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Dear Professional Colleague,

No Service Tax Audit by the Service Tax Department or CAG

We are sharing with you an important judgement of the Hon'ble Delhi High Court in the case of ***Mega Cabs Pvt. Ltd. Vs. Union of India And Ors [2016-TIOL-1061-HC-DEL-ST]*** on the following issue:

Issue:

- **Whether Service Tax Department or CAG can conduct Service Tax Audit?**
- **Whether substituted Rule 5A(2) of the Service Tax Rules, 1994 ("the Service Tax Rules") is ultra vires the provisions of the Finance Act, 1994 ("the Finance Act")?**

However, before dwelling into the detailed analyses of the recent judgment of the Hon'ble High Court of Delhi, we are foremost discussing hereunder brief background of the stated matter so far, for easy digest:

Background of the matter:

The Hon'ble High Court of Delhi in the case of ***Travelite (India) Vs. Union of India & Ors. [W.P. (C) 3774/2013, C.M. No. 7065/2013]*** ("the Travelite case") held that Rule 5A(2) of the Service Tax Rules ultra vires the provisions of the Finance Act, and "No Service Tax Audit can be conducted by the Department and only Special Audit within the Statute as mentioned under Section 72A of the Finance Act can be done either by a Chartered Accountant or Cost Accountant only in specified certain circumstances". It was further held that Service Tax Audit as envisaged in Rule 5A(2) of the Service Tax Rules does not have appropriate statutory backing of the Finance Act.

Even, the Hon'ble Allahabad High Court in the case of ***ACL Education Centre Pvt. Ltd. & Ors. Vs. Union of India [2014-TIOL-120-HC-ALL-ST]*** has held that the Audit under Service tax is to be conducted by Chartered Accountants/ Cost Accountants only and not by officers of the Department. Further, the Hon'ble Calcutta High Court in the case of ***SKP Securities Ltd. Vs. DD (RA-IDT) & Ors. [2013-TIOL-38-HC-KOL-ST]*** has also held that no Audit of private assessee can be undertaken by CAG under Rule 5A(2) of the Service Tax Rules.

Thereafter, in the background of the Travelite case, the Central Board of Excise and Customs ("CBEC" or "the Board") vide ***Circular No. 986/10/2014-CX dated October 9, 2014*** had clarified that judgment under the Travelite case does not deal with the issue of audit in the Central Excise. It was further clarified that there is adequate statutory backing for Audit by the Central Excise officers by virtue of Section 37(2)(x) of the Central Excise Act, 1944 and Rule 22 of the Central Excise Rules, 2002 for conducting Central Excise Audit.

Bimal Jain

FCA, FCS, LLB, B.Com (Hons)

Further, the Central Government vide **Notification No. 23/2014-ST dated December 5, 2014** ("**Notification No. 23**") had substituted Rule 5A(2) of the Service Tax Rules, thereby nominating a Chartered Accountant or a Cost Accountant along with an officer authorised by the Commissioner or the Audit Party deputed by the Commissioner or CAG to conduct Service Tax Audit.

Later on, the Board vide **Circular No. 181/7/2014-ST dated December 10, 2014** ("**Circular No. 181**"), in an attempt to remove the mist surrounding the power of the Departmental officers to conduct Service Tax Audit, had clarified that Rule 5A(2) of the Service Tax Rules, *interalia*, provides for scrutiny of records by an officer authorised by the Commissioner or the Audit Party deputed by the Commissioner or CAG and such scrutiny essentially constitutes Audit by the Audit Party consisting of the Departmental officers.

It was further clarified that Rule 5A(2) of the Service Tax Rules has appropriate statutory backing for conducting Service Tax Audit by the Departmental officers by virtue of Section 94(2)(k) of the Finance Act as amended by Section 114(J) of the Finance Act, 2014 w.e.f. August 6, 2014 which reads as under:

*"(k) Imposition, on persons liable to pay service tax, for the proper levy and collection of tax, of duty of furnishing information, keeping records and the manner in which such records shall be **verified**."*

Furthermore, it was clarified that the expression "*verified*" used in Section 94(2)(k) of the Finance Act is of wide import and would include within its scope, Audit by the Departmental officers, as the procedure prescribed for Audit is essentially a procedure for verification mandated in the Statute.

Thereafter **Circular No. 995/2/2015-CX dated February 27, 2015** ("**Circular No. 995**") was issued by the CBEC on the subject – "Central Excise and Service Tax Audit norms to be followed by the Audit Commissionerates" and this too contemplated of the Department's officers themselves undertaking audits. A **Central Excise and Service Tax Audit Manual, 2015** was also issued by the Directorate General of Audit of the CBEC in this regard.

It may also be noted here that on December 18, 2014, the Hon'ble Apex Court in the case of Union of India And Ors Vs. M/s Travelite (India) [2014 (12) TMI 1099 - SUPREME COURT] granted stay on the operation of the Hon'ble Delhi High Court judgment in the Travelite case.

Facts of the instant case:

Mega Cabs Pvt. Ltd. ("**the Petitioner**") received a letter dated April 30, 2015 issued by the Commissioner of Service Tax, New Delhi informing that a team of officers of the said Commissionerate comprising three Superintendents and an Inspector would be verifying the

Bimal Jain

FCA, FCS, LLB, B.Com (Hons)

relevant records of the Petitioner's business in terms of Rule 5A to the Service Tax Rules read with Section 94(1), 94(2)(k) and 94(2)(n) of the Finance Act as amended, during the first week of May 2015 for the Financial Years 2010-11 to 2013-14 (“**the Impugned letter**”).

Being aggrieved, the Petitioner filed a petition before the Hon’ble High Court of Delhi, challenging the Impugned letter, along with Rule 5A(2) of the Service Tax Rules (as amended), for being beyond the rule making powers of the Central Government.

The Petitioner also challenged the constitutional validity of Section 94(2)(k) of the Finance Act on the ground that it gives “plainly unguided and uncontrolled” delegated powers to the Central Government for framing rules and also the Circular No. 181.

Landmark judgment of the Hon’ble Delhi High Court:

The Hon’ble Delhi High Court took an extensive deliberation on relevant provisions of the Finance Act and Rules made thereunder, as under:

Analysis of the provisions of the Finance Act:

- At the outset it requires to be noticed that unlike the Income Tax Act, 1961 or even the Delhi Value Added Tax Act, 2004, there is no provision in the Finance Act for re-assessment of a Service tax return. There can be a self-assessment in which case the return filed by the Assessee is accepted as such and the tax amount indicated therein is accepted as being correct;

Section 72 of the Finance Act (i.e. Best judgement assessment)

- Even for the purpose of Section 72 of the Finance Act, a prima facie satisfaction is to be arrived at that the return filed by the Assessee fails to assess the tax in accordance with law. Even in such an instance, the calling for the accounts, documents and other evidence is not to be undertaken by an Assessing Officer mechanically;
- Moreover, it is not any or every officer of the Service tax department who can exercise the power under Section 72 of the Finance Act. The function of making an assessment has to be assigned to such officer. It is only such officer who is entrusted with such power who can proceed to ask for the documents, records, accounts etc.;

Section 72A of the Finance Act (i.e. Special Audit)

- It is only where one of the three contingencies as mentioned in Section 72A of the Finance Act exists, that the Commissioner may direct the Assessee to “*get his accounts audited either by a Chartered Accountant or a Cost Accountant nominated by such Commissioner*”. The extent of the audit and the period for which it should be conducted is also to be specified by the Commissioner.

Bimal Jain

FCA, FCS, LLB, B.Com (Hons)

Section 82 of the Finance Act (i.e. Power to search premises)

- The power to search the premises is also hedged in by certain limitations, like the requirement of the officer to record reasons to believe that (i) there are documents or books that have been secreted in a place (ii) such documents or books are useful or relevant for any proceedings. Therefore even the power under Section 82 cannot be said to be totally without guidelines or restrictions.

Analysis of the amended Rule 5A(2) of the Service Tax Rules:

- There are three distinct types of documents that can be asked to be made available “on demand” by an Assessee:
 - (i) Records mentioned in terms of Rule 5(2);
 - (ii) Cost Audit Reports, if any, under Section 148 of the Companies Act, 2013;
 - (iii) Income Tax Audit Report, if any, under Section 44AB of the Income Tax Act, 1961.
- Rule 5(2) of the Service Tax Rules, requires the Assessee to furnish to the Superintendent of Central Excise a list in duplicate of all the records prepared or maintained by the Assessee for accounting of transactions, in regard to providing any service receipt or procurement of anybody's service and payment of such service;
- Interestingly, Rule 5A(2) of the Service Tax Rules does not restrict itself to such records as mentioned in Rule 5(2) but also required production of Cost Audit Reports and the Income Tax Audit Report mentioned supra. These documents are not envisaged to be produced under Rule 5(2) and definitely not under any of the provisions of the Finance Act. This is, therefore, going far beyond the Finance Act itself;
- Rule 5A(2) of the Service Tax Rules lists out the following persons who can make a demand for such documents from an Assessee:
 - (i) Officer empowered under Rule 5A(1);
 - (ii) Audit party deputed by the Commissioner;
 - (iii) CAG;
 - (iv) Cost Accountant;
 - (v) Chartered Accountant.
- The Petitioner would have no objection to producing before a Cost Accountant or a CA the documents of accounts, records etc., but only if such Cost Accountant or CA has

Bimal Jain

FCA, FCS, LLB, B.Com (Hons)

been nominated by the Commissioner for the purpose of Special Audit under Section 72A of the Finance Act;

- As far as an officer of the Department was concerned, although under Rule 5A(1) of the Service Tax Rules, such officer is authorised by the Commissioner to have access to unregistered premises for the purposes of carrying out any “*scrutiny, verification and checks as may be necessary to safeguard the interests of the Revenue*”, such officer can, in terms of Rule 5A(2) simply demand the production of such documents without any requirement of recording reasons to believe that the production of such document is necessary. There is also no requirement of such officer having to be authorised to carry out a search under Section 82 of the Finance Act or an assessment under Section 72 thereof. **If any and every officer is going to be deputed for that purpose, it would result in harassment of the Assessee;**
- **Rule 5A(2) of the Service Tax Rules envisages that even the CAG can require production of documents from an individual Service tax Assessee. This appears to have no rational basis;**
- The powers and functions of CAG flow from Articles 148 and 149 of the Constitution of India read with the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971. This Court in *K. Satyanarayanan Vs. Union of India [ILR (1996) II Delhi]* explained that the essential function of the CAG is to audit the accounts of public sector undertakings. Although in Association of *Unified Tele Services Providers Vs. Union of India [2014-TIOL-49-SC-MISC]*, the Hon'ble Supreme Court has, in the context of the functioning of telecom companies accepted the plea that their accounts can be subjected to scrutiny by the CAG, **to expect the CAG to undertake an audit of the records of every Service Tax Assessee would indeed be extraordinary;**
- **As far as the Service Tax Assessee are concerned, one would still have to turn to the provisions of the Finance Act, to examine whether this kind of an access to the books of accounts etc., of an Assessee can be given to the CAG or just to any officer of the Department. With there being no such authorisation under the Finance Act, the answer has to be in the negative.**

Analysis of the CBEC Instructions and Manual:

- In Circular No. 995, there is no requirement that any of the mentioned officers should be duly authorised to carry out an assessment for the purpose of Section 72 of the Finance Act or adjudication for the purposes under Section 73 thereof. The entire instruction appears to be without any reference to the applicable provisions in the Finance Act or the Rules;

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- Earlier Audit Manual of 2011 was held by this Court in the Travelite case, not to have any statutory force. 2015 Manual again fails to acknowledge that there is no statutory backing for the officers of the Department to themselves undertake an audit of the Assessee's accounts and records. This lacuna pointed out by the Court in the Travelite case has not been set right.

Section 94(2)(k) of the Finance Act:

- Although in the Circular 181, it is asserted by the Department that the expression 'verified' is of wide import and would include within its scope audit by the Department officers, the Court is unable to agree;
- The expression 'verified' has to be interpreted in the context of what is permissible under the Finance Act itself. The verification of the records can take place by the officers of the Department provided such officers are authorised to undertake an assessment of a return or of adjudication for the purposes of Section 73 of the Finance Act. It is not any and every officer of the Department who could be entrusted with the power to demand production of records of an Assessee. Therefore, **the Court does not agree with the submission that the expression 'verify' is wide enough to permit the audit of the accounts of the Assessee by any officer of the Service Tax Department.**;
- **There is a distinction between auditing the accounts of an Assessee and verifying the records of an Assessee. Audit is a special function which has to be carried out by duly qualified persons like a Cost Accountant or a CA. It cannot possibly be undertaken by any officer of the Service Tax Department.**

Rule 5A(2) of the Service Tax Rules is ultra vires the Finance Act:

- Tested on the legal principles as laid down in the case of *Municipal Corporation of Delhi Vs. Birla Cotton Spinning and Weaving Mills [AIR 1968 SC 1232]*; *General Officer Commanding-in-Chief Vs. Dr. Subhash Chandra Yadav [AIR 1988 SC 876]*, the Court has no hesitation in concluding that Rule 5A(2) of the Service Tax Rules exceeds the scope of the provisions under the Finance Act;
- **Under the garb of the rule making power, the Central Government cannot arrogate to itself powers which were not contemplated to be given it by the Parliament when it enacted the Finance Act. This is an instance of the Executive using the rule making power to give itself powers which are far in excess of what was delegated to it by the Parliament.**

Validity of circulars, the manual and the Impugned letter:

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- As pointed out in ***Ratan Melting & Wire Industries [2008-TIOL-194-SC-CX-LB]***, a Circular or a Manual cannot travel beyond the scope of the statute itself. It will have no binding effect if it does so. In the present case inasmuch as Section 94(2)(k) of the Finance Act, does not permit the exercise of audit to be undertaken by an officer of the Department, and the attempt in the circular to recognise such powers in the hands of officers of the Central Excise and Service Tax Departments is held to be ultra vires the Finance Act and, therefore, legally unsustainable;
- For all of the above reasons, the Impugned letter issued to the Petitioner, informing it of the appointment of an audit team to inspect all the records, books and accounts by the officers cannot be sustained in law.

Conclusion:

The Hon'ble High Court, after detailed analyses:

- Declared Rule 5A(2) of the Service Tax Rules, as amended, to the extent that it authorises the officers of the Service Tax Department, the audit party deputed by a Commissioner or the CAG to seek production of the documents mentioned therein on demand, as ultra vires the Finance Act and, therefore, struck it down to that extent;
- Held that the expression 'verify' in Section 94(2)(k) of the Finance Act cannot be construed as audit of the accounts of an Assessee and, therefore, Rule 5A(2) of the Service Tax Rules, cannot be sustained with reference to Section 94(2)(k) of the Finance Act;
- Declared Circular No. 181 as ultra vires the Finance Act and was struck down;
- Quashed the Impugned Letter addressed to the Petitioner as being unsustainable in law;
- Declared Circular No. 995 and the Central Excise and Service Tax Audit Manual 2015 issued by the Directorate General of Audit of the CBEC, as ultra vires the Finance Act, as they do not have any statutory backing and cannot be relied upon by the Department to legally justify the audit undertaken by officers of the Service Tax Department.

Hope the information will assist you in your Professional endeavours. In case of any query/information, please do not hesitate to write back to us.

Thanks & Best Regards

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