

Telecommunication Services are Not Liable to VAT

Does the nature of the transaction by which mobile phone connections are enjoyed fall under the category 'sale' or is it a 'service', or is it both? This article looks at this issue in the light of Supreme Court's observations and decision in the case of *BSNL and Others v. Union of India (SC) (2006) 145 STC 91*.

Principal Question Before the Court

The principal question to be decided by the Court was the nature of the transaction by which mobile phone connections are enjoyed. Is it a sale or a service, or both? If it is a sale, states are legislatively competent to levy sales tax on the transaction under entry 54, List II of the Seventh Schedule to the Constitution. If it is a service, the Central Government alone can levy service tax under entry 97 of List I (or entry 92c of List I after 2003). And if the nature of the transaction falls in categories of both sale and service, the moot question would be whether both legislative authorities could levy their separate taxes at the same time or only one of them can do so.

Petitioners' Contention

The petitioners, i.e., the mobile service providers, supported by the Union Government, contended that no sale transaction is involved and that the attempt of the States to levy tax on the provision of mobile phone facilities by them to subscribers was constitutionally incompetent. They stated that the transaction in question was merely a service and the Union Government alone was competent to levy tax thereon.

The Petitioners further submitted that there was no transfer of any legal right by the service providers or delivery of any goods which may be covered under the Telegraph Act, 1885, as the same is barred and prohibited in terms of the license granted to service providers.

It was further emphasised that there must be goods of which the right to transfer is covered by sub-clause (d) of clause (29A) of article 366.

It was also submitted that the Court should apply the standard of the ordinary man for deciding whether the transaction in question was a contract for service or for transfer of a right to use deemed goods.

The legal fiction created in Article 366(29A) provided for specific composite contracts to be subjected to sales tax. Therefore, even after the 46th Amendment other transactions had been held not to be sales. Reliance has been placed on the decisions in *Everest Copiers v. State of Tamil Nadu [1996] 103 STC 360 (SC)*, *Rainbow v. State of Madhya Pradesh [2000] 118 STC 9 (SC)*, *Hindustan Aeronautics v. State of Karnataka [1984] 55 STC 314 (SC)*.

It is further submitted that the SIM card was merely an identification device for granting access and was a means to access services.

Respondents' Contention

The respondents, i.e., the States, raised a preliminary objection contending that the plea of the petitioners is barred by *res judicata* because the issue has been decided by the Apex Court as above stated in *State of UP v. Union of India (2003) 130 STC 1 (SC)*. The respondents contended that the transaction was a deemed sale under Article 366(29A)(d) of the Constitution, i.e. a tax on the transfer of the right to use any goods for any purpose read with the charging sections in their various sales tax enactments and, therefore, they are competent to levy sales tax on the transactions.

The respondents further submitted that



— CA. Virander Chauhan

(The author is a Member of the Institute. He can be reached at akvk2003@yahoo.com)

delivery of goods was not necessary for the purpose of transferring the right to use and this had been held in the decision of Apex Court in *20th Century Finance Corpn. Ltd. v. State of Maharashtra* (2000) 119 STC 182 (SC).

It is also submitted that in any event different aspects of a given transaction can fall within the legislative competence of two legislations, then both would have the power to tax that specific aspect.

The use of the words "any goods" in Article 366(29A)(d) showed that the goods need not necessarily be transferred by the transferor. It is further emphasised that sub-clause (d) also uses the words "for any purpose". This could include the purpose of service.

Past History of Such Transactions

The High Court of Allahabad in the case of *Union of India v. State of UP* (1999) 114 STC 288, Andhra Pradesh High Court in the case of *Union of India v. Secretary, Revenue Dept (CT-II) Govt. of AP* (1999) 113 STC 203 and Punjab and Haryana High Court in the case of *Union of India v. State of Haryana* (2001) 123 STC 539, held that there was no sale of goods under the State Sales Tax Acts justifying the levy of sales tax on rentals charged by service providers to its subscribers.

All the above three decisions were overruled by the Apex Court in *State of U.P. v. Union of India* (2003) 130 STC 1 (SC).

Also, the High Court of Kerala took a different view from the view expressed by the above three High Courts in *Escotel Mobile Communication Ltd. v. Union of India* (2002) 126 STC 475 (Kerala).

Introduction of Article 366 (29A)

On the recommendations of the Law Commission, Article 366 was amended by inserting a definition of "tax on the sale or purchase of goods" in clause (29A). The definition reads: "(29A) 'tax on the sale or purchase of goods' include—

(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 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 thereof 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.

Considering the above facts and circumstances of the case, the Hon'ble Apex Court framed the following questions for its consideration:

- A. What are "goods" in telecommunication for the purposes of article 366(29A)(d)?
- B. Is there any transfer of any right to use any goods by providing access or telephone connection by the telephone service provider to a subscriber?
- C. Is the nature of the transaction involved in providing telephone connection a composite contract of service and sale? If so, is it possible for the states to tax the sale element?
- D. If the providing of a telephone connection involves sale, is such sale an interstate one?

- E. Would the 'aspect theory' be applicable to the transaction enabling the states to levy sales tax on the same transaction in respect of which the Union Government levies service tax?

Apex Court's Observations

First of all, the Apex Court rejected the contention of the respondents that the principle of *res judicata* does not apply in matters pertaining to tax for different assessment years because *res judicata* applies to debar Courts from entertaining issues on the same cause of action whereas the cause of action for each assessment year is distinct.

- (a) **Definition of "Goods" Not Altered:** The Apex Court further observed that by introducing separate categories of "deemed sales", as a result of introduction of Article 366(29A), the meaning of the word "goods" was not altered and secondly the *Gannon Dunkerley* case had survived with reference to the dominant nature test to be applied to a composite transaction not covered by article 366(29A).
- (b) **Dominant Nature Test Still Alive:** The reason why these services do not involve a sale for the purposes of Entry 54 of List II is, as we see it, for reasons ultimately attributable to the principles enunciated in *Gannon Dunkerley's case [1958] 9 STC 353 (SC)*, namely, if there is an instrument of contract which may be composite in form in any case other than the exceptions in article 366(29A), 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 test, therefore, for composite contracts other than those mentioned in article 366(29A) continues to be— "whether the parties had in mind or intent to 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 as to what is "the substance of the contract".

We will, for the want of a better phrase, call this the *dominant nature test*.

- (c) **Telecommunication Services:** It is clear that electromagnetic waves are neither abstracted nor are they consumed in the sense that they are not extinguished by their user. They are not delivered, stored or possessed. Nor are they marketable. They are merely the medium of communication. What is transmitted is not an electromagnetic wave but the signal through such means. The signals are generated by the subscribers themselves. In telecommunication, what is transmitted is the message by means of the telegraph. No part of the telegraph itself is transferable or deliverable to the subscribers.
- (d) **Only Handsets can be Taxable:** The second reason is more basic. A subscriber to a telephone service could not reasonably be taken to have intended to purchase or obtain any right to use electromagnetic waves or radio frequencies when a telephone connection is given. Nor does the subscriber intend to use any portion of the wiring, the cable, the satellite, the telephone exchange, etc. At the most, the concept of the sale in a subscriber's mind would be limited to the handset that may have been purchased for the purposes of getting a telephone connection. As far as the subscriber is concerned, no right to the use of any other goods, incorporeal or corporeal, is given to him or her with the telephone connection.
- (e) **Goods Necessary for Right to Use:** In our opinion, the essence of the right under article 366(29A)(d) is that it relates to user of goods. It may be that the actual delivery of goods is not necessary for affecting the transfer of the right to use the goods, but the goods must be available at the time of transfer, must be deliverable and delivered at some stage. It is assumed, at the time of execution of any agreement to transfer the right to use, that the goods are available and deliverable. If the goods, or what is claimed to be goods by the respondents, are not deliverable at all by the service providers to the subscribers,

the question of the right to use those goods would not arise.

- (f) **A Situation that Goods are There but No Right to Use:** In the *State of Andhra Pradesh v. Rashtriya Ispat Nigam Ltd. (2002) 126 STC 114 (SC)/3 SCC 314*, it was claimed by the sales tax authorities that the transaction by which the owner of certain machinery had made them available to the contractors was a sale. The Court rejected the submission saying that: ".....the transaction did not involve transfer of right to use the machinery in favour of contractors..... The effective control of the machinery even while the machinery was in use of the contractor was that of the respondent company, the contractor was not free to make use of the machinery for the works other than the project work of the respondent.
- (g) **A Situation that Goods are There and Also Right to Use:** In the case of *Aggarwal Brothers v. State of Haryana (1999) 9 SCC 182/113 STC 317 (SC)*, when the assessee had hired shuttering to favour of contractors to use it in the course of construction of buildings, it was found that possession of the shuttering materials was transferred by the assessee to the customers for their use and therefore, there was a deemed sale within the meaning of sub-clause (d) of clause 29A of article 366. What is noteworthy is that in both cases there were goods in existence, which were delivered to the contractors for their use. In one case there was no intention to transfer the right to use while in the other there was.
- (h) **Goods Must be Deliverable:** Therefore, whether goods are incorporeal or corporeal, tangible or intangible, they must be deliverable. To the extent that the decision in *State of U.P. v. Union of India (2003) 3 SCC 239/130 STC 1 (SC)* held otherwise, it was, in our humble opinion, erroneous.
- (i) **Telecommunication Services Nothing but Service:** As we have seen, article 366(29A) has no doubt served to extend the meaning of the word "sale" to the extent stated but

no further. We cannot presume that the Constitutional amendment was loosely drawn and must proceed on the basis that the parameters of "sale" were carefully defined. But having said that, it is sufficient for the purposes of this judgment to find, as we do, that a telephone service is nothing but a service. There is no sales element apart from the obvious one relating to the handset if any. That and any other accessory supplied by the service provider in our opinion remain

Although the Court has not decided about the taxability of the SIM cards by the States, the principles set out by the Apex Court in this matter for the taxability of the SIM cards entail that the SIM cards cannot be made liable to tax by the States.

to be taxed under the State Sales Tax laws. We have given the reasons earlier why we have reached this conclusion.

- (j) **SIM Card is a Question of Fact:** It is not possible for this Court to opine finally on the issue. What a SIM card represents is ultimately a question of fact as has been correctly submitted by the States. In determining the issue, however, the assessing authorities will have to keep in mind the following principles: if the SIM card is not sold by the assessee to the subscribers but is merely part of the services rendered by the service providers, a SIM card cannot be charged separately to sales tax. It would depend ultimately on the intention of the parties. If the parties intended that the SIM card would be a separate object of sale, it would be open to the sales tax authorities to levy sales tax thereon. There is insufficient material on the basis of which we can reach a decision. However, we emphasise that if the sale of a SIM card is merely incidental to the service being provided and only facilitates the identification of the subscribers, their credit and other details, it would not be assessable to sales tax. In our opinion the High Court ought not to have finally determined the

issue. In any event, the High Court erred in including the cost of the service in the value of the SIM card by relying on the aspects doctrine. That doctrine merely deals with legislative competence. As has been succinctly stated in *Federation of Hotel & Restaurant Association of India v. Union of India* (1989) 3 SCC 634/74 STC 102 (SC)—“subjects which in one aspect and for one purpose fall within the power of a particular legislature may in another aspect and for another purpose fall within another legislative power. They might be overlapping; but the overlapping must be in law. The same transaction may involve two or more taxable events in its different aspects. But the fact that there is overlapping does not detract from the distinctiveness of the aspects”. No one denies the legislative competence of States to levy sales tax on sales provided that the necessary concomitants of a sale are present in the transaction and the sale is distinctly discernible in the transaction.

For the aforesaid reasons, here are the answers to the questions formulated by us earlier, in the following manner:

- A. Goods do not include electromagnetic waves or radio frequencies for the purpose of article 366(29A)(d). The goods in telecommunication are limited to the handsets supplied by the service provider. As far as SIM cards are concerned, the issue is left for determination by the assessing authorities.
- B. There may be a transfer of right to use goods as defined in the answer to the previous question by giving a telephone connection.
- C. The nature of the transaction involved in providing the telephone connection may be a composite contract of service and sale. It is possible for the State to tax the sale element, provided there is a discernible sale and only to the extent relating to such sale.
- D. The issue is left unanswered.

- E. The aspect theory would not apply to enable the value of the services to be included in the sale of goods, or the price of goods in the value of the service.

Conclusion

Res judicata does not apply in matters pertaining to tax for different assessment years because *res judicata* applies to debar Courts from entertaining issues on the same cause of action whereas the cause of action for each assessment year is distinct.

The Apex Court further observed that by introducing separate categories of “deemed sales”, as a result of introduction of article 366(29A), the meaning of the word “goods” was not altered and secondly *Gannon Dunkerley* has survived with reference to the “dominant nature test” to be applied to a composite transaction not covered by article 366(29A).

In this case, the Apex Court followed *ACC v. Commissioner of Customs* (2001) 124 STC 59 (SC) and *Tata Consultancy v. State of Andhra Pradesh* (2001) 122 STC 198 (SC), whereas it overruled *Rainbow Color Lab v. State of M.P.* (2000) 118 STC 9 (SC) and *K Jidheesh. v. Union of India* (2006) 144 STC 322 (SC).

Although the Court has not decided about the taxability of the SIM cards by the States, the principles set out by the Apex Court in this matter for the taxability of the SIM cards entail that the SIM cards cannot be made liable to tax by the States.

Telecommunication Services are not taxable under State laws, except handsets and other accessories. However, the same are services and are liable to Union tax.

The Apex Court did not rule out the possibilities of simultaneous imposition of ‘sales tax’ and ‘service tax’. However, Court also ruled out the possibility of double taxation not allowing the states to encroach upon the Union list and tax services by including the cost of such services in the value of goods. The Court equally warned the Centre for doing the opposite. □