Paradigm Shift in Taxing Services

Every once in a while the lion has to show jackals that the time is not to run but to kill. It can be argued that this is not the best of times, but then there is never a right time to bring in sweeping amendments. Given the GST-times ahead, the negative List of Services may just be the sound of the lion's roar. It is 18 years since taxation of services was introduced for the first time in India. From a mere three services to taxation of almost all kinds of services (barring a few) today, it represents an exemplary shift in the era of services taxation. From a monetary point of view, as per the Finance Minister's estimate, it would contribute over ₹100,000 crore in the current financial year.

With GST looming on the horizon, it was essential for service tax to move from the current regime of taxation of specified services to an era where little differences would exist on what service is taxed and what is not. Consequently, a study was initiated last year to examine the modalities for a new regime, which has now resulted in taxation of services on the basis of a negative list. But before we jump into any conclusions, it is essential to bear in mind that notwithstanding the dramatic change and the attempt to adopt *"…a paradigm shift in the way services are proposed to be taxed..."* it will do little to abandon 18 years of experience and understanding of transactions involving services. That apart, before we start to dissect and analyse the new regime, we must remember that though over the years we have had ample opportunities to bemoan the unwieldy tax structure that has come to represent service taxation, within a year of its implementation, we will all be talking about the 'negative list' approach without a single emphatic expression.

The "Negative List of Services" based approach is contained in the following amendments proposed:

Section 66B – charging section which levies tax on all services (as defined)

Section 66C – authorising the Government to prescribe rules for determining the situs of the service

Section 66D – specifying the negative list of services that will not be taxed

Section 66E – specifying the 'declared services' that will be taxable without entertaining any debate

Section 66F – specifying interpretation principles on bundled-services

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The "Negative List of Services" based approach is contained in the proposed amendments of Section 66B, Section 66C, Section 66D, Section 66E and Section 66F. Taxation on the basis of a Negative List of Services would essentially mean charging tax on all services to the exclusion of a few that are not taxable or if ordinarily taxable, specifically excluded for taxation purposes.

Taxation on the basis of a Negative List of Services would essentially mean charging tax on all services to the exclusion of a few that are not taxable or if ordinarily taxable, specifically excluded for taxation purposes. It is important to note that this negative list neither lends itself to scrutiny nor behaves as specie to allow anyone to extrapolate the exclusions.

It is a truism that tax is a liability that is attracted to the subject matter of levy when the taxing event occurs. While the taxing event is never the object of a commercial transaction or a contract, the law authorises an inquiry into the presence of the taxing aspect in that transaction or contract. And when its presence is established, liability is fastened and someone is designated as the payer.

Service tax, in this new approach, will be applicable when "any activity is carried out by one person for another for a consideration." From here onwards, there is a considerable shift in the determination of taxable services. From the current scenario, where one had to wade through the different types of services, and see if the service provided fits into any one of the taxable services, the inquiry would shift to sifting through:

17 services enshrined in the negative list;
34 exempted service categories under a mega notification; and
9 exclusions/abatement notifications.

For long, a simple principle stood the test of time - sellers pay VAT, service providers pay service tax and importers pay import duties. But since life is one continuous cycle of learning, we were soon made aware (after much litigation) of another mode of levy when importers of services were called upon to pay service tax under "reverse charge" - a scenario where the recipient of service was being made responsible for payment of service tax. Having tasted success with this new method of collection, the Government has now unabashedly deployed this mechanism all over the new system of levy. So from a situation where this was deployed only to collect tax from people who were rendering service in India but located outside the taxing jurisdiction, we now move to a perhaps more cautious regime where the service receiver is being tasked with payment of a portion of the service tax due through the reverse charge mechanism when the service provider is either unorganised or fearsome.

The table below is an immediate case in point where to check deliberate non-compliance, citing the pretext that the service provider is not organised (an individual, firm or an LLP), and the recipient is better organised (corporate body), the tax payable is differentially assigned to the service provider and service recipient, namely:

S. No.	Description of Service	Service Recipient	Service Provider
1	Hiring of motor vehicle designed to carry passengers:		
	- with abatement	100%	Nil
	- without abatement	40%	60%
2	Supply of manpower for any purpose	75%	25%
3	Works contract service	50%	50%

Services are taxed in the hands of the person charged with paying the tax, but the levy is based on *situs* of the service that is performed. "Taxable territory" as an expression has been introduced to refer to territories where the Finance Act extends. Services are taxable only when provided in the taxable territory. And as an extension of this analogy, *situs* of a service is established based on the location of the service receiver. If the service receiver is located in a taxable territory, then tax becomes payable.

A Service receiver is a person who carries the underlying contractual obligation to pay the agreed consideration to the service provider. Under the new regime, who pays the consideration is indicative, but who is liable to pay the consideration would be conclusive.

Hence, to sum up:

- Any taxable activity – being any activity that eludes all clauses in the negative list, mega exemption notification and exclusion categories;
- performed for a consideration;
- for another person;
- who is located within the taxable territory; and
- will be liable to service tax.

And:

- The person who is most proximate to the activity (service provider or service receiver);
- such person being situated within the taxable territory; and
- will be responsible for discharging the tax.

The export of services to an overseas customer will be exempted, because the service receiver is situated outside the taxable territory. For similar reasons,

services performed outside India for an Indian customer will still be taxable.

Given the number of services that are liable to tax, there is no motivation to qualify the negative list or the exemptions. With the proposed amendment in Section 66F that "services used for providing services" ought to be viewed as being distinct and separate; if any service becomes non-taxable, then the entire CENVAT chain will have been severed leading to a surge in cost of sales. It would be utter folly to want to qualify the negative list or exemption. With the sweeping coverage of taxes on goods and services, wandering away from the continuum of input-output chain of taxation will cost very dear. With a squeeze on margins being rampant in a shrinking global economy, one can ill afford the loss of tax credits in a business.

Although we are yet to see what changes may come about in the CENVAT Credit Rules, as the situation beckons, we can expect to see a service-specific reference making way for a more liberal yardstick. Definition of inputs, capital goods and input services, and their significance would evaporate, and the nexus theory is *passé* to usher in an era of (near) total pass-through of all credits. However, given the urge to hold back some of the credits, weighted reduction may exist only to remind us about the past.

In a hurry to adopt the new methodology, one must not lose sight of an important fact – new or old, the basic ingredients of a contract under the Indian Contract Act, Sale of Goods Act and mutual exclusivity in the taxing powers (or limitations) under the Constitution cannot be given a go-by. What was contracted for, what does the tax law look for and how to identify its presence will continue to play a central role even in this new approach.

That taxation follows business arrangements to identify the presence of taxing ingredients can be seen yet again in the amendment proposed by sub-section 3 to Section 66F in the expression "naturally bundled in the ordinary course of business." If taxable and non-taxable services are naturally bundled, then the "essential service" guides taxation and any attempt to artificially bundle services is swiftly met with incremental tax burden.

Unbundling of composite transactions into its constituents is not permissible except in works contracts and catering contracts. Seemingly insightful vivisection of a composite transaction does not have the sanction in law, much less views of an adventurous bench of the Tribunal. "What did the parties have in mind?" is simple, yet profound. Conduct of parties prevails over any presupposition about what they may have had in mind. Observing the conduct of the parties provides the facts necessary to make a determination of the "object of contract", and then the tax law freewheels its way and provides us the answer to taxability. Following principles may be noted as the touch points for ascertaining the taxability of composite transactions:

- Except in two instances, vivisection of composite transactions is not permissible;
- If "severally severable objects" were contracted by the parties, then though a single document may enshrine the agreement of the parties, unbundling is necessary and desirable; and
- Intent of parties to be discerned from the conduct of the parties, which will guide taxability of the whole or the constituents severally.

From the current scenario, where one had to wade through the different types of services and see if the service provided fit into any one of the taxable services, the inquiry would shift to sifting through 17 services enshrined in the negative list; 34 exempted service categories under a mega notification; and 9 exclusions/abatement notifications.

"Sale" and "service" will be mutually exclusive, unless established otherwise by the above methodology. That some services are provided, while selling goods or some materials are used/used-up in providing services should not pose a predicament in deciding taxability as sale or service. Sure, taxmen will canvass that both VAT and service tax can co-exist. But it is for the discerning to guide compliance by industry and suitably represent to stave-off the avarice of such taxmen.

Verb is an "action word" and "service" is a verb; but not when it is used in the context of "service tax". If we feel compelled to look for the action in a given service, we may be greatly disappointed saying, "where is the service for a tax to be charged". Look what happened to "renting of immovable property service". There is no such "verbal conjugation" that the law submits itself to. Now, under the negative list of services, where service is being defined as an "activity", it is clear that we ought not to look for the "service" in any taxable service.

If neither the State nor the subject seeks to stretch this legislation (when it becomes one) to undeservedly raise revenue or claim exclusion, compliance will be almost uneventful under this approach. The sheer length of the TRU letter issued on Budget Day shows how unnerving it must be even for the establishment to make such a *paradigm shift*. And while the powerful lions may roar, we professionals walk tall as elephants keeping a watch over the use of that power. ■