Sale, Service and Works Contract: Searching for the Blurred Lines

This article, written primarily from sales-tax viewpoint, analyses the scope of "sale", "service" and "works contract". While income tax provisions are considerations, the principles emerging from the discussion could be relevant for the purpose of tax laws as well, particularly on applicability of withholding taxes on contracts such as EPC contracts.

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Introduction

From a comprehensive sales-tax regime and no tax on services, to a tax on limited services, to a comprehensive tax on services, we have travelled a long way. However, what we have not been able to achieve so far is an integrated tax regime, so that the tax structure on sales and services remains fragmented. The world of commerce has grown more complicated over time: there are lots of contracts where the borderline of sales and services are not clearly defined. There are several composite contracts which have strands of both sales and services – works contracts are one of these – which fall under both sales-tax law and service-tax law. The implications of whether a contract is sale or service are multifarious – sales-tax law is obviously one of them, but there are other immediate consequences – applicability of TDS and withholding tax in international transactions, issues pertaining to accrual of income, etc.

In case of composite contracts, the borderlines of sales and services may not be clear at all, and the massive tax consequences of either treatment, expose tax payers to a substantial risk. The question remains involved, and far from clarity despite years of court rulings.

Meaning of sale, service and works contracts

Sale

In general parlance "sale" means a transaction where one person transfers property in goods to another person in lieu of a consideration paid by the latter. "Goods" normally mean movable property, which may be tangible or intangible. "Sale", as defined under Section 4(1) of the Sale of Goods Act, is a "***contract*** whereby the seller transfers or agrees to **transfer the property in goods** to the buyer for a price." Therefore, the essence of sale is that *the property in goods must pass on from one person to another*. Benjamin's oft-cited ingredients of a sale are illustrated in Figure I-Essential Ingredients of Sale. In addition, since a "sale" is necessarily a "contract", all the requisites of a valid contract are essential for a "sale" to be considered as such.

Figure I: Essential Ingredients of Sale

Necessary ingredients of a "sale" have been discussed by courts in several rulings, illustratively: *M/S New India Sugar Mills Ltd vs. Commissioner of Sales Tax*[1], *Bhopal Sugar Industries Ltd. vs. D. P. Dube*[2], *Century Club and Others. vs. The State of Mysore and Another*[3], etc.

While the above is the common-law meaning of the word "sale", for sales-tax purposes, the term "sale" has got wider dimensions, after the insertion of clause 29(A) under Article 366 vide 46th Constitutional Amendment. This definition expanded the meaning of the term "sale" to include 6 transactions which are not sales under the common law definition cited above, but deemed to be sales ("deemed sales") for sales-tax purposes. Post the Constitutional amendment, State laws in different states were changed over a period of time beginning from 1984 to include these deemed sales, though the Central Sales-tax Act was amended much later i.e. in the year 2002. However, currently, all sales-tax laws include the extended meaning of sale such as the definition in Section 2(g) of the Central Sales Tax Act, 1956 (CST Act) as under:

> **"Sale"**, with its grammatical variations and cognate expressions, means any transfer of property in goods by one person to another for cash or deferred payment or for any other valuable consideration, and includes,–
>
> (i) a transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;
>
> (ii) a transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;
>
> (iii) a delivery of goods on hire-purchase or any system of payment by instalments;
>
> (iv) a 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;
>
> (v) a supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration;
>
> (vi) a supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service, is for cash, deferred payment or other valuable consideration, but does not include a mortgage or hypothecation of or a charge or pledge on goods.

Each of the 6 clauses included in the generic meaning of word "sale" are deemed sales.

Service

Section 65B of the Finance Act, 1994 (as effective from 1st July, 2012) defines the term "service" as follows:

> ***"Service"*** *means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include-*
>
> *(a) an activity which constitutes merely,-*
>
> *(i) a transfer of title in goods or immovable*

[1] *[1963 AIR 1207, 1963 SCR Supl. (2) 459]*
[2] *[14 STC 408 (SC)]*
[3] *[(1965) 1 MysLJ]*

property, by way of sale, gift or in any other manner; or

(ii) such transfer, delivery or supply of any goods which is deemed to be a sale within the meaning of clause (29A) of Article 366 of the Constitution; or

(iii) a transaction in money or actionable claim

(b) a provision of service by an employee to the employer in the course of or in relation to his employment;

(c) fees taken in any Court or tribunal established under any law for the time being in force.

This definition casts a very wide net for the term service, and holds every activity, understandably economic activity, to be a service, with exceptions of:

- a transfer of movable property;
- a transfer of immovable property;
- deemed sales as discussed above;
- a transaction in money or actionable claims
- personal services by an employee to an employer
- fees charged by judicial or quasi judicial bodies.

As is obvious, the above definition does not lay down what a service is; it lays down what a service is not. However, with basic commonsense, it is possible to lay down the following ingredients for a "service contract": (a) it is a contract, and hence, satisfies all basic requirements of a contract, including duality of parties, consideration, free asset, etc; (b) consideration may be cash or kind; (c) the involvement of the servicer by an "activity" need not imply a personal engagement model – it may even be by way of a facility, equipment or infrastructure – for example, renting of property does not involve any "activity" of the landlord as such, but is still a service.

Works Contract

Sales and services are mutually exclusive – a sale cannot be a service and a service cannot be a sale. Works contracts, as discussed below, fall in both the regimes, but one must take that as a case of an overlap, since the goods element of a works contract is taken to be sale, and the service element is taken to be a service. Likewise, a catering contract is a case of sale of goods as well as services, but here again, bifurcation is done and the two taxes apply to their respective domains. In essence, there is no way a single contract could be one of sale and service both.

Before coming to the issue of taxability of such contracts, one needs to have an understanding of the meaning of "works contract". To understand the meaning of the term, one may look at the definition given in the CST Act in context of sales-tax laws, in the Finance Act, 1994 in context of service tax, and authoritative writings in general.

Works Contract under Sales Tax Law

I. Definition of Works Contract in the CST Act and implication thereof

Section 2(ja) of the CST Act defines works contract as follows:

"(ja) **"works contract"** means a contract for carrying out any work which includes assembling, construction, building, altering, manufacturing, processing, fabricating, erection, installation, fitting out, improvement, repair or commissioning of any movable or immovable property."

The seemingly exhaustive definition (works contact *means*) is rendered inclusive, once it reads on – "any work which *includes*". Therefore, it is not possible to find the exact meaning of scope of the expression "works contract" from the above definition. It is safe to say that what the law gives are examples of works contracts. Three main characteristics of works contracts as can be inferred from the definition are:

1. It is a contract for carrying out *any work*.
2. "Work" includes (but is not limited to) assembling, construction, building, altering, processing, manufacturing, erection, fabrication, fitting out, making improvements, repairs or commissioning.
3. The "work" may be in respect of movable property or immovable property. Point to be noted here is: though the work may be in respect of movable or immovable property, sales tax is chargeable on transfer of property in *goods* involved in the execution of works contract. *Goods*, under the sales tax law, are essentially movable property only. See discussion below on this.

The first limb of the definition is not suggestive – since not every work can be a works contract. The second part is the heart of the definition, but as it gives an illustrative list, it is not possible to deduce an exhaustive meaning of the expression from the definition.

II. The 46th Constitutional Amendment and taxability of Indivisible Composite Contracts

As mentioned earlier, transfer of property in goods involved in the execution of a works contract is

"deemed sale" coming from the 46th Constitutional Amendment that inserted Article 366(29A) to include a "transfer of property in goods involved in works contract" within the ambit of "sales". Thus, it is not enough for a transaction to be a works contract – a works contract must result into a transfer of property in goods. As noted above, the term "goods" is confined to movable properties. It is notable that the third limb of the definition of "works contract" in CST Act includes works done with regard to immovable properties as well. There is no conflict between the principle that only transfer of property in "goods" is chargeable to sales-tax, and the third limb of the CST definition. In fact, if goods, that is, movable property, are acceded at the time of construction of an immovable property, the transfer of property in such goods is taken as a works contract. That is to say, prior to accession to a contract, if the property was movable, and becomes immovable by virtue of such annexation, it is still chargeable to tax as a "works contract". On the other hand, the immovable property itself that gets transferred, even if under a works contract, cannot be chargeable to sales-tax. For instance, if a building is repaired, the movable property such as concrete or cement that goes into the repair is chargeable to works contract tax, but not the building itself.

Works contracts and composite contracts

To reiterate, works contracts have combined ingredients of "sales" and "service"; as such they fall under the category of Composite Contracts: Works Contract is *specie* of Composite Contracts. Composite Contracts are transactions that involve an element of transfer of title of goods as well as an element of provision of service; these two elements are so inextricably linked that they form part of the same transaction. No separate rights arise out of the constituent contract of sale and contract of service. The same has been illustrated in Figure II-Composite Contracts.

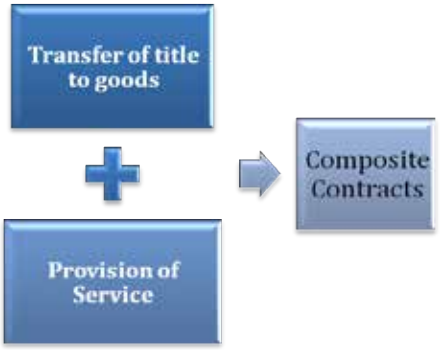

Figure II: Composite Contracts

Every works contract is a composite contract, but every composite contract is not a works contract. The 46th Constitutional Amendment, by insertion of Article 366(29A), created a legal fiction so as to impart divisibility to composite contracts, if such composite contract is a works contract. Thereby, transfer of property in goods involved in the works contract and catering services were given the status of deemed sales such that the material (i.e. "the transfer of goods") portion in these services can be subjected to sales tax.

Therefore, for taxation purposes, one has two broad categories of composite contracts, as depicted in Figure III-Types of Composite Contracts.

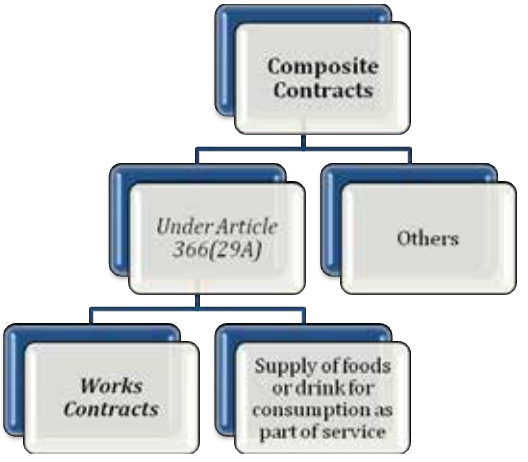

Figure III: Types of Composite Contracts

Since composite contracts are not limited to works contracts, Figure III: Types of Composite Contracts illustrates two types of composite contracts which have been captured within the deeming fiction laid by the 46th Amendment. This does not eliminate the existence of any other composite contract, which has not been captured by the 46th Amendment. If such contract is not a works contract as per statutory definition of the CST Act, nor is it a contract for supply of food and drinks, and still is a composite contract providing for supply of goods and services under an indivisible contract, there is no machinery under the law to bifurcate such a composite contract. Then which law applies to such a contract? If the contract is not divisible, no fiction can be superimposed on the contract to divide what the contracting parties have not divided. In view of composite consideration, such a contract is not a service, and is not a sale. So the inescapable conclusion is – there is no machinery in law to tax such a contract, and hence, such a contract is not taxable, even under the negative list of service tax. If such a contract was

"service", it would be caught by the negative list. If such a contract was "sale of goods", it would be caught by sales-tax law which has always had a negative list of exempted items. But if it is a composite contract, it can be said to be neither a sale nor a service.

In the world of commerce, several such contracts exist very naturally. One instant example is the service of a taxi driver – he fuels the taxi, and operates the taxi, and charges one single consideration for both. This is not a works contract, nor is it a service. Nor can it be said that the dominant intent is to provide fuel or provide driving. It is a combination of man, machine and the fuel with an impossible benchmark to decide the dominant intention.

The Judicial Precedents on Works Contracts

Judiciary has dealt with issues pertaining to "works contract" at length: before and after the 46th Constitutional Amendment. An important case is *Builders Association of India & Others vs. Union of India and Others*[4], where the Supreme Court answered the question of Constitutional validity of the 46th Amendment and power of the States to levy tax on the transfer of property in goods involved in the execution of works contracts. The contracts in question were building contracts. However, the Supreme Court was very clear with the fact that works contract is a genetic concept which consists of various species; "building contracts" is one of them. The Supreme Court observed,

> "We, however, make it clear that the cases argued before and considered by us relate to one *specie* of the genetic concept of 'works contracts'. The case-book is full of the illustrations of the infinite variety of the manifestation of 'works-contracts'- Whatever might be the situational differences of individual cases, the constitutional limitations on the taxing-power of the state as are applicable to 'works contracts' represented by "Building-Contracts" in the context of the expanded concept of "tax on the sale or purchase of goods" as constitutionally defined under Article 366(29A), would equally apply to other species of 'works-contracts' with the requisite situational modifications."

As regards the nature of works contract, the Court referred to *Building Contracts and Practice*[5] wherein the learned author views that vesting of property in materials can take place by affixing materials, etc. to the freehold: "As soon as materials of any description are built into a building or other erection, they cease to be the property of the contractor and become that of the freeholder". Further, in *Benjamin's Sale of Goods*[6], it is stated that,

> "Chattel to be affixed to land or another chattel.-----Where work is to be done on the land of the employer or on a chattel belonging to him, which involves the use or affixing of materials belonging to the person employed, the contract will ordinarily be one for work and materials, the property in the latter passing to the employer by accession and not under any contract of sale. Sometimes, however, there may instead be a sale of an article with an additional and subsidiary agreement to affix it. The property then passes before the article is affixed, by virtue of the contract of sale itself or an appropriation made under it."

Therefore, an observation that can be made here is that in a works contract, the property in the goods *"passes on"* to the contractee by *"accession"*; the transfer of property in materials is not the result of a separate contract or appropriation. Most suitable example here would be that of a building contract: if you engage a contractor to build a house for you; you are not buying cement, bricks, etc. individually. The contractor has to use these materials to build the house for you; his ultimate work is "to construct" the house and deliver the same to you: the materials just "pass on" from the contractor to the you in the process of delivering the end product, i.e. the house.

Nature of works contract was also discussed in the *State of Madras vs. Gannon Dunkerley & Co.*[7] in which the Supreme Court cited interesting rulings of English Courts on the subject matter, one of which was *Clark vs. Bulmer*[8]. In this case, the plaintiff entered into a contract with the defendant to build an engine. Different parts of the engine were constructed at the plaintiff's manufactory and sent in parts to the defendant's colliery where they were fixed piecemeal and were made into an engine. The Honourable judge Parke B. observed:

> "The engine was not contracted for to be delivered, or delivered, as an engine, in its complete state, and afterwards affixed to the freehold; there was no sale of it, as an entire chattel, and delivery in that character; and therefore it could not be treated as an engine sold and delivered. Nor could the different parts of it which were used in the construction,

[4] *1989 SCALE (2)768*
[5] *Building Contracts and Practice: Bmden and Watson; (6th edition), p. 229-230*
[6] *Benjamin's Sale of Goods: 3rd edition, para 43, p.36*
[7] *1958 AIR 560, 1959 SCR 379*
[8] *(1843) 11 M & W. 243; 152 E- R. 793.*

and from time to time fixed to the freehold, and therefore became part of it, be deemed goods sold and delivered, for there was no contract for the sale of them as moveable goods; the contract was in effect that the plaintiff was to select materials, make them into parts of an engine, carry them to a particular place, and put them together, and fix part to the soil, and so convert them into a fixed engine on the land itself, so as to pump the water out of a mine."

Another interesting case pertained to building contract: *Tripp vs. Armitage*[9] in which a builder entered into an agreement with certain trustees to build a hotel. The buider became bankrupt and dispute arose as to the title to certain wooden sash-frames which had been approved on behalf of the trustees but had not yet been fitted in the building. The trustees claimed the same on having approved them; but the Judge remarked,

"this is not a contract for the sale and purchase of goods as movable chattels; it is a contract to make up materials, and to fix them; and until they are fixed, by the nature of the contract, the property will not pass." Further, "but in this case, there is no contract at all with respect to these particular chattels: it is merely parcel of a larger contract. The contract is, that the bankrupt shall build a house; that he shall make, amongst other things, window-frames for the house, and fix them in the house' subject to the approbation of a surveyor; and it was never intended by this contract, that the articles so to be fixed should become the property of the defendants, until they were fixed to the freehold."

The Court, in *Gannon Dunkerley's case (supra)* thus concluded that there is no sale of materials used in a building contract and that works contract is entire and indivisible.

In view of the indivisibility of the works contracts, a legal fiction was created to impose tax on transfer of property in goods involved in the execution of works contract by the 46th Constitutional Amendment.

Works Contract under Service Tax Law

A works contract has been defined under Section 65B (54) of the Finance Act (as effective from 1st July, 2012) as follows:

"works contract" means a contract wherein transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods and such contract is for the purpose of carrying out construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation, alteration of any movable or immovable property or for carrying out any other similar activity or a part thereof in relation to such property"

Regarding the applicability of service tax on such Works Contracts, Section 66E of the Finance Act (as effective from 1st July, 2012) includes "service portion in the execution of a works contract" in the list of "declared services"; therefore, service part is to be segregated from the whole works contract and the same has to be subjected to service tax.

Earlier Definition of Works Contract under the Service Tax Law

Prior to the amendment made by the Finance Act, 2012, Section 65(105)(zzzza) of the Finance Act included services rendered to any person in relation to the execution of a works contract in the taxable services, subject to certain exclusions. The relevant section read as follows:

"(zzzza) to any person, by any other person in relation to the execution of a works contract, excluding works contract in respect of roads, airports, railways, transport terminals, bridges, tunnels and dams.

Explanation.—For the purposes of this sub-clause, "works contract" means a contract wherein,—

(i) transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods, and

(ii) such contract is for the purposes of carrying out,—

(a) erection, commissioning or installation of plant, machinery, equipment or structures, whether pre-fabricated or otherwise, installation of electrical and electronic devices, plumbing, drain laying or other installations for transport of fluids, heating, ventilation or air conditioning including related pipe work, duct work and sheet metal work, thermal insulation, sound insulation, fire proofing or water proofing, lift and escalator, fire escape staircases or elevators; or

(b) construction of a new building or a civil structure or a part thereof, or of a pipeline or conduit, primarily for the purposes of commerce or industry; or

(c) construction of a new residential complex or a part thereof; or

[9] *(1839) 4 M & W. 687 ; 15o E.R. 1597.*

(d) completion and finishing services, repair, alteration, renovation or restoration of, or similar services, in relation to (b) and (c); or

(e) turnkey projects including engineering, procurement and construction or commissioning (EPC) projects;"

A keen observation of the definitions under the new and the old service tax regimes will reveal that the definition introduced by the Finance Act, 2012 is all the more comprehensive and pervasive: instead of giving numbers to count on fingers and specifying each type of work to be classified as works contract, this time the definition enlarges the scope of works contract. Now, the contract may pertain to erection, commissioning, installation, etc. of both movable or immovable properties. It is also notable that the new definition is dependent on the definition in the CST Act, since it is clear from the definition that the service element of a works contract is taxable only where it is a sale. Accordingly, for service tax to be imposed on works contract, three essential requirements are to be met:

1. There should be transfer of property in goods involved in the execution of the contract which is leviable to tax as sale of goods.
2. The transfer of property in goods shall be taxable as sale of goods.
3. The purpose of the contract is to carry out construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation, alteration of any movable or immovable property or any other similar activity.

The third element seems to suggest that every activity may be a works contract, but given the fact that it is conditioned by the first two conditions, the scope of "works contract" for service tax can be no wider than the scope under CST Act.

Going by the clarification provided by the Department in the *Taxation Guide*[10], it can be stated that transfer of property in goods involved in the execution of the contract is quintessential to classify the contract as "works contract", though service tax would be levied only on the service portion of such a contract. As such, labour contracts, in which there is no transfer of property in goods involved in the execution of the contract, will not qualify as works contract; though such contracts will fall under the category of pure service contracts and chargeable accordingly. On similar lines, one can say that repairs and maintenance of motor vehicles, cars, etc; construction of a pipeline or a conduit, painting, repair, renovation of building, wall tiling, flooring, or similar activities are works contracts, *provided these contracts involve provision of materials as well*.

'A' approaches 'B' to paint his house. A provides the paint for the purpose. B's work is limited to painting the house according to A's instructions, using his own tools and equipments. In this case, no transfer of property in goods takes place from B to A. B rendered a pure service. So, this is not a works contract.

However, in the above example, if B would have been asked to supply the paint also, it would have been a case of works contract.

There is one more critical issue involved. Even if there is transfer of property in goods involved in the sale of goods alongwith provision of services, the same may not qualify as works contract owing to the possibility that the transfer of such property in goods may not be taxable as sale of goods. So, the taxability of service portion of a works contract is dependent on taxability of sale portion of the same.

Identifying the Border Line

In layman's language, when a person buys a material that the supplier already has, it is sale. When he buys an activity from the supplier, it is service. When he contracts with the supplier to provide what the supplier is not ready with, but supplier can provide the same after "working" for it, then it is a "works contract". This, however, is overtly simplified version of the distinction. One needs to go through each of the principles discussed above to come to concrete conclusions.

Having discussed in length the meaning and scope of "sale", "service" and "works contract", it is now important to look into the taxability aspect of these transactions. Taxability of a transaction to sales tax or to service tax depends entirely on the nature of transaction-whether it is a "sale" or "a service". Sometimes, there are complicated contracts where the distinction between sale and "service" get blurred – leading to questions as to whether it is a sale or a service or a composite contract. In such cases, *what is to be seen is the dominant nature of the transaction* – that is, predominantly, have the parties intended providing a service, or simply intended transfer of property in goods. Detecting such predominant intention may not be easy – subjecting the transaction to controversy. However, when it comes to composite contracts covered by Article 366(29A), then the predominant

[10] *Taxation of Services: An Education Guide; issued by CBEC.*

nature principle will not work because of the deeming fiction of the law. The discussion that follows tries to focus on this aspect: the authors have tried to imbibe the judicial views taken in the matter and various clarifications issued by the taxing authorities so as to reach a conclusion.

Judicial Precedents

Bharat Sanchar Nigam Limited and another vs. Union of India and Others

The milestone case relevant to the context is *Bharat Sanchar Nigam Ltd. and Another. vs. Union of India and Ors*.[11] where the Supreme Court coined the term **"dominant nature test"** to determine the taxability of composite contracts-the contracts having elements of both "sales" and "service", as can be stated here-

> *"The test therefore, for composite contracts* ***other than those mentioned in Article 366 (29A)****, continues to be – did the parties have in mind or intend separate rights arising out of the sale of goods. If there was no such intention there is no sale even if the contract could be disintegrated. The test for deciding whether a contract falls into one category or the other is to as what is* ***`the substance of the contract'****. We will for want of a better phrase, call this the* ***dominant nature test****."*

The Court stated ***that it is only in the cases of works contract and catering services where splitting of the transaction into "sale" and "service" has been constitutionally permitted***, there is no other service that has been permitted to be split. The Court cited an example of hospital services or professional services of lawyers-it be said that there is a sale of goods when a doctor writes out and hands over a prescription or a lawyer drafts a document and delivers it to his/her client.

> *"Strictly speaking, with the payment of fees, consideration does pass from the patient or client to the doctor or lawyer for the documents in both cases."*

But these services do not involve a sale for levy of sales-tax, reason being *"if there is an instrument of contract which may be composite in form in any case other than the exceptions in Article 366(29-A), unless the transaction in truth represents two distinct and separate contracts and is discernible as such, then the State would not have the power to separate the agreement to sell from the agreement to render service, and impose tax on the sale"*.

The principle was enunciated in *M/s. Gannon Dunkerley & Co. & Ors. vs. State of Rajasthan & Ors*.[12]

Indian Railways Catering & Tourism Corporation Limited vs. Government of NCT Delhi and Others

In *Indian Railways Catering & Tourism Corporation Limited vs. Government of NCT Delhi and Others*[13], the question was: whether the supply of food and beverages is a contract of providing service, or a contract only for sale/supply of goods, or a composite contract of providing services and selling goods. Here a distinction was made between the services rendered in a restaurant or hotel and the services rendered by outdoor caterers. When a person goes to a restaurant, orders food and pays for it; and the food items are supplied to him, it would simply be case of transfer of property in goods to the customer. The rendering of services there is merely incidental to the sale of food, which the dominant object. The Delhi High Court came up with these well-defined legal propositions-

a) States have the right to levy tax on the whole of the consideration in the transaction of sale of goods (e.g. supply of food in restaurant, irrespective of the fact that there is an incidental element of service necessarily involved in sale of goods of this nature)

b) In cases of transactions covered under Article 366(29A) [e.g. Works contract], States have the power to levy and collect sales tax/VAT on the value of goods involved in the execution of the transactions. However, levying sales tax/VAT on the service component of the transactions is, in no way, permissible.

c) Coming to the composite contracts that are not covered under Article 366(29A), the State would have the power to separate the agreement involving sale of goods, from the agreement to provide services, and impose tax on the sale component of the transaction, only ***if the intention of the parties was to segregate the element involving sale of goods from the element involving providing the service*** and ***actually the transaction represents distinct and clearly visible or discernable contracts***.

Therefore, if the intention is not found or the transaction does not involve distinct contracts, it is not permissible to disintegrate such composite

[11] *[145 STC 91 (SC)]*
[12] *[(1993) 1 SCC 364]*
[13] *[W.P. (C) No. 5483/2008] (2010-TIOL-517-HC-DEL-ST)*

contract so as to levy sales tax/Value Added Tax on that component which involves sale of goods, during the course of the transaction. Now, in order to decide whether the intention of the parties is present, the test would be to ascertain: what is the dominant nature of the transaction between the parties?

The Delhi High Court held the transaction between IRCTC and Indian Railways is a transfer of goods by the former to the latter for consideration and the property in the goods also passes to Indian Railways- clearly a sale of goods under the provision of "Sale of Goods Act as well as Delhi Value Added Tax Act". The element of service, say heating the food, heating/ cooling the beverages, and then serving them to the passengers, is purely incidental and minimal effort required to sell the food and beverage (just like in the case of restaurants). Therefore, the transaction of providing meals and snacks to the passengers is not a composite contract of service and sale but is ***predominantly a transaction of outright sale*** by IRCTC to the Indian Railways.

Imagic Creative Private Limited vs. Commissioner of Commercial Taxes & Others

In *Imagic Creative Private Limited vs. Commissioner of Commercial Taxes & Others*[14], the question before the Supreme Court was whether the charges collected towards the services for evolution of prototype conceptual design (i.e. creation of concept), on which service tax had been paid under the Finance Act, 1994 as amended from time to time is liable to tax under the Karnataka Value Added Tax Act, 2003. The company was an advertising agency, that created original concept and design advertising material for their clients and design brochures, annual reports, etc. Considering the entire ambit of activity of the dealer, the authority under the Karnataka VAT Act held that it is a comprehensive contract or supply of printed material developed by the company and that the sale of printed material with a background of providing the concept is an indivisible activity liable to tax at 4% as a whole. The Company preferred an appeal to the Apex Court, wherein it vehemently contended that it being an advertising agency, i.e., providing professional services, is not liable to pay Value Added Tax (VAT) upon application of dominion nature test or otherwise. The Court admitted that the Company is a service provider and *"It is also not in dispute that the orders received by it to provide such services is party specific and issue specific; be it for issuance of a brochure or a year book or for any other purpose."*

The Supreme Court referred to decisions laid down in cases of *Builders Association of India & Ors. vs. Union of India & Ors.*[15] and *M/s.Gannon Dunkerley & Co. & Ors. vs. State of Rajasthan & Ors*[16], and viewed that Article 366(29A), with respect to works contract, creates a legal fiction to alter an indivisible contract into a divisible contract so as to make the supply of goods involved in a works contract, subject to tax. However, the transaction in the present context was not contemplated there. A reference was made to the case of *Bharat Sanchar Nigam Limited (supra)*. Further, the Court emphasised on drawing a distinction between an indivisible contract and a composite contract. Ultimately, the Court decided that payments of service tax and VAT should be held to be applicable, having regard to the respective parameters of service tax and sales tax as envisaged in a composite contract as contradistinguished from an indivisible contract. The contract may consist of different elements consequently attracting different nature of levy. *"It is, therefore, difficult to hold that in a case of this nature, sales tax would be payable on the value of the entire contract; irrespective of the element of service provided."*

State of Andhra Pradesh vs. M/s Kone Elevators (India) Limited

The Supreme Court in *State of Andhra Pradesh vs. M/s Kone Elevators (India) Limited*[17] brought out the distinction between a contract of sale and a works contract. As it observed,

> "It can be treated as well settled that there is no standard formula by which one can distinguish a "contract for sale" from a "works-contract". The question is largely one of fact depending upon the terms of the contract, including the nature of the obligations to be discharged thereunder and the surrounding circumstances. If the intention is to transfer for a price a chattel in which the transferee had no previous property, then the contract is a contract for sale. Ultimately, the true effect of an accretion made pursuant to a contract has to be judged not by artificial rules but from the intention of the parties to the contract. *In a "contract of sale", the main object is the transfer of property and delivery of possession of the property, whereas the main object in a "contract for work" is not the*

[14] *[(2008) 2 SCC 614]*
[15] *[(1989) 2 SCC 645]*
[16] *[(1993) 1 SCC 364]*
[17] *[(2005) 3 SCC 389]*

transfer of the property but it is one for work and labour (emphasis supplied). Another test often to be applied to is : when and how the property of the dealer in such a transaction passes to the customer: is it by transfer at the time of delivery of the finished article as a chattel or by accession during the procession of work on fusion to the movable property of the customer? If it is the former, it is a "sale"; if it is the latter, it is a "works- contract". Therefore, in judging whether the contract is for a "sale" or for "work and labour", the essence of the contract or the reality of the transaction as a whole has to be taken into consideration. The pre-dominant object of the contract, the circumstances of the case and the custom of the trade provides a guide in deciding whether transaction is a "sale" or a "works- contract". Essentially, the question is of interpretation of the "contract".”

Clarification from the Taxing Authority

Support can be drawn from the *Taxation Guide*[18] issued by the Central Board of Excise and Customs. In order to determine the taxability of composite transactions, the Guide too looks up to the *BSNL's case* (*supra*). It has been explicitly stated in the Guide that the taxability of composite transactions will be judged on the basis of the dominant nature test laid down in *BSNL's case* (*supra*) and it has been clarified that:

> “Although the judgement was given in the context of composite transactions involving an element of transfer in title of goods by way of sale and an element of provision of service, the ratio would equally apply to other kind of composite transactions involving a provision of service and transfer in title in immovable property or actionable claim.”

The Taxation Guide then discusses the principles that emerge from the judgment given in *BSNL's case* (*supra*). The principles are laid down as follows:

1. 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***.
2. 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.***
3. 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.***
   a. If the dominant nature of such a transaction is sale of goods or immovable property, then such transaction would be treated as such.
   b. 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.
4. 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.
   (**Author's Note:** Section 66E lists down the “declared services”. Clause (h) includes “service portion in the execution of a works contract”; therefore service portion of a works contract is chargeable to service tax)
5. *If the transaction represents two distinct and separate contracts and is discernible as such then contract of service in such transaction would be segregated and chargeable to service tax if other elements of taxability are present.* ***This would apply even if a single invoice is issued.***

Taxability Issue

On the basis of the analysis made above, the conclusion that can be derived is as follows: Where the transaction is clearly classifiable as a sale, charge sales tax. In case the transaction is a service, charge service tax. In case the transactions involves both “sale” and “service”, see whether it is a works contract. If the same is a works contract, split the contract into two components, charge sales tax on the transfer of property in goods and service tax on the service portion. In case the contract is not works contract, identify the dominant nature of

[18] *Taxation of Services: An Education Guide; issued by CBEC.*

the transaction and accordingly determine taxability without splitting the contract. If it is not possible to identify the dominant nature, no tax is leviable.

Figure IV-Taxability of Sale, Service, Works Contract depicts the manner of determining the taxability of the transactions in a lucid way.

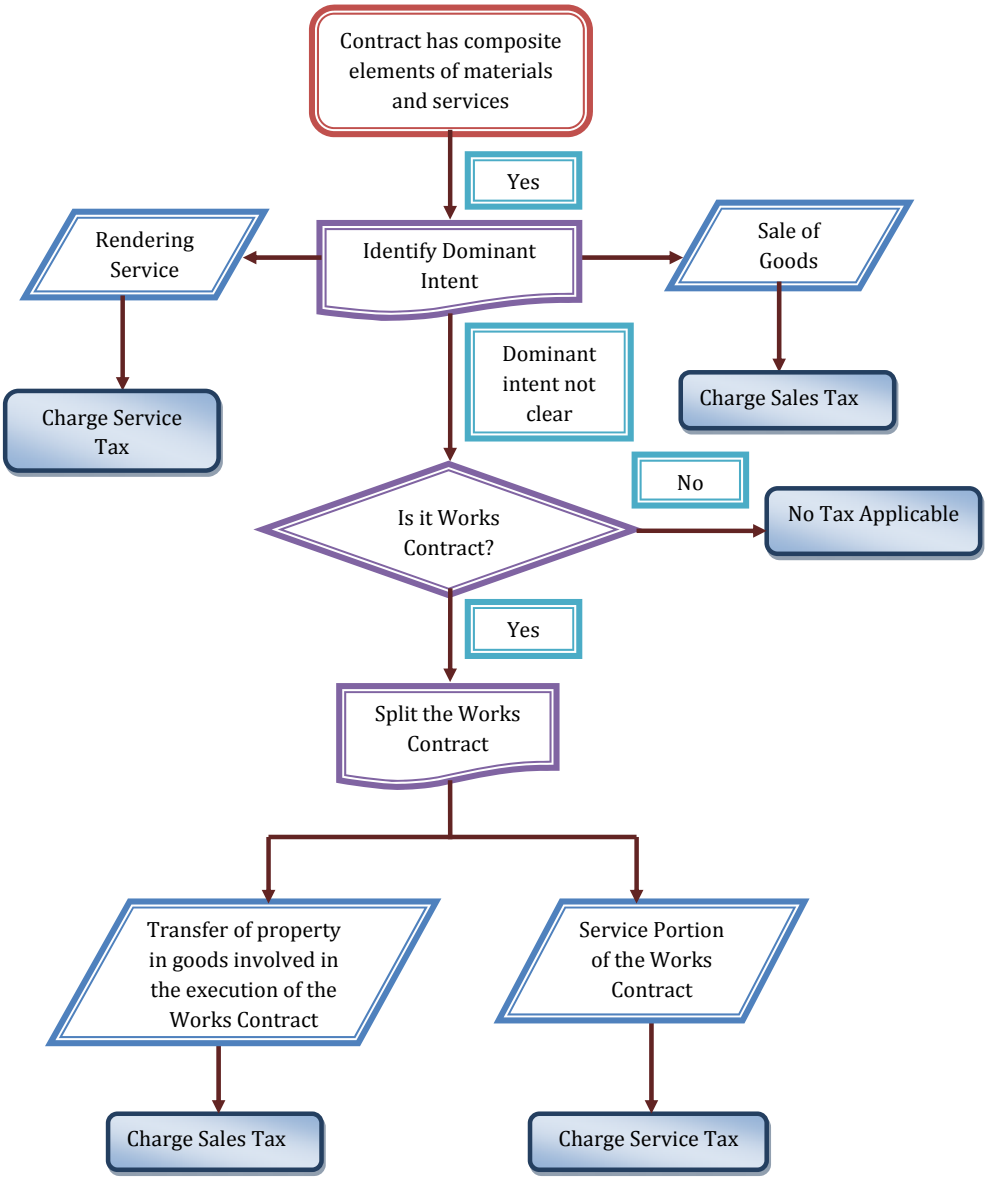

Figure IV: Taxability of Sale, Service, Works Contract

The issue gains all the more significance because once the transaction gets classified into sale or service or works contract, it is important to determine whether the tax is leviable as per jurisdictional principles.

The Final note

Thus, one needs to have a clear view of the substance of the transaction to determine its nature, which in turn will help in determining the taxability thereof. "Sales", "service" and "works contract", all three have unique characteristics, which seem to get blurred sometimes, owing to complexity of those characteristics. Application of right principles and thorough understanding of the transaction in question can help a lot to clear the blur and present a clear picture. ■