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Narrating the History of Service Tax on Leasing Transaction – No Service Tax post The Finance Act, 2012 effective from July, 2012

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When it comes to taxation, the taxing authorities leave no opportunity to fill up the coffers; while the assessees leave no stone unturned to save their pockets. So, there is a constant tug of war when the lawmakers leave any grey area as regards the applicability of any particular provision of law. Leasing transactions have witnessed the same history. Leases of movable property, by virtue of 46th Amendment of the Constitution, became taxable under the Sales tax laws. The "transfer of right to use goods" is included in the definition of "sale" under sales-tax/ VAT laws. Thereafter, service tax was imposed on banking and financial services which cover within its ambit the financial leasing transactions. And then follows the spate of judicial pronouncements making distinction between a sale and a service. Therefore, leasing transactions have always been in grey area as far the taxability of these transactions is concerned.

The Finance Act, 2012 has made drastic amendments to the service tax laws and the applicability of the amendment is with effect from July 1, 2012. Let us see whether it clears the cloud of doubts or leaves the leasing industry with the continuing uncertainty. Before this, attention is drawn to the history behind.

Service Tax on Banking and Other Financial Services:

- Going way back to 2001, when Banking and Other Financial Services (B&FS) were covered within the ambit of service tax by ***Notification No. 4/2001-S.T. dated 09.07.2001***[1]. The B&FS were defined under Section 65(12) of the Finance Act to include *"financial leasing services including equipment leasing and hire-purchase".* By virtue of this provision, financial lease transactions came within the purview of service tax.

- Thereafter, in 2006, the Department came with the ***Notification No. 4/2006-Service Tax***, wherein the Government had granted a deduction of 90 per cent from the installment amounts and only the balance 10 per cent was charged to the service tax.

- **The Finance Act, 2012-tables turned -** The Finance Act, 2012 wherein excluding the negative list prescribed under the Act, all the other services were covered within the purview of service tax. **"Service"** has been defined to exclude the transfers stipulated under Article 366(29A); while section 66E of the Act, laying down the list of **declared services** include "transfer by way of hiring, leasing, licensing or in any such manner without transfer of right to use such goods".

[1] http://www.servicetax.gov.in/st-profiles/banking-finl-services.htm

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So, the question remains – Is financial lease taxable under the Service Tax law? An attempt is made by the Authors to analyze the relevant provisions in the Finance Act, 2012, various notifications and clarifications issued by the Ministry of Finance to seek an answer to this.

"Service" as defined under the Finance Act, 2012

Section 65B of the Finance Act 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 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*
>
> ***

The definition draws a reference to Article 366(29A) of the Constitution of India which states as under:

> *"(29A) tax on the sale or purchase of goods includes-*
> ***
> *(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;*
> *……"*

The definition of "service" itself excludes any transaction involving transfer, delivery or supply of any goods which is deemed to be a sale within the meaning of Article 366 (29A) of the Constitution. Lease, or a transfer of right to use, is a deemed sale under Article 366(29A). It is to be noted here that under the sales tax laws, "goods" have been defined to include only movable property. Therefore, whether it is a financial lease or an operating lease, if the same transfers the right to use any goods (necessarily movable property), then the transaction is outside the scope of "service" and as such not chargeable to service tax. These transactions will suffer Central Sales Tax or Value Added Tax, as the case may be.

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The Department has also come up with a comprehensive education guide named, ***"Taxation of Services: an Education Guide"***[2] wherein it has been stated -

> *"'Transfer of right to use goods' is deemed to be a sale under Article 366(29A) of the Constitution of India and transfer of goods by way of hiring, leasing, licensing or any such manner without transfer of right to use such goods is a declared service under clause (f) of section 66E.*
>
> *Transfer of right to use goods is a well-recognized constitutional and legal concept. Every transfer of goods on lease, license or hiring basis does not result in transfer of right to use goods."*[3]

Notifications issued by the Department-twists and turns

The Ministry of Finance, Department of Revenue issued a clarification Circular vide ***D. O. F. No 334/1/2012-TRU on 16th March, 2012*** wherein in-depth analysis of various judicial pronouncements including Bharat Sanchar Nigam Limited (BSNL) case (as discussed below) were made and the distinction between sale and service was highlighted.

But then comes the ***Notification No. 13/2012- Service Tax[4] dated March 17, 2012***, by which the exemption notification of 2006 was put back in force with respect to financial leasing services including equipment leasing and hire purchase.

However, this notification i.e. Notification No. 13/3012 was suppressed by a later ***Notification No. 26/2012-Service Tax dated June 20, 2012***[5]. There was a change in the language used in the latest notification: the description of taxable service was given as **"Services *in relation to* financial leasing including hire purchase"**, while previously it was **"Financial leasing services including equipment leasing and hire purchase"**.

Though there was a change in the language, but the exemption was still available for an amount equal to service tax leviable thereon under section 66B of the Finance Act which is in excess of the service tax calculated @ 10% of the gross amount charged by the service provider for providing the taxable service, which is exactly the same as per the March 17, 2012 notification and 2006 notification.

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[2] http://www.servicetax.gov.in/EducationGuide.pdf
[3] Taxation of Services: an Education Guide,p.87
[4] http://www.servicetax.gov.in/st-notfns-home.htm
[5] http://www.servicetax.gov.in/notifications/notfns-2012/st26-2012.htm

Further, the Explanation given in all the three notifications also remained the same which reads as under:

> *"For the purposes of exemption at Serial number 1 -*
> *(i) The amount charged shall be an amount, forming or representing as interest, i.e. the difference between the installments paid towards repayment of the lease amount and the principal amount contained in such installments;*
> *(ii) the exemption shall not apply to an amount, other than an amount forming or representing as interest, charged by the service provider such as lease management fee, processing fee, documentation charges and administrative fee, which shall be added to the amount calculated in terms of (i) above."*

The attention is also drawn to clause (g) of Section 66E, by which *"activities in relation to delivery of goods on hire purchase or any system of payment by instalments"* is covered as a declared service. The Department has clarified that the delivery of goods on hire purchase or any system of payment by installments is not taxable. However activities or services provided in relation to such delivery of goods are covered in this declared list entry[6].

The same logic is to be applied in case of financial leasing. *Notification No. 26/2012 talks about "services **in relation to** financial leasing including hire purchase", and not financial leasing itself.*

The change in language suggests the intent of law makers to exclude the interest element of financial lease from the purview of service tax and which is also in line with the new definition of service, and to tax only the services in relation to financial lease which can be charged as lease management fee, processing fee, documentation charges and administrative fee. But, the non-deletion or non-amendment of the explanation with respect to amount charged comes as a hurdle in achieving the true intent of law. The authors hold a view that this non-deletion or non-amendment in the explanation is occurring only on account of error and should not frustrate the purpose/ intent of law.

Declared Services-"transfer of right to use" excluded

Another provision that supports the above stated view is section 66E of the Finance Act, 1994, that lists down the "declared services". Clause (f) of section 66E includes

[6] Taxation of Services: an Education Guide,p.88

> *"transfer of goods by way of hiring, leasing, licensing or in any such manner* ***without transfer of right to use*** *such goods."*

So, even if the goods are transferred by way of hiring, leasing, or licensing, the same may not qualify as "declared service" if the transfer of right to use the goods have not taken place. However, is it possible to make a difference between leasing and right to use goods? So, the quick question that comes up here is - if the intent is to exclude transfer of right to use goods, then why would the law include leasing, hiring, etc. The answer can be found in Mr. Vinod Kothari's Analytical Article on Budget 2012[7], wherein he has made reference to the ruling of the Supreme Court in *Bharat Sanchar Nigam Limited* and other rulings which distinguished between "transfer of right to use" and "provision of right to use", such that in transactions where control is not handed over, the transaction will not amount to a transfer of right to use.

Supporting non applicability of service tax on financial lease with the Judicial precedents

1. **Supreme Court's decision in case of *Bharat Sanchar Nigam Limited vs. Union of India (2006-TIOL-15-SC-CT-LB)*** – it was held that a particular transaction could not be charged to both the goods tax and the service tax and the test for deciding whether a transaction fell within the ambit of either tax was to determine its substance i.e. its dominant nature.

2. **Supreme Court in *Imagic Creative Pvt. Ltd. vs. Commissioner of Commercial Tax (2008-TIOL-04-SC-VAT)*** – it was held that service tax and VAT were mutually exclusive and operated in mutual domains.

Though, in a recent decision, in the case of ***Association of Leasing and Financial Companies Vs. Union of India and Others (2010-VIL-17-SC-LB-ST),*** the full bench of the Supreme Court had occasion to deal with the constitutional validity of the levy of service tax on financial leasing transactions including hire purchase and equipment leasing of goods. The issue before the Apex Court was whether hire purchase and leasing transactions involved any element of service, in order for the service tax to apply, especially where such transactions were explicitly chargeable to the VAT, being a tax in relation to goods. To which, the Supreme Court has upheld the charge of service tax on hire purchase and leasing transactions, if forming part of

[7] http://www.vinodkothari.com/Analytical_Articles_Budget_2012.pdf

'financial leasing services' under service tax law, notwithstanding that the same transactions were chargeable to the VAT.

However, the clarification notification of service tax and the amendments made by Finance Act, 2012 go against this judgement and uphold the spirit of BSNL's case.

End note

The article after making a thorough analysis of the amendments brought in by the Finance Act, 2012, various notifications, clarifications and judicial pronouncements made in the context ends with a safe conclusion that it is the dominant nature of the transaction that has to be given weight. If the transaction is pre-dominantly a sale transaction, it would be chargeable to sales tax/VAT; or if the dominant nature is providing a service, i.e. no transfer of right to use takes place then service tax is applicable. However, there might be cases where the dominant intention is not clear. In such possibilities, the transaction, other than works contract transactions under Article 366(29A), will neither be exposed to service tax nor sales tax.

To add further, the dominant nature of the transaction is to be ascertained by going through every minute detail in the agreement entered. In such cases, one needs to look beyond the whirlpool of words to see the intent of the parties - it definitely involves piercing the veil of the documentary form and considering the substance, as prudently held by our Courts time and again. So, any lease transaction in which "transfer of right to use" takes place will not suffer service tax, as it comes under the ambit of "sales" and thus chargeable to "sales tax".