Kerala HC's decision on deemed sales – some major ramifications … – 13-02-13

By S Sivakumar, Advocate

WHILE thanking TIOL for bringing out the decision of the Kerala High Court, **2012-TIOL-1032-HC-KERALA-VAT** with its usual swiftness, I could not help looking at the possible ramifications, arising out of this decision. Here is an attempt.

Firstly … the decision reinforces the widely held view that, only VAT can be levied on transactions involving transfer of right to use goods, which are also referred to as 'deemed sales'. Though this decision has been rendered in the context of 'trade marks' which, of course, are 'goods', within the meaning of the VAT law, the decision has equal applicability in terms of the transfer of right to use 'goods' such as, packaged software, etc. With specific reference to software, the decision refers to the Apex Court's decision in the TCS case **2004-TIOL-87-SC-CT-LB** . In terms of this decision then, royalty for licensing of packaged software would be exigible to VAT only and not to service tax. This decision will cover transfer or usage of all kinds of intellectual property which are covered under the definition of 'goods' and other movable property like export licenses, motor cars, etc.

Secondly … if transfer of right to use goods can only be subjected to the VAT levy, how can the levy of service tax on the same transaction be sustained?

It is interesting to read Para 25 of this decision, which is reproduced below:

Quote

25. Faced with this situation, counsel for the petitioner relied on the Apex Court judgment in Imagic Creative (supra) and contended that Service Tax and VAT being mutually exclusive, since the petitioner is paying service tax on royalty received, the impugned demand for tax and penalty are illegal. In this judgment, I have already held that royalty received is liable to be taxed under the Act and this Court is not called upon to decide the legality of the levy of service tax on the royalty received by the petitioner. Therefore, if the petitioner has a case that levy of service tax is illegal for any reason, it is upto them to challenge the levy in appropriate proceedings.

Unquote

Though the High Court has not decided the constitutional validity of the levy of service tax on deemed sales transactions, it is very clear that this decision does have a lot of persuasive impact on the service tax law concerning the levy of service tax on deemed sales transactions. The Apex Court, in the *Imagic* case **[2008-TIOL-04-SC-VAT]**, had held that, service tax and VAT are mutually exclusive. Of course…. the view is that, just because VAT and service tax are mutually exclusive, it would not stand to reason that, just because one tax (in this case, service tax) has been levied, it cannot be said that the other tax (in this case, VAT) cannot be levied, on the basis of the mutuality concept.

However….. based on a combined reading of this decision and the Apex Court's decision in the *Imagic* case, it would seem that, with the validity of the levy of VAT on transfer of right to use 'goods' being confirmed now, the levy of service tax on the same transactions would not be permissible. To this extent, in my view, service tax cannot be levied on deemed sales transactions, despite that, no High Court has, till now, struck down the constitutional validity of the service tax levy on deemed sales.

Thirdly … as rightly pointed out in the **DDT-2007** column dated 20-12-2012, there seems to be a dichotomy in terms of a deemed sale transaction (which is subject to the VAT levy) being excluded from the definition of 'service', in terms of Section 44(a)(ii), while, the " temporary transfer or permitting the use or enjoyment of any intellectual property right" has been included as a 'declared service' under Section 66E of the Finance Act, 1994. The Central Government, in its infinite wisdom, seems to be of the view that, while a temporary transfer of intellectual property is a service, a permanent transfer of the intellectual property is a deemed sale. This view is extremely flawed, as the VAT law makes no distinction between a temporary transfer and a

permanent transfer, of movable property. In other words, there is no distinction between a temporary deemed sale and a permanent deemed sale, under the VAT law. Since, even a temporary transfer of right to use goods is taxable under the VAT law, in terms of this decision as also, in the light of the definitions contained in the VAT law, such a transaction cannot be subjected again the levy of service tax, in the light of the Apex Court's decision in the *Imagic* case.

Hence, post this decision, it would seem that, even temporary transfer of right to use goods is not taxable under the service tax, as these transactions are taxable under the VAT law and to this extent, the new service tax which has come into effect from 1-7-2012 would have to read and interpreted.

Fourthly and lastly …under the VAT law, there is no distinction between 'sales' and 'deemed sales', in terms of levy of tax. In fact, the tax rate applicable for deemed sales of a movable asset is equivalent to the tax rate applicable for the sales of the very asset. This fact has also been referred to, in the decision of the Kerala High Court.

However, the Central Government seems to be bent on distinguishing between 'sales' and 'deemed sales', for no reason other than to deny certain benefits to the assessees. The classic case is the attempt by the Revenue to deny the benefit of Notification No. 12/2003-ST, to the Construction Industry, on the basis that the word' sales' used in this Notification, cannot include' deemed sales', for the period prior to July 1, 2012. To some extent, this decision, though given in the context of the VAT law, does reinforce the view that, in so far as the VAT levy is concerned, 'sales' and 'deemed sales' are very similar concepts and the distinction is only relevant, from the perspective of Article 366(29A) of the Constitution. Given the fact that the very concept of 'deemed sale' is largely irrelevant for purposes of levy of VAT, one should expect that a similar approach should be adopted for the service tax law, especially given the fact that the 'deemed sale' concept has been borrowed from the VAT law.

This decision comes as a huge relief to Intellectual Property ('IP') Industry in general and the packaged software industry, in particular, in terms of the double levy of service tax and VAT on the royalties/license fees charged on various forms of IP and packaged software.

Before concluding…

If the view that service tax cannot be levied on deemed sales transactions is to be finally confirmed, the Central Government would stand to lose, thousands of crores of rupees as revenue, for sure. It is well known that, just to avoid litigation, most of the packaged software players are charging both VAT and service tax, on the royalties charged on these licenses. If this decision is not struck down by the Apex Court, the view that service tax cannot be charged on deemed sales transactions would get confirmed. I don't think the Central Government has a good cause to take this to the Apex Court, in any case, in my view.

This is probably the first High Court decision dealing with the double levy of VAT and service tax, on the same transaction. While some element of over-lapping, in terms of levy of indirect taxes by the States and the Centre is unavoidable, the entire transactional value to be subjected to both VAT and service tax, as is the case in respect of licensing of software, etc., is not acceptable. One does hope that the Central Government will take this decision in the right spirit and make amends for the constitutional impropriety that it has been committing by seeking to levy service tax on deemed sales transactions which are already being subjected to the VAT levy.

There is indeed a distinction between a transfer of right to use goods and a license to use goods, without a transfer of the right to use such goods, as brought about, in this decision. Despite this clear legal distinction, at the ground level, all license fees are sought to be subjected to the levy of VAT, by the State Government Authorities, despite that, VAT cannot be levied on these transactions.

With specific reference to deemed sales transactions, the only solution to the double levy would seem to be, GST. The faster GST is implemented, the better it is, at least in so far as the double levy on the entire transaction is concerned.

A similar situation prevails in respect of ‘composite transactions’, post 1-7-2012, with both the States and the Centre seeking to levy VAT and service tax on these transactions, based on their own understanding of what is the ‘dominant intention’ behind these transactions. With the interpretation of what is the dominant intention, being driven purely by revenue collection considerations vis-à-vis the Centre and the States, a lot of hardship to the taxpayer is bound to arise, along with the resultant litigation.

Will this decision have an impact on the income tax law? Well….I guess, it would. The subject involving charging of income-tax and the consequent need to withhold tax at source, under Section 195 of the Income tax Act, 1961, on royalty payments made by importers of packaged software licenses to non-residents is yet to attain finality, owing to contradictory decisions from the High Courts. This decision from the Kerala HC would perhaps, go to strengthen the view that, royalty paid for transfer/use of packaged software is a ‘sale transaction’, which cannot be subjected to charging of income tax in India.

And lastly… one does expect the Government to take this decision in the right spirit and amend the service tax law so as to remove the double taxation on deemed sales transactions.