The Validity of the Provisions Relating to Credit Facilities under the Modvat Scheme - A Study

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Introduction

On the 1st of March, 1986, the Central Government, in exercise of its power under section 37 of the Excise Tariff Act, 1985 brought into force rules 57A to 57J of the Central Excise rules, 1944. These rules are popularly known as the MODVAT rules. By a notification dated 1st March, 1986, the Central Government further specified the goods in respect of which credit would be available under rule 57A of the Central Excise rules.[1]

Rule 57A of the MODVAT rules provides that the MODVAT provisions apply to such finished excisable goods[2] as the Central Government, may by notification in the official gazette specify. The purpose of this rule is to allow credit of any duty of excise or the additional duty under Section 3 of the Customs Tariff Act, 1975 as may be specified in the said notification, paid on the goods used in or in relation to the manufacture of the said final products.[3]

This credit so allowed, can be utilised towards payment of duty of excise leviable on the final products, whether under the Act or any other Act, as may be specified in the notification. This would however be subject to the other MODVAT provisions and the restrictions that may be specified in the notification. The rule also lays down, what falls within the ambit of "inputs" and what does not.

Rule 57F deals with a situation where the inputs in respect of which a credit duty has been availed under Rule 57A are removed from the factory for home consumption or export. According to 57F(1) (ii), the inputs may be removed from the factory for the aforesaid purposes "as if such inputs have been manufactured in the said factory". The proviso to sub-rule (1) of Rule 57F provides that when the said inputs are removed from the factory for home consumption on payment of duty of excise, such excise shall in no case be less than the amount of credit that has been allowed in respect of such inputs under Rule 57A.

The question that arises is whether the Central Government can force factory owners to pay duty on the inputs referred to in rule 57F(1) (ii) at prices at which they are sold in the open market, though the goods are neither produced nor manufactured in the factory.

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1. Notification No. 177/86.
2. Hereinafter referred to as "final Products".
3. Hereinafter referred to as "Inputs".

Ultra Vires Rule Making Powers Under Section 37 of the Excise Tariff Act, 1985

Section 37 of the Central Excise and Salt Act, 1944 only prescribes duties on goods which are produced or manufactured in India. In *Hyderabad Industries Ltd.* v. *Union of India*,[4] it was held that goods are liable to duty only if they arise out of a process of manufacture or production, that is, if they are a new and commercially distinct identifiable article. Hence, Rule 57F(1) (ii), in trying to impose excise duty on goods not "manufactured or produced is ultra vires the rule making power of the Central Government and the scope of the Act. It is an unauthorised expansion of the taxing event and alters the very nature of duty leviable under the Act, from a tax on production and manufacture on an impost on the sale of goods. The rule making power conferred on the Central Government under Section 37 of the Act has necessarily to be circumscribed by the purposes of the Act.

57F(1) (ii) without Legislative Competence

Entry 84, List I of the VII Schedule grants Parliament the power to legislate on duties of excise on tobacco and other goods "manufactured or produced" in India. Thus, any rule under the Excise Tariff Act, 1985 must necessarily be confined to the Scope of entry 84, and rule 57F(1)(ii) in trying to levy excise duty on trade or sale of goods, would clearly be unconstitutional.

Double Taxation

The mere fact that credit was taken of the duty paid on the said inputs cannot and does not detract from the fact that the same were duty paid goods. By availing of such a credit under rule 57A, the character of the goods, as duty paid goods is neither lost nor changed. Hence rule 57F(1)(ii) purports to expand the scope of the said Act itself and the same is ultra vires and void.

Violative of the Provisions of the Constitution

It would be irrational to levy duty under rule 57F(1)(ii) when no process, either of manufacture or otherwise is applied by the person to the said inputs. It is arbitrary, unreasonable and violative of equal treatment guaranteed under Article 14 of the Constitution. This provision also imposes a restriction on the freedom of the person to carry out his trade and business and is thereby violative of Article 19(1)(g) of the Constitution.

By assessing the said inputs at a higher price, the Central Government is levying and collecting tax without the authority of law contrary to Article 265 of the Constitution.

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4. 1995 (78) E.L.T. 641 (SC).

Hence, the impugned provision, "on payment of excise as if such inputs have been manufactured in the said factory" appearing in the said rule 57F(1)(ii) would be unconstitutional so, null and void.

In the Alternative

The impugned provision in rule 57F(1)(ii) may be held to be valid if it is construed so as to bring it within the scope of the Act.

The words, "as if manufactured in the factory" used by the legislature has to be construed merely as a provision whereby the procedure and formalities of clearing the inputs and repaying the amount of credit could be provided for. The proviso to rule 57F(1)(ii) lays down that the amount of duty on inputs cleared for home consumption should in no case be less than the amount credited. It is merely an measure ex abundanta cautella to prevent a loss of revenue on duty already accrued to the government in case the rate of duty comes down at a later date. Thus, all that is required by the impugned provision is that, if credited inputs are not used but removed for the home consumption or export, the credit entry should be reversed and that this should be done by the party who brought the said inputs into the factory. If the provision is construed thus, it would be intra vires and valid.

Conclusion

The validity of the impugned provision in rule 57F(1)(ii) of the Central Excise Rules, 1944, has been challenged in *Atlas Corporation India Ltd.* v. *Union of India and others*[5] and later in *Tata Engineering and Locomotive Company Ltd. and another v. Union of India.*[6] Both these petitions are still pending before the Bombay High Court.

However, on the 28th of June, 1995, an amendment was made to rule 57F(1)(ii) of the Central Excise Rules, 1944 by notification.[7] By this amendment, the Department seems to have accepted the contention that the words, "as if manufactured in the said factory" are ultra vires the rule making power of the Central Government and so dropped the controversial words. By simultaneously amending the proviso and specyfying that the excise duty to be paid while diverting Modvat credit availed inputs will be equivalent to Modvat credit initially availed upon receipt of the input, the government has left little about its interpretation, unlike the earlier proviso, under which it is possible to impliedly hold that the duty on diversion of Modvat inputs could, in some cases, exceed the amount of Modvat credit availed initially. This amendment should be treated as a clarificatory provision and should be applied retrospectively in respect of past clearances as well.

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5. Writ Petition no. 3448 of 1987.
6. Writ Petition no. 1799 of 1988.
7. Notification No. 28/95.