SALE FOR YOU, SERVICE FOR HIM, BOTH FOR THE TAXMAN!!

Ananth Padmanabhan & Giridharan Padmanabhan*

ABSTRACT

This article studies the evolution of the Parliament’s experience and attempts to incorporate a tax on services under its purview and also the expansion of the scope of sales tax to included services. The paper begins with the attempts of the State legislatures to expand the ambit of sales tax and the subsequent decision of the Supreme Court in the case of Gannon Dunkerley. The paper has traced the evolution of the State’s attempts to continuously expand the scope of its legislative authority to tax services and discusses the obvious contravention of the Federal structure and division of legislative competence which it has resulted in, and perhaps has been overlooked by the Judiciary in a series of decisions on the matter. Subsequently, it highlights the significant contemporary development to tax different aspects of a single commercial transaction under both the service and the sales tax nets between the Union and the state Governments and the levy of service taxes upon transactions which are clearly of different character. With the highest judicial authority of the land overlooking vital distinctions and ignoring the balance of competence between the Union and the states, even more commercial transactions may fall susceptible to the Parliament’s urge to maximise revenue in this manner. A development, which the authors argue, was perhaps dealt much better by the early benches of the Supreme Court.

I. INTRODUCTION........................................................................................................... 77

II. RESTRICTIONS ON THE POWER TO TAX- THE DECISION IN GANNON DUNKERLEY ........................................................................................................ 78

III. RESTRICTIONS POST GANNON DUNKERLEY AND THE CALL FOR REFORM ...... 80

IV. ARTICLE 366(29A) – CHALLENGED AND UPHOLD ........................................ 82

* Advocates, Madras High Court.
I. INTRODUCTION

World over, taxation has been accepted as a mechanism to rectify market imperfections and bring in economic stability. As governments get more profligate, especially in countries like ours where the attitude has been to resort to the power of taxation to make up for losses sustained by the exchequer for reasons legitimate or otherwise, service tax has been the Brahmastra for the Indian government since 1994. Unfortunately, law and economics are strange bedfellows, and what may be useful for the government to augment its revenues may not survive the test of constitutionality.

The liberalisation era has been witness to dynamic changes in the banking and information technology sector. New market instruments which are quite hybrid in their design, and products from the IT and ITES sectors whose legal character leave the most eminent jurists in doubt, have given rise to enormous complexities and consequential constitutional challenges. When the taxman goes after these transactions, the most obvious question is, does the law maker have the competence to levy the tax or fee in question? This arises due to the federal character of the Indian Constitution, which envisages mutually exclusive legislative competence, wherein taxing entries are divided between the Union and State lists (Lists 1 and 2 of the VIIth Schedule). While interpreting the constitutionality of any new tax, it is necessary to remember that there is no scope for any overlap between the taxing entries in the Union list and those in the State list. The challenge to taxation on the ground of legislative competence is all the more important, as the other protective barrier, being the Fundamental Rights chapter in Part III, offers very little effective protection in the case of taxing statutes. We have, in the past, been witness to inordinately high rates of taxation, which Courts have considered constitutionally valid when tested on the touchstone of Articles 14, 19 and 21.

1 Bharat Sanchar Nigam Ltd. v. Union of India, (2006) 3 SCC 1 [Supreme Court of India]. [Hereinafter, "BSNL v. UOI"]
In this article we examine the constitutional framework for levy of service tax by the Union and sales tax by the states. We contend that any new transaction has to be taxed either under one or the other legislation, and not taxable under both. In our view, the recent trend wherein both the Union and the States are mongering to augment their revenues by targeting the very same transaction for the purpose of sales and service tax, will have detrimental consequences for the industry concerned. This stance taken by governments – both at the States and the Centre – needs a serious relook. In our earnest view, Courts have unfortunately failed, despite repeated constitutional challenges, to appreciate the existing constitutional limitations and to prioritise them over the economic necessities and hardships that the government may be facing. In short, taxes seem to trump rights even though the Constitution promises otherwise.

II. Restrictions on the power to tax- The decision in Gannon Dunkerley

Immediately after independence, there was a scamper by various State Governments to expand the definition of ‘sale’ in Entry 54 of List II for the purpose of levy of sales tax. In one such early attempt in 1947, the State of Madras enlarged the definition of sale contained in Section 2(h) of the Madras General Sales Tax, Act, 1939. The earlier definition was the same as that contained in the Sale of Goods Act, 1930, i.e., “every transfer of the property in goods by one person to another in the course of trade or business for cash or for deferred payment or other valuable consideration”. This definition was sought to be expanded to include “a transfer of property in goods involved in the execution of works contract.” This expansion posed a major threat to the construction industry, as most works were being executed on works contract basis by the builders, and resulted in a constitutional challenge to the 1947 amendment. By the time this case came up for hearing before the Supreme Court, various other States had also attempted similar expansion of taxing powers under Entry 54 by amending and enlarging the definition of sale.

In a seminal decision by a Constitution Bench of the Supreme Court in The State of Madras v. Gannon Dunkerley & Co., (Madras) Ltd.,2 it was held that the power

---

2 The State of Madras v. Gannon Dunkerley & Co., (Madras) Ltd., AIR 1958 SC 560 [Supreme Court of India]. [Hereinafter, “Gannon Dunkerley”] The State went on appeal as a Division Bench of the Madras High Court, in a path breaking judgment which deserves reading for its sound legal and analytical reasoning, held the Madras Amendment to be ultra vires the taxing power vested in Entry 48 of List II of VIIth Schedule to the Government of India Act, 1935.
of States to levy tax on the sale of goods, contained in Entry 48 of List II of the Seventh Schedule in the Government of India Act, 1935, was limited in its own terms by two words in that entry, 'sale' and 'goods'. If a transaction did not count as a 'sale', the States would not have the competence to levy sales tax. Similarly, if the object of the sale was not 'goods', there would not be any competence to levy sales tax. The contention of the States was that the word 'sale' must be given a liberal, and not a narrow, construction. While accepting the correctness of this submission, the Supreme Court held that the word 'sale' must still be construed in its legal sense, and not in the popular sense. Therefore, though the popular sense of this word would include transactions where title in the property fails to pass as an outcome of the transaction, the legal sense would not. The Supreme Court also rejected the submission of the States that 'sale' in Entry 48 of List II, Schedule VII, Government of India Act, 1935, would have a different meaning from that in the Sale of Goods Act, 1930, due to the difference in objective. The States had contended that the objective of the latter enactment was to define the rights of parties to a contract, while that of sales tax legislation was to bring money into the coffers of a State. The Supreme Court considered this immaterial due to the total absence of any legislative practise pertaining to Entry 48 before its introduction in the Government of India Act, 1935.

The Court hence concluded that the word 'sale' in its legal sense would have the same meaning as in the law relating to sale of goods. Sale, according to the Court, had to be an agreement whereby the seller transferred the property in goods to the buyer for a consideration called the price. The Court further went on to explain that only property which satisfied the following attributes would qualify as goods, namely, (i) having utility, (ii) capable of being bought and sold, and (iii) capable of being transmitted, transferred, delivered, stored and possessed. Applying the above parameters, the Court held that the Madras Amendment would fall outside the purview of Entry 48, since a works contract was not an agreement to transfer the property in the materials used for the construction activity. In effect, the Court was making it clear that while the Legislature and the Executive may be faced with concerns such as augmenting of revenues, the function of the Court was only to ensure strict compliance with the constitutional law of the land. Solutions to polycentric problems would have to still fit within the parameters of constitutionality.

III. RESTRICTIONS POST GANNON DUNKERLEY AND THE CALL FOR REFORM

The strict view taken by the Court in the above decision placed important restrictions on the unbridled power that States thought they could arrogate for themselves while levying taxes on sale of goods. Over time, different kinds of transactions were held to fall outside the scope of ‘sale’ and as a natural corollary, outside the purview of the States’ taxing powers under Entry 54 of List II, Sch.VII, relying on the decision of the Supreme Court in Gannon Dunkerley. In New India Sugar Mills Ltd. v. Commr. of Sales Tax, Bihar, the Supreme Court took the view that in the case of transfer of controlled commodities in pursuance of a direction under a control order, the element of volition by the seller, or mutual assent, was absent and therefore there was no sale as defined in the Sale of Goods Act, 1930. Though this was watered down considerably by a 7-judge Bench decision in Vishnu Agencies v. C.T.O., the framework continued to be the same, i.e. whether the transaction in question was a ‘sale’ as defined in the Sale of Goods Act, 1930, and imported to Entry 54 vide the decision in Gannon Dunkerley. Despite questions being raised in Vishnu Agencies as to the correctness of the view taken in Gannon Dunkerley, it continued to be good law.

Applying this framework, in Dy. C.T.O. v. Enfield India Ltd., it was held that canteen operations run by a cooperative society for the benefit of its members would not amount to sale of food articles to the members by the society. The

---

4 Entry 54 was couched in the same language as Entry 48 in the Government of India Act, the scope of which came up for consideration in Gannon Dunkerley.

5 New India Sugar Mills Ltd. v. Commr. of Sales Tax, Bihar, AIR 1963 SC 1207 [Supreme Court of India].

6 Vishnu Agencies v. C.T.O., AIR 1978 SC 449 [Supreme Court of India]. [Hereinafter, "Vishnu Agencies"]

7 In the words of the Court: “The view expressed in Gannon Dunkerley that the words “sale of goods” in entry 48 must be interpreted in the sense which they bear in the Sale of Goods Act, 1930 and that the meaning of those words should not be left to fluctuate with the definition of ‘sale’ in laws relating to sales of goods which might be in force for the time being may, with respect, bear further consideration but that may have to await a more suitable occasion.”

8 The majority in Vishnu Agencies concluded so: “In other words, the effect of the construction which the Court put on the words of Entry 48 in Gannon Dunkerley is that a sale is necessarily a consensual transaction and if the parties have no volition or option to bargain, there can be no sale. For the present purposes, this view may be assumed to reflect the correct legal position but even so, the transactions which are the subject matter of these appeals will amount to sales.”

9 Dy. C.T.O. v. Enfield India Ltd., AIR 1968 SC 838 [Supreme Court of India].
Court felt that there was no transfer of property in such arrangements, and that the society could at best be treated as an agent whose services were utilised by the members for fulfilling their needs. Similarly, in *K.L. Johar v. Dy. C.T.O.*, it was held by another Constitution Bench, after relying on the decision in *Gannon Dunkerley*, that hire-purchase transactions cannot be constitutionally subject to sales tax. In the Court's view, there was no transfer of property at the time of entering into the hire purchase transaction, and hence no 'sale'. It was also specifically contended that the decision in *Gannon Dunkerley* requires reconsideration, an argument that was rejected by the Constitution Bench on the ground that this decision had held the field for many years and also found acceptance in some later decisions.

In *Northern India Caterers (India) Ltd. v. Lt. Governor of Delhi*, the Supreme Court held that there was no sale when food and drink were supplied to guests residing in a hotel and that supply of meals was essentially in the nature of a service provided to the guests and could not be identified as a transaction of sale. The Court rejected the contention of the revenue that they were entitled to split up the transaction into two parts, one of service and the other of sale of foodstuffs. In *A.V. Meiyappan v. Commr. Of Commercial Taxes*, the Madras High Court held that an operational lease for 49 years of the negative print of a film would not amount to a sale as there was only transfer of the right to use, but no transfer of the property in the negatives.

The Law Commission of India, taking a note of these and other judgments where the principle laid down in *Gannon Dunkerley* was used to treat different transactions as outside the purview of 'sale' for purposes of sales tax levy, suggested an amendment to the Constitution wherein the sales tax net would be widened to cover certain categories of these transactions. This led to the introduction of Article 366(29A) *vide* the Constitution (Forty Sixth Amendment) Act, 1982, which reads as follows:-

> 366. Definitions. - In this Constitution, unless the context otherwise requires, the following expressions have the meanings hereby respectively assigned to them, that is to say-

---

10 *K.L. Johar v. Dy. C.T.O., AIR 1965 SC 1082 [Supreme Court of India].*
11 *Northern India Caterers (India) Ltd. v. Lt. Governor of Delhi, (1978) 4 SCC 36 [Supreme Court of India]. See also State of Punjab v. Associated Hotels of India Ltd., (1972) 1 SCC 472 [Supreme Court of India].*
(29-A) 'tax on the sale or purchase of goods' includes -

(a) a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;

(b) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;

(c) a tax on the delivery of goods on hire-purchase or any system of payment by instalments;

(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;

(e) a tax on the supply of goods by any unincorporated association or body of persons to a member therefore for cash, deferred payment or other valuable consideration;

(f) a tax on the 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, and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made.

IV. Article 366(29A) – Challenged and upheld

The introduction of this provision had monumental significance for several industries where the template transactions were structured in such fashion to get around the definition of ‘sale’. The construction industry was one of the most affected, since works contracts were now sought to be covered, for purposes of sales tax, under clause (b) of Article 366(29A). Soon enough, the Constitution (Forty Sixth Amendment) Act, 1982, was challenged in Builders’ Association of India v. Union of India, on the ground that ratification by the legislatures of one-half of the States was not obtained. This was a rather weak ground of challenge and was not sustained by the Supreme Court. However, the Supreme Court made some pertinent observations as to the object behind Article 366(29-A), which are reproduced below:

14 Builders’ Association of India v. Union of India, AIR 1989 SC 1371 [Supreme Court of India].
"The object of the new definition introduced in Clause (29A) of Article 366 of the Constitution is, therefore, to enlarge the scope of 'tax on sale or purchase of goods' wherever it occurs in the Constitution so that it may include within its scope the transfer, delivery or supply of goods that may take place under any of the transactions referred to in Sub-clauses (a) to (f) thereof wherever such transfer, delivery or supply becomes subject to levy of sales tax. So construed the expression 'tax on the sale or purchase of goods' in Entry 54 of the State List, therefore, includes a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract also. The tax leviable by virtue of Sub-clause (b) of Clause (29-A) of Article 366 of the Constitution thus becomes subject to the same discipline to which any levy under Entry 54 of the State List is made subject to under the Constitution.

We are surprised at the attitude of the States which have put forward the plea that on the passing of the 46th Amendment the Constitution had conferred on the States a larger freedom than what they had before in regard to their power to levy sales-tax under Entry 54 of the State List. The 46th Amendment does no more than making it possible for the States to levy sales tax on the price of goods and materials used in works contracts as if there was a sale of such goods and materials. We do not accept the argument that Sub-clause (b) of Article 366(29A) should be read as being equivalent to a separate entry in List II of the Seventh Schedule to the Constitution enabling the States to levy tax on sales and purchases independent of Entry 54 thereof.

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 (29A) of Article 366 is to be found only in Entry 54 and not outside it."

Thus, the Court made it amply clear that all constitutional restrictions on the power of taxation would continue post the introduction of Article 366(29A) and that this provision was meant to expand the scope of Entry 54 of List II without creating a separate field of taxation. It is relevant to mention here that amending the Constitution in this fashion, i.e. by expanding the scope of sales tax levy, was one of the three possible solutions mooted in the 61st Law Commission Report. One other was to vest the power of taxation of all these sui generis or 'non-sale' transactions with the Parliament, an option which Parliament impliedly ruled against by introducing Article 366(29A). In fact, the Law Commission noted that the power to tax work contracts would, in the absence of any enlargement of the
power under Entry 54 of List II, continue to vest with Parliament under Entry 97 of List I.\(^5\) Despite having such power, Parliament chose to expand the scope of ‘sale’ under Entry 54 of List II, probably keeping in mind political and financial exigencies. This course of action amounted to a waiver by Parliament of any powers of taxation that they may have had earlier in respect of these transactions. Unfortunately, with the introduction of the service tax levy, this waiver has been indirectly circumvented.

V. Service Tax and Parliament’s Competence

With the opening up of the Indian economy, services sector assumed a lot of significance both globally and locally. The Government of India felt that a tax on services, in line with international practise, would result in augmenting the revenue of the Union as well as bringing within the tax net various transactions that were so far not covered within the existing indirect taxes such as central excise (due to the absence of any ‘manufacture’ in many of these service transactions), customs, or sales tax. While one cannot find any fault with this policy decision of the Government, service tax has over time been extended to cover transactions that are already prone to sales tax. Moreover, the Union has not even applied its mind to whether the transaction in question is a composite contract or a contract of sale \textit{simpliciter}, when adding new heads of service tax.

Before a scrutiny of these heads of service tax, it is imperative to take a quick look at the legislative competence for levy of service tax. Service tax was introduced for the first time in 1994, when there was no separate entry in the Constitution covering ‘taxes on services’. Hence, Parliament could exercise its power of taxation over services only under Entry 97 of List I, being the residuary powers vested in Parliament.\(^6\) The exercise of such residuary powers is specifically provided for in Article 248, where it is made clear that such residuary powers can only be exercised “\textit{with respect to any matter not enumerated in the Concurrent List or the State List}.” The correct approach when tracing legislative competence to Entry 97 of List I has been clarified in \textit{International Tourist Corporation v. State of Haryana.}\(^7\) Here, the Supreme Court was faced with the submission that State Legislatures would

---


\(^6\) Entry 97, List I, Schedule VII, The Constitution of India, 1950. This includes any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists.

\(^7\) \textit{International Tourist Corporation v. State of Haryana}, \textit{AIR} 1981 SC 774 [Supreme Court of India].
be incompetent to extend their taxing power over passengers and goods to those commuting or being transported on the National Highways running within the territories of these States, as Parliament alone had exclusive jurisdiction under Entry 23 read with Entry 97 of List I of the Seventh Schedule to the Constitution to legislate in respect of National Highways, including levy of taxes on goods and passengers carried on National Highways. While rejecting this contention, the Supreme Court protected the federal framework in our Constitution by holding that the scope of residuary powers could not be expansively interpreted to the extent of whittling down the powers of the State legislature. It was categorically stated that Parliament could resort to its residuary powers only when the legislative incompetence of the State legislatures had been clearly established by virtue of the absence of relevant entries in Lists II and III. As a necessary corollary, if a specific taxing power is already covered in List II, the same tax cannot be imposed again under Entry 97.

Entry 92C was inserted subsequently vide the Constitution (Eighty-eighth Amendment) Act, 2003, though this provision has not been notified as yet. Ignoring this vital fact, the Supreme Court, in All India Federation of Tax Practitioners v. Union of India, has traced the competence of Parliament to levy service tax, to this entry. Even assuming for a moment the correctness of this view, the scheme under our Constitution, well articulated in Article 246, is that Parliament is supreme in its own sphere being List I of the VIIth Schedule, while the States are supreme in their own sphere being List II of the same Schedule. The necessary corollary to this is that a tax on the sale of goods under Entry 54 of List II belongs to the exclusive domain of the States, and Parliament has no competence to levy any tax on the same transaction of sale. This position will not alter whether service tax is levied under Entry 97 or under Entry 92C of List I. Parliament however chose to exceed the scope of its jurisdiction, as seen from the unfolding of events.

VI. THE EXTENSION OF SERVICE TAX TO ‘DEEMED SALES’

Kalyana Mandapams were among the first to suffer from the proclivity of the Union to cover ‘deemed sale’ transactions within the service tax net. The taxable service in relation to these transactions was the “service provided to a client, by a Mandapam - keeper in relation to the use of a Mandapam in any manner including the facilities provided to the client in relation to such use and also the services, if any, rendered as a caterer.” This levy was challenged in Tamil Nadu Kalyana Mandapam Asscn. v. All India Federation of Tax Practitioners v. Union of India, (2007) 7 SCC 527 [Supreme Court of India].

18 English translation of which would mean ‘marriage halls’.

19 English translation of which would mean ‘marriage halls’.
Union of India, inter alia on the ground that supply of food articles was already covered within the purview of sales tax vide Article 366(29A)(f) of the Constitution. Since the transaction was reserved for the exclusive domain of the States under Entry 54 of List II by way of the Constitution (Forty Sixth Amendment) Act, 1982, it was constitutionally impermissible to levy service tax on any services rendered in connection with the supply of food and drinks, according to the Petitioner. This was, in other words, the 'waiver' argument raised in the previous section. Rejecting this contention, the Supreme Court reasoned that various aspects of the same transaction could be taxed under various taxing statutes by different taxing authorities and that there was a service aspect to the activity carried on by the petitioner and its members. The judgment however, does not clearly state as to how Parliament had discharged its burden of illustrating the existence of a specific service element, independent of the element of sale as covered in Article 366(29A). There is a discussion about the differences between 'outdoor catering' and restaurants at the end of which, it has been concluded that "outdoor catering has an element of personalized service provided to the customer. Clearly the service element is more weighty, visible and predominant in the case of outdoor catering." However, the Court did precious little to show the exact nature of this service element independent of the supply of food and drinks, which was already covered within Article 366(29A). This error in the approach by the Supreme Court in Kalyana Mandapam Assocn., has been subsequently used to affirm the levy of service tax on various transactions where the service element is, if at all present, quite hazy.

A classic example is the treatment of hire-purchase transactions. Parliament introduced "banking and other financial services" in 2001, wherein financial leasing services, including equipment leasing and hire-purchase by a body corporate, were sought to be covered within the service tax net. On the face of it, these transactions were covered under Article 366(29A)(c) and sales tax was also being collected. Aggrieved parties, such as non banking finance companies, challenged this levy of service tax before the Kerala and Madras High Courts, both of which upheld the levy. The reasoning was the same, being that aspect theory permitted taxation by two different legislatures over two different aspects of the same transaction. Hence, the service aspect and sale aspect of hire-purchase transactions could be taxed by Parliament and State Legislatures respectively. This view has now been upheld by the Supreme Court in Association of Leasing and Financial Service Companies v. Union of India.22

20 Tamil Nadu Kalyana Mandapam Assocn. v. Union of India, AIR 2004 SC 3757 [Supreme Court of India]. [Hereinafter, "Kalyana Mandapam Assocn."]
21 Kalyana Mandapam Assocn., AIR 2004 SC 3757 [Supreme Court of India].
22 Association of Leasing and Financial Service Companies v. Union of India, (2011) 2 SCC 352 [Supreme Court of India]. [Hereinafter, "Leasing and Financial Service"]
Sale for you, Service for Him, Both for the Taxman!!

Strangely, most of the reasoning in the above decision of the Supreme Court harps on the presence of a service element to hire-purchase transactions independent of Article 36(29A)(c), but without any identification of what that distinguishable service element is. Supreme Court has held that the impugned provision operates *qua* an activity of funding/financing of equipment/asset under equipment leasing under which a lessee is free to select, order, take delivery and maintain the asset. In the view of the Court, the Non Banking Finance Companies make arrangements for the finance, accept invoices from the vendor and pay the vendor, thereby rendering financial services to their customers. This begs the question: what else does one mean by a hire-purchase transaction? It is exactly the same activity over which State legislatures levy sales tax.

The reasoning gets even more interesting as the Supreme Court goes on to place reliance on a Notification and a Circular (Notification No. 4/2006 – Service Tax dated 1.3.2006, and Circular F.No.B.11/1/2001-TRU dated 9.7.2001) issued by the Tax Research Unit, which concede that service tax in the case of financial leasing, including equipment leasing and hire-purchase, will be leviable only on the lease management fees/ processing fees/ documentation charges recovered at the time of entering into the agreement and on the finance/interest charges recovered in equated monthly instalments, and not on the principal amount. This approach by the Supreme Court is without any basis in law, as the constitutional validity of a provision cannot be decided based on the exemptions conferred by the Executive. In all likelihood, the exemption will be rescinded when the Union finds it economically sensible to collect more tax. As already stated above, good economics and correct law are not always the best of blood brothers.

Similarly, Parliament has been hounding the software industry with a tax on services provided to a person, including "acquiring the right to use information technology software for commercial exploitation including right to reproduce, distribute and sell information technology software and right to use software components for the creation of and inclusion in other information technology software products." On the basis of this charging provision, service tax was sought to be imposed on sale of canned and customised software. Promptly, the industry took steps to challenge the same by filing a writ petition in the Madras High Court. The contention taken up by the petitioner association, in Infotech Software Dealers Association *v.* Union of India, was that the transfer of the right to use goods was already covered

23 § 65(105)(zzzze), The Finance Act, 1994. The word ‘acquiring’ has been subsequently replaced with ‘providing’.
24 Infotech Software Dealers Association *v.* Union of India, (2010) 34 VST 133 [Madras High Court].
within 'deemed sale' under Article 366(29A)(d) and hence could not be subject to
service tax. Rejecting this contention, the High Court again reasoned that there
was a service element in these transactions under which software was licensed to
the end user by members of the petitioner association. In this case too, the High
Court hardly pointed out the specific service element in the transfer of canned or
customised software apart from stating that the end user was being permitted to
use the software by purchasing the Compact Discs or other storage media, or by
downloading the software through internet. This was precisely the activity for
which sales tax was already being levied on the industry. If one were to extend
the logic applied in all the above cases, the day is not far when shopkeepers will
be covered under 'shopkeeper services' for providing access to goods that are
sold in the shop!!

VII. The Extension of Service Tax to Other
Transactions of a Non-service Character

Apart from transactions of sale / 'deemed sale' that have been held to fall
within the service tax net, some other transactions have also been absurdly brought
within the purview of service tax. A classic case is that of service tax on renting
of immovable property. Parliament, in its strange wisdom, thought that mere
renting of property for use in the course or furtherance of business or commerce is
a service, and imposed service tax on the same.25 Earlier, the Union had attempted
to do the same vide a notification followed by a circular, which was struck down
by a Division Bench of the Delhi High Court in Home Solution Retail India Ltd. v.
Union of India.26 The Delhi High Court had correctly reasoned that service tax is a
value added tax, and there was no value addition in merely renting out premises.
There had to be some additional service offered in connection with the rental.

After the Finance Act, 1994, was amended to legislatively provide for what
was contained in the invalidated notification and circular, various aggrieved parties
approached different High Courts challenging the amendment. The primary
contention was that service tax on mere renting of immovable property would
amount to a tax under Entry 49 of List II, i.e. a tax on land and buildings, and that

25 As per § 65(105)(zzzz), The Finance Act, 1994, the taxable service was defined initially
as any service provided, or to be provided, to any person, by any other person in
relation to renting of immovable property for use in the course or furtherance of
business or commerce. Later, this was amended to include service provided by renting
of immovable property.

26 Home Solution Retail India Ltd. v. Union of India, (2009) 158 DLT 722 [Delhi High
Court].
Sale for you, Service for Him, Both for the Taxman!!!

this was outside the competence of Parliament. Rejecting this contention, a Division Bench of the Bombay High Court has, very recently in Retailers Association of India v. Union of India, upheld the validity of this levy. In some ways, the choices were limited for the Bombay High Court as Supreme Court had already closed its eyes to the clear division of powers between the Union and State List. However, it was an excellent opportunity which the High Court sadly lost, to clarify the boundaries of the aspect theory which has time and again been repeated like a mantra to permit Parliamentary overlap into taxing entries reserved for the States. Mere repetition of the well-established principle that legislative entries must receive liberal construction does not address the issue of whether a frivolous aspect can be used to indirectly do what cannot be directly done. It is also pertinent to note that no overlap is permissible at all in the case of taxing entries, and to that extent, the principle of liberal construction does not apply with the same flexibility as with other legislative entries.

VIII. SUPREME COURT IGNORES THE CORRECT EXPOSITION OF LAW IN BSNL v. UNION OF INDIA

It is not our contention that the Supreme Court has failed to appreciate the constitutional scheme or the purpose behind the introduction of Article 366(29A). At least in one decision, Bharat Sanchar Nigam Ltd. v. Union of India, a three Judge Bench of the Supreme Court has correctly analysed the scope of Article 366(29A). This case arose from a challenge to the imposition of sales tax on mobile operators. The contention of the State legislatures was that SIM cards were being transferred in order to activate the cellular services and such SIM cards being goods, sales tax would be attracted. While rejecting this contention and holding that the providing of cellular services would fall within the exclusive domain of Parliament, the Supreme Court embarked on an analysis of Article 366(29A). After scrutinising each clause of this Article, Ruma Pal, J. speaking for the majority, held:

"Clause (a) covers a situation where the consensual element is lacking. This normally takes place in an involuntary sale. Clause (b) covers cases relating to works contracts. This

29 Bharat Sanchar Nigam Ltd. v. Union of India, (2006) 3 SCC 1 [Supreme Court of India]. [Hereinafter, “BSNL v. UOI”]
30 BSNL v. UOI, (2006) 3 SCC 1 [Supreme Court of India].
was the particular fact situation which the Court was faced with in Gannon Dunkerley and which the Court had held was not a sale. The effect in law of a transfer of property in goods involved in the execution of the works contract was by this amendment deemed to be a sale. To that extent the decision in Gannon Dunkerley was directly overcome. Clause (c) deals with hire purchase where the title to the goods is not transferred. Yet by fiction of law, it is treated as a sale. Similarly the title to the goods under Clause (d) remains with the transferor who only transfers the right to use the goods to the purchaser. In other words, contrary to A.V. Meiyappan’s decision a lease of a negative print of a picture would be a sale. Clause (e) covers cases which in law may not have amounted to sale because the member of an incorporated association would have in a sense been both the supplier and the recipient of the supply of goods. Now such transactions are deemed sales. Clause (f) pertains to contracts which had been held not to amount to a sale in State of Punjab v. Associated Hotels of India Ltd. That decision has by this clause been effectively legislatively invalidated.

All the clauses of Article 366(29A) serve to bring transactions where one or more of the essential ingredients of a sale as defined in the Sale of Goods Act 1930 are absent, within the ambit of purchase and sales for the purposes of levy of sales tax. To this extent only is the principle enunciated in Gannon Dunkerley limited. The amendment especially allows specific composite contracts viz. works contracts (Clause (b)), hire purchase contracts (Clause (c)), catering contracts (Clause (e)) by legal fiction to be divisible contracts where the sale element could be isolated and be subjected to sales tax.

Gannon Dunkerley survived the 46th Constitutional Amendment in two respects. First with regard to the definition of ‘sale’ for the purposes of the Constitution in general and for the purposes of Entry 54 of List II in particular except to the extent that the clauses in Article 366(29A) operate........ The second respect in which Gannon Dunkerley has survived is with reference to the dominant nature test to be applied to a composite transaction not covered by Article 366(29A). Transactions which are mutant sales are limited to the clauses of Article 366(29A). All other transactions would have to qualify as sales within the meaning of Sales of Goods Act 1930 for the purpose of levy of sales tax.

Of all the different kinds of composite transactions the drafters of the 46th Amendment chose three specific situations, a works contract, a hire purchase contract and a catering contract to bring within the fiction of a deemed sale. Of these three, the first and third involve a kind of service and sale at the same time. Apart from these two cases where splitting of the service and supply has been constitutionally permitted in clauses (b) and (g) of Clause 29A of Article 366, there is no other service which has been permitted to be so split.”
Four things are crystal clear from the above statement of law: (i) all 'deemed sales' today fall within the purview of sale, but not all of them are composite in character. Cases where the consensual element is lacking [cl. (a)], or there is only a transfer of the right to use [cl. (d)], or there is a supply of goods to oneself [cl. (e)] are not composite but covered within Article 366(29A) for different reasons while works contracts [cl. (b)], hire purchase contracts [cl. (c)], and catering contracts [cl. (f), wrongly mentioned as cl. (e) in the judgment] are composite in character and brought specifically within the ambit of Article 366(29A) so that the sale aspect of these transactions can be taxed by the State Legislatures. So in the case of the first set of transactions, there is no question of any service aspect as the entire transaction is deemed to be a sale; (ii) even in the case of composite contracts, i.e. the second set of transactions, the legal fiction only extends to the extent of making it possible to isolate the sale element for the purposes of taxation. If the entire transaction is covered within the sweep of Article 366(29A), it will exclusively fall within the legislative domain of the State legislatures. The burden is on the concerned Legislature to show the existence of a specific sale or service element so as to tax the same; (iii) of the three transactions in the second set, only works contract and catering contracts involve a kind of service and sale at the same time. Hire purchase contracts do not involve a service element; (iv) Gannon Dunkerley holds good for the purpose of determining competence to levy sales tax in so far as transactions not covered under Article 366(29A) are concerned.

Viewed from this perspective, the final outcome arrived at by the Supreme Court in Kalyana Mandapam Asscn.,31 can be justified since it was a case involving catering contracts as part of the Kalyana Mandapam services. However, the approach and reasoning of the Supreme Court in this case is still wrong. The application of aspect theory without an understanding of the nuances behind this theory has resulted in great damage as transactions involving hire-purchase and transfer of right to use have also been brought within the service tax net, incorrectly applying the aspect theory. The decision in BSNL v. UOI,32 has been the casualty in this process.

Another decision of the Supreme Court, though not one arising out of a constitutional challenge, where the analysis has been quite clear, is the decision in Imagic Creative Pvt. Ltd. v. Commr. Of Commercial Taxes.33 The Supreme Court clarified in this case that the levies of service tax and sales tax are mutually exclusive. Therefore, they should be held to be applicable having regard to the respective

31 Kalyana Mandapam Asscn., AIR 2004 SC 3757 [Supreme Court of India].
32 BSNL v. UOI, (2006) 3 SCC 1 [Supreme Court of India].
33 Kalyana Mandapam Asscn., (2008) 2 SCC 614 [Supreme Court of India].
parameters of service tax and sales tax as envisaged in a composite contract. Thus, in a composite contract, if the charge of the tax is on the entire contract value and not the sale or service element as the case may be, it would amount to an invalid levy. Unfortunately, this principle was not kept in mind while deciding Leasing and Financial Service. The Supreme Court did not examine closely the service element in the hire purchase transaction at all, even though it was shown that the entire interest component was already being subject to sales tax.

It is also pertinent at this juncture to highlight the decision of the Supreme Court in Gannon Dunkerley v. State of Rajasthan, where it was held that the cost of incorporation of the goods could not be included for the purposes of sales tax levy over works contracts in accordance with Article 366(29A) read with Entry 54 of List II, since such cost of incorporation “forms part of the contract relating to work and labour which is distinct from the contract for transfer of property in goods.” When States have the power to levy sales tax only over the proportion of the transaction consideration attributable to the sale (being the entire transaction value in the case of hire-purchase transactions) it is baffling as to how Parliament will have competence to levy service tax over hire-purchase transactions when the consolidated proceeds, including the hire charges, is subject to sales tax!!

IX. Aspect Theory and its Incorrect Application

The reluctance of the Supreme Court to strike down invalid levies of service tax such as the ones covered in the preceding sections of this essay, stems largely from the incorrect application of the aspect theory. This import from Canadian constitutional law hit Indian shores through the decision in Federation of Hotel & Restaurant Association of India v. Union of India. In this case, while upholding the levy of expenditure tax, the Supreme Court held that this tax was on the aspect of expenditure and hence not covered within Entry 62 of List II, pertaining to taxes on luxuries. Therefore, Parliament was considered competent to levy Expenditure Tax under Entry 97 of List I.

34 See also, State of Rajasthan v. Rajasthan Chemists Association, (2006) 6 SCC 773 [Supreme Court of India].
35 Leasing and Financial Service, (2011) 2 SCC 352 [Supreme Court of India].
38 Federation of Hotel & Restaurant Association of India v. Union of India, (1989) 3 SCC 634 [Supreme Court of India]. [Hereinafter, “FHRAI v. UOI”]
There are strong reasons for limiting, if not negating, the scope and applicability of the aspect theory in the context of our constitutional scheme. The double aspect theory was judicially evolved in Canada to specifically address the problem created by distribution of legislative powers between the Federation and the Provinces. This doctrine appears to have been stated for the first time in Hodge v. The Queen, in the following words: "subjects which in one aspect and for one purpose fall within sect. 92, may in another aspect and for another purpose fall within sect. 91." It follows from this theory that two relatively similar rules or sets of rules may validly be found, one in legislation within exclusive federal jurisdiction, and the other in legislation within exclusive provincial jurisdiction, because they are enacted for different purposes and in different legislative contexts which give them distinct constitutional characterizations.

As explained by the Canadian Supreme Court in Multiple Access Ltd. v. McCutcheon, when the court considers that the federal and provincial features of the challenged rule are of roughly equivalent importance so that neither should be ignored respecting the division of legislative powers, the decision is made that the challenged rule could be enacted by either the federal Parliament or provincial legislature. So, it is seen that the 'double aspect' doctrine as evolved in Canada allows both legislatures to enact the same rule, as opposed to the doctrine as used by the Indian Supreme Court in FHRAI v. UOI. Therefore, before blindly applying this doctrine to the Indian constitutional context, it is imperative to understand the constitutional scheme in Canada.

Section 91 of the Constitution Act, 1867, of Canada vests power in the Parliament of Canada to make Laws for the Peace, Order, and good Government of Canada, in relation to all Matters not falling within the Classes of Subjects assigned exclusively to the Legislatures of the Provinces and specifically, in relation to all matters falling within the class of subjects enumerated in this Section. Section 92 vests power in the Provinces to make laws dealing with all matters of a local or private nature in the Provinces, and specifically, in relation to all matters falling within the class of subjects enumerated in this Section. Section 91 also specifies that any Matter coming within any of the Classes of Subjects enumerated in this Section shall not be deemed to come within the Class of Subjects of a local or private Nature enumerated in Section 92. Thus, a very important difference emerges between the

39 The terms 'double aspect' and 'aspect' are interchangeably used by the Canadian Courts.
40 Hodge v. The Queen, (1883) 9 App. Cas. 117 [Privy Council].
41 Multiple Access Ltd. v. McCutcheon, [1982] 2 SCR 161 [Supreme Court of Canada].
42 FHRAI v. UOI.
Indian and the Canadian Constitutions, being the absence of a Concurrent List in the latter. In India, the founding fathers of our Constitution found it advisable to enumerate separately those matters which both the Parliament and the State Legislatures would have a legitimate interest in legislating upon. In this light of the matter, there was no requirement of resorting to the double aspect theory and thereby permitting both the Parliament and the State legislatures to enact laws on certain subjects, in India. This was indeed what the “double aspect” theory was capable of achieving as is seen from the warning issued by Viscount Haldane in Attorney-General for Canada v. Attorney-General for Alberta, regarding this theory. In the words of the learned judge, this doctrine “is now well established, but none the less ought to be applied only with great caution”.

The reason for such exercise of caution has been articulated by the Canadian Supreme Court in Bell Canada v. Quebec. According to the Supreme Court, “the reason for this caution is the extremely broad wording of the exclusive legislative powers listed in ss. 91 and 92 of the Constitution Act, 1867 and the risk that these two fields of exclusive powers will be combined into a single more or less concurrent field of powers governed solely by the rule of paramountcy of federal legislation. Nothing could be more directly contrary to the principle of federalism underlying the Canadian Constitution.” In order to avoid this consequence, the Supreme Court held that the double aspect theory could only be invoked when it gave effect to the rule of exclusive fields of jurisdiction, and only where the multiplicity of aspects was real and not merely nominal.

The concurrent nature of the aspect theory is also evident from the fact that the rules of federal paramountcy and repugnancy have found their significance in cases relating to aspect theory. In O’Grady v. Sparling, the Canadian Supreme Court while repelling the contention that Section 55(1) of the Manitoba Highway Traffic Act was in conflict with Section 221 of the Criminal Code held that the former provision had for its true object, purpose, nature or character the regulation and control of traffic on highways. In this connection, the Supreme Court held that there was no conflict or repugnancy between these provisions and that both provisions could operate concurrently. Similar reasoning was adopted by the Canadian Supreme Court in Ross v. Registrar of Motor Vehicles, thus showing that the double aspect doctrine in Canada is closely connected with the concurrent

44 Bell Canada v. Queen, [1988] 1 SCR 749 [Supreme Court of Canada].
46 Ross v. Registrar of Motor Vehicles, [1975] 1 SCR 5 [Supreme Court of Canada].
operation of federal and provincial legislation. It is a doctrine specially evolved to recognize concurrent matters or fields in the absence of specific constitutional sanction for the same.

Another factor to be kept in mind is the higher degree of detailing present in the VIIth Schedule to the Indian Constitution. While Sections 91 and 92 contain a total of 43 entries, List I of our VIIth Schedule alone contains 97 entries. More importantly, when it comes to the power of taxation, the Indian constitutional scheme is much more detailed in the enumeration of various kinds of taxes that may be levied by the Parliament and the State Legislature. Moreover, from the conspicuous absence of any taxing entries from the Concurrent List, it is clear that the framers of our Constitution did not envisage any “double aspect” taxing statutes in the same sense as understood by the judiciary in Canada.

Without appreciating these fine, yet highly significant, distinctions between our constitutional scheme and that of Canada, the Indian Supreme Court in FHRAI v. UOI misapplied this doctrine and upheld the levy of Expenditure Tax. The same error continues today when extending service tax levy to transactions that have been deemed to be ‘sale’ under Article 366(29A). Unfortunately, no Indian Court has embarked on a serious study of the aspect doctrine and examined its true position and place in our constitutional scheme.

X. CONCLUDING REMARKS

The protector of citizen’s rights, the Supreme Court of India, has failed in its duty to correctly demarcate the scope of legislative power of Parliament vis-à-vis the States. The Supreme Court of the 1950s had, in Gannon Dunkerley, protected industry against unbridled exercise of taxing powers by the State legislatures. The Supreme Court had stood as a wall between the State and the citizen, finally compelling Parliament to amend the Constitution. Unfortunately, the Court of today has not been applying existing constitutional restrictions to prevent the imposition of service tax on transactions already subject to sales tax and exclusively covered under Entry 54 of List II. Ironically, it was so much easier for the Court of the 50’s to rule in favour of the revenue as *ex facie* there were no restrictions on the scope and ambit of ‘sale’. Despite this, the Supreme Court protected industry by reading in a limitation, i.e. ‘sale’ has to be as defined in the Sale of Goods Act, 1930. The Court of today is confronted with a Constitution where *ex facie* certain transactions have been reserved under Article 366(29A) within the exclusive domain of the State legislatures. Yet they continue to rule in favour of the State.

47 FHRAI v. UOI.
The decision in *Leasing and Financial Service* is the last nail on the coffin, as it is unlikely that Courts will, after this decision, come to the rescue of an assessee who is subject to double taxation under the shadow of the aspect doctrine. This approach has serious repercussions for the industry as well as the end user, since the ultimate incidence of these indirect levies will have to be borne largely by the customer and to some extent by the industry. One can only hope that Parliament realises this just in time before any inflationary push is set in motion, and takes necessary steps to at least ensure that the incidence of service tax is only on the service element, if any, in these transactions and not on the entire value of the contract. Though even this is not permissible as per our constitutional scheme post the introduction of Article 366(29A), this is all that the citizen can expect considering the wide leeway given to Parliament by the Supreme Court.

---

48 *Leasing and Financial Service*, (2011) 2 SCC 352 [Supreme Court of India].