

Service Tax versus VAT on Supply of Tangible Goods

Currently, there is lot of confusion among the industry, trade and the taxmen on whether the activity of Renting of movable goods or supply of tangible goods attracts Service Tax or whether it attracts Sales Tax. The confusion has only been used as a tool by the departmental officials in issuing demand notices under both the tax laws and therefore a tug of war. Before we begin our discussion, let us understand the various illustrative business transactions that are in the nature of 'Renting of a Movable goods' or 'Supply of Tangible goods' as under:

- ✚ Renting the Motor vehicles/ Motor cabs etc. to business entities or to other travel companies for use;
- ✚ Renting of machinery, equipment etc. for use to business entities;
- ✚ Renting of furniture, electronic appliances etc. along with the rent of accommodation for which separate amount is charged as consideration.

For ease of understanding, this article attempts to throw clarity on the subject issue considering the business of renting of Motor cabs/motor vehicles as an illustration.

However, the principle enunciated herewith may equally apply to renting of other movable goods also (i.e. other than motor vehicles).

Currently, many individuals owning Motor vehicles would give the same on rent to other body corporates or to other travel companies/ agents for use. Further, business entities or travel agents also prefer hiring of vehicles on lease instead of purchasing the same as it involves huge cash outflows apart from dreary day-to-day maintenance jobs attached to it.

A general business transaction of renting of motor vehicle could be as under:

- ✚ Vehicle owner (hereinafter referred to as 'transferor') would give the vehicle on rent, lease or hire basis to a travel agents or body corporates on short term or long term lease based on the needs of the client;
- ✚ Both the parties enter into an agreement (generally known as 'vehicle hire agreement') clearly defining the scope, objective, fees etc involved in the execution of the said agreement;

- ✚ Vehicle would be given with or without driver as agreed between both the parties and the consideration could be fixed monthly rentals, or variance rentals based on the kilometers run or both.

In light of the above business transaction, let us examine whether it attracts sales tax or service tax and the factors triggering the levy. For the ease of discussion, let us assume the person giving the vehicle on hire as the 'Transferor' and person obtaining the vehicle on hire as the 'Transferee'.

DISCUSSION OF LEVY UNDER SERVICE TAX AND SALES TAX

Whether the above business transaction of a vehicle hire agreement attracts service tax or sales tax needs to be understood based on the relevant provisions in the Service tax law and the Sales tax law as under:

As per sub-clause (d) of clause 29 of article 366 of the Constitution of India **Transfer of the right to use any goods** for any purpose for cash, deferred payment or other valuable consideration is considered as a **"Deemed Sale"**.

Contrary to this, as per clause (f) to Section 66E of the finance act, 1994 Transfer of goods by way of hiring, leasing, licensing or in any such manner **without transfer of right to use such goods** is a **"Declared Service"**.

Therefore, currently in order to tax the transaction of renting or hiring of movable goods a deeming fiction has been created under both sales tax as well as service tax law with the difference that,

- Sales tax shall be levied on renting of movable goods only if the **'right to use the goods' has also been transferred**; and
- Service tax shall be levied on renting of movable goods only if the **'right to use the goods' has not been transferred**.

Now, the moot questions comes down in analyzing whether in any transaction of renting or hiring of movable goods whether rights to use the goods has also been transferred or not? If this question is posed on to the sales tax officials then they shall

use all means in proving that the rights are also transferred in a transaction and as a consequence demand sales tax as “**deemed sale**” and similarly as per service tax officials rights are never transferred in such transactions and the same is always held liable for Service tax as “**Declared Service**”.

DISCUSSION ON TRANSFER OF ‘RIGHTS TO USE’ GOODS

A test to determine whether or not the rights to use goods has been transferred in a particular transaction has not been explained in both service tax law and also in sales tax law and therefore the said matter has to be understood based on the various landmark judgments pronounced in this regard.

Although this question has been an area of dispute since long and the matter has been heard and decided at various judicial proceedings, but the following judgments can be considered as landmark rulings in respect of the current issue and provides certain principles and directive guideline for determining the taxability of this transaction:

- **(BSNL v UoI)** (2006) 6 SCC 1 (2006) 145 STC 91 (SC)
- State of AP v **Rashtriya Ispat Nigam Ltd** 2002 089 AIR 1305-SC
- M/S **G S Lamba and Sons** v State of AP 012-TIOL-49-HC-AP-CT

Following five principles emerge from reading of all the above landmark judgments, i.e. if it has to be concluded that the ‘**right to use**’ has been transferred in a particular transaction of hiring, leasing etc. then the following five principles must be satisfied:

First Principle: Identification of the goods for delivery

“There must be goods available for Delivery”;

*“There must be a consensus ad idem as to the **identity of the goods**”;*

Paper writers Comments: In a vehicle hire agreement, generally the vehicle that needs to be supplied on hire will be available for delivery and the same will also be separately identified i.e. the name, model, registration no. of the motor vehicles that are going to be transferred will have to be clearly mentioned in the agreement.

Therefore, this condition mostly satisfies and favours the transfer of right to use goods.

Second Principle: Effective control over the goods

*“Transferee must hold the **effective control over the goods** – The effective or general control does not mean always physical control and even if the manner, method, modalities and the time of the use goods is decided by the lessee or the customer, it would be under the effective or general control over the goods”;*

Paper writers Comments: In order to understand who possesses the effective control over the motor vehicles needs to be understood based on the terms of the agreement. For instance, there could be certain terms in the agreement which would establish that the transferee possess the effective control over the vehicle as under:

- i. Transferee possesses the absolute right to decide the allotment of the taxis;
- ii. The Vehicle Owner (transferor) shall use the vehicle/ or equipment only in the manner directed by the transferee from time to time;
- iii. Transferee shall decide the timing, route and other modalities of the usage of the vehicles;
- iv. Transferee has the right to inspect the vehicle to ensure a serviceable condition;
- v. A regular log of customers and other details in relation to the daily plying of the vehicle should be maintained as per the requirements of the transferee;
- vi. The driver shall operate the vehicle properly and safely at all times in accordance with the regulations and instructions as may be prescribed by the transferee;
- vii. The driver of the vehicle observes and complies with all rules, regulations or directives, applicable from time to time, made by competent authorities and/or transferee;

On the contrary, there may be some other terms in the agreement which would establish that the transferor possesses the effective control over the use of the vehicle as under:

- i. The transferor provides the Taxi along with the driver;
- ii. Vehicle to be in the complete possession and control of the driver;

- iii. Conditions and maintenance of the Taxi in respect of fuel availability, regular checking, adjustments of battery and engine fluid levels, regular cleaning etc shall be solely the responsibility of the transferor or his driver;
- iv. Transferor or driver shall be fully responsible for the regular up-keep or maintenance of the vehicle;

The above are only illustrative list of terms, there can be many other terms in the agreement and therefore one has to look into all the terms of the agreement in totality to understand which party possesses the effective control over the usage of the vehicle. The right to use of the vehicle is available with the party that possesses the effective control over the vehicle.

Third Principle: Transfer of legal rights and consequences

*“The transferee should have a **legal rights** to use the goods – consequently all **legal consequences** of such use including any permissions or licenses required therefor should be available to the transferee”;*

“The approvals, concessions, licences and permits in relation to goods would also be available to user of the goods, even if such licences or permits are in the name of owner (transferor) of the goods”;

Paper writers Comments: In order to establish the transfer of right to use of the vehicle, it must be proved that the ‘legal rights’ and ‘legal consequences’ of the usage of the vehicle have also been transferred.

Generally, in case of a vehicle hire agreement, the legal rights to use can be said to have been transferred, since the transferor and the transferee have entered into a vehicle hire agreement duly signed by both the parties thereby legally allowing the transferee to use the vehicle. Further, as per the Indian contract act, the contract between the two parties is a legal document through which the legal rights and obligations of each party are agreed upon and also have legal enforceability. Therefore by way of entering into a contract, a legal right can be said to have been transferred by the transferor to the transferee.

However in order to understand whether the **'legal consequences'** arising out of the usage of the vehicle has also been transferred or not, we need to look into the various terms of the agreement to understand who bears the liability for any fines, penalties for mis-use of the vehicle or contravention of the any law, rules, regulations while using the vehicle.

Generally, from the following illustrative terms of the contract it can be said that the legal consequences arising out of the mis-use of the vehicle vests upon the transferor as under:

- i. Transferor shall make the payment to the appropriate authorities and transferee is indemnified against all fines, penalties and liabilities imposed for contravention of any transport, traffic or other law or regulation;
- ii. Transferor shall take all necessary steps at his own expense to retain and recover possession and control of the Taxi if the driver of the Taxi loses possession or control of the Taxi;

The above are only illustrative list of terms, there can be many other terms, we need to look into the terms of the agreement in totality to understand which party bears the legal consequences of the usage of the vehicle.

Fourth Principle: Exclusivity of use

*“During the period of contract **exclusive right to use** goods along with permits, licences, etc., vests with the lessee”;*

For a period during which the transferee has such legal right, it has to be the exclusion to the transferor this is the necessary concomitant of the plain language of the statute – viz. a transfer of a right to use and not merely a license to use the goods;

*Having transferred the right to use the goods during the period for which it is to be transferred, the owner **cannot again transfer the same rights to others**”;*

Paper writers Comments: Generally in a typical vehicle hire agreement, the transferee wishes to have the exclusive authority to use the vehicle and the same cannot be transferred to any other person during the period of the agreement. As practically, it would be a challenge to rent a same vehicle to multiple clients during the same period and therefore to avoid such problems, various terms would be fixed in the agreement granting the rights of exclusive usage of vehicle to the transferee as under:

- i. This agreement and all rights and obligations hereunder, are personal to the vehicle owner and the **vehicle owner shall not assign or attempt to assign any such rights or obligations to any third party** without the prior written consent of the transferee;
- ii. The vehicle owner cannot be a party or privy to any contract, deed or document whereby or by reasons whereof the vehicle owner is prevented or prohibited or prohibited from entering into this agreement or fulfill his obligations hereunder;
- iii. Permission is not given to any third party to drive or operate the Taxi;
- iv. The driver shall take all bookings and instructions only from the transferee.

However, there may be exceptional business clauses in the agreement which would state that the transferee does not possess the exclusivity of usage as under:

- i. Vehicle shall be made available to transferee only between 9AM to 6PM and later the same can be used by the vehicle owner as per its own requirement;
- ii. Transferor shall not allow the usage of vehicles to any other vendor during weekdays between Monday to Friday, however transferee is not concerned over usage of vehicle by the transferor during weekends i.e. Saturdays and Sundays.

Fifth Principle: Terms of the Contract:

*“Whether the transaction amounts to transfer of right or not cannot be determined with reference to a particular word or clause in the agreement. To determine the nature of transaction and whether or not the right to use have been transferred, the **agreement has to be read as a whole**”;*

As per the discussion above, we have seen that there are certain clauses in the agreement through which it can be established that the right to use has been transferred, but there can also be certain other clauses in the agreement through

which it can be proved that the right to use has not been transferred, an agreement can have a mix of divergent clauses and therefore it is important to note that the agreement must be read in full and the true meaning of the object and purpose of the contract must be given effect to. The rights, obligations and authority of the each party to the contract can be understood only upon appraisal of the contract in full.

Agreement must not be interpreted based on the reading of the various individual clauses in it, but the true spirit of the agreement must be given effect only upon reading of the entire agreement in full.

CONCLUSION:

In order to decide whether the transaction of the vehicle hire agreement towards the renting, leasing or hiring of the motor vehicle would attract service tax or sales tax, one need to use the above principles arising out of various landmark judgments.

Further, it must be ensured that the terms of agreement are not too divergent and dissimilar to allow both the tax authorities to take an undue advantage on the assesses. In other words, the sales tax authorities would pick and choose clauses in the agreement which favours transfer of right to use and would demand sales tax based on such clauses in the agreement and similarly the service tax authorities would pick clauses which enunciates non-transfer of rights to use goods and issue service tax demands.

Therefore, agreements must be clearly defined keeping the above principles in mind and rights and liabilities of both the parties needs to be very clearly brought out in the agreement and only one tax (i.e. either sales tax or service tax) needs to be paid. vagueness of clauses in the agreement would only give brownie points to both the tax authorities to levy demand notices.

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