Report of the Comptroller and Auditor General of India

for the year ended March 1999

Union Government

(Indirect Taxes - Central Excise & Service Tax)

No.11 of 2000

Report of the
Comptroller and Auditor General
of India

for the year ended March 1999

Union Government

(Indirect Taxes - Central Excise & Service Tax)

No.11 of 2000

Laid on the Table of the Lok Sabha and Rajya Sabha on..... 05 MAY 2000

CONTENTS

SECTION I - CENTRAL EXCISE

SECTION II - SERVICE TAX

PREFATORY REMARKS

This Report for the year ended 31 March 1999 has been prepared for submission to the President under Article 151 of the Constitution.

The report presents the observations noticed in test audit of Indirect Taxes (Central Excise and Service Tax) of the Union Government. Section I of the report covers matters relating to "Central Excise" and section II covers "Service Tax".

The cases mentioned in the Report are among those which came to notice in the course of audit during the year 1998-99 and early part of the year 1999-2000, as well as those which came to notice in earlier years but were not reported.

OVERVIEW

This report is presented in two sections :

Section I	**Chapters 1 to 11**	**Central Excise**
Section II	**Chapter 12**	**Service Tax**

Some of the significant findings are highlighted below :-

SECTION I - CENTRAL EXCISE

This section contains 170 paragraphs featured individually or grouped together and a system appraisal and has a financial implication of Rs.9,803.08 crore. Some of the significant findings of Audit included in this section are mentioned below :-

A. General

The net receipts from excise duty during the year 1998-99 were Rs.53,053 crore against the budget estimates of Rs.57,690 crore, a shortfall of Rs.4,637 crore.

(Paragraph 1.2)

While the value of output increased by 13.68 times between 1980-81 and 1998-99, central excise receipts went up by only 8.16 times during the corresponding period. Central excise decreased from 11.2 *per cent* of the value of production in 1980-81 to 6.68 *per cent* in 1998-99.

(Paragraph 1.3)

While central excise receipts grew 2.83 times during the decade 1988-89 to 1998-99, the amount of Modvat availed increased 9.32 times. The percentage of Modvat availed to duty paid by cash has increased from 20.31 *per cent* in 1988-89 to 66.89 per cent during 1998-99.

(Paragraph 1.4)

Cost of collection as a percentage of central excise receipts has shown a rising trend. While the revenue growth had averaged around 11.03 *per cent* during the period 1994-95 to 1998-99, the expenditure has risen at an average rate of 18.37 *per cent*.

(Paragraph 1.5)

84,877 cases involving Rs.32,478.24 crore of Central Excise duty were pending finalisation with different authorities as on 31 March 1999.

(Paragraph 1.6)

B. Review

Levy of duty on the basis of capacity of production on certain iron and steel products

An appraisal of the scheme for levy of duty based on capacity of production on certain iron and steel products introduced with effect from 1 September 1997 revealed various lacunae in the formulation of the scheme and lapses in implementation. Some of the major deficiencies noticed were as follows:-

⇒ **Despite an increase in production in 1998-99, the revenue realised from hot re-rolling mills and induction furnaces dipped by Rs.208 crore after introduction of the scheme, indicating negative impact of the scheme on revenue.**

(Paragraph 2.4.1)

⇒ **The scheme enabled assessees to defer payment of duty resulting in Rs.377.94 crore from 723 assessees (units) remaining outstanding. Of this, 276 assessees (units) had already closed down without payment of dues of Rs.157.07 crore. Absence of provisions for bank guarantee/bond/security in the scheme for deferment of duty made the recovery of the deferred revenue doubtful in these cases.**

(Paragraph 2.4.2)

⇒ **Allowance of deferment of duty under the scheme enabled the downstream buyer manufacturers of 'Re-rolled products' to avail Modvat credit of Rs.125.41 crore, without duty actually having been remitted to Government.**

(Paragraph 2.4.3)

⇒ **Deferment in the implementation of the scheme enabled 220 assessees in 27 commissionerates to pay duty short by Rs.12.57 crore during August 1997.**

(Paragraph 2.4.4)

⇒ **Absence of provisions to levy duty on goods produced in excess of the determined production capacity, resulted in non-payment of duty of Rs.3.66 crore and undue enrichment of the assessees to the same extent. Additionally, an estimated Modvat credit of Rs.1.07 crore would have been availed by downstream purchasers (manufacturers), despite no duty having actually been paid to Government.**

(Paragraph 2.4.5)

⇒ **Delay in determination of annual capacity, resulted in non-recovery of Government revenue of Rs.3.02 crore.**

(Paragraph 2.4.6)

⇒ **Despite the provisions in the scheme barring availment of Modvat credit and for lapse the accumulated amount, credit of Rs. 2.84 crore was not lapsed/expunged by 41 assessees.**

(Paragraph 2.5.1)

C. Non-levy/short levy of duty

Short levy/under assessment/non-collection of central excise duty amounting to Rs.9,053.89 crore (excluding system appraisal) were noticed. The more significant of these findings were as follows :

(Paragraph 1.1)

⇒ **Four petroleum oil companies collected central excise duty of Rs.4036.75 crore on the sale of imported petroleum products but did not remit it to the Government.**

(Paragraph 3.1(a))

⇒ **Failure of the Government to revise specific rates of duty on sugar periodically to keep pace with rising prices as recommended by the Tariff Advisory Committee, resulted in non mobilisation of Rs.3,070 crore.**

(Paragraph 3.2)

⇒ **Grant of deemed credit in excess of the duty suffered by inputs, resulted in unjust enrichment of 56 processors of fabrics to the extent of Rs.57.57 crore.**

(Paragraph 3.3)

⇒ **Modvat credit of Rs.201.18 crore was availed in excess of actual duty paid by downstream manufacturers.**

(Paragraph 3.4)

⇒ **Cess of Rs.1.20 crore on natural rubber produced, was neither levied nor recovered, notwithstanding specific provisions to do so in the Rubber Act, 1947.**

(Paragraph 3.5)

⇒ **Non-raising/short raising of demands for duty or delay in adjudication of demands or non-realisation of confirmed demands, resulted in non-recovery/loss of revenue amounting to Rs.899.39 crore.**

(Paragraph 4)

SECTION I - CENTRAL EXCISE

CHAPTER 1 : CENTRAL EXCISE RECEIPTS

1.1 Contents of Report

This section includes 170 paragraphs featured individually or grouped together and one system appraisal on 'Levy of duty on the basis of capacity of production on certain iron and steel products', arising from important findings from test check in audit and has a total revenue effect of Rs.9,803.08 crore. The Ministry of Finance/department had, till 15 January 2000 accepted audit observations included in 95 paragraphs/system appraisal involving Rs.343.33 crore.

1.2 Budget estimates, revised budget estimates and actual receipts *

(a) The budget estimates, revised budget estimates and actual receipts of central excise duties during the year 1994-95 to 1998-99 are exhibited in the table below:-

(Amount in crore of rupees)

Year	Budget estimates	Revised budget estimates	Actual receipts	Difference between actual receipts and budget estimates	Percentage variation
1994-95	36,732	36,732	37,208	(+) 476	(+) 1.30
1995-96	42,579	40,767	40,009	(-) 2570	(-) 6.04
1996-97	46,883	46,190	44,818	(-) 2065	(-) 4.40
1997-98	52,200	47,700	47,763	(-) 4437	(-) 8.50
1998-99	57,690	53,200	53,053	(-) 4637	(-) 8.04

* Figure furnished by Principal Chief Controller of Accounts (Central Board of Excise and Customs)

(b) Commodity wise break-up

Details of collection vis-à-vis budgetary estimates in respect of commodities (as per budget heads) which yielded revenue of more than Rs.1000 crore during 1998-99 alongwith corresponding figure for 1997-98 are as follows :

(Amount in crore of rupees)

Sl. No.	Budget Head	Description	1997-98 (Actual)	1998-99 (Budget estimates)	1998-99 (Actual)	Percentage variation of actual over budget	Percentage share in total collection
1.	27	Cigarettes, cigarillos or tobacco substitutes	3080.05	3584.32	4591.96	(+) 28.11	8.65
2.	34	Motor spirit	2941.95	2901.24	4442.04	(+) 53.11	8.37
3.	102	Iron and steel	4037.58	4195.72	3823.11	(-) 8.88	7.21
4.	36	Refined diesel oil	2052.42	3372.90	3139.17	(-) 6.93	5.92
5.		Cess on crude oil	2739.90	3060.00	2633.70	(-) 13.93	4.96
6.	31	Cement clinkers, cement all sorts	2326.31	2447.26	2573.83	(+) 5.17	4.85
7.	40	All other goods falling under chapter 27 (Mineral fuels, oils etc.)	1899.44	1000.00	2201.93	(+) 120.19	4.15
8.	61	Plastics and articles thereof	1776.20	2129.54	2037.59	(-) 4.32	3.84
9.	128	Motor cars and other motor vehicles for transport of persons	1659.84	1749.19	1772.20	(-) 1.32	3.34
10.	119	All other goods falling under chapter 84 (Machinery, Mechanical appliances, etc.)	1501.40	1444.93	1515.18	(+) 4.86	2.86
11.	130	All other goods falling under chapter 87 (Motor vehicles other than at Sl. No.9)	1192.61	1593.60	1419.84	(-) 10.90	2.68
12.	45	Organic chemicals	1109.24	1105.77	1231.04	(+) 11.33	2.32
13.	79	Synthetic filament yarn and sewing thread including synthetic monofilament and waste	842.94	992.11	1168.32	(+) 17.76	2.20
14.	62	Tyres, tubes and flaps	1166.87	1350.59	1132.60	(-) 16.14	2.13
15.	125	All other goods falling under chapter 85 (Electrical machinery, equipment's, etc.)	981.48	895.93	1040.84	(+) 16.17	1.96

The overall shortfall of 8.04 *per cent* between actual realisation of central excise revenue and budget estimates during 1998-99 was mainly due to a shortfall in (i) Tyre, tubes and flaps by 16.14 *per cent*, (ii) Iron and steel by 8.8 *per cent* and (iii) Refined diesel oil by 6.93 *per cent*.

1.3 Value of output* *vis-à-vis* central excise receipts

The value of output from the manufacturing sector vis-a-vis receipt of central excise duties through Personal Ledger Account (cash collection) during the years 1980-81, 1986-87 and 1990-91 to 1998-99 are as follows:

(Amount in crore of rupees)

Year	Value of output	Central excise	Percentage of central excise receipts to value of production
1980-81	58065	6500	11.19
1986-87	134602	14387	10.69
1990-91	274241	24514	8.94
1991-92	305293	28110	9.20
1992-93	345204	30614	8.87
1993-94	390561	31548	8.08
1994-95	479717	37208	7.76
1995-96	597354	40009	6.70
1996-97	661613	44818	6.77
1997-98	720410	47763	6.63
1998-99	794465	53053	6.68

* Includes value of all goods produced during the given period including net increase in work-in-progress and products for use on own account. Valuation is, at producers values, that is the market price at the establishment of the producers. As separate figure of value of production by Small Scale Industry Units and for export production were not available, these have not been excluded from the value of output indicated. Soucrce : Central Statistical Organisation

The above table reveals that while value of output had increased by a factor of 13.68 during the period 1980-81 to 1998-99, the corresponding increase in the central excise receipts was by a factor of 8.16 only.

1.4 Central excise receipts vis-a-vis Modvat availed

A comparative statement showing the details of central excise duty paid through Personal Ledger Account (PLA), the amount of Modvat availed during the year 1988-89 to 1998-99 is given in the following table:

(Amount in crore of rupees)

Year	Central excise duty paid through PLA		Modvat availed		Percentage of Modvat to duty paid through PLA
	Amount	Percentage increase	Amount	Percentage increase	
1988-89	18749	--	3809	--	20.31
1989-90	22307	18.97	5279	38.59	23.66
1990-91	24514	9.89	6496	23.05	26.49
1991-92	28110	14.66	7965	22.61	28.33
1992-93	30614	8.91	10840	36.09	35.40
1993-94	31548	3.05	11896	9.74	37.70
1994-95	37208	17.94	21687	82.30	58.28
1995-96	40009	7.53	29951	38.10	74.86
1996-97	44818	12.02	34222	14.25	76.35
1997-98	47763	6.57	35164	2.75	73.62
1998-99	53053	11.07	35489	0.92	66.89

The above table shows that while the central excise receipts had grown by 2.83 times during the decade 1988-89 to 1998-99, the increase in Modvat availed during the relevant

period had been 9.32 times. It would also be seen that the percentage of Modvat availed to duty paid by cash had been increasing consistently from 20.31 *per cent* to 76.35 *per cent* till 1996-97 with a marginal decline to 2.73 and 6.73 during 1997-98 and 1998-99, respectively. The marginal decline in percentage of Modvat availed to PLA collection during 1998-99 as compared to the corresponding figure of 1997-98 could be attributed to the restriction of 95 *per cent* imposed on availment of Modvat during the period 2 June 1998 to 27 February 1999.

The overall increasing trend in availing Modvat credit can be attributed to the expansion of the scheme to cover most of the excisable goods including capital goods and to a certain degree is also indicative of misuse of Modvat credit facility as also brought out in earlier Audit Reports and paragraphs 2.4.3, 2.4.5, 2.5.1, 3.3, 3.4 and 5 of this Audit Report.

1.5 Cost of collection *

The expenditure incurred during the year 1998-99 in collecting central excise duty alongwith the corresponding figures for the preceding four years is given below:-

(Amount in crore of rupees)

Year	Receipts from excise duty		Expenditure on collection		Cost of collection as percentage of receipts
	Amount	Percentage increase over previous year	Amount	Percentage increase over previous year	
1994-95	37208	17.94	249.10	12.38	0.67
1995-96	40009	7.53	285.47	14.60	0.71
1996-97	44818	12.02	333.82	16.93	0.74
1997-98	47763	6.57	455.68	36.50	0.95
1998-99	53053	11.07	507.89	11.46	0.96

* Figure furnished by Principal Chief Controller of Accounts (Central Board of Excise and Customs)

Cost of collection as a percentage of the central excise collection has shown a rising trend. Further, while growth in revenue averaged around 11.03 *per cent*, expenditure on collection had risen at an average rate of 18.37 *per cent* during the period 1994-95 to 1998-99.

1.6 Outstanding demands *

The number of cases and amount involved in demands for excise duty outstanding for adjudication/recovery as on 31 March 1998 and 31 March 1999 are given below :

(Amount in crore of rupees)

		As on 31 March 1998				As on 31 March 1999			
		Number of cases		Amount		Number of cases		Amount	
		More than five years	Less than five years	More than five years	Less than five years	More than five years	Less than five years	More than five years	Less than five years
(a)	Pending with Adjudicating officers	3062	38471	1525.72	8169.28	2159	37415	828.38	12145.27

(Amount in crore of rupees)

		As on 31 March 1998				As on 31 March 1999			
		Number of cases		Amount		Number of cases		Amount	
		More than five years	Less than five years	More than five years	Less than five years	More than five years	Less than five years	More than five years	Less than five years
(b)	**Pending before**								
(i)	Appellate Commissioners	162	7772	138.40	2530.30	609	13215	548.12	11835.91
(ii)	Board	131	86	120.38	11.80	33	126	5.20	16.88
(iii)	Government	30	21	1140.36	1.56	14	71	2.81	20.60
(iv)	Tribunals	3159	6630	991.17	3135.48	2724	6031	1235.11	2540.47
(v)	High Courts	1254	1076	405.70	1095.33	1450	1463	1065.48	587.39
(vi)	Supreme Court	482	371	130.30	328.86	610	453	880.20	176.37
(c)	**Pending for coercive recovery measures**	13052	6584	181.80	5264.53	12231	6273	62.99	527.05
	Total	**21332**	**61011**	**4633.83**	**20537.14**	**19830**	**65047**	**4628.30**	**27849.94**

* Figure furnished by Directorate of Audit, Customs and Central Excise, New Delhi and relate to 48 out of 60 commissionerates.

It may be seen that 84,877 cases involving demands amounting to Rs.32,478.24 crore were pending on 31 March 1999 with different authorities. While the number of cases pending with adjudicating authorities decreased by 1,959 over the previous year, duty involved increased from Rs.9,695 crore in 1997-98 to Rs.12,973.65 crore in 1998-99.

1.7 Fraud/presumptive fraud cases *

The position of fraud/presumptive fraud cases alongwith the action taken by the department against the defaulting assessees during the period 1996-97 and 1998-99 is depicted in the following table :

(Amount in crore of rupees)

Year	Cases detected		Demand of duty raised	Penalty imposed		Duty collected	Penalty collected	
	Number	Amount	Amount	Number	Amount	Amount	Number	Amount
1996-97	429	2409.94	221.04	132	15.15	31.93	34	1.25
1997-98	852	913.40	438.97	177	22.51	15.52	13	0.54
1998-99	747	2044.22	998.83	262	12.23	259.25	42	1.33
Total	2028	5367.56	1658.84	571	49.89	306.70	89	3.12

* Figure furnished by Directorate of Audit, Customs and Central Excise, New Delhi and relate to 44 out of 60 commissionerates.

The above data reveals that while a total of 2,028 cases of fraud/presumptive fraud were detected during the years 1996-99 by the department, involving a duty of Rs.5,367.56 crore, the department raised a demand of Rs.1,658.84 crore only and recovered Rs.306.70 crore (18.49 *per cent*) out of it. Similarly, out of imposed penalty of Rs.49.89 crore, the department recovered Rs.3.12 crore only.

CHAPTER 2 : REVIEW OF THE SCHEME FOR LEVY OF DUTY ON THE BASIS OF CAPACITY OF PRODUCTION ON CERTAIN IRON AND STEEL PRODUCTS

2.1 Highlights

- **The scheme had a negative impact on revenues realised from this segment of iron and steel sector of around Rs.208 crore per annum in 32 commissionerates.**

(Paragraph 2.4.1)

- **The scheme enabled assessees to defer the duty payment without interest till the end of the financial year and with interest at the rate of 18 *per cent* thereafter. Due to this lacuna in the scheme, 723 assessees (including 276 closed units) did not pay duty of Rs.170.35 crore. Penalty of Rs.170.35 crore and interest of Rs.37.24 crore till December 1999 had also not been recovered in these cases. In the absence of any requirement for furnishing bank guarantees/securities etc., the possibility of recovery in these cases is low.**

(Paragraph 2.4.2)

- **Due to the allowance of deferment of duty under the scheme, the downstream buyer manufacturers of 'Re-rolled products' would have used an estimated Modvat credit of Rs.125.41 crore, without duty actually having been remitted to Government account.**

(Paragraph 2.4.3)

- **Due to shifting dates from which the scheme was to take effect, 220 assessees in 27 commissionerates paid duty short by Rs.12.57 crore during August 1997.**

(Paragraph 2.4.4)

- **While there are provisions in the scheme to allow reduction in duty in cases where actual production is less than the determined capacity, there was no provision to levy additional duty when production exceeded the capacity so determined. Due to this lacuna, excess production from eight assessees was not subjected to duty amounting to Rs.3.66 crore, despite the fact that the manufacturers would have recovered the duty from the purchasers. This also enabled the downstream manufacturers to avail an estimated Modvat credit of Rs.1.07 crore despite the fact that no duty was actually paid to the Government on the excess production.**

(Paragraph 2.4.5)

- **The Annual Capacity of eight assessees was not finally determined despite the scheme having been introduced in September 1997. No time limit has been prescribed under the Act or the Rules for such determination. An amount of Rs.3.02 crore including penalty besides interest was outstanding from these assessees.**

(Paragraph 2.4.6)

- **The scheme was applicable only to 'Non-alloy steel products' and not to 'Alloy steel products'. This enabled an assessee to mis-declare his production profile as mainly "Alloy steel products" to evade duty under the scheme amounting to Rs.3.36 crore. Penalty of Rs.3.36 crore besides interest was also recoverable in this case.**

(Paragraph 2.4.7)

- **Even though all accumulated Modvat credit was to lapse in respect of units covered under the scheme, Modvat credit of Rs.2.84 crore was not reversed/expunged by 41 assessees.**

(Paragraph 2.5.1)

- **12 assessees reduced their duty liability by Rs.2.48 crore on their own.**

(Paragraph 2.5.2)

- **Goods valuing Rs.11.43 crore with a duty liability of Rs.1.50 crore were cleared by a job worker without payment of any duty.**

(Paragraph 2.5.4)

- **Annual capacity was determined incorrectly in six cases resulting in short levy of duty of Rs.1.48 crore.**

(Paragraph 2.5.6)

2.2 Introduction

Section 3A was inserted in the Central Excise Act, 1944 with effect from 14 May 1997 by Finance Act, 1997. This empowered the Central Government to charge excise duty on the basis of capacity of production in respect of notified goods. The section stipulated that goods would be so notified to safeguard the interest of revenue taking into account factors such as (a) nature of the process of manufacture and (b) the extent of evasion of duty. The section also empowered the Government to make rules for determination of annual capacity and levy duty at rates to be notified. Using the aforesaid powers, the Government notified certain iron and steel products like ingots and billets and hot re-rolled products of non-alloy steel to be brought under the system of duty based on capacity of production with effect from 1 September 1997 (hereinafter referred to as 'The scheme').

For determination of Annual capacity, the Government notified 'Induction Furnace Annual Capacity Determination Rules, 1997' and 'Hot Re-Rolling Mills Annual Capacity Determination Rules, 1997' through notifications dated 25 July 1997 and 1 August 1997, respectively. Specific rules 96ZO and 96ZP were framed under the Central Excise Rules, 1944 prescribing the procedure to be followed by the manufacturers of ingots and billets and hot re-rolled products, respectively.

The rates of duty for non-alloy steel ingots and billets for units working under rule 96ZO were fixed as under:

(i) Rs 750 per tonne multiplied by the determined capacity of production, under sub-rule (1), or

(ii) Concessional rate of Rs.5 lakh per month per furnace of capacity 3 tonne, subject to the condition that no reduction in duty is allowable for actual production being less than the determined capacity, under sub-rule (3).

For hot re-rolled products of non-alloy steel units working under rule 96ZP, the duty was fixed as under:

(i) Rs.400 per tonne multiplied by the determined capacity under sub-rule (1), or.

(ii) Concessional rate of Rs.300 per tonne multiplied by determined capacity subject to the condition that no reduction in duty is allowable for actual production being less than the determined capacity (The rate of Rs.300 per tonne is to be replaced by Rs.150 per tonne for mills in which the nominal centre distance of the pinions in the pinion stand is upto 160 mm), under sub-rule (3).

The entire duty was to be paid in cash as Modvat was not envisaged under this scheme.

2.3 Scope of audit

In order to evaluate the detailed procedures formulated by the Government to implement the levy of duty on capacity of production basis and its operation with special emphasis on its impact on revenue realisation, a review was carried out and records of 586 units out of the total of 2074 units that were reported to be covered under this scheme were test checked for this purpose. The findings of the review are contained in succeeding paragraphs under 2 sections namely (a) lacunae in scheme formulation and (b) lapses in implementation.

2.4 Lacunae in scheme formulation

With effect from 1 September 1997, duty of central excise is leviable with reference to the annual capacity of production in respect of manufacturers of 'Non-alloy steel ingots' and 'Hot re-rolled products' falling under specified headings under chapter 72, in terms of rules 96ZO and 96ZP read with section 3A of the Central Excise Act, 1944.

2.4.1 Negative impact of the scheme on revenue

To assess the impact of introduction of the scheme to levy duty on the basis of capacity of production on certain 'Iron and steel products', data from 32 commissionerates was collected and analysed in audit. The results are summarised below:

(Amount in crore of rupees)

Years	No. of Units	Clearance in tonne	Value of clearance	Duty paid in cash (PLA)	Duty paid through Modvat	Total duty paid	Total revenue from iron and steel	Percentage of (a) to (b)
						(a)	(b)	
1996-97	813	2404	4288	77.30	404.55	481.85	3377.76	14.27
1997-98	1030	2833	3224	141.12	204.69	345.81	3515.40	9.84
1998-99	994	2854	2446	89.96	47.65	137.61	1980.80	6.95

The above table reveals the following:

(i) Even though production from hot re-rolling mills and induction furnaces increased from 2,833 tonne in 1997-98 to 2,854 tonne in 1998-99, the total duty collection from these units dropped from around Rs.346 crore to 138 crore, a decline of Rs.208 crore. This indicates that the scheme had a negative impact on revenue realised from this segment of iron and steel sector.

(ii) Revenue from these units as a percentage of total revenue from iron and steel sector declined from 14 *per cent* in 1996-97 to 7 *per cent* in 1998-99.

On being pointed out in November 1999, the Ministry of Finance stated (January 2000) that the studies conducted in respect of the duty payment by units working under the scheme showed no general decline in the revenue collection. They also contended that the scheme was successful to prevent evasion of duty and augment collection of duty.

The data relating to 38 commissionerates supplied by the Ministry (January 2000), however, showed reduction in collection of duty from Rs.168.46 crore in 1996-97 to Rs.149.59 crore in 1998-99 from induction furnace units. Revenue collection from all the units covered under the scheme in respect of 38 commissionerates during 1998-99 was the same as in 1996-97. The Ministry also reported that almost Rs.259 crore duty liability had not been discharged by the units. It is apparent that even the studies conducted by the Ministry do not indicate that the scheme has succeeded in plugging revenue leakage.

2.4.2 Deferment of duty liability without time limit to discharge it finally

While notifying the procedure for payment of the duty liability based on the determined capacity in rules 96ZO(1) and 96ZP(1), the Government allowed the assessees to pay the undischarged duty liability relating to the period 1 September 1997 to 31 March 1998 by the end of March 1998 and relating to the subsequent financial years by 31 March of the relevant year. Interest at the rate of 18 *per cent* per annum was also leviable only after the expiry of the relevant financial year. Although the scheme was intended to plug evasion of duty, the assessee was permitted to discharge the assessed liability by the end of the year without payment of any interest.

Audit examination of the relevant records revealed that 723 assessees covered under the scheme cleared their goods without payment of any duty or on payment of duty lesser than the duty determined. Non-payment or short payment of duty at the time of clearance, resulted in deferment of payment of Government revenue of Rs.170.35 crore during the period from September 1997 to March 1999 on which penalty of equal amount of Rs.170.35 crore and interest of Rs.37.24 crore (till December 1999) was also recoverable. Of this, 276 assessees with total liability of Rs.157.07 crore had closed down their units.

In the absence of appropriate provisions in the rules, no bank guarantee/bond/security was taken from any of the assessees for protection of recovery of the Government revenue of Rs.377.94 crore.

On being pointed out in November 1999, the Ministry of Finance stated (January 2000) that the assessee had to pay duty of Rs.750/Rs.400 per tonne at each clearance and only the balance duty with reference to determined capacity was to be discharged at the end of the year. As such they argued that no benefit was extended to the manufacturers.

The reply is not tenable. Since the scheme to levy duty on the installed capacity was introduced in view of the perceived evasion of duty in this sector, linking duty payments to clearances under self removal procedure provided no additional safeguard to revenue. The studies conducted by the Ministry have also shown that 35 per cent of the total duty liability in respect of units under 38 commissionerates had not been discharged. The Ministry did not furnish any steps taken to recover the outstanding amount and to ensure timely payment on clearance.

2.4.3 Misuse of deemed Modvat credit

Deemed Modvat credit at the rate of 12 *per cent* of the invoice value was allowed to the purchasers of products (Hot re-rolled products of non-alloy steel) from units working under the scheme. Since, the units working under the scheme were given an option to defer the payment of duty till the end of the year and indefinitely at interest of 18 *per cent* per annum thereafter, there was a possibility of downstream manufacturers availing Modvat credit without duty having actually been paid into Government account.

For cases commented upon in para 2.4.2 where duty of Rs.170.35 crore had not been paid by the manufacturers till March 1999, audit estimated a possible availment of Modvat credit of around Rs.125.41 crore by the downstream purchasers of goods from these 723 units (The estimation has been done by adopting the overall ratio of Modvat at 73.62 *per cent* of the excise duty paid in cash during 1997-98). In other words, downstream manufacturers were able to reduce their liability through deemed Modvat credits, without duty actually having been realised by the Government.

On being pointed out in November 1999, the Ministry of Finance stated (January 2000) that deemed credit was allowed only in cases where payment of duty of excise had been declared on the invoices by the manufacturer and the assessees taking credit of duty had to ensure the duty paid nature.

Reply of the Ministry is not tenable as the downstream manufacturers (assessee) had already availed deemed credit eventhough duty had not actually been paid to Government by a large number of manufacturers of input goods. The fact of non-payment of duty by the manufacturers has been brought out by Audit in paragraphs 2.4.2 and 2.4.5 which has also been admitted. Reliance entirely on the declaration made by the assessees is not in consonance with the procedure prescribed under Modvat rules where the assessees have to produce invoices containing details of duty paid. The department has also not adopted any mechanism for verifying the veracity of the declaration made by the asessees.

2.4.4 Deferment of the date for implementation created confusion

By notifications dated 25 July 1997, the scheme was initially to come into force from 1 August 1997. However, on 30 August 1997 the scheme was deferred till 1 September

1997 by notification dated 30 August 1997. Duty for August 1997 was, therefore, payable on ad valorem basis.

Audit verification of 220 assessees in 27 commissionerates revealed that these assessees paid duty under the new scheme for the month of August 1997 also, instead of correctly at ad valorem rates, leading to short payment of duty of Rs.12.57 crore. Some illustrative cases are as under:

Five assessees, in Bangalore I and II Commissionerates of Central Excise, engaged in the manufacture of hot re-rolled products falling under sub-heading 7214.90 had cleared the goods for Rs.6.93 crore during August 1997 and paid duty of Rs.3.84 lakh at the rate of Rs.300 and Rs.150 per tonne under the new scheme against duty of Rs.1.04 crore payable at the rate of 15 *per cent* ad valorem on the value of goods. This resulted in short payment of duty of Rs.1 crore.

On being pointed out in November 1999, the Ministry of Finance stated (January 2000) that duty was leviable at specific rats on goods cleared during August 1997.

Reply of the Ministry is not tenable as some commissionerates levied duty at specific rates where as others at 15 per cent ad valorem on similar goods cleared by the units during August 1997. This establishes that deferment of the date of implementation of scheme created confusion among the commissionerates.

2.4.5 No provision to tap production in excess of determined capacity

As per rules 96ZO and 96ZP of the Central Excise Rules, 1944, a manufacturer of non-alloy steel ingots and hot re-rolled products has to discharge duty liability on the basis of production capacity determined by the department. The amount so paid shall be deemed to be full and final discharge of duty liability.

While there are provisions in the rules to allow reduction in duty and levy duty on actual production in case actual production is less than the determined capacity, there is no provision to levy duty if the actual production is more than the annual capacity determined. Such exemption from levy of duty on production in excess of determined capacity is also contrary to rules 9 and 49 read with rule 173G which prescribe that excisable goods shall not be removed from the place of manufacture or storage unless the excise duty leviable thereon has been paid. Thus, while the manufacturers were protected in a period of economic recession, the State would not get a share of higher turnover during economic boom.

In cases of excess production, under rule 96ZP the downstream manufacturers would also be entitled to avail deemed Modvat credit (at the rate of 12 *per cent* of the invoice value) notwithstanding the fact that no duty is required to be paid or has actually been paid.

Eight assessees, in four Commissionerates of Central Excise, engaged in manufacture of non-alloy steel ingots and hot re-rolled products, produced quantity in excess of determined capacity ranging between 12.49 *per cent* and 261.83 *per cent* during the period from September 1997 to March 1999. Absence of provision to levy duty on excess production resulted in loss of Government revenue of Rs.3.66 crore besides enabling the down stream manufacturers to avail the benefit of deemed credit estimated at Rs.1.07 crore in two cases, even when no corresponding duty was actually paid to the Government

on account of excess production. Such large variation in actual production against that determined was also indicative of faulty determination of annual capacity. Further, the absence of provisions in the scheme to levy duty on excess production was also against the provisions of section 11D of the Act, as in these cases the manufacturers would have collected duty from the customers but were not required to deposit it with the Government. An illustrative case is given below:

The annual capacity of an assessee engaged in the manufacture of goods falling under chapter 72, was fixed at 9,600 tonne per annum with a duty liability of Rs.5 lakh per month under rule 96ZO(3). Based on this determined capacity, the production during the period September 1997 to March 1999 should have been around 15,200 tonne . It was, however, observed that during this period the assessee actually produced 25,280.65 tonne which was 166 *per cent* of the determined capacity. The excess production of 10,080.85 tonne valuing Rs.11.67 crore was cleared without payment of duty of Rs.75.60 lakh, though the assessee would have collected the same from the buyers.

On being pointed out (November 1999), the Ministry of Finance stated (January 2000) that it was essential to give finality to the process of determination of production capacity from the Government side and its re-determination would lead to adhocism in the working of the scheme.

Reply of the Ministry is not tenable as the rules do provide reduction in duty in cases where actual production is lesser than the determined capacity.

2.4.6 No time limit for determination of annual capacity

Rule 3(4) of Hot Re-Rolling Mills Annual Capacity Determination Rules, 1997 provide for provisional determination of annual capacity pending verification of the parameters as declared by the assessee. Thereafter, the Commissioner may determine the annual capacity and pass an order accordingly. Such provisional determination of capacity was, however, not permissible in case of "Induction furnaces" in terms of Induction Furnace Annual Capacity Determination Rules, 1997". No time limit for such determination had, however, been prescribed under the Act/Rules. The Central Board of Excise and Customs in their Circular dated 25 July 1997 clarified that final determination of annual capacity should be completed within August 1997 itself.

The Commissioner of Central Excise, Bolpur provisionally fixed the capacity and the duty liability in respect of eight assessees (five rolling mills and three induction furnaces). Such provisional determination of capacity in case of induction furnaces was totally without the authority of law. In terms of provisional determination they were liable to pay provisional duty of Rs.2.19 crore for the period from 1 September 1997 to 31 March 1999. Test check of records of the aforesaid assessees however, revealed that they paid duty of Rs.68.60 lakh only during the said period. No action was taken by the Commissioner either to recover the duty which remained unpaid as per provisional capacity or to determine the capacity and duty liability finally even after a lapse of 19 months (upto 31 March 1999). This resulted in non-recovery of duty of Rs.1.51 crore besides an equal amount of penalty of Rs.1.51 crore leviable upto 31 March 1999 and interest of Rs.9.99 lakh payable upto 31 March 1999 on the duty of Rs.55.47 lakh outstanding upto 31 March 1998.

2.4.7 Change in production profile to avoid duty/non-application of scheme to alloy steel products

The scheme was applicable to ingots and billets of non-alloy steel of specified sub-headings manufactured in an induction furnace. The scheme was not made applicable to manufacturers of alloy steel ingots and billets. These products being similar, the rationale behind keeping the alloy products out of the scheme was not clear. While there are no provisions in the Act or Rules to levy duty simultaneously under section 3A (on capacity basis) and under section 3 (on ad valorem basis) on both non-alloy and alloy steel products manufactured by the same assessee, the Board clarified (July 1997) that where non-alloy steel products get manufactured only incidently and the main production was of alloy products, duty will be determined on ad valorem rates and not under section 3A of the Act.

An assessee, in Chandigarh II Commissionerate of Central Excise, having four induction furnaces each of three tonne capacity, was manufacturing non-alloy steel products which attracted duty on the basis of capacity of production in respect of notified goods, under section 3A of the Central Excise Act, 1944. As per Induction Furnace Annual Capacity Determination Rules, 1997, the aggregate monthly duty liability in respect of 4 induction furnaces with capacity of 3 tonne each, worked out to Rs.20 lakh per month. Based on this, the duty liability of the assessee for the period from 1 September 1997 to 31 March 1999 worked out to Rs.3.80 crore. To avoid payment of duty under the scheme, the assessee declared to the department on 31 July 1997, that he shall be mainly manufacturing ingots/billets of alloy steel and was, therefore, outside the purview of section 3A duty. This letter of the assessee was accepted by the department without any verification of actual production profile.

Audit scrutiny of records, however, revealed that contrary to his assertion, the assessee manufactured mainly non-alloy steel products. During the period September 1997 to March 1999, he manufactured 72,623 tonne and cleared 4,099.86 tonne of non-alloy steel ingots on payment of duty at 15 *per cent* ad valorem. Compared to this the production of alloy steel was 62,055 tonne and clearance of 1,717.74 tonne which clearly indicates that the assessee was very much covered under the levy of duty in terms of section 3A of the Act. The assessee however, paid duty on ad valorem basis amounting to Rs.43.60 lakh only through cash on the non-alloy products instead of Rs.3.80 crore. This resulted in escapement of duty of Rs.3.36 crore. In addition, the assessee was liable to pay penalty of Rs.3.36 crore and estimated interest at the rate of 18 *per cent* per annum which amounts to Rs.28.11 lakh.

2.5 Lapses in implementation

2.5.1 Irregular availment of Modvat credit

The facility of Modvat credit of duty paid on inputs was not available to the units brought under the new scheme in terms of rule 57F(17) and 57S(11). Accordingly, credit of duty lying unutilised on 1 August 1997 was to be lapsed.

Test check of excise records of 41 assessees, in 17 Commissionerates of Central Excise, revealed that Modvat credit of duty of Rs.2.84 crore lying in the accounts as on 1 August 1997 was not reversed/lapsed, as required.

On being pointed out in November 1999, the Ministry of Finance admitted (January 2000) that the amount of credit was required to lapse.

2.5.2 Suo moto reduction in duty payment

Under rule 96ZO(2) of the Central Excise Rules, 1944, where a manufacturer does not produce ingots or billets of non-alloy steel during any continuous period of seven days or more and wishes to claim abatement under sub-section (3) of section 3A of the Act, the abatement shall be allowed by an order passed by the Commissioner of such amount as may be specified in such order, subject to fulfilment of specified conditions.

Twelve cases of reduction of duty by the assessees themselves, without specific orders of the Commissioner, involving duty reduction of Rs.2.48 crore were noticed in six Commissionerates of Central Excise. These cases had neither been regularised on the basis of merits in each case nor had the duty been recovered. Some illustrative cases are given below:-

Two assessees, in Calcutta II and Bolpur Commissionerates of Central Excise, manufacturing notified goods of chapter 72 and having induction furnaces, closed their factories for a period of more than seven days and availed abatement from duty on their own volition, without any orders from the Commissioners. Non-observance of specific provision, resulted in irregular availment of benefit of duty amounting to Rs.65.92 lakh from September 1997 to May 1998 and March 1999.

On this being pointed out (October 1998/February 1999), the department in one case contended (March 1999) that the assessee was entitled to claim the abatement subject to the fulfilment of conditions under rule 96ZO(2) and the assessee had followed the conditions.

The department's reply is not tenable since the abatement claimed by the assessee was to be approved by the Commissioner under sub-section 4 of section 3A of the Central Excise Act, 1944 which was not done in the case.

2.5.3 Impermissible reduction in duty

Sub-rule (3) to rules 96ZO and 96ZP provide for payment of duty every month at a concessional rate. However, if an assessee opts for this variant, he is barred from seeking any reduction in duty liability on account of production being lesser than the determined capacity.

(a) An assessee, in Chennai III Commissionerate of Central Excise, manufacturing ingots of non-alloy steel opted for payment of duty based on the capacity of production under rule 96ZO(3). Duty payment was fixed by the Commissioner on 11 September 1997 at Rs.6,66,667 per month. The assessee claimed abatement for the period from October 1997 to August 1999 during which the furnace was closed down. The Commissioner also allowed abatement of Rs.58.81 lakh, which was clearly not permissible.

(b) Calcutta II and Calcutta IV Commissionerates of Central Excise, fixed the monthly duty liability of two assessees at only 70 and 20 *per cent* of the actual duty liability respectively under sub-rule (3) of rules 96ZO and 96ZP on the plea of the assessees that

they shall manufacture only 70 and 20 *per cent* of non-alloy steel product respectively. No provision for such reduction was available. This incorrect fixation of monthly duty liability, resulted in short levy of duty of Rs.51.49 lakh between September 1997 and October 1998.

On being pointed out (October/December 1998), the department, in one case, contended (March 1999) that the assessee was allowed to pay duty under section 3 and 3A simultaneously on alloy steel products and non-alloy steel products on the basis of a clarification issued by the Central Board of Excise and Customs in their circular dated 25 July 1997.

Reply of department is not tenable as: (i) there is no provision in the Act/Rules for such reduction and duty payment under section 3 and 3A simultaneously; and (ii) the clarification cited only states that where the manufacturer is mainly producing alloy steel products and non-alloy products are produced incidentally then duty under section 3A will not be applicable.

2.5.4 Non-payment of duty on goods manufactured on job work

Notification dated 25 March 1986 provides exemption from duty on certain specified goods manufactured in a factory as a job work and used in relation to the manufacture of specified final products. This notification was amended on 30 August 1997, through which ingots and billets and hot re-rolled products of non-alloy steel on which duty of excise has been paid under section 3A of the Central Excise Act, 1944, were excluded. Accordingly, excise duty on these products when manufactured on job work basis was required to be paid.

A job worker, in Chandigarh I Commissionerate of Central Excise , who recovered conversion charges from the principal manufacturers cleared these "excluded" goods without payment of any duty. During the period September 1997 to March 1999, the assessee cleared 7,002.11 tonne of such goods valuing Rs.11.43 crore which attracted duty at the rate of 15 *per cent* ad valorem amounting to Rs.1.50 crore, which was not paid/recovered.

2.5.5 Duty paid less than the amount determined

Duty on non-alloy steel ingots and billets and hot re-rolled products is payable under section 3A of the Act, based on the capacity determined and rates prescribed under rules 96ZO/96ZP. Under section 11A of the Act, the department has to issue show cause notice and recover any duty paid short.

Three assessees, in three Commissionerates of Central Excise, did not pay duty in accordance with the annual capacity as determined by the department. The short payment of duty in these cases was Rs.50.97 lakh during the period September 1997 to January 1999. It was observed in audit that no show cause notice was issued by the department to recover the duty short paid.

2.5.6 Incorrect fixation of annual capacity

As per rule 5 of Hot Re-Rolling Steel Mills Annual Capacity Determination Rules, 1997, in case the annual capacity determined by the formula in sub-rule (3) of rule 3 in respect of

a mill, is less than the actual production of a mill during the financial year 1996-97, then the annual capacity, so determined shall be deemed to be equal to be actual production during the financial year 1996-97.

In six cases, in five Commissionerates of Central Excise, audit verification revealed that the annual capacity determined was less than the actual production of the mills during the year 1996-97. This faulty fixation of annual capacity resulted in short levy of duty of Rs.1.48 crore during September 1997 to March 1999. An illustrative case is given below:-

The annual production capacity as declared by an assessee in Calcutta III Commissionerate of Central Excise, was 29,890 tonne whereas the actual production during the financial year 1996-97 was 41,567.194 tonne as per excise records. Accordingly, the Commissioner fixed the annual capacity as 41,567.194 tonne on the basis of rule 5 and communicated it to the assessee on 6 October 1997. However, the scrutiny of balance sheet of the assessee in audit, revealed that the actual production during the financial year 1996-97 was 62,502 tonne whereas the statutory records of central excise showed the production as 41,567.194 tonne, only. This resulted in a wrong fixation of annual capacity by the Commissioner, which ought to have been re-determined as 62,502 tonne. This led to short levy of duty of Rs.57.57 lakh from September 1997 to July 1998.

2.5.7 Non-levy of duty on waste and scrap

As per notification dated 1 August 1997, 'Waste and scrap' arising out in the course of manufacture of the goods notified under section 3A of the Central Excise Act, 1944, are exempt from the whole of the duty leviable thereon. The above scheme was, however, deferred from August 1997 and implemented from 1 September 1997. The exemption on waste and scrap, therefore, was not available on the quantity manufactured before and during the month of August 1997. This view had also been upheld by the Central Board of Excise and Customs in their Circular dated 26 February 1998.

Nine assessees, in four Commissionerates of Central Excise, cleared waste and scrap manufactured either before August 1997 or during the month of August 1997 without payment of duty as per notification dated 1 August 1997. Since the compounded levy scheme under section 3A was available from 1 September 1997, the clearance of 'Waste and scrap' without payment of duty was not correct. This resulted in non-levy of duty on 'Waste and scrap' of Rs.13.29 lakh during the above period.

2.5.8 Unauthorised change in production capacity

Hot re-rolling Steel Mills Annual Capacity Determination Rules, 1997 and Induction Furnace Annual Capacity Determination Rules, 1997 provide that in case a manufacturer proposes to make any change in installed machinery or any part thereof in case of hot re-rolling mills and in the total capacity of production or for any part of the year in the case of Induction furnace, such manufacturer shall intimate about the proposed change to the Commissioner of Central Excise in writing, with a copy to Assistant Commissioner of Central Excise, at least one month in advance of such proposed change, and shall obtain the written approval of the Commissioner before making such change. Thereafter the Commissioner of Central Excise shall determine the date from which the change in installed capacity shall be deemed to be effective after verification of facts.

Four cases of unauthorised changes in production capacity without proper orders of the Commissioner leading to short recovery of Rs.37.89 lakh were noticed in Chandigarh I Commissionerate of Central Excise. One of these cases is discussed below:

An assessee, manufacturing girders, channels and flats falling under sub-headings 7216.10 and 7214.90 opted for the scheme with effect from 1 November 1997 by reducing [1]parameter 'd' of his mill from 415 mm to 409 mm, as the scheme was applicable for parameters 'd' upto 410 mm only and duty was determined at Rs.6,25,909 per month. After remaining under the scheme for about 8 months, the assessee switched over to payment of duty at ad valorem rates availing modvat with effect from 22 October 1998 by changing parameter 'd' from 409 mm to 430 mm without obtaining the written permission of the Commissioner of Central Excise, as required under rules. This resulted in short payment of duty of Rs.18.78 lakh for the period from 22 October 1998 to 21 January 1999. However, the permission was granted by the Commissioner on 22 January 1999.

On being pointed out in December 1998, the department admitted the facts and stated (May 1999) that a penalty of Rs.2 lakh had since been imposed on the assessee.

2.6 Recommendations

(i) **In order to safeguard revenue, the scheme may be revised so as to provide for advance or regular payment of the duty determined on installed capacity. Provision for bank guarantee/security may also be made.**

(ii) **Provision to tax production in excess of determined capacity should be brought in the Act to safeguard revenue.**

(iii) **A reasonable time limit for final determination of annual capacity should be prescribed in the Act/Rules.**

Out of the above observations pointed out in November 1999, reply of the Ministry of Finance had not been received in respect of paragraphs 2.4.6, 2.4.7 and 2.5.2 to 2.5.8 (January 2000).

[1] Parameter 'd' refers to the nominal centre distance of pinions in the pinion stand in millimetres.

CHAPTER 3 : TOPICS OF SPECIAL IMPORTANCE

3.1 Non-implementation of section 11D of Central Excise Act - Duty collected but not paid to Government

Section 11D(1) of the Central Excise Act, 1944 states that "notwithstanding anything to the contrary contained in any order or direction of the Appellate Tribunal or any Court or in any other provisions of this Act or the Rules made thereunder, every person who collected any amount from the buyer of any goods in any manner as representing duty of excise, shall forthwith pay the amount so collected to the credit of Central Government".

(a) Four petroleum oil companies imported petroleum oils like high speed diesel oil, motor spirit, superior kerosene oil, furnace oil, aviation turbine fuel, etc., and sold them together with indigenous products at the administered prices fixed by the Ministry of Petroleum and Natural Gas. In addition to the administered prices, the assessees had been collecting central excise duty at applicable rates from their customers. The total amount collected as duty of excise on such imported products by various units of four oil companies worked out to Rs.4,036.75 crore during the period from April 1994 to December 1998. This amount was not remitted to Government account.

This was also pointed out to Government in earlier Audit Reports (Para 4.2 of Audit Report 1995-96, para 4.1 of Audit Report 1996-97 and para 11(1)(i) of Audit Report 1997-98). The Ministry of Finance initially (August 1996) admitted the objection and intimated confirmation of demands of Rs.5.35 crore in December 1995 in one case. Later, the Ministry stated (January 1999) that the central excise duty recovered by the oil companies on imported products represents the countervailing duty but the relevant invoices had at times indicated it as central excise duty. They attributed this lapse to the notional accounting system allowed by the Ministry of Petroleum to the oil companies, as imported and domestically manufactured petroleum products are not separately stored.

The reply of the Ministry of Finance is not acceptable in view of the specific provisions of section 11D of the Act which states that any amount collected as duty of excise is required to be remitted invariably to the Government. In any case, during relevant years International prices of petroleum were low and the administered prices higher than the landed cost. Hence the possibility of undue enrichment of oil companies on account of excise duty collected on imported petroleum products cannot be ruled out. The implications of this accounting procedure in the context of emergence of private oil companies also needs to be considered.

(b) An assessee, in Chennai III Commissionerate of Central Excise, cleared 'Additional free sale sugar' on payment of basic excise duty of Rs.17 per quintal and additional excise duty of Rs.21 per quintal. However, the assessee collected basic excise duty of Rs.34 per quintal and additional excise duty of Rs.37 per quintal from the buyers, resulting in excess collection of duty of Rs.25.22 lakh for the period from May 1996 to November 1996.

On being pointed out (January 1997), the Ministry of Finance reported (December 1999) that in the absence of any procedure being prescribed under section 11D for recovery of

excess duty collected, the entire amount had since been recovered under section 11A and by voluntary payment. The need for appropriate amendment in the Act/Rules is apparent.

3.2 Non-revision of specific rate of duty on sugar

The relative merits and demerits of ad valorem and specific duties have been examined by several Committees from time to time. The matter was also considered by the Tax Reforms Committee headed by Dr. Raja J. Chelliah constituted by the Government in August 1991. In their interim report submitted to the Government in December 1991, the Committee held that the advantage of having ad valorem duties far outweigh the administrative benefits of specific duties. They also held that in a system of comprehensive taxation with a wide coverage of Modvat, it would be necessary to have by and large only ad valorem duties to ensure a rational system of taxation. Accordingly, they recommended switch over to ad valorem rates in respect of number of commodities. They also recommended that where specific rates are retained, there should be a system of revising the rates every year to take into account price increases as represented by the relevant sectoral wholesale price index. In so far as sugar is concerned, the Committee recommended levy of a uniform rate of 10 *per cent* ad valorem (basic duty plus additional duty) for both levy and free sale sugar.

Sugar continues to be taxed at specific rates of duty. On levy sugar, duty is levied at the rate of Rs.17 per quintal (basic) plus Rs.21 per quintal (additional). Duty on free sale sugar is levied at Rs.34 per quintal (basic) plus Rs.37 per quintal (additional). These rates have remained unchanged even though the prices of levy and free sale sugar have steadily increased over the years. Consequently, the incidence of duty in real terms has steadily declined as detailed in the following table :-

Year	Free sale sugar		Levy sugar	
	Average price per quintal (in rupees)	Incidence of total duty at Rs.71 per quintal (as percentage of price)	Price per quintal fixed by Government (in rupees)	Incidence of total duty at Rs.38 per quintal (as percentage of price)
1989-90			525	7.24
1990-91			610	6.23
1991-92	958	7.41	690	5.51
1992-93	1138	6.24	830	4.58
1993-94	1400	5.07	905	4.20
1994-95	1285	5.53	905	4.20
1995-96	1380	5.15	905	4.20
1996-97	1455	4.88	1050	3.62
1997-98	1600	4.44	1140	3.33
1998-99	1575	4.51	1200	3.17

Source : The figure for prices and clearances have been obtained from Ministry of Food and Consumer Affairs, Department of Sugar and Edible Oils, Directorate of Sugar, Government of India.

Failure to periodically revise the rates of specific duty on sugar to keep pace with rising prices as recommended by the Tax Reforms Committee resulted in non-mobilisation of additional resources to the extent of Rs.3070 crore between 1992-93 and 1998-99 or Rs.654.91 crore during 1998-99.

This was pointed out in December 1999, reply of the Ministry of Finance had not been received.

3.3 Excessive grant of deemed credit

Under rule 57A (2) {from 23 July 1996 and 57A (5) from 1 March 1997}, Government may declare, inputs on which duties of excise or additional duty paid shall be deemed to have been paid at such rates or equivalent to such amount as may be specified in the notification and allow Modvat credit of such declared duty deemed to have been paid. The above wording in the rule makes it clear that duty on the inputs should have been paid to make them eligible for deemed credit.

Further, while interpreting a similar provision {rule 57G(2) prior to 23 July 1996}, Tribunal in the case of M/s. Machine Builders Vs. Collector of Central Excise {1996 (83) ELT 576} ruled that:

"The intention is not to deem that the inputs which actually did not suffer duty are inputs which suffered duty. The purpose is to ensure the benefit to those who use inputs in the manufacture of which duty has actually been paid, but it might not be possible to produce duty paying documents"

Government issued two notifications dated 23 July 1996 and 3 September 1996 allowing deemed credit to fabric processors, to the extent of 50 to 70 *per cent* of the duty paid on final products. In the first notification dated 23 July 1996 dyes, chemicals, consumables and packing materials were not declared as eligible inputs, while in the second notification dated 3 September 1996 the said inputs were so declared. 'Grey fabric' which is the main raw material for producing processed fabrics, has not been declared as eligible input in either of these notifications.

Test check of records of fifty six assessees, in fourteen Commissionerates of Central Excise, engaged in manufacture of processed fabrics using 'Grey fabrics' falling under sub-headings 5207.10, 5208.10, 5209.10, 5406.10, 5511.10 and 5514.10 and dyes, chemicals, consumables etc., falling under chapter 32 were allowed deemed credit of Rs.75.62 crore during 23 July 1996 to 31 March 1999 despite the fact that 'Grey fabrics' were not eligible inputs and were exempt from duty. Allowing of deemed credit in these cases was accordingly not correct.

On being pointed out (between April 1999 and June 1999), the department stated (between October 1998 and July 1999) that in one case demand for Rs.38.19 lakh had been issued. In twenty one cases, it was contended that the deemed credit was allowed under relevant notifications. It was further contended that though 'Grey fabrics' were exempt from payment of duty, the yarn used in the manufacture of 'Grey fabrics' was dutiable.

The reply of the department is not tenable in view of the fact that the purpose of deemed credit was to reimburse duty paid on inputs. In these cases however, major portion of inputs did not suffer any duty. Duty was paid only on minor inputs like dyes, chemicals, etc. As such, the deemed credit of Rs.75.62 crore allowed was far in excess of the duty actually suffered on dutiable inputs which was estimated in audit as only Rs.18.05 crore, thereby resulting in undue financial benefit to the assessees of around Rs.57.57 crore.

Reply of the Ministry of Finance had not been received (December 1999)

3.4 Non-recovery of excess credit on petroleum products

Excise duty on specified petroleum products like furnace oil, low sulphur heavy stock, light diesel oil, raw naphtha etc. was increased from 10 to 15 *per cent* ad valorem from 23 July 1996. To maintain the level of administrative prices, the incidence of the increase in duty was to be passed on by the oil companies to the Oil Pool Account, being maintained by the Ministry of Petroleum and Natural Gas and not to the customers.

In order to ensure that buyer-manufacturers utilise the amount of Modvat credit to the extent of actual incidence of duty, excise duty at only 10 *per cent* ad valorem had to be exhibited in the invoices issued under rule 57G to the buyers, whereas excise duty at 15 *per cent* ad valorem had to appear in the bottom of the invoice. However, no such mechanism was provided for in the notification introducing the hike in duty.

Consequently, while the oil companies charged excise duty at 10 *per cent* ad valorem from the buyers, the amount of excise duty on the face of the Modvat invoices were shown at the rate of 15 *per cent* ad valorem. The buyer manufacturer thus became entitled to avail Modvat credit of duty at 15 *per cent* ad valorem instead of 10 *per cent* ad valorem. Accordingly, the buyer manufacturers availed excess credit (i.e. difference of 5 *per cent*) from 23 July 1996 to 2 May 1997 i.e. till the issue of notification on 3 May 1997 restricting availment of Modvat credit with retrospective effect on such products at 10 *per cent* ad valorem. According to the notification, credit taken in excess of 10 *per cent* ad valorem had to be paid back by the manufacturers within a period of 90 days from the date of the enactment of the Finance Bill i.e. 14 May 1997. If the excess credit was not paid within 90 days, interest was also leviable at the rate of 18 *per cent* per annum.

Test check of records of 194 buyer manufacturers, in 27 Commissionerates of Central Excise, disclosed that due to non-formulation of proper procedure, Rs.81.60 crore was taken as excess Modvat credit. Audit verification further revealed that till June 1999, Rs.24.52 crore only had been recovered from 171 manufacturers. Despite more than two years of issue of corrective notification, recovery of the balance amount of Rs.57.08 crore along with interest amounting to Rs.19.03 crore due till March 1999, was still pending in 23 cases.

The Ministry of Finance failed to furnish the exact amount of revenue involved, amount recovered and the amount pending for recovery on this account. The Ministry of Petroleum and Natural Gas had, however, confirmed (April 1999) that excess availment of Modvat credit was to the extent of Rs.201.18 crore.

3.5 Failure to implement Rubber Act - cess not levied on natural rubber exported

Under section 12 of the Rubber Act, 1947, cess at the rate notified by the Government of India from time to time is leviable on all rubber produced in India and is to be collected by the Rubber Board, in accordance with the Rules made in this behalf, from the owner of the estate or from the manufacturer by whom such rubber is used. As the levy is on production, rubber exported is not exempt from it. Further, there is no notification exempting cess on rubber exported, as under the Act, Government is not empowered to do so.

In the Audit Report 1977-78, mention had been made about non-levy of cess of Rs.58.33 lakh on rubber exported during the period from 1973 to 1977. The case was again taken up in Audit Report 1981-82 {Para 2.47 (vii)} wherein the Ministry of Commerce opined that Board had no power to grant exemption from cess on rubber produced in India and exported.

On the non-levy of cess on exported rubber being pointed out again (between July 1993 and September 1998), the Rubber Board stated (February 1994 and March 1999) that the cess could not be collected on rubber exported from producers of rubber as the Rules made under the Rubber Act did not empower them to demand/recover duties from producers of rubber and they could do so only from 'manufacturers'. Despite the inconsistency between the Act and Rules having been pointed out repeatedly in audit, the Ministry did not take any action to rectify the situation.

Failure to suitably amend the Rules in order to implement the provisions of the Act, resulted in non-recovery of cess of Rs.1.20 crore on 18,123 tonne of natural rubber exported during 1991-92 to 1997-98. While confirming the facts, the Ministry of Commerce stated (October 1999) that the Board's proposal for amending the provisions of the Act to rectify the situation was under examination.

CHAPTER 4 : DEMANDS DELAYED OR NOT RAISED

Short payment or non-payment of duty on any excisable goods is to be recovered by issuing a show cause notice under section 11A to be followed up with its adjudication and recovery proceedings. The period of limitation for issue of show cause notice is six months in normal cases of non-levy/short levy of duty. In case of short levy/non-levy due to fraud, collusion etc., the limitation period stands extended to five years. Some illustrative cases of demand not raised or raised with delay or not adjudicated are given in the following paragraphs :-

4.1 Non-adjudication of demands

There is no statutory time limit for finalisation of adjudication proceedings after issue of a 'show cause notice' for determination of duty. However, the Central Board of Excise and Customs have issued (January 1983) instructions for adjudication of the demand cases within a maximum period of six months from the date of issue of show cause notice. Since interest on duty short paid or not paid is leviable, in normal cases, only after three months of duty being determined, any delay in the adjudication of demand notice and determination of duty, is to the financial advantage of assessee and detrimental to revenue.

(a) An assessee, in Cochin I Commissionerate of Central Excise, clearing petroleum products to bonded warehouses at different stations did not produce the triplicate copy of AR3A (application for removal) with re-warehousing certificates in a large number of cases dating back to 1989. The irregularity was pointed out from time to time through audit inspection reports issued for the period from April 1990 to March 1999. The department issued show cause notices but still in 681 cases neither proof of re-warehousing certificates was produced nor was duty paid by the assessee. In the absence of these re-warehousing certificates, show cause notices should have been adjudicated in favour of revenue, which was not done. This resulted in non-recovery of revenue of Rs.341.20 crore (for the period August 1989 to January 1999) and financial accomodation to the assessee by way of interest of Rs.96.13 crore till May 1999.

This was pointed out in June 1999, reply of the Ministry of Finance/department had not been received (December 1999).

(b) In Tiruchirapalli Division of Tiruchirapalli Commissionerate of Central Excise, 131 show cause notices were issued between January 1991 and July 1998, on five assessees involving short levy of duty of Rs.34.62 crore for non-inclusion of interest on advance in the assessable value of the goods. These show cause notices were kept pending without adjudication for periods ranging from one to eight years, despite the fact that the Central Board of Excise and Customs had made it clear in May 1996 that the nexus between price and deposit, if any, for inclusion of the notional value of interest in the assessable value, has to be proved by the department. No action was however, taken to finalise the adjudication proceedings on these lines. Inaction on the part of the department, resulted in non-recovery of Government revenue of Rs.34.62 crore and financial accomodation to assessees by way of interest of Rs.15.58 crore till May 1999.

This was pointed out in June 1999, reply of the Ministry of Finance/department had not been received (December 1999).

(c) A show cause cum demand notice was served in February 1996 to an oil company in Kanpur II Commissionerate of Central Excise, demanding duty of Rs.6.18 crore which was paid short due to undervaluation of 'Liquified petroleum gas' cleared during September 1995 to January 1996. However, it was not adjudicated till date even though similar demands on the issue had been confirmed earlier by the department.

On being pointed out in September 1997, the department stated (November 1998) that a sum of Rs.2.63 crore was paid by the assessee between September 1995 and January 1996 and show cause notice for remaining amount of Rs.3.55 crore was pending adjudication.

Inordinate delay in adjudication of the demand has resulted in non-recovery of Government revenue of Rs.3.55 crore and financial accomodation to the assessee by way of interest of Rs.2.13 crore till March 1999.

While intimating (December 1999) that the adjudication was being expedited, the Ministry of Finance stated that financial accomodation or otherwise would be established only after the case had been adjudicated. The reply is not tenable since similar demands had already been confirmed, earlier.

4.2 Demands not raised

(a) Under rule 13 and notifications issued thereunder, goods can be cleared for export without payment of duty but under bond. The rules and notifications further require that the goods in question should be exported within six months from the date of clearance from the factory or warehouse and proof of export furnished. Rule 14 A provides for issue of a demand by the proper officer for duty leviable on the goods, if proof of export is not produced by the manufacturer within the prescribed period of six months. However, Commissioner of Central Excise may extend period of six months on merits, on a case to case basis.

Nine assessees, under six Commissionerates of Central Excise, engaged in the manufacture of 'Iron and steel products' and 'Cotton fabrics' cleared under bond, excisable goods for exports between April 1994 and September 1998, without payment of duty of Rs.41.19 crore. However, no proof of export was furnished by the assessees. Department also did not take action for raising the demand and recovering duty. This resulted in blockage of Government revenue of Rs.41.19 crore and financial accomodation of Rs.11.53 crore to the assessees by way of interest till March 1999. It was further noticed that bonds of Rs.8 crore only had been obtained from one of the assessees against which excisable goods entailing duty liability of Rs.39.30 crore were removed by him.

On being pointed out between May 1997 and November 1999, the Ministry of Finance while admitting (August and November 1999) audit objection in three cases, contended that the interest would be recoverable only after three months of the confirmation of demands in terms of the provisions of section 11AA.

While reply of the Ministry is legally correct in view of existing provisions, in the absence of provisions to levy interest from the date of clearance of goods, delay in raising demand and its confirmation is to the financial advantage of the assessees, To safeguard interest of Government, audit has repeatedly recommended amending section 11AA to levy interest from the relevant date of clearances. Reply in the remaining cases had not been received (December 1999).

(b) Another assessee, in Jaipur I Commissionerate of Central Excise, manufactured 'Cartridge taper roller bearing' consisting of cartridge bearing assembly, grease seal, caps, locking plate, nuts, bolts, backing rings, etc. The product was specifically designed for use as parts of 'Railway wagon'. Though the product was correctly classifiable under heading 86.07 as parts of railway wagon, these were cleared under heading 84.82 treating them as 'ball and roller bearing' and without filing proper declaration under rule 173B till 31 March 1997. The department issued show cause notice for incorrect classification in December 1997 and the assessee started classifying product under heading 86.07 from 10 December 1997. The department also demanded duty for the period from 24 June 1997 to 9 December 1997. However, no demand was raised for the period prior to 24 June 1997. Since facts were suppressed by not submitting declaration under rule 173B, demand for the extended period of five years from 16 March 1995 to 23 June 1997 should have been raised and action taken to impose penalty. Inadequate action on the part of the department resulted in duty of Rs.5.59 crore and penalty of Rs.335.82 crore (leviable under rule 173Q for violation of rule 173B) remaining unrealised.

On being pointed out in July 1998, the Ministry of Finance while confirming (January 2000) the facts did not comment upon the suppression of facts by the assessee. They, however, stated that (i) the extended period of demand was not invokable in the case and (ii) even the show cause notice issued in December 1997 was not adjudicated till date.

(c) Yet another assessee, in Bangalore III Commissionerate of Central Excise, engaged in the manufacture of instant coffee powder revised the price of his product effective from 1 January 1996 onwards and filed a fresh price list with the department on 10 October 1996. As the products were cleared by the assessee on payment of duty on lower price, the differential duty was required to be determined and demand raised for recovery of differential duty from January 1996 onwards, which was not done. The assessee on his own, paid the differential duty of Rs.2 crore for the period January 1996 to December 1996 on 6 March 1998. Non-raising of demand resulted in delayed realisation of duty of Rs.2 crore and loss of interest of Rs.42.08 lakh for the period January 1997 to February 1998 and financial accommodation to that extent, to the assessee.

On being pointed out in May 1999, the Ministry of Finance stated (December 1999) that there was no provision for charging interest in cases of delay in finalisation of provisional assessment. There is an apparent need to make appropriate provisions in this regard.

4.3 Demands raised short

According to sub-rule (5) of the rule 9A, the rate of duty and tariff valuation, if any, applicable to excisable goods shall be the rate and valuation in force on the date on which

the notice for demand of duty is issued or on the date on which duty is paid, whichever is earlier.

A petroleum oil refinery, in Calcutta II Commissionerate of Central Excise, cleared different petroleum products without payment of duty under bond during the period from 1 January 1996 to 14 June 1996. The department issued demand notices in 23 cases where no re-warehousing certificates were submitted to the officer-in-charge of the warehouse of removal within ninety days. Scrutiny of the records revealed that while issuing demand notices during the period 2 August 1996 and 26 November 1996 for the clearances of the products during the period from 1 January 1996 to 14 June 1996, the department applied the rate of duty and valuation as prevailing on the date of actual removal instead of the rate prevailing on the date of issue of demand notices as required under sub-rule (5) of rule 9A. This resulted in short raising of demand of Rs.9.48 crore.

On this being pointed out (November 1997), the department contended (February 1998) that sub-rule (5) of rule 9A was not applicable but rule 9A(1)(ii) was applicable since the expression 'cleared' used in the said rule covered even clearances made without payment of duty under bond. In support of their argument the department referred the Central Board of Excise and Customs letter dated 24 April 1980.

The department's contention is not tenable since sub-rule 9A (1)(ii) does not cover clearances of goods without payment of duty under bond. Further the Board's circular dated 24 April 1980 is no more applicable as sub-rule (5) of rule 9A was amended by notification dated 1 May 1985 by insertion of the word "on the date on which the notice for demand of duty is issued or on the date on which duty is paid, whichever is earlier". Further, the clearances from refinery to warehouse under bond would not be treated as final clearances but as temporary clearances which could not be considered as date of clearances for the purpose of paying duty. In fact, duty is paid on these products, as and when these are cleared from the warehouse and at rates and valuation prevalent on those dates as required under rule 9A(2). In cases where re-warehousing certificates were not produced, the dates of clearances/removal are not known and accordingly date of show cause notice becomes the only relevant date for purpose of rate of duty and valuation.

The Ministry of Finance contended (December 1999) that cases of removal of goods under bond for re-warehousing were covered by sub-rule (2) and not by sub-rule (5) of rule 9A.

The reply of the Ministry of Finance is not tenable as sub-rule (2) of rule 9A covers only those cases where duty is paid by the assessee subsequent to removal for re-warehousing. Since duty was not paid by the assessee subsequent to removal for re-warehousig but the department had issued show cause notice for recovery of duty, the case was covered by sub-rule (5) of rule 9A.

4.4 Other cases

In five other cases of demands short raised or not raised, the Ministry of Finance/department while accepting the objections involving duty of Rs.1.55 crore, reported recovery of Rs.56.21 lakh in two cases till December 1999.

CHAPTER 5 : GRANT OF MODVAT CREDIT

Under Modvat scheme, credit is allowed for duty paid on 'specified inputs' used in manufacture of finished goods and for duty paid on 'specified capital goods' used for producing or processing of goods. The credit can be utilised towards payment of duty on finished goods, subject to the fulfilment of certain conditions. Some cases of incorrect availment of Modvat credit, noticed in test audit are mentioned in the following paragraphs:-

5.1 Modvat credit allowed in contravention of provisions of the Rules and Board's instructions

(i) Modvat credit availed before installation or use of machinery

The Central Board of Excise and Customs clarified on 26 December 1994 that credit of duty paid on capital goods should be taken only when such capital goods are actually used in the production process and not merely when the goods are received. Sub-rule (2)(ii) had also been inserted under rule 57Q on 1 January 1996, to make it statutorily clear that no credit on capital goods should be taken before their installation or use.

Three assessees, in Aurangabad, Belgaum and Mumbai III Commissionerates of Central Excise, engaged in the manufacture of iron and steel products, availed Modvat credit of Rs.125.48 crore on account of duty paid on capital goods, purchased between April 1995 and November 1998, prior to the installation of these goods in their factories. It was further noticed that an amount of Rs.6.09 crore was also utilised for payment of duty on excisable goods cleared, before installation. Availment of credit and its utilisation was in contravention of the Board's instructions and provisions of the rule, ibid. No action was taken to reverse the credit availed and to recover the amount of credit incorrectly utilised.

This was pointed out between December 1998 and May 1999, reply of the Ministry of Finance had not been received (December 1999).

(ii) Modvat credit availed after six months

According to second proviso to rule 57G(5) inserted on 29 June 1995, credit of duty paid on inputs is not admissible after six months of the date of issue of specified duty paying documents.

Five assessees, in Aurangabad, Bhopal, and Pune II Commissionerates of Central Excise, engaged in the manufacture of various excisable goods were allowed to take credit of Rs.6.64 crore between August 1996 and December 1998 on inputs after a lapse of six months from the date of issue of specified duty paying documents. The credit so availed was also utilised by the manufacturers for the payment of duty on final products. The grant of Modvat credit beyond six months from the date of issue of duty paying documents, was in contravention of the provisions of rule 57G.

On being pointed out between February 1997 and June 1999, the Ministry of Finance, while admitting objection in three cases, intimated (December 1999) recovery of Rs.12.34 lakh and confirmation of Rs.79.32 lakh (including penalty) in the fourth case. In the fifth case, Ministry stated that the credit of Rs.6.12 crore was disallowed initially on two occasions (October 1998 and December 1998). However, on an appeal being preferred, the Commissioner (Appeals) allowed (April 1999) the credit to be utilised even after the time limit of six months holding that the time limit of six months is not sacrosanct.

5.2 Modvat credit availed on unspecified goods

(i) Items of project import

Items of project import falling under heading 98.01 of the Customs Tariff were neither covered under definition of 'inputs' in rule 57A nor under 'capital goods' in rule 57Q prior to 1 March 1997, as the heading 98.01 was not included in the Central Excise Tariff Act. Subsequently, through a notification dated 1 March 1997 issued under rule 57Q, manufacturers of specified final products were allowed Modvat credit of additional duty leviable under section 3 of the Customs Tariff Act, on project import falling under heading 98.01, only to the extent of 75 *per cent* of additional duty paid.

Twenty four assessees, in eleven Commissionerates of Central Excise, were allowed to take and utilise Modvat credit of countervailing duty paid on 'project import' items falling under heading 98.01 of the Customs Tariff, imported between April 1994 and February 1997. Since project import items falling under heading 98.01 were not covered under rule 57Q till 1 March 1997, the Modvat credit of Rs.24.06 crore so availed was not correct.

On being pointed out between May 1998 and July 1999, the Ministry of Finance contended (between September 1999 and February 2000) that if goods imported under project import under chapter 98 of Customs Tariff prior to 1 March 1997, were covered under the description of 'capital goods' as defined under rule 57Q, Modvat credit was to be allowed as clarified by the Central Board of Excise and Customs on 5 November 1997.

Reply of the Ministry is not tenable since chapter 98 was not included in the Central Excise Tariff Act and as such the item could not be regarded as a specified item under rule 57Q till 1 March 1997. This item has been included on 1 March 1997 and only 75 *per cent* of the countervailing duty paid on such imported project items was allowed as Modvat credit under the Rules. This also corroborates audit view that these goods falling under heading 98.01 of the Customs Tariff Act were outside the purview of capital goods under rule 57Q prior to 1 March 1997. Further, the Ministry in a similar case reported in para 10.2 (a) of Audit Report 1997-98 had admitted (October 1998) the objection.

(ii) Lubricating oils and greases

As per rule 57B(2)(v) as effective from 1 March 1997, manufacturer of final products shall not be allowed to take credit on the duty paid on lubricating oils, greases, cutting oils and coolants used as inputs in the manufacture of final products. From 1 September 1997, Modvat credit was allowed on these inputs by issue of another notification. Accordingly,

for the period 1 March 1997 to 31 August 1997, credit of duty paid on lubricating oils etc., was not to be allowed.

Two assessees, in Calcutta II Commissionerate of Central Excise, manufacturing 'Blended lubricating oils and greases' falling under chapter 27, received 'Lubricating base oil' on payment of duty and used as input in the manufacture of final products. The duty paid on such oils was taken as credit under rule 57A for some time and then under rule 57Q and utilised towards the payment of duty on 'Blended lubricating oils and greases'. The department initially disallowed the credit but later (31 March 1998) allowed the credit which resulted in incorrect allowance of credit of Rs.1 crore during March 1997 and August 1997.

On being pointed out (January 1999), the Ministry of Finance contended (December 1999) that the Modvat credit on these goods was admissible under rule 57Q from 1 March 1997.

Reply of the Ministry is not tenable as the concerned goods were used as "inputs" and not "capital goods" (covered by rule 57Q), on which 'credit' was not admissible during the relevant period.

(iii) High speed diesel oil

As per notification dated 1 March 1994 (as amended) issued under rule 57A, 'High speed diesel oil' (HSDO) falling under heading 27.10 was excluded from specified input for availing Modvat credit.

Three assessees, in Bangalore II, Chennai II and Hyderabad III Commissionerates of Central Excise, engaged in the manufacture of electric insulators, ceramic products, tyres, tubes, cement, etc., availed Modvat credit of Rs.88.96 lakh on high speed diesel oil between August 1997 and May 1998, which was incorrect.

On this being pointed out between January and July 1998, the Ministry of Finance admitted the objection in one case and stated (October 1999) that credit of Rs.31.96 lakh had been disallowed. Reply in the remaining two cases had not been received (December 1999).

5.3 Modvat credit availed in excess

As per sub-rule 3 and 5 inserted on 1 March 1997 under rule 57Q of the Central Excise Rules, 1944, credit of additional duty leviable under section 3 of the Customs Tariff Act, 1975, on goods falling under heading 98.01 of the Customs Tariff shall be allowed to the extent of 75 *per cent* of the additional duty paid.

Four assessees, in Delhi III, Mumbai VII, Surat I and Tiruchirapalli Commissionerates of Central Excise, engaged in the manufacture of various goods, imported capital goods like second hand paper board mill machines, tools, appliances, etc., under project import (heading 98.01 of the Customs Tariff) and availed Modvat credit for the entire amount of the countervailing duty paid on these items between March 1997 and January 1999 as against the admissible amount of 75 *per cent*. Credit of Rs.2.15 crore was therefore, availed in excess of the prescribed limit.

On being pointed out between October 1997 and January 1999, the Ministry of Finance admitted (August, September and December 1999) audit objection and intimated recovery of Rs.1.04 crore.

5.4 Modvat credit availed but duty not paid on finished products

According to rule 57CC of the Central Excise Rules, 1944, where a manufacturer is engaged in the manufacture of any final product which is chargeable to duty as well as any other final product which is exempt or is chargeable to 'nil' rate of duty and the manufacturer takes credit of specified duty on any input which is used in relation to the manufacture of both the categories of final products, whether contained in the final product or not, the manufacturer shall pay an amount equal to eight *per cent* of price of second category of final product charged by the manufacturer for the sale of such goods, at the time of clearance from the factory.

Ten assessees, in eight Commissionerates of Central Excise, manufacturing both dutiable and exempted products, availed of Modvat credit on inputs and utilised the same towards payment of duty on dutiable final products. The assessees did not maintain any separate account of inputs used for manufacture of exempted products. Accordingly, the assessees were liable to pay an amount equivalent to eight *per cent* of the value of such exempted products which was neither paid by the assessee nor was it demanded by the department. This resulted in non-payment of duty of Rs.2.14 crore during September 1996 to November 1998.

On being pointed out between January 1997 and May 1999, the Ministry of Finance, while admitting objection in four cases, intimated (December 1999 and January 2000) recovery of Rs.46.35 lakh and issue of demands for Rs.68.91 lakh out of which a demand of Rs.7.53 lakh had been confirmed. Reply in the remaining cases had not been received.

5.5 Modvat credit not reversed on raw materials written off

Rule 57A of the Central Excise Rules, 1944, allows credit of duty paid on inputs used in the manufacture of the final products. Central Board of Excise and Customs clarified on 14 February 1995, that where inputs are written off in the stock account of the assessee because of any reason, credit of duty paid on such inputs is not available for utilisation by the assessee and the Modvat credit so taken should be reversed.

Two assessees, in Hyderabad III and Pune I Commissionerates of Central Excise, engaged in the manufacture of various excisable goods, availed Modvat credit on inputs which were subsequently written off in the accounts in 1995-96 and March 1998 as being obsolete. The corresponding credit of Rs.74.63 lakh on such inputs was however, not reversed from the Modvat account.

On this being pointed out (June 1997 and December 1998), the Ministry of Finance, in one case contended (December 1999) that there was no provision in the Rules for recovery of duty as long as the Modvat availed inputs were physically available with the assessee.

The reply of the Ministry is not tenable as Modvat scheme allows credit of duty only on those inputs which are used in the manufacture of the final products. Inputs which had become obsolete and are unfit for use, cease to be inputs under rule 57A. Although reply of the Ministry, in the second case had not been received (December 1999), the department admitted the objection (February 1999).

5.6 Modvat credit availed on the basis of improper duty paying document

As per proviso below rule 57G(2) of the Central Excise Rules, 1944, no credit of duty paid shall be taken unless the inputs are received in the factory under documents like an invoice issued by a manufacturer of inputs under rule 52A, an AR-1, application for removal of excisable goods or triplicate copy of bill of entry etc., evidencing the payment of duty on such inputs.

An assessee, in Kanpur II Commissionerate of Central Excise, incorrectly availed Modvat credit of Rs.54.81 lakh in the month of March 1996 on the basis of improper duty paying documents (i.e input purchase invoices). Though the irregularity was noticed by the assessing officer while assessing the RT-12 return for the month of March 1996, action to recover duty by issue of show cause notice was not taken.

On the omission being pointed out in January 1998, the department intimated (October 1998) recovery of Rs.54.81 lakh in April 1998.

The Ministry of Finance however, contended (January 2000) that the Modvat credit availed in March 1996 was admissible as it was within the stipulated period of six months and accordingly there was no need of any show cause notice for recovery of the amount.

Reply of the Ministry is not relevant and factual as the documents on the basis of which credit was taken were held as improper by the department itself and duty had already been recovered.

5.7 Simultaneous availment of credit under Modvat scheme and depreciation under Income Tax Act

As per sub-rule (5) of rule 57R of the Central Excise Rules, 1944, credit of duty paid on capital goods would not be allowed if the manufacturer claimed depreciation under section 32 of the Income Tax Act, 1961, on that part of the value of the goods which represented duty of excise. Provisions of rule 57T(2) also require that a manufacturer availing credit of specified duty shall file a declaration with the department to the effect that he would not claim depreciation under section 32 of the Income Tax Act, 1961.

Two assessees, in Mumbai I and III Commissionerates of Central Excise, had availed Modvat credit of Rs.40.23 lakh on capital goods during 1995-96 and 1996-97 and claimed simultaneously depreciation on the same capital goods under section 32 of the Income Tax Act, 1961. Availment of Modvat credit was therefore, incorrect. Further, as facts were

suppressed by the assessees, they were liable to pay penalty of Rs.40.23 lakh under section 11AC and interest of Rs.14.08 lakh under rule 57U in addition to duty of Rs.40.23 lakh.

On being pointed out in April 1997 and June 1998, the department accepted the objection (November 1998 and February 1999) and reported recovery of Rs.22.17 lakh in one case.

5.8 Other cases

In 1132 other cases of incorrect availment of Modvat credit, the Ministry of Finance/department had accepted the objection involving duty of Rs.12.85 crore and reported recovery of Rs.7.84 crore in 1127 cases till December 1999.

CHAPTER 6 : EXEMPTIONS

As per section 5A(1) of the Central Excise Act, 1944, Government is empowered to exempt excisable goods from the whole or any part of the duty leviable thereon either absolutely or subject to such conditions as may be specified in the notification granting the exemption. Some cases of incorrect allowance of exemption noticed in test check are given in the following paragraphs :

6.1 Incorrect grant of exemption on final products

(i) Roofing sheets/asbestos products

According to a notification dated 28 February 1993 (as amended) and notification dated 23 July 1996, articles of stone, plaster, cement, etc., in which not less than 25 *per cent* by weight of fly ash or phospho gypsum or both has been used, are exempt from duty of excise.

(a) An assessee, in Bhopal Commissionerate of Central Excise, manufactured 'Roofing sheets' and cleared them after availing exemption under the above notification. Audit scrutiny of the records of the assessee revealed that the exemption was availed even though the percentage of fly ash and phospho gypsum used by the assessee was below 25 *per cent*. This was done by calculating the percentage of fly ash used in the manufacture of 'roofing sheets' without taking into account the quantity of water used in the manufacturing process. This was not detected by the department and the availment of exemption accepted, which resulted in short levy of duty of Rs.25.75 crore for the period April 1995 to November 1996 test checked in audit.

On being pointed out (February 1997), the department intimated (July and October 1998) that demand of Rs.124.25 crore (including penalty of Rs.62 crore and redemption fine of Rs.25 lakh) for the period March 1993 to December 1997 was confirmed in May 1998 and demand for Rs.1.55 crore for the period from January 1998 to March 1998 was pending adjudication. An amount of Rs.38.40 crore (approximately) was also recoverable by way of interest till November 1999.

The Ministry of Finance stated (November 1999) that the Central Board of Excise and Customs had clarified on 10 August 1999 that the percentage of weight of fly ash had to be calculated with reference to the weight of the finished product in dry condition.

Reply of the Ministry is not tenable as the clarification of the Board is not in consonance with the express wordings of the enabling notification which talks about the "use" of fly ash instead of fly ash "contained" in the finished goods.

(b) Another assessee, under Shillong Commissionerate of Central Excise, manufacturing products from 'Asbestos' (heading 68.04), while availing exemption under the above notification had determined the quantity of fly ash used on the basis of total materials used for production of finished goods without taking into consideration the water

contents present in the slurry. Since water was an essential raw material for making goods in question, quantity of water used was to be considered as one of the raw material unless it was specifically excluded by the notification. Thus, incorrect determination of fly ash contents resulted in incorrect allowance of exemption of Rs.15.94 crore for the period from April 1993 to March 1999.

This was pointed out in September 1999, reply of the Ministry of Finance/department had not been received (December 1999).

(ii) Cement

As per notification dated 25 July 1991 as amended, 'Portland cement other than white cement' falling under sub-heading 2502.29, was liable to duty at the concessional rate of Rs.165 per tonne till 28 February 1993 and Rs.185 per tonne thereafter if the licensed capacity of the factory using rotary kiln has been certified as not exceeding 600 tonne per day or 1,98,000 tonne per annum.

An assessee, in Chandigarh I Commissionerate of Central Excise, engaged in the manufacture of 'Cement' falling under sub-heading 2502.29 cleared it on payment of duty at concessional rate of Rs.165/185 per tonne in terms of the said notification, although the licensed capacity of the factory as certified by the Ministry of Industrial Development, Government of India was 2 lakh tonne per annum. Excise records also revealed that on many occasions during the year, actual production in the factory had exceeded 600 tonne per day which also substantiated that capacity of the factory was more than 1,98,000 tonne per annum. Incorrect grant of exemption resulted in short levy of duty of Rs.3.21 crore during the period from April 1992 to September 1993.

On being pointed out (February 1994), the Ministry of Finance admitted the objection and intimated (August 1999) that demand for Rs.4.25 crore for the period from July 1992 to November 1994 was raised out of which the demand of Rs.2.82 crore had been confirmed and penalty of Rs.25 lakh imposed.

6.2 Incorrect availment of exemption of additional duty of excise

(i) Processed fabrics

As per notification dated 11 August 1994, 'input fabrics' were exempt from whole of the duty of excise and additional duty of excise provided final products were not exempt from payment of whole of the 'duty of excise' or were leviable to 'nil' rate of duty.

Six assessees, in Surat I and one assessee in Ahmedabad I Commissionerate of Central excise, captively consumed 'input fabrics' for further manufacture of processed fabrics without payment of additional excise duty leviable under the Additional Duties of Excise (Goods of Special Importance) Act, 1957. Audit scrutiny revealed that the final products (viz. processed fabrics) in these cases were exempt from basic excise duty. The aforesaid notification granting exemption was, therefore, not applicable. Incorrect allowance of exemption resulted in non-levy of additional excise duty of Rs.7.85 crore between April 1995 and July 1996.

On being pointed out between January 1997 and February 1999, the department contended (between July 1997 and February 1999) that the exemption was admissible because additional excise duty was leviable on final products and in their view, the expression 'duty of excise' appearing in the notification would also include additional excise duty.

Reply of the department is not tenable because a corrective notification of 23 July 1996 mentions 'additional duty of excise' as a distinct item for determining eligibility for exemption on input fabrics. This would not have been necessary if the term 'duty of excise' covered additional excise duty. It is, therefore, clear that for the period 11 August 1984 to 22 July 1996, additional excise duty had to be levied.

Reply of the Ministry of Finance had not been received (December 1999).

(ii) Rubberised tyre cord fabrics

As per notification dated 16 March 1995 issued under section 5A of the Central Excise Act, 1944, specified excisable goods, manufactured in a factory and used as inputs in a factory in or in relation to the manufacture of final products, are exempt from payment of whole of the excise duty leviable thereon.

The Supreme Court in the case of M/s. Modi Rubber Limited {1986 (25) ELT 849} held that an exemption notification issued under rule 8(1) of the Central Excise Rules, 1944 (now section 5A of the Central Excise Act, 1944), does not mean an exemption from special excise duty and additional excise duty unless such exemption notification also refers to the statutory provisions relating to special excise duty and additional duty of excise.

An assessee, in Calcutta III Commissionerate of Central Excise, manufactured 'Rubberised dipped nylon tyre cord fabrics' from 'Dipped nylon tyre cord fabrics' procured from outside on payment of additional duty and consumed it captively in the manufacture of tyres and tubes etc., without payment of duty of excise and additional duty of excise, claiming exemption under the notification, ibid. As additional duty of excise leviable under Additional Duties of Excise (Goods of Special Importance) Act, 1957, was not covered under the said notification, exemption allowed was incorrect. This resulted in short levy of additional duty of excise of Rs.3.23 crore during April 1996 to February 1999 after abating duty paid on inputs viz., 'Dipped nylon tyre cord fabrics'.

On this being pointed out (April 1999), the department contended (June 1999) that exemption under section 5A of the Central Excise Act, 1944 would apply mutatis mutandis to additional duty of excise as per section 3(3) of the Additional duty of Excise (Goods of Special Importance) Act, 1957.

The reply of the department is not tenable as notification dated 16 March 1995 has no reference to the provisions of the Additional Duties of Excise (Goods of Special Importance) Act, 1957, and accordingly the additional duty was not exempt in terms of the Supreme Court decision referred to above.

While reply of the Ministry of Finance had not been received (December 1999) in this case, the Ministry had admitted the objection (April 1999) in a similar case pointed out through para 7.1(ii) of Audit Report 1996-97.

6.3 Incorrect grant of exemption on intermediate goods used captively

Two assessees, in Calcutta II and Chennai I Commissionerates of Central Excise, manufactured 'SL Wax IN' and 'Fuel oil' and consumed it within the refinery, in the manufacture of furnace oil, naphtha and sulphur, without payment of duty. Since the finished goods were cleared at nil rate of duty and no notification granting exemption on intermediate goods if used in non-dutiable/exempted finished goods was in vogue, duty on 'SL Wax IN' and 'Fuel oil', was leviable. This resulted in incorrect allowance of exemption and consequent short levy of duty of Rs.1.21 crore between April 1994 and March 1999.

On being pointed out (November 1997), the Ministry of Finance admitted (January 2000) the objection in one case and intimated issue of show cause cum demand notices for Rs.1.32 crore on the basis of actual percentage of 'SL Wax IN' used. Reply of the Ministry in the second case had not been received.

6.4 Incorrect grant of small scale exemption

As per notification dated 28 February 1993 and notification dated 1 March 1997, full or partial exemption was allowed to Small Scale Industrial units on clearances of excisable goods upto an aggregate value of Rs.75 lakh in a financial year. The notification provides that where a manufacturer clears specified goods from one or more factories, the exemption shall apply to the total value of the clearances and not separately for each factory.

As per notification {S.O.2 (E)} dated 1 January 1993 issued under the Industries (Development & Regulation) Act, 1957, where two or more industrial undertakings are set up as partnership firms, if one or more partners are common in such undertakings, each undertaking is deemed to be controlled by the other undertaking.

The Supreme Court in the case of Mcdowell and Company Limited Vs. Commercial Tax Officer {1985 (5) ECR 259} also, held that corporate identity can be disregarded if it is used to circumvent tax obligations.

An assessee (a partnership firm with two related partners - father and son), in Hyderabad-I Commissionerate of Central Excise, engaged in manufacture of meat extracts, plant extracts, etc., had two more duty paying units manufacturing the same products. One partner (father) was owner of another firm. Another partner (son) was owner of yet another firm. The partners of the three units had proprietary interests in each other's unit, and were covered under the definition of same management. Apart from being adjacent, the units had a common office, a common purchasing and sales network, pricing etc., and also financed and run by the same family members. Therefore, clearances of all the three units were required to be clubbed for grant of exemption. However, exemption was allowed to be availed separately to all three units which was incorrect and resulted in short levy of duty.

On being pointed out (October 1997), the department intimated (December 1998) that show cause notice demanding duty of Rs.81.91 lakh (including penalty under section 11AC) for the years from 1993-94 to 1997-98 had been issued. Department had also

proposed to levy penalty under rule 173Q and interest under section 11AB. Show cause notice was however, pending for adjudication.

The Ministry of Finance admitted the objection (October 1999).

6.5 Other cases

In eleven other cases of incorrect exemptions, the Ministry of Finance/department while accepting short levy of duty of Rs.95.45 lakh, reported recovery of Rs.16.33 lakh in three cases till December 1999.

CHAPTER 7 : NON-LEVY OF DUTY AND INTEREST

Under rule 53 of the Central Excise Rules, 1944, every manufacturer is required to maintain daily stock account in a prescribed form (RG-1) indicating inter-alia, the description of goods, quantity manufactured and quantity removed from factory for various purposes. Rules 9 and 49 read with rule 173G ibid, further prescribe that excisable goods shall not be removed from the place of manufacture or storage unless the excise duty leviable thereon has been paid. If any manufacturer, producer or licencee of a warehouse, removes excisable goods in contravention of these rules or does not account for them, then besides such goods becoming liable for confiscation, a penalty not exceeding three times the value of goods or five thousand rupees, whichever is greater, is also leviable under rule 173Q. Duty not paid or short paid by suppressing facts, or by fraud/mis-statement etc, attracts penalty equal to the duty determined under section 11AC of the Central Excise Act, 1944. Further, under section 11AA of the Act, delayed payment of duty determined under section 11A(2) also attracts interest at the rate of 20 *per cent* per annum. Some illustrative cases of non-levy of duty or interest are given in the following paragraphs :

7.1 Duty not levied on goods manufactured at site

Section 2(f) of the Central Excise Act, 1944, defines manufacture to include any process incidental or ancillary to the completion of manufactured product. As per Supreme Court decision in case of M/s. Narne Tulaman Manufacturers (P) Limited {1988 (38) ELT 566} assembly of various components/parts at site bringing out a different product amounts to 'manufacture'. In the case of M/s. Sirpur Paper Mills Limited {1998 (97) ELT-3 (SC)}, the Supreme Court further held that assembling and erection of a paper making machine at site, mainly from bought out components and by fabricating the rest of the parts at site, amounted to manufacture of a new marketable commodity under section 2(f) of Central Excise Act, 1944 and that just because a plant or machinery is fixed in the earth for better functioning, it does not automatically become an immovable property.

(a) An assessee in Visakhapatnam Commissionerate of Central Excise entered into an agreement with M/s. Asian Brown Boveri, Germany for the supply, erection and commissioning of a 235 M.W. mixed fuel base (Gas and Naptha) power plant comprising of three gas turbine units and one steam turbine unit. The major components like thermal blocks consisting of gas turbine/steam turbine, combustion blocks and compressors, generators for gas turbine units and heat recovery steam generators for steam turbine units, control valves, slide sections, steel tubes, slides and several other auxiliary items of equipment required for setting up of the above mentioned four units were imported under heading 98.01 of Customs Tariff in un-assembled condition on several bills of entry during 1996-97. The three gas turbine units were assembled at site during the year 1996-97. These units commenced commercial production on 6 August 1996, 4 December 1996 and 1 February 1997 respectively. The steam turbine unit was completed during 1997-98 and commenced production on 20 June 1997.

Though these items of equipment were imported as project imports classifying them under heading 98.01 of Customs Tariff, the individual components like generators (heading 85.01); thermal block consisting of gas turbines (sub-heading 8411.10); steam turbine (sub-heading 8406.10); compressors (sub-heading 8414.80) and furnace burners (heading 84.16)

procured for setting up of the gas turbine units and steam turbine units were classifiable under different chapters/headings of Central Excise Tariff. During the course of erection of the power plant units, electrical generating sets falling under heading 85.02 emerged as new marketable products which were distinct and different from the individual components referred to above. Therefore, excise duty was leviable on such electrical generating sets under heading 85.02. The department did not demand duty on the electrical generating sets which worked out to Rs.52.72 crore.

On being pointed out in January 1999, the Ministry of Finance reported (October 1999) issue of show cause notice for Rs.52.72 crore on 27 August 1999 which was pending adjudication. Further, progress in the case had not been received (December 1999).

(b) Eleven assessees, in six Commissionerates of Central Excise {Bangalore I (1), Calcutta III (1), Goa (1), Hyderabad III (1), Mumbai VI (3) and Pune I (4)} had undertaken projects on turnkey/contract basis. The assessees cleared some of the components from factory premises and other items were bought and taken directly to site. Chilling plant, lifts, refrigeration, water chilling units, pollution control system, furnaces, C.C. T.V system, building automation central system, etc. were manufactured by assembling components at site. Since these goods were new products distinct from the components and were excisable, duty was leviable on the entire value of the goods. However, the duty was paid only on the parts/components cleared from the factory. This resulted in short payment of duty of Rs.11.58 crore during May 1995 to March 1998.

On being pointed out (between July 1998 and April 1999), the Ministry of Finance confirmed the facts in one case (October 1999). In three cases, it was contended (September and December 1999) that the judgement of the Supreme Court cited by Audit was not applicable as bought out items were not subjected to any manufacturing process and were not attached with manufactured goods but were sent directly to the site of installation. It further cited decisions of the Tribunal in the case of M/s. Radient Electronics Limited {1996 (85) ELT 102}, M/s. Flakt India Limited {1998 (99) ELT 342}, etc to justify that the value of bought out items was excludible from the total value of final goods.

Reply of the Ministry is not tenable since Tribunal in the case K.S.E.D.C. {1994 (71) ELT 508} had decided that the battery was an essential component of an uninterrupted power supply (U.P.S.) system even though it was connected to the U.P.S. equipment by means of cables and held that the value of battery was includible in the assessable value of the system irrespective of the fact that it was bought out and invoiced to customers separately.

Reply in the remaining cases had not been received (December 1999).

In view of the divergent decisions of the judiciary, there is also a need to suitably amend the relevant Rules/Act to define the excisability and valuation of goods manufactured or erected at site.

7.2 Duty not levied on goods cleared

(i) Coal ash

The Central Board of Excise and Customs in their circular dated 7 April 1998 clarified that 'coal ash' is chargeable to duty under heading 26.21 and hence all pending

disputes/assessments on the issue should be settled by charging appropriate duty on 'coal ash'.

Five assessees in Hyderabad I, III and Visakhapatnam Commissionerates of Central Excise engaged in the manufacture of iron or steel products and three thermal power plants in Raipur Commissionerate engaged in generation of electricity using coal, obtained coal ash (cinder) as a by-product. The coal ash was cleared by them without payment of duty. None of them had maintained accounts/records of production and removal as stipulated in rules 53 and 173G. The thermal power plants had not even registered themselves with the Central Excise authorities as required under rule 174. Sales records revealed that coal ash valuing Rs.10.37 crore was cleared between July 1996 and March 1999 on which they were liable to pay duty of Rs.89.69 lakh and penalty of Rs.31.11 crore under rule 173Q for violation of rules.

On being pointed out between January and June 1999, the department stated (May 1999) that an amount of Rs.0.15 lakh had been recovered from an assessee and action was being taken to book offence cases against thermal power plants. In the case of another assessee, it contended (March 1999) that coal ash (cinder) was not produced by him and he had cleared only burnt coal which did not attract duty.

The reply of the department is not tenable as the assessee himself had filed declaration for the manufacture of cinder and cleared the same on commercial invoices in its commercial name 'char' (cinder). Reply had not been received in the remaining three cases (July 1999).

Reply of the Ministry of Finance had not been received (December 1999).

(ii) Electricity supply meters

A manufacturer, in Chandigarh I Commissionerate of Central Excise, manufactured and cleared '26,000 electricity supply meters' (heading 90.28) valuing Rs.75.41 lakh to the State Electricity Board during the period 1996-97 without payment of duty and without obtaining any central excise registration as required under rule 174. The department also failed to detect the manufacturing activity of the assessee. As the unit was not having central excise licence, it was not listed in the list of assessees by the department. However, cross-verification of purchase documents of Himachal Pradesh State Electricity Board, revealed the fact of the production of electricity supply meters by a local manufacturer, in audit. After collecting documents like invoices, etc., in support of the production and clearance of meters, the evasion of central excise duty by the assessee of Rs.2.34 crore (duty of Rs.0.08 crore and penalty of Rs.2.26 crore equal to three times of the value of excisable goods under rule 173Q) was pointed out (March 1997) to the department.

The Ministry of Finance admitted the objection and stated (November 1999) that the show cause notice had since been issued which is pending adjudication.

7.3 Interest not levied

As per section 11 AA of the Central Excise Act, 1944, effective from 26 May 1995, where a person chargeable with duty determined under sub-section (2) of section 11A, fails to pay such duty within three months from the date of such determination, he shall pay, in addition to duty, interest at the rate of 20 *per cent* per annum on such duty from the date

immediately after the expiry of the said period of three months till the date of payment. As per proviso to section 11 AA, where a person chargeable with duty, determined under sub-section (2) of section 11 A before the date on which the Finance Bill, 1995 received the assent of the President (i.e. 26 May 1995) fails to pay such duty within three months from such date (26 May 1995), then, such person shall be liable to pay interest under this section from the date immediately after three months from such date, till the date of payment of such duty. According to explanation 1 thereunder, where duty determined is reduced by the Commissioner (Appeals), Appellate Tribunal or the Court, the 'date of such determination' shall be the date on which an amount of duty is first determined to be payable

(a) The order confirming additional demand of Rs.24.89 crore against an assessee by the Commissioner of Central Excise, Mumbai-II was issued on 3 August 1995. The assessee paid the amount only by 3 October 1996. He paid interest for the period from 27 February 1996 to 2 October 1996 on the plea that the order was received by him on 29 November 1995. Since the order confirming demand was issued on 3 August 1995, interest was leviable from 3 November 1995 i.e. three months after the issue of confirmation order. Interest short paid for the period from 3 November 1995 to 26 February 1996 worked out to Rs.1.58 crore which was not demanded.

On this being pointed (July 1998), the department stated (January 1999) that the assessee had been asked to pay the amount. Further report on recovery had not been received.

Reply of the Ministry had not been received (December 1999).

(b) In another case the department directed an assessee to pay differential duty on account of misclassification in January 1991. Against this, the assessee filed an appeal with the Appellate Commissioner who decided the case on 29 October 1991 in favour of revenue and accordingly the assessee became liable to pay duty of Rs.2.67 crore for the period April 1990 to 31 January 1991. This amount was reduced by the Tribunal (30 December 1996) to Rs.2.20 crore which the assessee paid on 29 March 1997. In terms of provisions cited supra, interest amounting to Rs.70.03 lakh became payable by the assessee from 26 August 1995 (after expiry of three months from 26 May 1995) till the date of payment on 29 March 1997, which was not demanded by the department.

On being pointed out (October and November 1998), the department stated (December 1998 and January 1999) that provisions of section 11 AA would not apply retrospectively but only prospectively.

The reply of the department is not tenable as section 11 AA specifically covers cases where duty may have been determined prior to the crucial date of 26 May 1995 but was not paid within three months therefrom i.e 25 August 1995.

Reply of the Ministry of Finance had not been received (December 1999).

7.4 Other cases

In 262 other cases of non-levy of duty and interest, the Ministry of Finance/department while accepting the objections involving Rs.3.38 crore, reported recovery of Rs.1.75 crore in 258 cases till December 1999.

CHAPTER 8 : VALUATION OF EXCISABLE GOODS

Ad valorem rates of duty are charged on a wide range of excisable commodities. The valuation of such goods is governed by section 4 of the Central Excise Act, 1944, read with the Central Excise (Valuation) Rules, 1975. Some illustrative cases of short levy due to incorrect valuation are mentioned in the following paragraphs :-

8.1 Non-adoption of price fixed by Government

As per section 4(1)(a)(ii) of the Act, where excisable goods are sold in wholesale trade at a price fixed under any Law, then the price so fixed shall be deemed to be the assessable value of these goods.

The Supreme Court in the case of Pyrites Phosphates and Chemicals Limited upheld the Tribunal's decision that where a price is fixed under a Control Order, the assessable value shall be determined on the basis of the price fixed under such order {1996 (88) ELT - A 131}.

(a) An assessee, in Vadodara Commissionerate of Central Excise, manufactured liquified petroleum gas (LPG) and cleared it in bulk packing. Duty was, however, paid on the price of Rs.5309.18 and Rs.6901.95 per tonne applicable for 'LPG in domestic packing' instead of on the price of Rs.11601.78 and Rs.11900.00 per tonne fixed for 'LPG in bulk packing' by the Ministry of Petroleum and Natural Gas. The clearance of LPG in bulk packing at a lower price, applicable for domestic packing, resulted in recovery of duty at a lower rate.

On being pointed out in June 1997, the department intimated (December 1998) confirmation of demand of Rs.18.79 crore including penalty for the period from March 1994 to March 1998.

The Ministry of Finance confirmed the facts (October 1999).

(b) The Ministry of Chemicals and Fertilisers, issued orders from time to time under the Drugs (Price Control) Orders 1987/1995, fixing maximum prices in respect of certain scheduled bulk drugs/formulations.

Seven manufacturers, in three Commissionerates of Central Excise, cleared certain bulk drugs/formulations during January 1992 to July 1998, at prices lower than those fixed by the Ministry of Chemicals and Fertilisers and the department admitted these lower values for levy of duty even though the maximum prices should have been adopted as assessable values, irrespective of the prices charged from customers. This resulted in short levy of duty of Rs.2.58 crore.

On being pointed out between January and September 1998, the Ministry of Finance contended that the Drugs (Price Control) Order does not prohibit an assessee from selling

drugs at prices lower than maximum indicated. It would therefore, be improper to penalise an assessee and charge duty on the basis of the maximum price, when the law permits him to sell goods at a lower rate. The Ministry further contended that a distinction had to be made between a law fixing price of any goods and a law indicating only the maximum price of goods beyond which the goods cannot be sold.

Reply of the Ministry is not tenable in view of specific provision of section 4(1)(a)(ii) of the Act.

8.2 Excisable goods not fully valued

(i) Pre-delivery inspection charges

The Supreme Court in the case of M/s. Bombay Tyre International held in October 1983 that after sale service, being part of selling expenses, should be included in the assessable value as these expenses promote marketability of the product and thus enter into its value. This decision was reiterated by the Supreme Court in M.R.F. case {1995 (77) ELT 433}.

An assessee, in Jamshedpur Commissionerate of Central Excise, engaged in the manufacture of motor vehicles incurred pre-delivery inspection charges amounting to Rs.66.71 crore during the years 1991 to 1997 and the charges so incurred were not included in the assessable value, resulting in short levy of duty of Rs.11.57 crore.

On being pointed out in October and November 1998, the Ministry of Finance while accepting the objection as technically correct stated (October 1999) that comprehensive investigation on the issue had been undertaken before the issue was raised by Audit, but duty liability was yet to be quantified.

Reply of the Ministry is not specific and convincing as the duty liability could not be quantified even after a lapse of one year of the issue having been pointed out in audit.

(ii) Cost of packing

According to section 4(4)(d)(1) of Central Excise Act, 1944, when goods are delivered at the time of removal in a packed condition, value of such goods shall include the cost of such packing except 'Cost of packing' which is durable in nature and is returnable by the buyer to the assessee. Accordingly, 'Cost of packing' in which the goods are normally delivered at the factory gate is to be included in the wholesale price.

An assessee, in Tiruchirapalli Commissionerate of Central Excise, cleared 'Empty glass bottles' to the user industries using 'Packing materials' supplied by them, free of cost. The packings were not durable in nature, which could be returned by the purchasers to assessee. Yet the assessee did not include the cost of packing materials in the assessable value of the bottles. This resulted in undervaluation of goods and consequent short payment of duty of Rs.1.20 crore during April 1996 to June 1998.

On being pointed out in October 1998, the Ministry of Finance contended (December 1999) that the Supreme Court in the case of M/s. Hindustan Polymers {1989 (43) ELT 165

SC} had held that where packing material was supplied free of cost by the buyer, its cost was not to be added in the assessable value of the finished products.

The reply of the Ministry is not tenable as the case cited is not relevant to the case in question, as it related to durable and returnable packing material.

(iii) Value of material

An assessee, in Bangalore II Commissionerate of Central Excise, engaged in the manufacture of 'Electric storage batteries' was obtaining non-duty paid semi-finished batteries under rule 56B procedure from Tractor and Farm Equipments Limited (TAFE), Chennai for inspection, testing, packing and onward clearance to customers on payment of duty. The value adopted for payment of duty was even lesser than the value shown in the proforma challans received from TAFE, besides the value addition by way of inspection, testing and packing. Adoption of lower value, resulted in short levy of duty of Rs.61.70 lakh during April 1996 to June 1998.

On being pointed out in September 1997 and August 1998, the department replied (July 1998) that the case was under investigation for booking an offence case. Further progress had not been received.

Reply of the Ministry of Finance had not been received (December 1999).

8.3 Incorrect valuation of goods cleared to sister units

In terms of section 4(1)(b) of Central Excise Act, 1944, read with Central Excise (Valuation) Rules, 1975, the assessable value of excisable goods consumed within the factory of production or in any other factory of the same manufacturer has to be determined on the basis of value of comparable goods or cost of production including a reasonable profit margin, if value of comparable goods is not ascertainable. In such cases, assessee shall file with the proper officer, a price declaration under rule 173C.

(a) An assessee, in Bangalore II Commissionerate of Central Excise, manufactured parts of 'Bulldozers and motor vehicles' and cleared them to its sister concerns located in two different places. Duty was paid on these parts on the assessable value arrived at on the basis of cost which comprised material cost and local overheads only. Cost on account of labour overheads, administrative overheads, selling overheads, profit margin, etc., was not included, despite the fact that the relevant data was available. Declaration as required under rule 173C was also not submitted with the proper officer. This resulted in short payment of duty of Rs.7.55 crore during June 1994 to March 1999.

On being pointed out in December 1997 and May 1999, the Ministry of Finance admitted the objection and stated (September 1999) that show cause notice issued for Rs.7.55 crore was pending adjudication.

(b) Another assessee, in Bangalore II Commissionerate of Central Excise, engaged in the manufacture of 'Unpopulated printed circuit boards' had cleared the goods on payment of duty to its sister concerns. The value for purpose of duty was determined on cost data basis in which design, drawing and screen printing charges were not included. Non-

inclusion of these charges resulted in short levy of duty of Rs.2.66 crore during April 1994 to January 1999.

On this being pointed out (August 1996 and June 1999), the department contended (July 1997) that the design, drawing and screen printing charges had been included in the overheads of final products manufactured and cleared by sister concerns.

The reply of the department is not tenable as the inclusion of value of design, drawing and screen printing charges at the time of valuation of the final products manufactured by sister concern has no relevance. The valuation and payment of duty ought to be done on the basis of the actual cost of the goods manufactured and cleared by the assessee.

Reply of the Ministry of Finance had not been received (December 1999).

(c) An assessee, in Belgaum Commissionerate of Central Excise, cleared rolling ingots to its sister concern. The duty was paid on the assessable value which was equivalent to the assessable value of similar goods manufactured by another assessee in Madhya Pradesh. The assessable value so adopted was lower than the cost of basic raw material out of which these goods were manufactured. Based on the cost of production including profit, there was undervaluation of the goods to the extent of Rs.13.43 crore in respect of 21,135 tonne of final product cleared during February 1997 to June 1998, with consequential short levy of duty of Rs.2.02 crore.

On being pointed out in August 1998, the Ministry of Finance admitted the objection (January 2000)

(d) Another two assessees, in Bhopal and Calcutta I Commissionerates of Central Excise, manufacturing 'Ariel microsystem detergent powder' and 'Under frame for wagon', cleared the entire goods to their another unit on payment of duty. Test check of the records revealed that the element of profit was not included to arrive at the assessable value. Thus, there was undervaluation of goods and consequential short levy of duty of Rs.2.04 crore between April 1993 and January 1999.

On being pointed out in August 1997 and February 1999, the department, in one case, accepted the objection and stated (July 1998 and March 1999) that a show cause notice demanding duty of Rs.1.86 crore covering the years 1993-94 to 1997-98 had been issued and another show cause notice for the remaining amount of Rs.0.18 crore was under issue. Further progress in the case had not been received.

Reply of the Ministry of Finance had not been received (December 1999).

(e) Yet another assessee, in Nagpur Commissionerate of Central Excise, engaged in the manufacture of 'Paper and paper board', manufactured 'Bleached and unbleached pulp' and cleared the same to its sister concern. Duty was paid on the assessable value computed on cost basis in which indirect cost i.e. wages, overhead expenses, etc. were not included. This resulted in undervaluation of the finished products and consequential short levy of duty.

On being pointed out (November 1998), the department admitted the objection and stated (May 1999) that show cause cum demand notice for Rs.1.90 crore for the period

September 1996 to March 1999 was issued on 24 May 1999. Further progress in the case had not been received.

The Ministry of Finance had confirmed the facts (November 1999)

8.4 Valuation of goods belonging to brand name owner

Supreme Court, in the case of Union of India Vs. Bombay Tyre International {1983 (14) ELT (1896)}, held that value of an article for purpose of levy of excise duty shall include all costs and expenses which have given the article its marketability.

Four assessees, engaged in the manufacture of 'Biscuits' in Hyderabad I, Hyderabad III and Calcutta IV Commissionerates of Central Excise, and one assessee engaged in the manufacture of 'Vicks inhaler' in Hyderabad III Commissionerate of Central Excise, entered into an agreement with other companies which were exclusive registered owners of their brand names. The terms of the agreements indicated that these assessees would manufacture 'Biscuits/Vicks inhaler' in the brand names of the companies but assessees would not have control, ownership or any right, etc., in respect of raw materials, other inputs, packing materials, quality specifications, the size, shape or weights of the final product etc., in so far as it relates to their brand. Moreover, all the material was supplied to the assessees by the brand name owners, quality was tested before acceptance and assessees were paid only the job charges at an agreed rate.

The goods were assessed to duty based on the value of goods arrived at with reference to cost of raw materials plus job charges which was much lower than the wholesale price charged by the brand name owners. Under the provisions of section 4 read with section 2(f), the goods should have been assessed at the price at which the brand name owners sold the goods in the wholesale trade. This was not done which resulted in a short levy of Rs.3.50 crore between April 1996 and December 1998.

On this being pointed out (July and December 1998), the department replied (between July 1998 and February 1999) that; (i) the transactions were not covered under section 4(1)(a) as the depots from where the goods were sold did not belong to the assessees; (ii) the judgement of Supreme Court in the case of M/s. Ujagar Prints {1988 (38) ELT 535 (SC)} was followed; and (iii) many companies including some Multinational Companies throughout India had been adopting this modus operandi for which changes in section 4 were needed.

Similar cases of avoidance of duty by the brand name owners had been pointed out in para 3.5 (i) and 8.5 in Audit Report for the year ended March 1997 and para 5.6 in Audit Report for the year ended March 1998. To reduce the tendency of major manufacturers to avoid duty through these modus operandi, audit recommended levy of duty on all such consumer goods on the basis of 'MRP'.

The Government have since issued notification on 28 February 1999 levying duty on biscuits on the basis of 'maximum retail price'.

Reply of the Ministry of Finance had not been received (December 1999).

8.5 Incorrect adoption of assessable value of goods sold through branches/sale depots

As per section 4 of the Central Excise Act, 1944, where goods are assessable to duty ad valorem, the normal price at which such goods are sold ordinarily by the assessee to a buyer in the course of wholesale trade, for delivery at the time and place of removal, would be the assessable value, provided the price is the sole consideration for sale.

Two assessees, in Chandigarh I and Mumbai III Commissionerate of Central Excise, engaged in the manufacture of 'Cotton yarn, Acrylic yarn, Chemical products of chapter 38, etc'., cleared goods for sale through branches/sale depots. It was seen in audit that the value of goods cleared from branches/sale depots was higher than the value adopted for payment of duty since 1994-95. One assessee paid the differential duty for the years 1994-95 and 1995-96 in February 1997 but differential duty for 1996-97 was not paid. The other assessee did not pay differential duty from March 1994 to October 1996. Payment of duty with delay and non-payment of differential duty of Rs.2.86 crore was pointed out in October 1996 and December 1997.

The department intimated (March 1998 and April 1999) that an amount of Rs.24.43 lakh had been recovered and a show cause notice demanding interest of Rs.17.57 lakh for delayed payment had been issued in one case and in the other case show cause notice for Rs.2.62 crore had been issued in May 1997 which was pending adjudication. Delay in adjudication even after 25 months of issuing show cause notice, had further resulted in financial accommodation to the assessee and loss of revenue by way of interest amounting to Rs.1.09 crore till June 1999, as interest is leviable only after three months of confirmation of demand.

The Ministry of Finance had admitted (January 2000) the objection in one case. Reply in the second case had not been received.

8.6 Additional consideration not included in the assessable value

According to section 4 of the Act, the normal price at which goods are sold ordinarily by the assessee to a buyer in the course of wholesale trade, for delivery at the time and place of removal would be the assessable value, provided the price is the sole consideration for sale. In cases, where price is not the sole consideration, the assessable value of the goods, as per the provisions of rule 5 of Central Excise (Valuation) Rules, 1975, shall be based on the aggregate of the price and money value of additional consideration, flowing directly or indirectly from the buyer to the assessee.

(a) Eleven assessees, in Aurangabad (5), Delhi III (1), Meerut II (3) and Visakhapatnam (2) Commissionerates of Central Excise, received additional consideration of Rs.15.04 crore between November 1995 and December 1998 through the Ministry of Food, Government of India on account of refixation of ex-factory prices of levy sugar for the sugar seasons 1974-75 to 1979-80 pursuant to the Supreme Court's judgement dated 22 September 1993. The duty recoverable on the additional consideration received which worked out to Rs.1.92 crore, was neither paid by the assessees nor was it demanded by the

department. Further, interest amounting to Rs.93.08 lakh would have accrued had the department raised the demand for duty, in time.

On being pointed out between August 1997 and April 1999, the Ministry of Finance admitted the objection and intimated (December 1999) that the recovery of duty was being pursued with the Ministry of Food and Consumer Affairs.

(b) Two assessees, in Delhi III Commissionerate of Central Excise, engaged in the manufacture of 'Motor vehicle parts, TV parts, refrigerator parts, etc'., raised demand on the customers for escalation of prices in respect of goods cleared during 1997-98. Bills for Rs.5.65 crore were issued during 1997-98 but duty due on the amount was not paid. This resulted in short levy of duty of Rs.84.90 lakh.

On the omission being pointed out in November and December 1998, the Ministry of Finance while intimating payment of duty of Rs.84.90 lakh by the assessees (October and November 1999) contended (November 1999) that there was no loss of revenue as the differential duty paid by them would be available as Modvat credit to the buyers.

The reply of the Ministry is not tenable as availability of Modvat credit to the buyer (another assessee) is not relevant while determining the duty liability of the assessee (manufacturer). Further, the availability of Modvat credit to buyers is subject to fulfilment and observance of specific applicable conditions and rules.

8.7 Inadmissible deductions allowed from assessable value

The Supreme Court in the case of M/s. Coromandal Fertilisers Limited {1984 (17) ELT 607 (SC)} held that commission paid to selling agents is not a discount within the meaning of explanation to section 4 and does not qualify for deduction from the assessable value.

Two assessees, in Coimbatore and Mumbai VI Commissionerates of Central Excise, were selling their products through authorised dealers/indentors. Commission allowed to them was incorrectly deducted from the assessable value for payment of duty. This resulted in short levy of duty of Rs.1.21 crore for the period between February 1993 and May 1998.

On being pointed out (February 1997 and July 1999), the department in one case, accepted (November 1998) the objection but in the second case, it contended (April 1997) that such deduction represents an eligible trade discount.

The Ministry of Finance, however, admitted (January 2000) the objection in the second case also.

8.8 Other cases

In 139 other cases of incorrect valuation of excisable goods, the Ministry of Finance/department while accepting short levy of duty of Rs.9.54 crore reported recovery of Rs.5.06 crore in 114 cases (till 15 January 2000).

CHAPTER 9 : CLASSIFICATION OF EXCISABLE GOODS

The rates of duty leviable on excisable goods are prescribed under various headings in the Central Excise Tariff. Some illustrative cases of incorrect classification of goods resulting in short levy of duty are given in the following paragraphs :

9.1 Bodies and parts of motor vehicles

(i) Motor vehicle bodies

Heading 87.07 of the Central Excise Tariff specifically covers 'Bodies' for motor vehicles. The Punjab and Haryana High Court in the case of Darshan Singh Pavitar Singh {1988 (34) ELT 631} held that 'Motor vehicle bodies', built by independent body builders on the duty paid chassis supplied by customers, are to be classified under heading 87.07, even though the goods emerging from body builder's premises is a complete motor vehicle falling under heading 87.01 to 87.05. The High Court of Madhya Pradesh in the case of Rajasthan Coach Builders concurred with this decision {1992 (58) ELT 471}. In the case of Kamal Auto Industries {1996 (82) ELT 558}, Tribunal also decided that 'Motor vehicle bodies' built by independent body builders is rightly classifiable under heading 87.07. The Supreme Court has also upheld these decisioons {1997 (94) ELT 442}.

Nine assessees, in five Commissionerates of Central Excise, engaged in the manufacture of bodies on duty paid chassis of motor vehicles for the transport of passengers and goods (heading 87.02 to 87.05) classified 'Motor vehicle bodies' built on chassis, under heading 87.02 to 87.05 as 'Motor vehicles'' instead of under heading 87.07 as 'Bodies'. The incorrect classification resulted in short levy of duty of Rs.16.44 crore during April 1994 to June 1998.

On being pointed out (between September 1997 and July 1998), the department accepted the objection in six cases and intimated (between July and November 1998) that demand for Rs.71.76 lakh for the period from March 1997 to July 1998 had been issued, of which demand for Rs.21.71 lakh had been confirmed. In the remaining three cases, it contended (July and October 1998) that the resultant product after fabrication of body, was a motor vehicle as a whole and not a body, and hence it was not classifiable under heading 87.07 as 'Bodies'.

The Ministry of Finance contended (November and December 1999) that with the insertion of note 3 in chapter 87 with effect from 25 July 1991, building of body on the chassis would amount to manufacture of a motor vehicle. Therefore the various judgements cited by Audit, which pertains to the situation prior to July 1991, are not relevant to present cases covering post July 1991 period.

Reply of the Ministry is not tenable since Tribunal in the case of Kamal Auto Industries, had specifically examined the implication of said chapter note 3 and held that this chapter note does not talk about goods falling under heading 87.07 and hence is not applicable to

bodies classifiable under heading 87.07. In addition, the stand of the Ministry is also not in the interest of revenue, as considerable value addition by way of manufacture of bodies on duty paid chassis, escapes duty payment.

(ii) Turbo charger

Note 1 (k) of section XVI of schedule to Central Excise Tariff Act, 1985 which includes chapter 84, specifically excludes the articles of section XVII which includes chapter 87. Further, as per rule 3 (a) of Rules for the interpretation of Tariff, the heading which provides the most specific description shall be preferred to a heading providing a more general description for classification purposes.

An assessee, in Indore Commissionerate of Central Excise, produced 'Turbo charger' for use with the engine of automobiles of 125 HP and 160 HP of trucks and buses and cleared it after classifying under heading 84.14 as a compressor. As the goods were specially designed for use solely and principally with automobile engines of 125 HP and 160 HP (evident from the literature given therewith by the assessee), the product was correctly classifiable under heading 87.08 as 'Parts and accessories' of motor vehicles. The incorrect classification resulted in short levy of duty of Rs.40.28 lakh during the period 27 September 1996 to February 1999.

On being pointed out (between February 1997 and May 1999), the department contended (between July 1997 and December 1998) that a 'turbo charger' was a complete machine which increases air supply by means of compressor driven by a turbine mounted on the same shaft and that the Ministry of Commerce had also allotted EXIM code No.84148003, classifying it under heading 84.14.

The reply is not tenable as the heading 84.14 covers, inter-alia, compressor and not devices operated with compressor. Further, the goods in question were complete instruments specially designed for sole use in automobile engines of 125 HP and 160 HP and specifically excluded from chapter 84 through note 1 (k) of section XVI. The Ministry of Finance in the exemption notification No.175/85-Cus dated 17 March 1985 (as amended) has also included turbo charger as a component of motor vehicle.

Reply of the Ministry of Finance had not been received (December 1999).

9.2 Machinery, appliances, equipments, parts etc.

(i) Hydraulic cylinders

Heading 84.29 covers self-propelled bulldozers, graders, excavators, etc. Parts suitable for use solely or principally with the machinery of heading 84.25 to 84.30 are classifiable under heading 84.31 and are chargeable to duty at 15 *per cent* ad valorem.

As per note 2(b) of section XVI, other parts, if suitable for use solely or principally with a particular kind of machine or with a number of machines of the same heading, are to be classified with the machine of that kind or in heading 84.09, 84.31, etc., as appropriate.

The Tribunal in the case of M/s. Larsen and Toubro Limited {1997 (93) ELT 234} held that the 'Hydraulic cylinder' being a part meant for use with excavator, is classifiable under the same heading as that of excavator. It, therefore, follows that 'Hydraulic cylinders' for use in the bulldozers (heading 84.29) are rightly classifiable under heading 84.31.

An assessee, in Calcutta I Commissionerate of Central Excise, manufacturing 'Hydraulic cylinders' was allowed to clear them under heading 84.12 as 'Other engines and motors'. The literature published by the assessee revealed that such hydraulic cylinders were used in bulldozers only. Hence, the hydraulic cylinders, ought to have been classified under heading 84.31 as 'Parts of bulldozer'. Incorrect classification, therefore, resulted in short levy of duty of Rs.3.61 crore during April 1994 to February 1997.

On being pointed out in October 1998, the department contended (November 1998) that hydraulic cylinder was correctly classifiable under heading 84.12 as it was (i) a complete machine, (ii) assembled with cylinder, piston, etc., and (iii) excluded from heading 84.25 as per HSN notes under heading 84.25.

The department's contention is not acceptable since the subject product though assembled with cylinder, etc., was used only as parts in the bulldozer as per assessee's literature. Further, the notes under heading 84.25 of HSN excluded hydraulic cylinders of heading 84.12 but not the hydraulic cylinders used as parts in the bulldozers of heading 84.29. Therefore, the subject goods were not 'Other engine and motor' classifiable under heading 84.12.

Reply of the Ministry of Finance had not been received (December 1999).

(ii) Machine parts

Central Board of Excise and Customs clarified on 16 October 1996 that where it is not possible to load the entire machinery in one vehicle and where the consignment is loaded in more than one vehicle which travel separately or at intervals, separate invoices shall be made in respect of each conveyance on which part consignment is loaded and the manufacturer will pay the entire duty on the first invoice on the basis of the entire value of the machinery. Where the part consignment do not constitute 'Complete machinery' falling under a single heading or sub-heading, each such consignment will be classified on merits, say as 'Parts' and also a separate invoice showing the separate value arrived at under section 4 of Central Excise Act, 1944 and duty must accompany on each such consignment.

An assessee, in Jaipur I Commissionerate of Central Excise, engaged in manufacture of 'Cement plant machinery' and 'Chemical plants', had been clearing his product in part consignments on payment of duty at 10 *per cent* ad valorem applicable to complete machinery. Audit scrutiny revealed that the assessee had not manufactured the machines in his factory but had cleared only parts of machinery. The machines were manufactured at site out of bought out items including imported items which were directly brought at the site. Besides, the assessee was not paying entire duty leviable on total value of machinery as stipulated in the Board's circular, ibid. The product was, therefore, classifiable as parts of machinery and duty at 15 *per cent* ad valorem was leviable. This resulted in short levy of duty of Rs.1.74 crore during April 1995 to February 1997.

On being pointed out in May 1997, the department contended (July 1998) that the procedure set out in the circular was not opted for by the assessee and that the non-payment of duty at the first point would not change the nature and classification of goods.

The reply of the department is not tenable as it is not in consonance with the procedure prescribed by the Board. Moreover, the goods cleared were only parts of the machinery, the machines having been manufactured at site, using other bought out items.

Reply of the Ministry of Finance had not been received (December 1999).

(iii) Internal combustion engine

'Spark ignition reciprocating or rotary internal combustion piston engines' are covered under heading 84.07. As per note 2(a) of section XVI, of Central Excise Tariff Act, 1985, parts which are goods included in any of the heading of chapter 84 or chapter 85 (other than headings 84.09, 84.31, 84.48, 84.66, 84.73, 84.85, 85.03, 85.22, 85.29, 85.38 and 85.48) are in all cases to be classified in their respective headings.

An assessee, in Surat I Commissionerate of Central Excise, engaged in manufacture of internal combustion engines, had been classifying these under heading 84.07 as internal combustion engines and clearing them on payment of appropriate duty till March 1997. Eventhough, there was no change in the nature of the product, the assessee incorrectly changed the classification of said goods under heading 84.24 treating them as 'Mechanical appliances of a kind used in agriculture or horticulture' and cleared them at 'nil' rate of duty. This resulted in short levy of duty of Rs.60.74 lakh during 1997-98.

On being pointed out in March 1998, the department contended (March 1999) that the Board had clarified (March 1998) that when goods are prima-facie classifiable under two or more headings, the heading which provides the most specific description should be preferred to heading providing more general description. Since the item manufactured was an appliance for projecting, disposing or spraying liquids or powders and had no other use, it would fall under most specific sub-heading 8424.91.

Reply of the department is not tenable as interpretative rules are not to be resorted to when appropriate specific heading for goods is available in Tariff itself {International Auto Suppliers - 1994 (70) ELT 645 (T)}. Since specific heading 84.07 covers internal combustion engines, classification under heading 84.24 was not correct.

Reply of the Ministry of Finance had not been received (December 1999).

(iv) Hydraulic pit props

Sub-heading 7308.40 of the Central Excise Tariff, covers equipment for scaffolding, shuttering, propping or pit propping. Adjustable or telescopic pit props are excluded from heading 84.31 and are classifiable under heading 73.08 as per explanatory notes to HSN.

An assessee, in Calcutta I Commissionerate of Central Excise, manufactured 'Hydraulic pit props' and classified them under heading 84.25 as 'Jacks' Since subject product was used in coal mines as equipment to give support to the mine roof from collapsing with its hydraulic pressure and was specifically covered under sub-heading 7308.40, its

classification under heading 84.25 was incorrect. This resulted in short levy of duty of Rs.56.99 lakh during the period March 1994 to April 1998.

On this being pointed out in October 1998, the department contended (November 1998) that 'Pit props' and 'Hydraulic pit props' were completely different products. While 'Pit props' as defined in the HSN are a structure of iron and used as a support to the roof of buildings, etc., 'Hydraulic pit props' are used to support the roof of mines through hydraulic generated power.

The department's contention is not acceptable since the HSN does not differentiate between the two kind of pit props. Pit props if adjustable even by hydraulic generated power but used as an equipment to give support to roof of any kind, would be classifiable under heading 73.08.

Reply of the Ministry of Finance had not been received (December 1999).

9.3 Waste and scrap of precious metal

Wastes and scraps containing precious metals are classifiable under heading 71.01 with effect from 1 March 1997.

An assessee, in Jaipur I Commissionerate of Central Excise, engaged in manufacture of copper anodes, copper cathodes, copper wire bars, etc., had been transferring 'Copper anode slime' on payment of duty at 8 *per cent* ad valorem under heading 26.20 to its sister concern for extraction of precious metals (gold and silver). Since copper anode slime was waste and scrap containing precious metals, it was appropriately classifiable under heading 71.01, attracting duty at the rate of 18 *per cent* ad valorem from 1 March 1997.

On being pointed out (August 1997 and October 1998), the Ministry of Finance admitted the objection and stated (August 1999) that action for recovery of duty of Rs.2.35 crore paid short upto May 1998 was being initiated. Further progress in the case had not been intimated (December 1999).

9.4 Vitamins

Pro-vitamins and vitamins, natural or reproduced by synthesis (including natural concentrates), derivatives thereof used primarily as vitamins and inter-mixture of the foregoing, whether or not in any solvent, are classifiable under sub-heading 2936.00.

Three assessees, in Mumbai II Commissionerate of Central Excise, manufactured vitamins and cleared them under sub-heading 3003.10. Since vitamins were correctly classifiable under sub-heading 2936.00, incorrect classification resulted in short levy of duty of Rs.75.27 lakh during the period from April 1993 to September 1996.

On being pointed out November 1996, the Ministry of Finance admitted the objection and intimated (January 2000) issue of demands for Rs.1.28 crore, out of which demand of

Rs.97.58 lakh has since been confirmed and duty of Rs.1.70 lakh realised and show cause notices issued demanding balance amount were yet to be adjudicated.

9.5 Other cases

In 40 other cases of incorrect classification, the Ministry of Finance/department had accepted the objection involving duty of Rs.3.15 crore and reported recovery of Rs.22.94 lakh in 26 cases till December 1999.

CHAPTER 10 : REBATE AND REFUND OF DUTY

10.1 Incorrect availment of rebate at the time of clearance

According to a notification dated 22 September 1994, issued under rule 12 of the Central Excise Rules, 1944, rebate of duty paid, on 'Mineral oil products' exported as stores for consumption on board an air-craft on foreign run, is admissible subject to certain conditions prescribed in the notification and observance of the procedure laid down under rule 12. The benefit of this notification was not available to aircraft on foreign run to Nepal.

Two assessees, in Delhi I and Mumbai IV Commissionerates of Central Excise, were allowed to export aviation turbine fuel (ATF) as stores for consumption on board for air-crafts on foreign run to Nepal. Duty of Rs.24.94 per kilo litre only was paid by the assessee by self-availing of the rebate under notification dated 22 September 1994 issued under rule 12. Since rebate under this notification was not applicable to ATF exported to Nepal, grant of rebate of duty of Rs.1.59 crore during April 1994 to March 1999 was incorrect.

On being pointed out in July and August 1999, the Ministry of Finance stated (December 1999 and January 2000) that the benefit was made applicable to Nepal under Ministry's instructions dated 7 February 1975.

Reply of the Ministry is not tenable as the cited instructions were applicable to a specific airline (Royal Nepalese Airline) and had lost its validity after the notification dated 22 September 1994, which specifically excluded the benefit to all aircrafts on foreign run to Nepal.

10.2 Incorrect grant of refund

The Tribunal (Special Bench) in the case of M/s. Khaitan Fans (P) Limited {1986 (26) ELT 321 (T)} held that purchase tax paid on the raw materials can not be excluded from the assessable value.

An assessee, in Chennai III Commissionerate of Central Excise, cleared two wheeler motor vehicles for sale through sale depots on payment of duty on provisional basis during 1994-95. On finalisation of the relevant accounts, the assessee preferred a refund claim for the duty paid in excess due to less abatement made in the assessable value, on account of purchase tax paid on raw materials. The refund claim was admitted but the amount was credited to 'the consumer welfare fund' as the assessee could not prove that there was no unjust enrichment.

Audit pointed out (December 1997 and March 1998) that the amount of purchase tax was not an abatable item as per the Tribunal's judgement cited above. The portion of refund of duty amounting to Rs.44.01 lakh pertaining to the purchase tax, though credited to consumer welfare fund, was incorrect and resulted in loss of revenue to that extent.

The Ministry of Finance admitted the objection (January 2000).

CHAPTER 11 : OTHER TOPICS OF INTEREST

11.1 Short collection of revenue due to non-revision of price

Ministry of Petroleum and Natural Gas under its letter dated 18 May 1990, fixed the price of Ethane Propane (C_2-C_3) at Rs.3300 per 1000 M^3 to be charged by ONGC for supply to Maharashtra Gas Cracker Complex of IPCL. It was clarified that the price of Rs.3300 per 1000 M^3 was fixed after taking into account the current domestic price of natural gas at Rs.1400 per 1000 M^3. This fixation of price was not under any Law in terms of proviso (ii) under section 4(1)(a) of the Act, on valuation of goods.

It was noticed in audit that while the price of natural gas was enhanced to Rs.1500 per 1000 M^3 on 31 December 1991, Rs.1650 per 1000 M^3 on 1 January 1996, Rs.1800 per 1000 M^3 on 1 October 1997 and Rs.2003 per M^3 on 1 January 1998 by the Ministry of Petroleum and Natural Gas, the price of Ethane-Propane (C_2-C_3) supplied to Maharashtra Gas Cracker Complex was not revised either by the Ministry of Petroleum and Natural Gas or by the ONGC. Since the price of Ethane Propane fixed in May 1990 was based on the price of 'Natural gas' which was the principal input for production of Ethane-Propane (C_2-C_3), the price of C_2-C_3 was required to be accordingly raised. Subsequent scrutiny also revealed that this price was not only lower than the cost but also much below the prevailing international price. Short collection of duty of Rs.9.75 crore from April 1996 to September 1998 was estimated in audit on the basis of increase in price of Natural gas made in January 1996 and October 1997 alone. Actual short collection of duty for the whole period could not be worked out in audit as details of clearances of C_2-C_3 during the relevant periods was not made available.

On being pointed out (November 1998 and February 1999), the department admitted the objection (July 1999) and intimated issue of show cause notice demanding duty of Rs.89.46 crore for the period from March 1994 to December 1998. Department also proposed levy of penalty under section 11AC which worked out to Rs.89.46 crore, interest under section 11AB which was estimated to Rs.50.00 crore and penalty under rule 173Q.

11.2 Grant of higher abatement under MRP based assessment resulting in loss of revenue

In terms of section 4A of the Central Excise Act, 1944, inserted by Finance Act, 1997, the Central Government may, specify goods which would be charged to duty on a value equal to the 'Maximum Retail Price (MRP)' of the product less abatement allowed by the Government. In pursuance of the aforesaid provisions, Government issued notifications on 7 May 1997, 19 June 1997 and 2 June 1998 covering 'Pan masala' packed in pouch of not more than 2 grams of MRP not exceeding Rs.1.25, 'Cosmetics' falling under headings 33.03, 33.04, 33.05 and 33.07 and 'Glazed tiles' falling under sub-heading 6906.10 respectively. Accordingly, excise duty was leviable on assessable value equal to 50 *per cent* of 'MRP'.

It was observed that the rate of abatement from the MRP as allowed under the said notifications was higher than the abatements the manufacturers were themselves availing prior to the issue of notifications, resulting in lower duty realisation. The rationale behind fixation of higher abatements could not be checked in audit as the Government files leading to issue of the concerned notifications were not made available to audit, despite repeated requisitions. Cases of loss of revenue due to higher abatement, noticed in test check are given below :-

(a) Pan masala

Two assessees, in Delhi I Commissionerate of Central Excise, engaged in the manufacture of Pan masala, were clearing the product on payment of duty on tariff value of Re.0.80 per pouch of 1.8 grams with MRPs of Rs.1.25 and Re.1.00 per pouch prior to 7 May 1997. From 7 May 1997 onwards, both the assessees started paying duty under notification dated 7 May 1997 on 50 *per cent* of their MRPs of Rs.1.25 and Re.1.00 respectively. The assessable value of their products became lesser than those prevailing prior to 7 May 1997 as abatement allowed at 50 *per cent* of MRP was on the higher side. This resulted in less realisation of revenue of Rs.2.82 crore during the period May 1997 to March 1999 in two cases alone.

(b) Cosmetics

Seven assessees, in six Commissionerates of Central Excise, manufacturing cosmetics falling under heading 33.03 to 33.05 and 33.07, were clearing goods on payment of duty on the assessable value determined under section 4. From 1 July 1997 onwards, duty was paid on 50 *per cent* of the MRP, as allowed under the notification, ibid. This resulted in reduction of the assessable value upto 51 *per cent* in comparison to those prevailing prior to 1 July 1997. Failure to anticipate this, led to short realisation of revenue of Rs.1.84 crore during July 1997 to November 1998 in seven cases alone.

(c) Glazed tiles

Three assessees, in Mumbai VI and Mumbai VII Commissionerates of Central Excise, manufacturing glazed tiles (chapter 69), were clearing goods on payment of duty on the assessable value determined under section 4. From 2 June 1998 onwards, duty was paid on 50 *per cent* of the MRP, as allowed under the notification, ibid. This resulted in reduction of the assessable value upto 27 *per cent* in comparison to those prevailing prior to 2 June 1998, despite the fact that the MRPs of the products had not changed. Failure to anticipate this, led to loss of revenue of Rs.66.15 lakh during the period June 1998 to December 1998.

On the above observations being pointed out between September 1998 and April 1999, the Ministry of Finance stated (October 1999 and Janaury 2000) that the fixing of quantum of abatement on retail sale price was a policy matter.

Reply of the Ministry is not acceptable since no reasons/basis for fixing higher quantum of abatement was provided to audit.

11.3 Non-collection of cess under Textile Committee Act

According to the provisions of section 5A(1) of the Textile Committee Act, 1963 and the notification issued by the Ministry of Commerce on 1 June 1977, cess at 0.05 *per cent* is leviable on all 'Textiles and textile machinery' manufactured in India. The authority to collect such cess is vested with the 'Textile Committee' in accordance with the provisions of the Textile Committee (Cess) Rules, 1975.

Test check of records of 126 assessees, engaged in the manufacture of textile materials/articles, revealed that they had not paid cess of Rs.2.11 crore between April 1990 and March 1999. Action was not taken by the Textile Committee to raise demand for collection of cess from the manufacturers in accordance with the provisions of the Textile Committee (Cess) Rules, 1975.

On being pointed out in October 1999, the Ministry of Textiles stated (November 1999) that cess amounting to Rs.2.64 crore was due from 126 units out of which cess amounting to Rs.36.63 lakh had since been recovered and action was being taken for recovery of the remaining amount.

11.4 Incorrect application of rate of duty

An assessee, in Ahmedabad Commissionerate of Central Excise, produced and cleared 'Woven pile corduroy fabrics' falling under sub-heading 5801.22 on payment of basic duty at 10 *per cent* ad valorem instead of 12 *per cent* ad valorem. This resulted in short levy of duty of Rs.44.43 lakh during November 1996 to February 1998. The Ministry of Finance admitted (September 1999) the objection. Further developments had not been received (December 1999).

11.5 Other cases

In 361 other cases of short levy of duty, the Ministry of Finance/department while accepting the objections involving duty of Rs.55.20 crore reported recovery of Rs.3.02 crore till 15 January 2000.

SECTION II - SERVICE TAX

CHAPTER 12: SYSTEM APPRAISAL ON SERVICE TAX

12.1 Highlights

⇒ **Collections from service tax constitute less than 0.3 *per cent* of the value added in the service sector as against 20 *per cent* of the value added in the manufacturing sector collected through excise duty.**

(Paragraph 12.6.1)

⇒ **Collections from service tax amount to only 1.2 *per cent* of the tax revenue of the Union Government and could counter balance less than 3 *per cent* of the deficit in the revenue budget.**

(Paragraph 12.6.2)

⇒ **The poor performance of collections from service tax is largely attributable to inadequate coverage of services and a rate of tax not in consonance with the taxation philosophy of the Government.**

(Paragraph 12.7)

⇒ **Based on the National Accounts Statistics, the potential of tax at 5 *per cent*, for the period 1994-95 to 1998-99, should be Rs.1,42,612 crore against which the Government collected a mere Rs.5,690 crore.**

(Paragraph 12.7.1)

⇒ **Almost 3/4th of the collections are from 2 services namely Telephone and General Insurance, most of which are Government service providers.**

(Paragraph 12.7.1)

⇒ **Even though the service sector caters to the relatively better off sections of society, the rate of tax levied is far below the central rate of taxation envisaged in the rationalised tax structure for indirect taxes. In the context of a comprehensive Value Added Tax being the medium term fiscal objective, this could pose serious problems.**

(Paragraph 12.7.2)

⇒ **While covering services several sub segments were excluded. For instance in case of brokerage earned by brokers, only 33 *per cent* of the sector was captured.**

(Paragraph 12.7.3)

⇒ **Certain services like Goods transport, Outdoor caterers etc. were granted exemptions after being captured in the tax net. The revenue loss based on actual collections was Rs.342 crore per annum.**

(Paragraph 12.7.4)

⇒ **The Government's decision to levy tax in respect of 'Goods transport' and 'Clearing and forwarding agents' on service users rather than on service providers was held ultra vires by the Supreme Court, resulting in refund of Rs.221 crore apart from wastage of human and material resources.**

(Paragraph 12.7.5)

⇒ **The legislative and administrative superstructure for Service Tax Administration is not at par with the other taxes resulting in extremely poor realisation from services other than telephone and general insurance.**

(Paragraph 12.8)

12.2 Introduction

Service tax was introduced in India from 1 July 1994 through the Finance Act, 1994. It was initially levied on three services viz., Telephone, General Insurance and Stock Brokers. In 1996, three more services viz., Advertisement agencies, Radio pager and Courier were brought into the tax net.

In 1997, the tax was extended to capture twelve more services viz., Custom house agents, Steamer agents, Consulting engineers, Clearing and forwarding agents, Manpower recruitment agencies, Air travel agents, Goods transport operators, Outdoor caterers, Pandal or Shamiana contractors, Mandap keepers, Tour operators and Rent a cab operators.

The Finance Act, 1998, captured another twelve services viz., Architects, Interior decorators, Management consultants, Practising chartered accountants, Cost accountants, Company secretaries, Security agencies, Real estate agents or consultants, Market research agencies, Credit rating agencies, Underwriting agents and Mechanised slaughter house.

Service tax on taxable services provided by Goods transport operators, Outdoor caterers and Pandal or shamiana contractors was, however, exempted with effect from 2 June 1998, Tour operators in relation to tours from 18 July 1998 and Rent a cab operators from 28 February 1999.

Service tax is leviable at the rate of 5 per cent of the value of taxable services provided to the clients subject to certain exemptions, wherever applicable. Services provided by Mechanised slaughter houses are, however, charged to tax of Rs.100 per bovine animal.

12.3 Organisational set up

Administration of service tax has been vested with the Central Excise department. The Central Board of Excise and Customs has set up a separate apex authority headed by a Director General. Commissioners of Central Excise have been authorised to collect service tax within their jurisdiction. All the commissionerates have a service tax cell or division, headed by an Assistant Commissioner.

Service Tax Rules, 1994, have been framed for administration of the tax. These *inter alia*, deal with procedures and forms for registration, records, payments and filing of returns, appeals etc.

12.4 Scope of audit

An evaluation of the revenue mobilisation effort of the Government through service tax since its introduction in 1994 till March 1999 was undertaken in audit, to assess the extent to which the considerations and objectives which had prompted the Government to levy the tax were realised. National Accounts Statistics brought out by Central Statistical Organisation (CSO) were relied upon wherever necessary.

12.5 Paradigm for evaluation

Evaluation of the resource mobilisation effort through service tax would be appropriate with reference to the prevalent fiscal scenario, the considerations that lay at the basis of the recommendations of the Tax Reforms Committee and the adequacy of the legislative and administrative apparatus in protecting revenue.

12.5.1 The fiscal scenario

The rising contribution of the service sector to the overall output in the economy has been the most significant feature of the economy in rapid transition. In fact, the growth of the service sector has imparted much of the resilience to the overall growth of the economy, particularly in times of falling returns from agricultural sector and industrial slow down. This sector provides services which are skill based with high levels of value addition.

The services sector has also emerged as the fastest expanding sector. The share of the services inclusive of construction in GDP had increased from around 41 per cent in 1980-81 to almost 51 per cent in 1998-99. In fact, half of the growth in GDP had been contributed by the growth in the services sector Trade, Communications, Stock trading, Banking and Insurance segments had been the major contributors towards this growth. These are areas where there had been a spurt of technological process and increased competition, induced mainly by economic reforms.

The aforesaid trend is indicative of a shift of consumption expenditure from manufacturing to value added services which is generally associated with the process of economic development. This structural transformation has long run fiscal implications. Failure to tax adequately this significant proportion of the consumption spending could

result in adversely affecting elasticity of indirect tax revenues which is already under pressure due to substantial reduction in Customs Tariffs and rationalisation of excise duty structure.

12.5.2 Tax Reforms Committee

Service tax was introduced on the basis of recommendations made by the Tax Reforms Committee constituted by the Government of India under the chairmanship of Dr. Raja J. Chelliah in August 1991. The terms of reference of the Committee included inter-alia, ways of improving the elasticity of tax revenues and identifying new areas of taxation. In their interim report submitted to the Government in December 1991, the Committee recommended introduction of a tax on services. This recommendation was in keeping with the overall philosophy of the report that the tax system should be broad based, simple and have moderate rates. In their view, the indirect tax system must cover as many transactions as possible and be neutral in relation to production and consumption. They therefore, recommended that indirect taxes should move towards a Value Added Tax covering both services and commodities.

12.5.3 Legislative/administrative apparatus

Revenue collections from tax levied depend in a large measure on legislative and administrative support. Given the experience of revenue leakage and existence of a huge parallel economy, proactive and vigorous revenue administration is necessary to protect revenue. This would be all the more relevant while dealing with a multitude of service providers including self employed persons.

12.6 The evaluation

Service tax was finally introduced with effect from 1 July 1994. In the budget speech (February 1994), the then Finance Minister conceded that there was no sound reason for exempting services from taxation and added that in many countries goods and services are treated alike for tax purposes. He acknowledged the recommendation of the Tax Reforms Committee but indicated that the Government proposed to make only a modest effort in this direction.

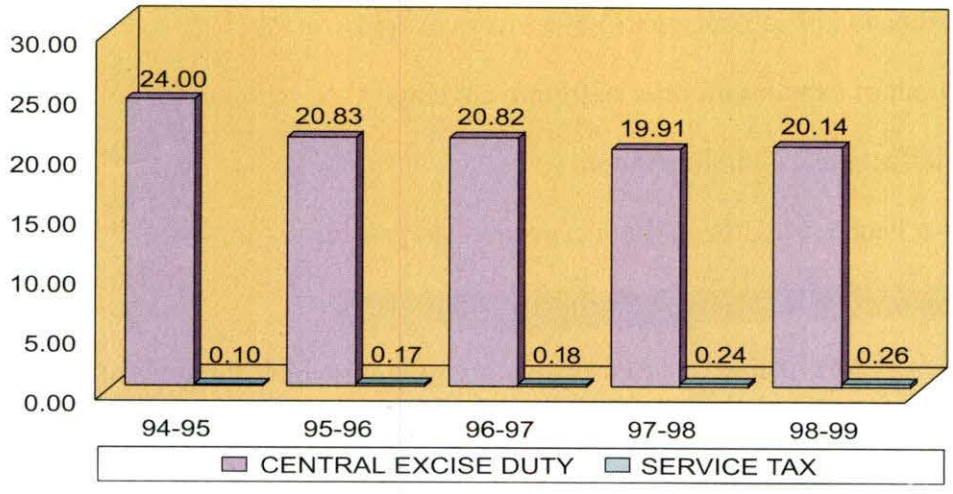
12.6.1 Collections from service tax vis a vis contribution of services to GDP

Receipts from service tax with reference to the contribution of services to GDP can be appreciated from the following table and graph :-

(Amount in crore of rupees)

Year	GDP - service sector	Collections from service tax	Service tax collections as percentage of value added by services	GDP – manufac-turing	Collections from excise duties	Excise collection as percentage of Value Added by manufacturing
1994-95	410184	410.61	0.10	155016	37208	24.00
1995-96	489531	846.16	0.17	192070	40009	20.83
1996-97	572170	1022.08	0.18	215293	44818	20.82
1997-98	646198	1515.93	0.24	239863	47763	19.91
1998-99	734169	1895.55	0.26	263481	53053	20.14
Total	2852252	5690.33	0.20	1065723	222851	20.91

Comparison of excise duty and service tax collections as a percentage of value added in manufacturing & service sectors



Contribution from Public Administration and Defence has been excluded from Services-GDP

While collections from central excise duties levied on manufacturing account for almost 20 *per cent* of the value added in the manufacturing sector, collections from service tax account for less than 0.3 *per cent* of the value added in the service sector (excluding public administration and defence). It can be surmised that the introduction of service tax has had only a minimal effect on the fiscal distortion in favour of services.

12.6.2 Contribution of service tax towards fiscal resources

The Tax Reforms Committee had recommended introduction of service tax in fulfilment of their mandate to identify new areas of taxation. The dynamics of structural transformation entailing a significant shift of income, consumption expenditure and employment in favour of the tertiary sector, requires greater resource mobilisation from this sector. The adequacy of the resource mobilisation efforts from service tax can be viewed in the following context:

COLLECTIONS FROM SERVICE TAX	1997-98
--As percentage of tax revenue	1.21
--As percentage of total revenue receipts	0.69
--As percentage of revenue expenditure	0.55
--As percentage of revenue deficit	2.55
--As percentage of fiscal deficit	1.70

It is apparent that even after five years of introduction of the tax, its contribution towards additional resource mobilisation or correction of fiscal imbalance had been meagre.

12.7 Factors responsible for poor performance

The rather dismal collections from service tax are attributable to the following causes :

(a) Inadequate coverage of services.

(b) Staggered coverage of services.

(c) Low rate of tax in comparison with the rationalised central excise tax structure.

(d) Exclusion of sub-segments of services covered.

(e) Grant of exemptions after notifying coverage.

(f) Ineffective tax administration.

These have been elucidated in the succeeding paragraphs:

12.7.1 Inadequate and staggered coverage of service.

The interim report of the Tax Reforms Committee, in which the levy of service tax was recommended, was presented to the Government in December 1991. The tax was levied only in 1994-95. Sufficient time was therefore, available to identify taxable services and put the administrative machinery in place to launch a wide net of service tax.

Instead, in its first pronouncement, service tax covered only 3 services viz. Telephone, Insurance and Stock brokers. Two of these were to be collected through departmental undertakings/public sector undertakings viz., Department of Telecom, MTNL and Insurance Companies. The tax has been subsequently extended to another 27 services. These subsequent extension of the tax had only marginally added to revenue realisation and the share of three services introduced in 1994 in the total collections from service tax had been very high. These are presented below in a table and graph :-

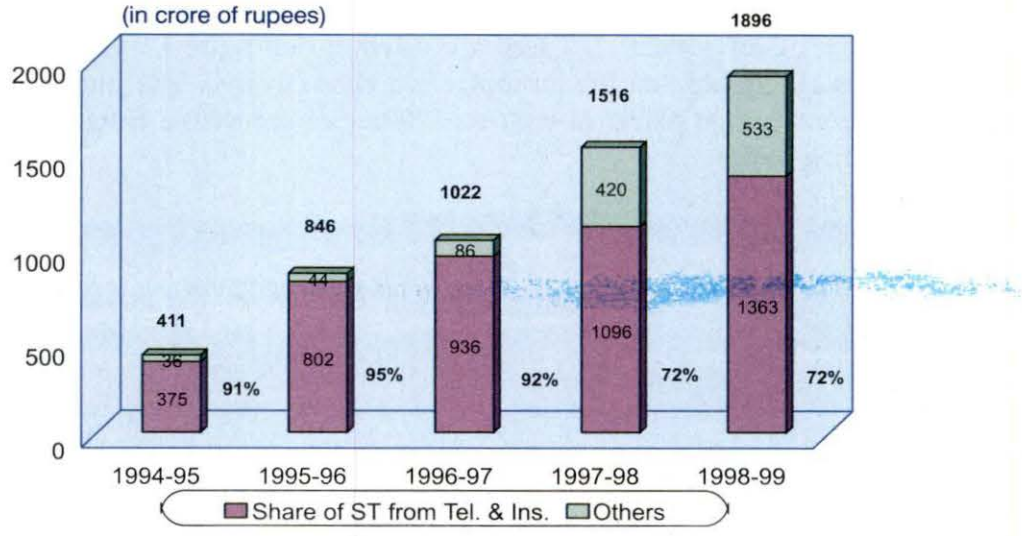
(Amount in crore of rupees)

Year of levy (1)	**Number of items** (2)	**Service tax collected** (3)	**Value of services taxed (at 20 times of tax collected)** (4)	**Value added in the service sector * (As per CSO)** (5)	**(4) as a percentage of (5)** (6)
1994-95	3	410.61	8212	410184	2.00
1995-96	3	846.16	16923	489531	3.46
1996-97	6	1022.01	20440	572170	3.57
1997-98	18	1515.93	30318	646198	4.69
1998-99	30	1895.55	37911	734169	5.16

* Contribution from Public Administration and Defence has been excluded from Services-GDP

The foregoing table shows that even after extension of service tax to 30 services up to 1998-99, only five *per cent* of value added in the service sector has been captured in the net of service tax.

SHARE OF TELEPHONE AND INSURANCE IN TOTAL COLLECTIONS



The foregoing graph shows that the Government failed to extend coverage of service tax to any other major service since its introduction and 72 *per cent* of its collections came from State owned service providers.

The inadequate coverage is attributable to major segments of the service sector being left untaxed. Some of these as per Central Statistical Organisation (CSO) classification along with their contribution to GDP, since the introduction of service tax, are detailed in the following table :-

(Amount in crore of rupees)

Sl.No.	Name of the service	GDP contribution 1994-95 to 1998-99	Untapped service tax at 5 per cent
1.	Trade	916323.70	45816.19
2.	Banking	343149.20	17157.46
3.	Construction	306495.00	15324.75
4.	Education	210224.70	10511.23
5.	Medical & Health	70025.31	3501.27
6.	Railways	68631.36	3431.57
7.	Hotels & Restaurants	56351.32	2817.57
8.	Water Transport	30484.29	1524.22
9.	Tailoring	27966.49	1398.33
10.	Services Incidental to Transport	21074.40	1053.72
11.	Research & Scientific	15130.20	756.51
12.	Domestic services	13616.68	680.83
13.	Legal Services	13330.86	666.54
14.	Air Transport	13325.65	666.28
15.	Sanitary	13204.43	660.22
16.	Laundry, Dyeing & Dry Cleaning	8366.98	418.35
17.	Beauty shops	7079.09	353.96
18.	Religious	6067.71	303.39
19.	Storage	4642.29	232.12
20.	Recreation & Entertainment	4085.05	204.25
21.	Radio & Television	796.01	39.80
	Total	**2150370.72**	**107518.56**

The uncaptured segments of service sector could yield maximum revenue to the extent of Rs.1,07,518 crore during 1994-95 to 1998-99.

As early as January 1995, a study carried out by the National Institute of Public Finance and Policy at the instance of the Ministry of Finance had identified 18 categories of services for levy of service tax. These are listed at Annexure I. Of these, only two namely customs agents and non-life insurance had been covered. The study had estimated that the Government could realise at least Rs.5000 crore per annum from such services at the then prevailing prices.

Inadequate and staggered coverage of services have the following implications:-

(a) The Government managed to tap only a fraction of the potential of resource mobilisation from the services sector. As against a total potential of Rs.1,42,612.60 crore between 1994-95 and 1998-99 (at the rate of 5 *per cent* of total GDP from services of Rs.28,52,252 crore), the Government managed to collect only Rs.5,690.33 crore which was less than four *per cent* of the potential.

(b) Several services were left un-taxed even after the introduction of service tax. In the view of the Tax Reforms Committee, this was equivalent to exempting a group of commodities from levy of excise duties.

(c) This discrimination was cited by some of the professionals as a ground for obtaining stay orders from levy of service tax from the Courts. For instance the association of Chartered Accountants obtained a stay from the High Court in Calcutta (12 December 1998) and the Karnataka State Chartered Accountants association obtained the stay from the High Court (12 April 1999) in Bangalore. Stays had also been granted by the High Courts in Rajasthan (24 November 1998), Uttar Pradesh (26 November 1998) and Mumbai (22 January 1999). Another petition was also filed by the Indian Institute of Architects in Chennai and interim stay was granted.

12.7.2 Tax rate

The Tax Reforms Committee had recommended movement towards VAT covering both commodities and services. In their view, to make the system simple and easy to administer, taxes should be levied at only two or three rates say 10, 20 and 30 *per cent*. In so far as services are concerned, they recommended levy of a 10 *per cent* service tax on the value of transaction except telephone services.

Even though the Government have repeatedly indicated that movement towards a comprehensive VAT is a definite goal of its fiscal policy, they levied the tax on services at a uniform rate of 5 *per cent* only. The reasonableness of this rate can be viewed in the following context:-

(i) Statistical analysis of consumption patterns reveals that expenditure on services as a proportion of income increases with the increase in household incomes. The principle of equity would, therefore, rule out categorisation of services along with such goods which are covered under the merit rate of taxation in the rationalised duty structure enunciated in the 1999-2000 budget. Infact in the regime of a single rate of excise duty/VAT, services would have to be treated at par with goods.

(ii) The value added for any business entity is obtained by adding compensation to employees (wages), rent, interest and profit. The proportion of these components in total sales in the services sector is generally likely to be very high. Implicit in the recommendation of the Tax Reforms Committee for a 10 *per cent* rate on value of transaction was an assumption that 60 *per cent* of the value of services would be added in the service sector. Only then would 10 *per cent* tax on value of transaction translate to around 16 *per cent* on value added which is the average rate of excise duty. In other words at this level of value addition, the 5 *per cent* tax levied by the Government amounts to 12 *per cent* VAT. This places it far below the central rate of 16 *per cent*.

It is therefore apparent that the rate of tax levied was neither based on a realistic estimation of value added in the service sector nor was it in consonance with the indirect taxation philosophy detailed in the rationalised tax structure.

Progress towards a unified VAT would require a significant increase in the rate of tax on services. A rational and scientific determination of tax rates would require categorisation of services on ground of equity/elasticity of demand and analysis of value addition in various categories. The following matrix attempts to outline the various options:-

Alternate rates of service tax on value of transaction

Rates on value added / Value added as a percentage of value of transaction	**Merit rate 8 *percent***	**Central rate 16 *percent***	**De-merit rate 24 *percent***	**Actual highest rate 40 *percent***	**Single rate 20 percent**
10	0.8	1.6	2.4	4	2
20	1.6	3.2	4.8	8	4
30	2.4	4.8	7.2	12	6
40	3.2	6.4	9.6	16	8
50	4.0	8.0	12.0	20	10
60	4.8	9.6	14.4	24	12
70	5.6	11.2	16.8	28	14
80	6.4.	12.8	19.2	32	16
90	7.2	14.4	21.6	36	18
100	8.0	16.0	24.0	40	20

If it is assumed that the rate of tax on services should not be less than the central rate and value added in any of the services is not less than 60 *per cent* of the value of transaction, the minimum rate of tax on value of transaction should not be less than 9.6 *per cent*. In case of uniform rate of 20 *per cent* VAT, the rate of service tax should be 12 *per cent*. Being skill intensive, most services are likely to have much higher levels of value

addition. Moreover, it is also an established fact that the consumers of services are generally the better off sections of the society.

12.7.3 Glaring omissions in sectors covered- brokerage

While brokers were covered with effect from 1 July 1994, the taxable service was defined as any service provided to an investor by a stock broker in connection with the sale or purchase of securities listed on recognised stock exchange.

This left out the following categories of services performed by brokers and the brokerage earned thereon:

(a) Brokerage on initial public offer (IPO) or primary issues.

(b) Brokerage collected on divert deals struck by sub-brokers.

(c) Brokerage on sale/purchase of Government securities not listed in the stock exchange.

(d) Brokerage on sale/purchases made by stock brokers who are not investors- e.g., 'Jobbing'.

A total number of 3,613 IPOs with net offering to the public of Rs.31,623.92 crore were made during July 1994 and March 1999. In addition, mutual funds had also raised an estimated amount of around Rs. 48,000 crore during the same period. At the rate of 1.5 *per cent*, a total of Rs.1,194 crore would have been paid as brokerage. At 5 *per cent*, an amount around Rs.60 crore could have been collected as service tax during the period.

The total turnover in the stock exchanges of the country between 1 July 1994 and 31 March 1999 was Rs.29,78,470 crore. Excluding the transactions of FIs and FIIs (15 *per cent*), the retail business worked out to around Rs.25,31,700 crore. Assuming that 50 *per cent* of the transactions in the secondary market aggregating Rs.12,65,850 crore would have been struck directly by sub-brokers, their brokerage of around 1/2 *per cent* aggregating Rs.6329 crore escaped the service tax net. The revenue foregone on this account was around Rs.317 crore.

As per Reserve Bank of India Annual Report for 1998-99, the aggregate volume of transactions, in Central and State Government dated securities, was Rs.2,27,228 crore in 1998-99. Assuming a brokerage of 0.5 *per cent*, the value of brokerage charged would be around Rs.1,100 crore. The service tax chargeable would be Rs.55 crore per annum or Rs.261 crore since July 1994.

Thus, a total amount of Rs.638 crore on brokerage services could not be collected due to exclusion of some of the subsegments. This was almost twice the amount collected on brokerage services.

Apart from the aforesaid omissions, the following services in the money/financial markets had been left out of the tax net:

(i) Services of lead managers

(ii) Portfolio management services

(iii) Advisory, consulting and other managerial services to an issue

(iv) Loan syndication

(v) Services rendered by Asset Managers to Mutual Funds

(vi) Custodian services

(vii) Financial advisory services

(viii) Services rendered by registrar to an issue, and

(ix) Services of share transfer agents

Underwriting services were brought in the tax net with effect from 16 October 1998.

12.7.4 Grant of exemptions

The Government covered certain services like Goods transport, Outdoor caterers, Pandal and shamiana contractors, Tour operators and Rent a cab operators from certain dates. However, before the tax collections from these services could stabilise and system like registration of all potential assessees etc. put in place, Government subsequently exempted these services from the levy of service tax. The details are as follows:-

(Amount in crore of rupees)

Service	Levied from	Exempted from	Tax collected during the period of levy	Tax foregone per year based on actual collection	GDP from the service in 1998-99	Potential tax foregone/Year based on GDP from service
Goods transport	16.11.97	2.6.98	168.99	311.98	62926	3146
Outdoor caterers	1.8.97	2.6.98	5.63	6.76	14217	711
Pandal contractors	1.8.97	2.6.98	6.59	7.91	NA	
Tour operators	1.9.97	18.7.98	12.15	13.89	NA	
Rent a cab operators	16.7.97	28.2.1999 till 31.3.2000	3.15	1.94	NA	
Total				**342.48**		**3857**

The above table indicates that based on actual collections during the period of levy of service tax on these services, the Government had chosen to forego an estimated revenue of Rs.342.48 crore per year. Based on the value addition in these sectors, the revenue foregone per year on Goods transport operators and Outdoor caterers alone was estimated in audit at Rs.3,857 crore per year.

12.7.5 Irrational point of levy

In departure from the practice of levying service tax on service providers, tax in respect of Goods Transport and Clearing and Forwarding Agents introduced with effect from 16 November 1997 and 16 July 1997, respectively, was levied on the users of these services. Provisions for this purpose were made in rule 2(d)(xii) and 2(d)(xviii) of the Service Tax

Rules, 1994 as amended. These were in conflict with section 66 read with section 65 of the Finance Act, 1994, which prior to 16 October1998 stated that the assessee would be a person who was responsible to collect tax.

The Supreme Court, in the case of Laghu Udyog Bharti Vs. Union of India, struck down (27 July 99), the provisions of these rules as ultra vires and held that service tax can only be collected from the services provider. Supreme Court also ordered refund of tax collected from the users of these services.

While service tax on goods transport continues to be under exemption, the Government, in case of Clearing and forwarding agents had since rectified the error by making the service providers liable to pay tax with effect from 23 August 1999.

Thus, due to the incorrect point of levy of service tax on these two services, the Government had to refund the tax collected from the services of Rs.221.02 crore collected during 1997-98 and 1998-99. Efforts of Government to collect service tax from these two services thus turned out to be futile. It also resulted in wastage of money, manpower and other administrative machinery spent on collection and refund.

12.8 Legislative/administrative superstructure

12.8.1 Absence of an independent Act

Service tax was introduced through the Finance Act, 1994. Even though 5 years had elapsed, no independent Act had been brought by the Government to administer this tax. This assumes importance in view of the following :

(a) At full potential, receipts from service tax could match those from other major taxes which are all administered by independent Acts.

(b) The levy of service tax is not temporary in nature. It will only expand in its coverage.

(c) In the absence of an independent Act, revenue authorities have not been vested with punitive powers at par with administration of other taxes and levies.

12.8.2 No penalty for delay in registration

With effect from 16 October 1998, the Finance Act and the Rules require that a taxable service provider should get registered within 30 days of the service being brought under the levy. No penalty is, however, leviable if the assessee chooses to get himself registered after the stipulated period or does not register at all. There is also no bar on a service provider collecting service tax from his clients without registration, as is the case in respect of other indirect taxes.

12.8.3 Insufficient details in the form of registration

The application form for registration does not seek certain essential information in the absence of which the department would not be in a position to plug leakage of revenue.

For instance, the assessee was not required to furnish the date from which he had been providing the service, tax collected, number of premises from which the service was being rendered and the actual premises being registered. Further, there is no requirement to indicate 'Permanent Account Number' (PAN) allotted by income tax department in cases where the assessee was an income tax assessee also, to have cross-verification mechanism for value of the service rendered and declared.

12.8.4 No requirement to maintain specific records

In order to facilitate revenue administration to effectively check taxable turnover and safeguard revenue, the central excise laws stipulate maintenance of specific records by the manufacturing units (RG 1). No such stipulation had been made for service tax. Instead, an assessee is free to maintain records in terms of the other relevant laws applicable to his activity such as Income Tax Act, Companies Act, Insurance Act, Securities Contract (Regulation) Act, SEBI Regulation Act, Customs Act, Sale of Goods Act, Motor Vehicles Act, Customs House Licensing Regulations, etc. Consequently there was no uniformity in maintenance of records. Any verification of returns by the revenue officials would require specialised knowledge of various laws, thereby restricting their efficacy.

12.8.5 Inadequate information in returns (ST-3) for assessments

In terms of section 70(1) of the Finance Act and rule 7 of the Service Tax Rules, the assessees were required to submit quarterly (half yearly since 16 October 1998) returns in form ST-3 (ST-3A for provisional assessments) alongwith copy of the Treasury Challan (form TR-6) in support of service tax paid. The return is not accompanied by any other supporting document like invoices billed to the customers for services rendered or other documents like balance sheet, trading and profit and loss account etc. from which the value of taxable services declared in the form can be cross checked and correlated.

The assessing officer had to assess this return through an assessment memorandum printed in this form itself demanding any duty short paid.

This assessment was however, only purely arithmetical as there was nothing in form ST-3 which can indicate any short levy or non-levy or non-payment of service tax on its own.

12.8.6 Assessments finalised in a routine manner

While section 71(1) of the Finance Act, 1994, as amended, authorises the Central Excise officer to call for additional documents/information in addition to the returns submitted by the assessee, for the purpose of making a proper assessment, no corresponding rule had however, been framed for its implementation. Sample verification by Audit revealed that this power to call for additional information for making a proper assessment had been used only infrequently. The assessments have been routinely made by accepting whatever the assessees had declared.

Failure to carry out surveys and near complete reliance on the returns filed by the assessees, had resulted in meagre collections from a number of services reflecting capture of only a fraction of the value addition in these sectors. Collections during 1998-99 in respect of 12 services covered with effect from 16 October 1998 detailed in the following table highlight this:

(Amount in crore of rupees)

Service	Service tax collected during 1998-99	Value of services captured
Cost Accountants	0.01	00.20
Mechanised slaughter house	0.02	00.40
Company secretaries	0.03	00.60
Interior decorators	0.05	01.00
Underwriters	0.10	02.00
Credit rating agencies	0.25	05.00
Real estate agents	0.27	05.40
Architects	0.61	12.20
Market research agencies	0.67	13.40
Chartered accountants	1.01	20.20
Management consultants	1.96	39.20
Security agencies	2.54	50.80

12.9 Budget formulation

A scrutiny of budgetary documents revealed that no budget estimates were made prior to introduction of service tax in 1994-95. Similarly, no initial budget estimates were made in respect of three services covered during 1996, 12 services covered in 1997 and 12 more services covered during 1998. It can therefore, be surmised that the Government did not carry out any preliminary survey or estimation of revenue potential from a service. The subsequent budgetary provisions were based on previous collections. The department did not furnish any information on the issue, despite specific query from audit.

12.10 Recommendations :-

(i) In order to realise its full revenue potential, the service tax net should be extended to capture most of the services.

(ii) In view of the imminent transition to a comprehensive Value Added Tax, the tax rate should be raised to make it consonant with the rationalised tariff structure.

(iii) In order to protect revenue and prevent leakages, the legislative and administrative arrangements for service tax be brought at par with other taxes.

The above observations were pointed out in December 1999, reply of the Ministry of Finance had not been received (January 2000).

New Delhi **(S.K. BAHRI)**

Dated : 6 March 2000 **Principal Director (Indirect Taxes)**

Countersigned

New Delhi **(V.K. SHUNGLU)**

Dated : 6 March 2000 **Comptroller and Auditor General of India**

Annexure I

(Refer para 12.7.1)

List of services recommended for levy of service tax by the National Institute of Public Finance and Policy in January 1995

(i) Construction and service contractors;

(ii) Stock, real estate, customs agents and brokers;

(iii) Lease/distribution of cinematographic films;

(iv) Milling, processing, manufacturing or repacking of products for others (i.e., 'job work');

(v) Services of professionals, including consultants, film actors, directors, etc.;

(vi) Lease of property whether personal or real;

(vii) Warehousing

(viii) Hotels, motels, rest houses, inns and resorts;

(ix) Restaurants, cafes and other eating places, including clubs and caterers;

(x) Services of dealers in securities;

(xi) Transport operators (taxi cabs, cars for rent or hire, tourist buses and other common carriers by land, air and sea);

(xii) Services of franchise grantees of telephone and telegraph, radio and television broadcasting, cable TV operators;

(xiii) Computer services;

(xiv) Services of banks, non-bank financial intermediaries and finance companies;

(xv) Non-life insurance companies;

(xvi) Entertainment services (cinema, theatre, video parlours, etc.);

(xvii) Decorators, tent houses; and

(xviii) Repairs and maintenance services