would reduce. Thus classification or identification of income as exempt or export or not liable to tax would drastically impact the amounts of eligible Cenvat credit to be reversed. Needless to add the litigation on this account will increase too.

Lastly, even the state where the CGST/SGST can be availed will depend on these rules to decide whether the credits are to be availed based on origination or destination. Without that clarity even availment of credits state wise will become an onerous and litigious task.

Thus it can be seen how the provisions to determine where an intangible service like the one provided by Banks are originated and consumed need to be explicit in a GST regime.

Separately, the rules need to provide for place of provision of services in case of credit card services specifically. Currently, service tax is centralized and hence irrespective of where the customer is placed, service tax is paid in the state where Bank is registered. Going forward under GST this would necessarily change since otherwise major tax collections from financial service industry will go to Maharashtra as most of them have their head offices in Mumbai.
Whilst as explained above, the compliance in normal course of business is going to be complicated to multi state operations like Banks, in the case of credit card customers it is even more so. If the destination principle is to be followed, the state where the customer is swiping the card would need to receive the related GST.

However, on a practical level, this is extremely difficult to comply with. But if it is determined based on the service provider which is the Bank location the tax collections will get skewed. Thus some solution needs to be found for this. From an ease perspective, location of Banks seems to be the only practical solution.

**Input Tax Credit Recovery**

Prior to 1 April, 2011, Banks were allowed to take Cenvat credit of taxes paid on the input services used in the provision of output services in proportion to their taxable output services. Thus Banks had to do the onerous process of analyzing their income and classifying it into taxable, non taxable and exempt. However as explained earlier this classification was not very easy leading to litigation on the amount of ITC recovery. From 1 April 2011, this process is made easier by requiring Banks to reverse flat 50% of the ITC availed post excluding certain input services.

**Other issues in relation to Banks**

Whilst the ones mentioned above are the main issues impacting Banks and financial services industry there are a multitude of other issues faced due to unclear legislation.

**Valuation of services liable to service tax for foreign exchange conversion**

The law provides for slab rate system for paying service tax currently on services of foreign exchange conversion provided by Banks. This is separate and distinct from income received by Banks at the time of inward remittances. The banks charge service tax on the conversion of foreign exchange at the time of inward remittance and not on the remittance itself nor on the fees
involved therein. The fees are dealt with separately by the Banks depending on the recipient status of the fees.

However, a circular issued by the authorities in relation to the foreign inward remittances, which was not worded appropriately and was misinterpreted at lower levels led to tremendous pressure on Banks to waive service tax on conversion charges too. This when the circular was not at all in relation to the service tax charged on conversion of foreign exchange at the time of inward remittance.

The circular was actually on the charges payable to foreign banks for their services in the remittance. However this was interpreted as the service tax charged by Banks on the actual conversion leading to tremendous pressure to waive such charges. Further, even in the return the service tax collected on slab system cannot be reflected correctly leading to income reconciliation issues. It is relevant to note that India is the only country to tax margins on foreign exchange trading. This can be addressed at the time of introduction of GST.

**Exemptions to be given to customers located in SEZ/STP areas**

In relation to SEZ customers, one of the problems is to decide whether the service is provided in the SEZ based on the POPS as mentioned above. Another common issue is that the government keeps on modifying and improvising on the compliances to be undertaken by entities located in SEZ to avail of the exemptions from taxes.

However on a practical level it is very tedious to continuously keep upgrading the documents to be obtained from customers by Banks so that their SEZ status is not disturbed. Any delay or lacuna in obtaining documents as per latest notification means litigation for the Bank with authorities demanding service tax even for intervening periods where the customer is in process of updating his permissions. This approach is completely uncalled for. The authorities should
ensure that the guidelines/notifications released are not constantly revised since this causes unnecessary litigation and harassment for assesses who are otherwise very compliant.

Further, for determination of whether services provided by Banks are provided within the SEZ the same POPS need to be relied upon. Again this is not free from litigation since for different types of services different rules are to be relied upon.

**Point of time when services become liable to service tax**

Currently the Point of Taxation Rules contains the provisions in relation to when a service is said to be provided. These provisions are relevant since they determine when the Banks are required to pay the tax. Any ambiguity in the same results in unnecessary interest/penalty demands from the authorities.

These rules are specially relevant in the cases where advance is received, or where the rate of charging tax changes, in cases of continuous supply of service etc. Any ambiguity in this causes litigation. Further given service tax and proposed GST are indirect taxes, any recovery at later dates by authorities due to different interpretations leads to direct loss to Banks.

**Reverse charge liability in case of domestic service providers**

Under the negative list of taxation system, the authorities introduced a new concept of reverse charge service tax liability for certain assessees even where the services were received domestically. Quite a few of the input services regularly received by the assesses were made liable to domestic reverse charge. Few examples were works contract services, rent a cab services, legal services etc.

This liability was cast generally in cases where the service provider was a small entity and the service recipient was a big entity. The rationale for this was to ensure that all input services suffered service tax and the department collated data on small service providers. Indirectly the
authorities were using the bigger compliant assessees like Banks to make the smaller assessees compliant.

Further, the provisions in relation these cases are not free from ambiguity. They are complicated, and onerous leading to a lot of to and fro between the service provider and service recipient. The latest example is the amendment to the provisions in relation to rent cab operators.

This responsibility cast on compliant assessees was unfair since it meant that such assessees now had to not only spend resources on interpreting law and ensuring compliances on their output side but also interpret provisions on services received by them and ensure that their input service providers were compliant.

Under the GST regime, it is expected that with CGST, SGST and IGST there will be a challenge for all to comply. In such a scenario such additional responsibility is either completely avoidable or the provisions should be unequivocal so as to avoid wastage of time and resources in litigation.

The provisions for such compliances should at least be without the service recipient having to calculate portion of the tax (like 50% etc.) or confirm on whether the service provider has availed abatement etc. At the most it should be like international reverse charge compliance.

**Importance & scope of the project**

In view of the above, it is highly relevant that laws in relation to taxation of services are clear and unambiguous. This is especially so because in the case of financial services, as explained above, it is extremely conflicting determining the taxability of the services, place of provision of the services, consumption of the services, value of the services, liability under reverse charge in case of domestic input services etc.

Currently, the law lends itself to various interpretations, thereby increasing litigation. Hence it is imperative that the proposed GST address these concerns of the financial services industry.
Secondly, the financial services industry globally contributes around 15-20% of the total tax collections. The indirect tax contribution by the sector is difficult to determine since there are different rules globally for treatment of output service of the sector. Where the service is treated as exempt, input credit of taxes paid on input services is not allowed and becomes a cost. Where the service is zero rated the input credit is available. In some economies partial recovery is allowed which ranges from 0-74%. In India the recovery rate is 50% currently. Thus the indirect tax contribution is difficult to estimate, but the fact that the sector contributes 20% of the total taxes is indicative of how important the stability of the sector is.

Further with reference to India, total taxes are approx. 10% of the gross domestic product of the economy of which indirect taxes are 4.4%. Introduction of GST is expected to increase this proportion.

Further, the service industry contributes around 57% of the total GDP of which approx. 6% is by Banks. Financial services together (includes insurance, real estate, etc.) contribute approx. 14% of the total GDP. Thus any change in law/rates etc. will have a great impact on the country’s GDP.

Thus clear provisions for taxability of the industry, specially for indirect taxes is important to ensure that the introduction of GST meets its overall goals. Hence the paper studies the completeness of the existing provisions in relation to service tax for the banking industry and the alterations/amendments required to ensure that both the authorities and the industry benefit with introduction of GST.

Also, given that India has a federal system of government, the proposed GST in India would have the CGST, SGST and IGST. This would mean availability of proper legislation for registration, availing and utilization of Cenvat credit, determination of place where service originated and is provided or consumed etc. under the proposed law.

The paper also aims to study the existing provisions/laws read in light of the proposed GST, impact of this proposed framework on the banking industry, the changes in IT and administration
it would entail for them, the method of compliances which banks would need to employ, impact on Cenvat credit blockage due to non availability of fungibility of credits etc.