Service tax on composite transactions – Confrontation between Centre and States on cards? – Mar 23, 2012

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MARCH 23, 2012
By S Sivakumar, CA

THE Central Government says that it is moving to a new service tax regime based on the law laid down by the Supreme Court in the BSNL case and the customary TRU Circular D. O. F. No 334/1/2012-TRU dated March 16, 201, in respect of service tax levy on composite transactions. This Circular, in Para 2.5.3 talks, at length on how, composite transactions would be taxed under the new dispensation. I've extracted the relevant portion from the TRU Circular…

Quote:

2.5.3 Would it mean that all composite transactions which in addition to a transfer of title in goods involve an element of provision of service be considered as a 'service' and taxable as such?

No. The manner of treatment of such composite transactions for the purpose of taxation, i.e. are they to be treated as sale of goods or provision of service, has been laid down by the Hon'ble Supreme Court in the case of Bharat Sanchar Nigam Limited vs Union of India [2006(2)STR161(SC)]. The relevant paras 42 and 43 of the said judgment are reproduced below ….

The following principles emerge from the said judgment for ascertaining the taxability of composite transactions-

++ Except in cases of works contracts or catering contracts [exact words in article 366(29A) being – 'service wherein goods, being food or any other article of human consumption or any drink (whether or not intoxicating) is supplied in any manner as part of the service'] composite transactions cannot be split into contracts of sale and contracts of service.

++The test whether a transaction is a 'composite transaction' is that did the parties intend or have in mind that separate rights arise out of the constituent contract of sale and contract of service. If no then such transaction is a composite transaction even if the contracts could be disintegrated.

++ The nature of a composite transaction, except in case of two exceptions carved out by the Constitution, would be determined by the element which determines the 'dominant nature' of the transaction.

++ If the dominant nature of such a transaction is sale of goods or immovable property then such transaction would be treated as such.

++If the dominant nature of such a transaction is provision of a service then such transaction would be treated as a service and taxed as such even if the transaction involves an element of sale of goods.

In case of works contracts and 'service wherein goods, being food or any other article of human consumption or any drink (whether or not intoxicating) is supplied in any manner as part of the service' the 'dominant nature test' does not apply and service portion is taxable as a 'service' This has also been declared as a service under section 66E of the Act.

Unquote:

The sum and substance of the new service tax law on taxation of composite services is that, except for transactions which are specifically listed under Article 366(29A), all other composite transactions involving

sale of goods and providing of services would be taxed, by applying the dominant test. The TRU Circular further goes on to state that, in the light of this, Notification No. 12/2003 would be deleted.

From a legal perspective, this seems fine…. The concern is, how much of this would help the tax payer, vis-à-vis the VAT law. There are several composite transactions involving sale of goods and providing of services and these transactions, referred to works contracts in a rather loose manner, are currently taxed both under VAT and service tax. Typical examples would be maintenance transactions, software development, tyre re-treading transactions, erection and commissioning, etc. Under most VAT laws, a deduction is allowed in respect of the services element (referred to 'labour and like charges') in respect of these composite transactions. For instance, under Rule 3(2) of the Karnataka Value Added Rules, 2005, a standard deduction is provided in respect of the various types of works contracts, with a residuary clause providing for a 25% deduction for 'other works contracts', when separate books are not maintained. This deduction is also available in respect of software development, which is classified as a works contract, under the Karnataka VAT Act, 2003. This scheme has been working very well under the VAT law and also, under the service tax law, till now.

It looks extremely unclear as to how these transactions would be treated under the new service tax dispensation. It looks that, these composite transactions would be treated as transactions with a dominant nature of service and with Notification No. 12/2003 being withdrawn, service tax would get levied on 100% value of these transactions. VAT would continue to get levied on about 75% of the transaction value, given the fact that the VAT law provides for a deduction of only towards labour and like charges, in most cases. Will we have then, a case of service tax being levied on 100% of the transaction value and VAT being levied on 75% of the transaction value in respect of most composite transactions other than works contracts?

The law laid down by the Apex Court in the IMagic case and several other cases is that, service tax and VAT/sales tax cannot be levied on the same portion of the composite transaction. It looks like this important element of taxability of composite transactions would get lost, with the same portion getting taxed both under the new service tax law as well as the VAT law.

This is a rather worrying development, which may not be to the liking of the States, which are empowered to levy sales tax/VAT on composite transactions, on the 'goods' part of the transactions.

And, more importantly, how would one determine the dominant nature of a transaction? It would be open to the Service Tax Department to contend that the dominant nature is one of services (eg. maintenance transactions) while, the VAT Department could contend that the same transaction's dominant nature is one of sale of goods. At least, under the VAT law, we have a provision for not paying VAT on the service element, in terms of the deduction provided. With Notification No. 12/2003 getting withdrawn, the Centre would levy service tax on the entire transaction value, resulting in a double levy of service tax and VAT on a significant portion of the composite transaction..

We could therefore, have instances where the Centre and the States would oppose each other, in the judicial forums. It would a good sight for the hapless assesse watching the two Governments fighting it out, in the Courts.

Before concluding……..

Notification No. 1/2006 is also getting withdrawn, it looks. This would mean that many services for which, abatement has been provided with the intention that the sale portion of the transaction should not get taxed under the service tax law, would now get taxed to the full extent.

The move to levy service tax on the entire value of the composite transactions would go against the federal structure in terms of levy of taxes, as the service tax would seem to get into the goods taxation area. In

another disturbing development, the Centre wants to keep the current provision of levying service tax on 25% of the total value of the works contracts including the value of the land, in respect of construction services. Is this not a case of the Centre getting into the State Governments' shoes? How can the Centre levy service tax on sale of land, directly or indirectly?

Take, for instance, the sale of electricity by Developers of commercial and industrial complexes. In terms of the service tax law, this is a transaction whose dominant nature is one of service. But, from the VAT point of view, electricity is goods included in the exempted schedule to the VAT Act. With the benefit of Notification No. 12/2003 no longer being available, can the Central Government go ahead and levy service tax on the entire value of the transaction including the cost of the electricity distributed by the Realty Developers? Such a move would be highly unsustainable and would lead to a lot of litigation.

Can a view be now taken by the Centre that, the dominant intention of a software transaction is a service and consequently, no VAT can be levied? Would the States be willing to give up taxation of software licenses, for instance?

Apart from the service tax assesses, it would now seem that the State Governments would have a lot to worry about the new service tax law on composite transactions. We should see a lot of litigation in terms of the new law on levy of service tax on composite transactions.

In terms of works contracts….under the new dispensation, only civil works contracts are getting treated as 'works contracts' under the service tax law. How about the other transactions like software development, erecting contracts, etc., which are treated as works contracts under the VAT law and not so, under the service tax law? If the Central Government goes ahead and treats these as composite transactions with a dominant nature involving providing a service and levies service tax on 100% of the transactional value, where would this leave the States, given the fact that, currently, States are collecting VAT on 75% of the transaction value, treating these as works contracts.

Withdrawal of Notification No. 12/2003 would lead to chaos in respect of levy of indirect taxes on composite transactions, for sure. The Industry would need to fight these provisions, tooth and nail, as otherwise, most composite transactions would get taxed both under the service tax law as well as under the VAT law, something, that the Supreme Court has frowned upon, time and again.

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