

Tax Hotline

November 27, 2003

FINANCE MINISTRY REINTRODUCES THE EXEMPTION FOR PAYMENTS IN FOREIGN EXCHANGE BY SERVICE PROVIDERS

The service industry may now breath easy as the Ministry of Finance ("**Ministry**") has, vide its Circular No. 21/2003 dated November 20, 2003, reintroduced the exemption to service providers in respect of services, for which payments are received in India in convertible foreign exchange. However, the exemption is not available when the payment received in India in convertible foreign exchange is repatriated from or sent outside India.

HISTORICAL BACKGROUND

Taking into account the growing contribution of the services sector to the Indian gross domestic product, service tax regime was introduced in India for the first time in 1994, vide Chapter V to the Finance Act, 1994 ("**Act**"). Subsequent Finance Acts and notifications/ circulars issued by the Ministry have widened/clarified the provisions of the Act. The most controversial being the exemption in relation to export of services wherein the Ministry has wavered time again about the scope of the applicability of the exemption, as summarised hereunder:

- **April 9, 1999:** Exemption was introduced for payments received in India in convertible foreign exchange.
- **March 1, 2003:** Circular April 9, 1999 was rescinded. It was clarified that only those services which were rendered prior to March 1, 2003 and in respect of which payments were received in convertible foreign exchange in India, would be exempt from service tax.
- Anxious about the ramifications of this notification, several representations were made to the Ministry requesting clarifications on whether there was a change in Government's policy and that whether the intention was to now tax export of services.
- **April 25, 2003:** The Ministry clarified that "service tax is a destination based consumption tax and it is not applicable on export of services. Export of services would continue to remain tax-free even after withdrawal of notification no.6/99 dated 9.4.99."
- This "*clarification*" led to debate in the professional and government official circles alike as to what constituted "export of service". There could be no consensus of interpretation, as the Act itself does not throw any light on what would be regarded as "export of services" or "place of consumption of service".
- **November 20, 2003:** Exemption reintroduced.

IMPLICATIONS OF THE REINTRODUCED EXEMPTION

- The exemption does not state that it has been introduced retrospectively. Thus, services rendered during the interim period viz. March 1, 2003 to November 19, 2003 in respect of which payments were/are received in foreign exchange would not be covered by the exemption. The service providers would need to prove that such services were consumed outside India to be eligible for the exemption under the April 2003 circular.
- The notification states that this exemption would not be available if the "payment received in India in convertible foreign exchange for taxable services rendered is repatriated from or sent outside India". This again brings in confusion as to the extent of the exemption. Whether mere dividend distributions by the service provider to its foreign parent would lead to loss of exemption and such other issues are sure to crop up in days to come.

Source: Notification No. 21/2003, dated November 20, 2003

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