Finance Act 2004 brought into Service Tax net *inter alia* Construction Services, Intellectual Property Rights and Transport Services. The construction contracts involving material and services were hitherto considered as indivisible contract. Transactions of 'Intellectual Property Rights' such as transfer of trademark etc. were held as sales of goods. Receiver of transport service in organised sector is made liable to tax. Very recently, Supreme Court has held that "telephone rentals" can be taxed under Sales Tax Act as right to use goods. Service Tax is required to be paid after receipt of payment for services while accounts are maintained on accrual basis. In this background, this article attempts to analyse some issues in relation to Service Tax.

SERVICE TAX: CERTAIN ISSUES

— Ashok Chandak

Indivisible contracts and transaction of Sales of goods:

Entry 92C of the list I of the Seventh schedule (1st List) to the Constitution of India (the Constitution) enables the union to levy "Taxes on Services". Entry 92C was introduced by 88th Constitution Amendment Act, 2003. Prior to that, Service Tax was imposed under Entry 97 of the List I, which is a residuary entry. Levy of tax under Entry 97 was upheld by various courts as well as by Supreme Court.

Entry 54 of List II of the Seventh Schedule (List II) to the Constitution enables the State to levy "taxes on the sale or purchase of goods other than newspapers subject to provision of Entry 92A of list I". Article 366 of the Constitution is definitions clause for the purposes of the Constitution. The 46th amendment to Constitution has inserted a new clause (29A) which defines term "tax on the sale or purchase of goods" and it includes under (b) "a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of works contract" and under (d) "a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration". Therefore, having regard to entry 54 of List II of the Seventh Schedule, the transaction contemplated by sub-clause (b) and (d) of clause (29A) of article 366 is a transaction of sales of goods.

The Supreme Court of India in paragraph 40 of its judgement in case of Builders' Association of India V. Union of India [1989] 73 STC 370 (SC); (1989) 2 SCC 645, says:

"As the Constitution exists today, the power of the States to levy taxes on sales and purchases of goods including the 'deemed' sales and purchases of goods under clause (29-A) of article 366 is to be found only in entry 54 and not outside it".

Thus following questions do arise for consideration: (i) Whether Service Tax can be imposed where contract is composite or indivisible (i.e. for sale/supply of goods and services) such as construction contracts, software development contracts, etc? (ii) Whether Service Tax can be imposed where the whole contract is legally considered as a

It appears from the provisions of Service Tax that in various mattes wherever there is a possibility of composite contract for goods and services, certain percentage of gross receipt is only taxed or an assessee is given an option to deduct the value of goods supplied. The objective of all these deductions is to tax only the services part of the composite contract.

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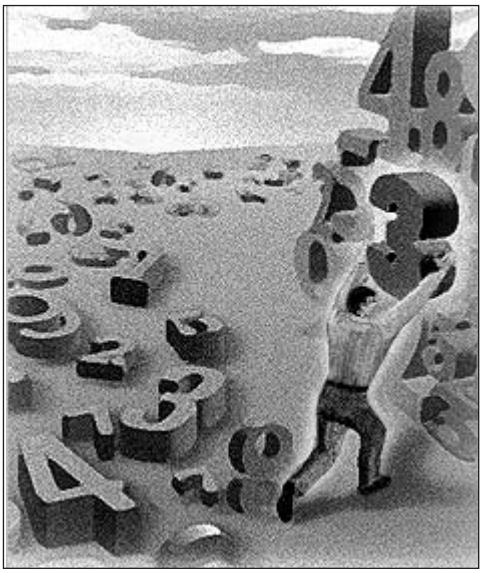
contract of sale, such as contracts of right to use telephone lines, transfer of Intellectual Property Rights (Trade marks, Patents, Designs) etc.?

So far as first question is concerned, two views are possible. According to one school of thought, Service Tax cannot be imposed by dividing indivisible contract. Arguments in support are as under:

The Supreme Court way back in 1959 in case of Gannon Dunkerly & Co., 9 STC 353 held that "in a building contract which is one, entire and indivisible – and that is its norm – there is no sale of goods, and it is not within the competence of the Provincial Legislature under Entry 48 to impose a tax on the supply of the materials used in such a contract treating it as a sale. But the parties to the contract might enter into distinct and separate contracts, one for the transfer of materials for money consideration and the other for payment of remuneration for services and for work done. In such a case, there are really two agreements, though there is a single instrument embodying them, and the power of the State to separate the agreement to sell from the agreement to do work and render service and to impose a tax thereon cannot be questioned". This judgement resulted in 46th amendment to the constitution by which sub-article 29A was added to article 366.

The Supreme Court in case of Builder Association of India (73STC 370) discussed the effect of 46th Constitution Amendment as under:

"After the 46th amendment, the Works Contract, which was an indivisible one, is by legal fiction altered into a contract which is divisible into one for sale of goods and the other for supply of labour and services. After the 46th Amendment, it has



become possible for the States to levy sales tax on the value of goods involved in a works contract in the same way in which the sales tax was leviable on the price of the goods and materials supplied in a building contract which had been entered into two distinct and separate parts".

As stated above the article 366 states definitions. Clause (12) defines the word "goods" and clause 29A defines the term "sale or purchase of goods". Before clause 29A, the sales tax was not leviable in an indivisible or a composite contract or some other non-sale transactions as listed in clause 29A. However, there is no such definition in relation to providing services. Entry 92C of the first list of the Constitution is required to be read just like the Supreme Court read the entry 54 of the list II in the context of Sales Tax Act prior to 46th amendment and after the 46th amendment. Therefore, Service Tax cannot be imposed where the contract is indivisible or composite by artificially dividing the same into two parts.

The word "Goods" is defined under Service Tax which will have the meaning assigned to it in clause 7 of Section 2 of the Sales of Goods Act 1930. Thus Service Tax law also recognises that taxation of sale of goods is States subject.

This view also finds support from the observation in the judgement of the Supreme Court in case of Daelim Industries Co. Ltd., Vs. Commissioner of Central Excise 155 ELT 457. Para 7 of the judgement is as under :

"Thus a perusal of the clauses of the contract leaves no doubt that the appellant's contract with IOC was a works contract on turnkey basis and not a consultancy contract. It is well settled that a works contract cannot be divided vivisected and part of it subjected to tax"

The other view is just opposite. According to this school of thought, Constitutional validity of Service Tax on services provided by various service provider is already upheld by the various courts therefore service tax can be imposed on the indivisible contracts. Arguments in support are as under.

The Supreme Court in the case of TamilNadu Kalyan Mandapam Association Vs. Union of India 167 ELT 3 has upheld the constitutional validity. Similarly various High Courts in the context of various services upheld the constitutional validity. One will have to very carefully note that in all cases before various high courts the challenges to constitution validity were with reference to Union's Powers to levy tax in relation to various entries viz 18,49, 60 of list II and article 14 and 19(1)(g) of Constitution. In all cases it was held that this tax is covered by entry 97 of list I and not covered by any entry of List II so also there is no violation of article 14 and 19(1)(g). In case of Tamilnadu Kalyan Mandapam

Association, the article 366(29A)(g) was also considered by the Supreme Court. The Court observed that "it is well settled that for the tax to amount to a tax on sale of goods, it must amount to a sale according to the established concept of a sale in the law of contract or more particularly the Sale of Goods Act, 1930. Legislative cannot enlarge the definition of sale so as to bring within the ambit of taxation transactions which could not be a sale in law".

The court also referred the judgement given in 1959 in case of Gannon Dunkerly & Co. (9 STC 353). The court further observed that "the operative words of the said sub article (i.e.366(29A)) is supply of goods and it is only supply of foods and drinks and other articles for human consumption that is deemed to be a sale or purchase of goods". The Court however observed "The concept of catering admittedly includes the concept of rendering service. The fact that tax on the sale of goods involved in the said services can be levied does not mean that Service Tax cannot be levied on service aspect of catering". Accordingly court held that, "the fact that Service Tax is levied as a percentage of the gross charge for catering cannot alter or effect the legislative competence of the parliament in the matter".

The observation of Madras High Court in case of Advertising Clubs and others vs. CBEC 131 ELT 35 in the context of Service Tax are worth noting. The Court in relation to Service Tax observed that "it is entirely independent of and different from the existing taxes covered by the tax provided in list II of the 7th Schedule to the Constitution that itself suggest that this could not come within the arena of entry 55 of list II". While observing this, the Court also observed that the statement of Finance Minister while presenting the finance bill 1994 is very relevant to understand the object of Service Tax.

Can there be a Service Tax on such services which are held as sale of goods?" In my view answer to this question is in negative. However, to get this issue decided one will have to approach in Writ to High Court.

It appears from the provisions of Service Tax that in various mattes wherever there is a possibility of composite contract for goods and services certain percentage of gross receipt is only taxed or an assessee is given an option to deduct the value of goods supplied. The objective of all these deductions is to tax only the services part of the composite contract.

Thus, according to other view, Service Tax can be levied on a service portion of the indivisible contract also by dividing the same in two parts. Method to divide is also given in various notifications.

While I do subscribe to first view matter will have to be decided by Court only.

One matter is atleast clear from the above discussion that <u>where the transaction is fully of a sale than Service Tax is not attracted.</u> The Supreme Court in case of State of Uttar Pradesh vs. Unions of India 130 STC 1 by judgement dated 04.02.2003 has held that telephone rentals received for providing telephone connection to subscriber is sale under clause 29A(d) of article 366 and State can impose Sales Tax on the same. On these rentals service tax is being imposed from 1994 and all service providers are paying the same. Now that Supreme Court held that it is a transaction of sale taxable under States Sales Tax Laws new controversy about coverage of transaction will have to be answered. If transaction is sale then it cannot be service and taxable under entry 92C of the List I. In case of some other services such as intellectual property rights, also transactions are held as sale of goods. Software development, etc. are also held as sale of goods by the Supreme Court in case of Tata Consultancy Services (137 STC 620). Designs are held as goods by the Supreme Court in case of Associated Cement Co. Ltd. (124 STC 59). So also Trade Marks are held as goods by the High Courts. The question therefore is, "can there be a Service Tax on such services which are held as sale of goods?" In my view answer to this question is in negative. However, to get this issue decided one will have to approach in Writ to High Court.

Transportation Service

1. Finance Act 1997 had earlier levied Service Tax on Goods Transport Operators w.e.f. 16.11.1997 which was subsequently withdrawn after nation vide strike. Thereafter by the Finance Act, 2004 Service Tax has been imposed on Goods Transport Booking service rendered by any goods transport agency with effect from 10th September 2004. However, the levy

was deferred till further notice again in view of transporters strike. The Government thereafter constituted a committee to study the matter. Now, on the basis of report of the committee, issued various notifications dated 03.12.2004, levying tax of Transportation Services w.e.f. 01.01.2005.

2. Provisions in brief :

'Taxable Service' is defined as under–

"Any service provided to a customer, by a goods transport agency, in relation to transport of goods by road in a goods carriage"(Section 65(105)(zzp))

Thus, any goods transport agency rendering services in relation to transport of goods by road shall be liable to pay Service Tax and shall be treated as assessee for the Service Tax purpose. However Rule 2(1) of Service Tax Rule provides that if such service is provided to the consignor or consignee who is in organised sector then the tax would be payable by the consignor or the consignee and not by goods transport agency. Rule 4B of the Service Tax Rules defines consignment note and makes it mandatory for transport agency to issue a consignment note to a customer for providing services in relation to transport of goods in a goods carriage. The explanation to Rule 4B further makes it mandatory that the consignment note *inter alia* must contain the name of consignor and consignee, registration number of goods carriage in which the goods are transported, and person liable for paying the Service Tax whether the consignor or consignee or goods transport agency. One can avail abatement of tax from the gross value to work out taxable value subject to condition that no Cenvat credit will be available. These provisions bring certain issues.

3. Can receiver of services be made liable to tax?

The Supreme Court in the case of M/s Laghu Udog Bharti Vs. Union of India (112 ELT 365) had earlier struck down the provision under which the receiver of service was held liable for collection and payment of tax. The Supreme Court considered Sec. 65,66,67,68 & 70 of Finance Act 1994 and held that a rule which makes person other than the service liable provider for collection of Service Tax is *ultra-virus* the Act itself. Careful reading of wording of present section 65,66,67,68 & 70 will bring that while under earlier provision receiver of service was held liable for collection and payment of tax and under the current provision receiver of services is liable only for payment of tax. A person who is liable for payment of tax is thereafter consider at par with a person rendering services. It would be necessary to note the basis for levy of tax is rendering of services. Thus one can take a view that even by amending the Act the ratio of Supreme Court's judgement in the case of M/s Laghu Udyog Bharti is not overcome. However, the matter will have to be taken to the Courts for appropriate decision.

4. Who is a customer and how the transport agency will know about it?

Service provided to a customer is liable to tax. A customer is a person who takes services. Whether consignor or consignee is a customer depends upon the facts. If the contract of sale of goods between consignor and consignee is FOR destination basis then transportation of goods from place of origin to destination is responsibility of the consignor. This consignor will be customer. Whereas if the contract is FOR dispatching station basis then the services are hired by the consignee and thus consignee will be customer. The transport agency, for want of information will not be in a position to know legally who is customer. A practical view can be taken that one who is making payment of freight is a customer. Therefore if the transport receipt is on freight paid basis or to be billed to consignor then the consignor is a customer and if it is "to pay" basis or to be billed to consignee then consignee is a customer. This is also logical because the Service Tax is payable only on cash basis. This is also relevant for claiming CENVAT credit by the consignor or consignee.

Any goods transport agency rendering services in relation to transport of goods by road shall be liable to pay Service Tax and shall be treated as assessee for the Service Tax purpose.

5. Consignment Note:

Rule 4B of Service Tax rules provides certain particulars to be recorded in consignment note.

It is mandatory to write name of consignee in consignment note:

In number of contracts the document for goods are negotiated through banks. Therefore bank insist that in the consignment note consignee should be 'self'. The consignment note is endorsed by the consignor in favour of bank and later on, on retirement of documents consignment note is endorsed in favour of consignee. This is also in accordance with the Negotiable Instrument Act, which is an Act passed by the Parliament. The question, therefore, is can Rule mandate something against the provision of another Act of Parliament? The logical answer is No. Therefore, it would not be a mandatory to write a name of consignee. One can still make a consignment note with self as consignee. It would be sufficient compliance of The Service Tax Rule.

Registration number of goods carriage to be stated:

In most of the case when the goods are accepted for transportation the booking agent himself might not have identified the goods carriage to be used for transportation of such goods. Thus when the consignment note is required to be issued to the consignor immediately after booking it is not possible to write registration number of goods carriage. Thus how one can comply with the provision is a big question. Non compliance of law is an offence.

Person liable to pay service tax to be stated:

It is difficult for a transporter to know who is a person liable to pay Service Tax. The rule provide that if the consignor or consignee of the goods is in organised sector then tax can be paid by any person liable to pay freight. The transport agency is, therefore, required to state in consignment note as to who is liable to pay tax. Thus, every transporter is expected to make inquiry, when he issues freight paid consignment note, as to whether consignor is in organised sector. Similarly inquiry will have to be made when "freight to pay" basis consignment note is to be issued as to whether the consignee is in organised sector. In case consignee is "self" then technically consignor is undertaking a liability to pay the freight but latter on freight is paid by consignee. In such case, question is whether consignee is an agent of consignor? If yes then consignor being in organised sector will be a person liable to pay tax, though freight might have been paid by any other person who may or may not be in a organised sector. Question is on what basis he should pay tax. Transporter is also in fix as to who will be person liable to pay tax and if a consignor is from non-organised sector and consignee is self then in all cases transporter will be person liable to pay tax. This is practical difficulty. Department will have to come out with some solution.

The Service Tax law recognised only cash system of accountancy. However, the Companies Act provides that every company will have to keep its account on accrual basis and while maintaining the account on accrual basis, the accounting standards as promulgated by the ICAI needs to be followed.

6. Multi-model Transport Receipts:

The Negotiable Instrument Act recognises the multimodel transport receipt. Under this consignment note, the goods are transported by several modes of transport such as road, train, sea, air etc. and consolidated amount is charged for total transportation. Dispute may arise as to whether any tax is required to be paid on such consignment note and if so on what amount? Again contract being composite one view will be tax is not attracted while other is tax attracted on 25% of total consideration. It is suggested that if possible and practicable freight for road be shown separately.

7. Transportation of goods to outside countries:

Transportation of goods to neighboring countries like Nepal, Bhutan, Bangladesh, Pakistan etc. is not new. Under the Sales Tax laws sale of goods where goods are dispatched under consignment notes is considered as export of goods. A question therefore arises whether the freight for such transportation will attract the Service Tax? Naturally this is an export of services. In most of the cases amount will not be received in non-repatriable foreign exchange.

8. Availment of cenvat credit for input services :

Document for availment of credit: The CENVAT Credit Rules

grant credit of Service Tax in relation to the input services subject to availability of document from service provider in prescribed manner. Recipient of transport services in organised sector is expected to pay the Service Tax himself naturally he will not have any document or invoice for such payment of Service Tax as provided in rule. Can he claim CENVAT credit? Current provisions do not give any answer to this question. It is suggested that in such case also person paying Service Tax should generate a suitable document for such services.

Multiple Service Provider: If the recipient of transport service is also a service provider and provides multiple services for which he uses the transport services and being in organised sector is liable to pay Service Tax. As per notification No. 32/2004 dtd.03.12.2004 Service Tax is to be paid on 25% of freight paid. This notification bars him taking a Cenvat credit. Question therefore arises as to whether he can take a Cenvat credit in relation to input services for other services? One interpretation could be since abatement is taken Cenvat credit in relation to other services cannot be taken. However, this would be illogical interpretation. Tax on transport service is not paid as service provider. It is paid as receiver of the same. Similarly since service is not provided one can argue that no other input services are used for receiving transport services. Therefore in my view on all other services including transport services Cenvat credit will be available. No doubt CENVAT will not be available on the input services, which are directly attributed to receipt of transport services. Other question is can for payment of tax on transport service input credit in relation to other services be used. My view is since in the case tax is paid as receiver of service CENVAT credit cannot be adjusted from the tax liability.

COST OF GOODS SOLD

Sec. 67 of Finance Act and other notifications provides for valuation

of taxable services for charging Service Tax. According to these provisions, in case of certain services, deduction for cost of parts etc. used in providing certain services is provided. The term "cost of parts" is not defined. In normal commercial parlance, the cost of parts needs to be understood as the cost of parts to the service provider. Similarly since valuation is being done for value of services provided, the cost in the hands of service provider is required to be deducted. However, it may be noted that in composite contract consideration also includes profit on material. Section further provides deduction of "cost of goods sold to customer". Therefore, another interpretation is the cost of parts to the customer (i.e. sale price of parts) should be considered for the purpose of deduction. Thus there will always be dispute about valuation in case of composite service provider. Under the Central Excise Act in relation to disputes about the valuation, Supreme Court held that for imposing central excise duty, manufacturing profit needs to be included in valuation. Applying the ratio profit on goods used in composite contract needs to be considered for claiming deduction.

ACCOUNTING ISSUES

Under the provisions of Service Tax, the tax is payable only when the consideration for providing the services is received. Similarly Cenvat credit of inputs services can be taken only when the payment/or the same is made to service provider. Thus, the Service Tax law recognised only cash system of accountancy. However, the Companies Act provides that every company will have to keep its account on accrual basis and while maintaining the account on accrual basis, the accounting standards as promulgated by the Institute of Chartered Accountants of India (ICAI) needs to be followed. In the context of accounting for Ccenvat credit on inputs for manufacturing, it is provided by ICAI that the cost of such goods be taken net of Cenvat credit. The same treatment will have to be given for the Cenvat credit available on the services. Thus, while accounting for cost of services received, it needs to be accounted net of Cenvat credit. Therefore, when one record the telephone bill payable, only net amount will go to expenditure account and the Service Tax part will have to be recorded in Cenvat credit receivable account. However, this credit is available only when the bill is paid. Similarly the tax is to be paid when the consideration is received. This provision makes it difficult to ascertain correct periodical liability under accrual system. Thus for keeping track one may have to either create memoranda ledger accounts for Service Tax payable as well as Cenvat

credit receivable or make some entries in financial books. The following entries are suggested in financial books.

i) When the invoice for providing services is raised to customer.
Sundry Debtors A/c Dr. —-
(by full amount of invoices)
To Service Receipts A/c (Revenue) Cr. —-
(by amount of charges for services)
To Service Tax liability A/c Cr. —-
(by amount of Service Tax charged in the invoice)

ii) When the payment is received from the customer.
a) Normal entry
Cash/Bank A/c Dr.
To Sundry Debtors A/c Cr.
(by amount of payment received)
b) Service Tax liability a/c Dr.
To Service Tax payable a/c Cr.
By the amount of Service Tax component received from the customer. The total of all such credit in Service Tax payable a/c during the period will be actual amount payable for the period.

iii) when the goods are purchased for use as input in providing services.
a) Material A/c Dr.
(net value of goods)
Cenvat credit available Dr.
(By the amount of Cenvat credit available)
To Sundry Creditors A/c Cr.
This is normal entry and no further entries are required since in case of goods Cenvat credit is available even if suppliers bill is not paid.

iv) when the input service is received, :
a) Service A/c (Primary head) Dr.
(net value of services)
Cenvat credit Receivable A/c Dr.
(by amount of Service Tax charged in the bill)
To Sundry Creditors A/c Cr.
(full value of bill)

v) when the payment is made to the input service provider.
Normal entry
a) Sundry Creditors A/c Dr.
To Cash/Bank A/c Cr.
(By amount paid)
b) Cenvat credit available a/c Dr.
To Cenvat credit Receivable A/c Cr.
(to the extent of Service Tax component in the amount paid to service provider)

vi) when capital goods are purchased for providing services.
a) Assets A/c Dr.
(Net of Cenvat Credit)
Cenvat Credit Available A/c Dr.
(50% of Cenvat Credit)
Cenvat Credit Receivable A/c Dr.
(50% of Cenvat Credit)
Sundry Creditors A/c Cr.

In case of capital goods Cenvat Credit Rules provide that only 50% of credit will made available in the year of purchase and balance will be available in the subsequent years. In next year balance of 50% Cenvat credit be transferred to Cenvat Credit Available A/c.

In case any discount or adjustment is made in the invoice for rendering services necessary reverse entry be passed. Similarly if any discount or credit is received from sundry creditor necessary reverse entry need to be passed.

With these entries the Cenvat credit available a/c will show the amount credit available to the service provider which can be used during the period for payment of Service Tax. Similarly the Service Tax payable a/c will show the amount payable for the period.

Necessary amount may be transferred from the Cenvat credit available account to Service Tax payable account periodically based upon actual credit availed during the period. The actual amount of Service Tax paid be debited to Service Tax payable a/c.

At the end of a year : (a) Service Tax payable a/c will show a credit balance which would be equal to Service Tax payable at the year end. (b) The Service Tax liability a/c will represents liability of the Service Tax, which has not become due since the payment for rendering services is not received. (c) Cenvat credit available a/c will show a debit balance which is available for discharging the liability (d) The Cenvat Credit Receivable a/c will shows a debit balance which will be available in next year for availment subject to fulfillment of conditions i.e. (i) payment of consideration to the service provider or (ii) balance of credit available for capital goods to be used in any of the subsequent year.

Conclusion

This gives lots of scope for accountancy profession in providing the services to the Service Tax assessee. ■