



# E - NEWS LETTER



Tuticorin Branch of Southern India Regional Council of The Institute of Chartered Accountants of India  
(Set up by an Act of Parliament)

October 2008

## Voice of the Chairman



### Dearest esteemed members & students

Greetings for peace and prosperity

The month September 2008 was a very busy month for all of us with Tax audit assignment and e-filing process. In the month of October 2008 we witnessed many activities at our Branch. The CPT courses are on in our Branch. We also listened to young and energetic minds during the Branch level national debate on the topic “Instead of Metros in big cities, we need good roads in small towns and villages” conducted at our Branch for Higher Secondary School children. It was a wonderful experience to witness. Happy to state that we have inaugurated our Branch website for the benefit of the members and students.

CA B. Francis Amal George, Secretary of our branch and myself had the pleasure of attending the meeting of the Chairpersons of Branches of SIRC of ICAI held at SIRC premises on 21st and 22nd and had an opportunity to interact with the office bearers of the other Branches of SIRC, Regional Council members and Central Council members. It was very heartening to listen to the SIRC Chairman and Central Committee members showered their heartfelt appreciation about our Branch and our activities during the meeting. Thank you friends for making it possible.

At the International level we witnessed disastrous occurrences in the financial service sector and we watched with dismay the falling of stock indices and fall of many iconic Banks throughout the Western World. At the National level we witnessed violence in the name of linguistics and narrow regionalism and rape and brutality in the name of religion.

As part of our ongoing Diamond Jubilee year celebration our Branch is planning to have “Investors Awareness Programme” to be sponsored by Ministry of Corporate Affairs and also “Computer Awareness Programme” for Senior members during the month of November 2008. We also invite to all the members to attend the Regional Conference “**Karka Kasadara**” to be held at Chennai in 28/29th. I also request members and students to contribute articles for the News Letter.

May the festive session bring lots of joy, peace and prosperity to all of you and your family?

Dear friends, we have miles to go and let us all resolve to make this Diamond Jubilee year a sparkling one by our resolve, commitments and continue support.

With warm regards

CA G. Xavier Fernando

# Service Tax in India

**Service tax is levied on several services. This article analyses the constitutionality of levy of service tax on services provided as part of works contract.**

Whether Service Tax can be levied on the service element involved in the execution of composite works contracts involving service and goods.

1. A Constitution Bench of the Hon'ble Supreme Court has recently, in the case of Bharat Sanchar Nigam Ltd v. Union of India [(2006) 145 STC 91], rendered a landmark decision on the subject relating to composite contracts and the exigibility to tax of such transactions. Although the question before the Court was whether sales tax is leviable on sales of SIM cards used in mobile telephony, the Hon'ble Supreme Court has comprehensively discussed the nature of composite transactions, involving an element of sale as well as service, and whether such transactions can be vivisected for the purpose of taxation – sales tax and service tax.

2. Before discussing the judgment rendered by the Supreme Court in BSNL's case, it would be pertinent to note that vivisection of composite contracts that involve an element of sale of goods as well as rendering of services is impermissible. This is in view of the express pronouncement by the Hon'ble Supreme Court in State of Madras v. Gannon Dunkerley [(1958) 9 STC 353], which held that composite contracts, which do not indicate the intention of the parties to separately sell goods and render service, cannot be separated/vivisected for the purpose of taxation.

3. At this stage, it would be pertinent to trace the history of the taxability of composite transactions that involve an element of both sale and service.

4. At the outset, it is critical to note that the States derive their power to legislate on the levy of sales tax in pursuance of Entry 54 of List II under the VII Schedule appended to the Constitution. The Said Entry 54 reads as – “Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of Entry 92-A”. Therefore, the power of the States to enact all sales tax/VAT legislations is derived from the above Entry. The Hon'ble Supreme Court, in the case of State of Madras v. Gannon Dunkerley [(1958) 9 STC 353], while interpreting the words ‘sale of goods’, as mentioned in the Entry, held that a contract under which a contractor agreed to set up a building would not be a contract for ‘sale of goods’. This was in view of the fact that the contract was one, entire and indivisible and that there was no separate agreement for sale of goods justifying the levy of sales tax. As a result of the judgment of the Supreme Court in Gannon Dunkerley's case, all composite contracts, which consisted an element of sale as well as a service, could not be bifurcated/vivisected for the purpose of levy of sales tax. In other words, since composite contracts were in fact, entire and indivisible, it was not possible to say that the parties intended to effect a sale of goods. The intention of the parties was merely to enforce the entire composite contract and no separate intention to sell goods could be discerned. Therefore, the Supreme Court struck down various provisions of State sales tax statutes authorizing levy of sales tax on goods transferred in the execution of a works contract.

5. In order to address the aforesaid anomaly, the Government amended Article 366 of the Constitution by inserting a definition of the phrase ‘tax on the sale or purchase of goods’ vide clause (29-A). The inserted definition deemed that a tax on the sale or purchase of goods would include ‘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’. Therefore, what the Government sought to do was to authorize the levy of sales tax by States on the value of goods that were transferred in the execution of a works contract. As a result, those composite transactions, whose vivisection was impermissible in view of the judgment in Gannon Dunkerley's case, could now be bifurcated. It was only on account of the amendment to Article 366 that the states were permitted to levy tax on the value of goods involved in the execution of the works contract, in spite of the fact that the contract might have been a composite one where the intention of the parties was not to sell

goods. The observation of the Supreme Court in Gannon Dunkerley's case, that composite contracts that do not in truth represent two separate and distinct contracts cannot be separated for the purpose of taxation, thus came to be neutralized by the Constitutional Amendment.

6. The Hon'ble Supreme Court in BSNL's case has dealt with this very aspect and the relevant observations of the Court are extracted below-

“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 the 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 (f) of clause (29A) of Article 366, there is no other service which has been permitted to be split”. (Emphasis supplied by us).

7. On a reading of the emphasized portion of the order extracted above, it is clear to see that the Supreme Court has held that only those transactions specified in Article 366 (29A) (b) and (f) are permitted to be split. In other words, it is only due to the legal fiction created in the Constitution that these composite transactions are permitted to be split.

8. It is critical to note that the legal fiction is created only in so far as the definition of the phrase 'taxes on the sale or purchase of goods'. Hence, the legal fiction will be applicable only for the purpose of interpreting Entry 54 of List II of the VII Schedule and not for any other purpose. Consequently, it can be discerned that the splitting of a composite contract is not permitted for any purpose other than for the purpose of permitting State legislatures to levy sales tax on those goods involved in the execution of a works contract, or for those other purposes mentioned under Article 366 (29A). It thus absolutely clear that the Amendment to Article 366 by including clause (29A) had the singular effect of permitting State legislatures to levy sales tax on those transactions, including works contracts, which were not taxable prior to the amendment.

9. Subsequently, the Central Government has introduced the levy of Service Tax on a vast number of services in pursuance of the power vested in it under Entry 97 [Entry 92-C after 2003] of the I List under the VII Schedule. Among the services that are currently brought to tax a number of works contracts have also been included. Examples of the aforesaid include construction of complex service, construction of residential complexes, erection, commissioning and installation service, repair and maintenance service, etc.

10. It is pertinent to note that all of the aforesaid services are in fact composite transactions involving the transfer of goods as well as the rendering of services. As mentioned above, the state Governments have been empowered vide Article 366 (29A) read with Entry 54 to bifurcate the composite contract and levy sales tax on the element of goods transferred.

11. However, there is no such provision in the Constitution that enables the Central Government to do so for the purpose of levying Service Tax. Currently, the Service Tax provisions levy tax on the value of services rendered as regards construction service, installation and commissioning service, etc. However, in view of the fact that the said transactions are composite in nature, it is absolutely impermissible for the Central Government to vivisect the same and levy tax on the service element. In order to do the same, a similar Constitutional amendment will have to be introduced, which expands the definition of the phrase 'taxes on services' to include services rendered in the execution of a works contract. Currently however, there exists no such definition and thus the levy of service tax on all works contract is clearly unconstitutional. It is hence reiterated that the Central Government is not vested with the power to split/vivisect a composite works contract and levy service tax on the value of services rendered.

12. Therefore, it is our opinion that the levy of service tax on all works contract can be challenged under Article 226 of the Constitution of India as unconstitutional.



# INCOME TAX AGREEMENT BETWEEN INDIA AND NEW ZEALAND



Whereas the annexed Second Protocol to the Convention between the Government of the Republic of India and the Government of New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, comes into force on 30<sup>th</sup> December, 1999, thirty days after the date of receipt of the later of notifications by both the Contracting States to each other, under article 9 of the Second Protocol, of the completion of the procedures required under their respective laws for bringing into force the said Second Protocol.

Now, therefore, in exercise of the powers conferred by section 90 of the Income-tax Act, 1961 (43 of 1961), the Central Government hereby directs that all the provisions of the said Second Protocol shall be given effect to in the Union of India.

## **ANNEXURE**

SECOND PROTOCOL TO THE CONVENTION BETWEEN THE GOVERNMENT OF THE REPUBLIC OF INDIA AND THE GOVERNMENT OF NEW ZEALAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME.

### **SECOND PROTOCOL**

TO THE CONVENTION BETWEEN THE GOVERNMENT OF THE REPUBLIC OF INDIA AND THE GOVERNMENT OF NEW ZEALAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME.

The Government of the Republic of India and the Government of New Zealand,

Having regard to the convention between the Government of the Republic of India and the Government of New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income done at Auckland on the 17th day of October, 1986 (hereinafter referred to as "the Convention"),

Have agreed as follows:

#### **Article 1**

Paragraph 1(a)(ii) of article 3 of the Convention is replaced by the following :

"(ii) the term 'India' means the territory of India and includes the territorial sea and the airspace above it, as well as any other maritime zone in which India has sovereign rights, other rights and jurisdiction, according to the Indian law and in accordance with international law, including the U.N. Convention of the Law of the Sea ;"

#### **Article 2**

Paragraph 3 of article 4 of the Convention is replaced by the following :

"3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated cannot be determined, then the competent authorities of the Contracting States shall settle the question by mutual agreement."

### **Article 3**

Paragraph 1 of article 6 of the Convention is replaced by the following :

"1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may also be taxed in that other State."

### **Article 4**

In paragraph 2 of article 10 of the Convention, "20 per cent" is replaced by "15 per cent."

### **Article 5**

In paragraph 2 of article 11 of the Convention, "15 per cent" is replaced by "10 per cent."

### **Article 6**

In paragraph 2 of article 12 of the Convention' " 30 per cent" is replaced by "10 per cent."

### **Article 7**

**Paragraph 1 of article 13 of the Convention is replaced by the following :**

"1. Income or gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may also be taxed in that other State."

### **Article 8**

1. Paragraph 2 of article 24 of the Convention is replaced by the following :

"2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other

State carrying on the same activities. This provision shall not be construed as preventing a contracting State from charging the profits of a permanent establishment which a company of the other Contracting State has in the first-mentioned State at a rate of tax which is higher than that imposed on the profits of a similar company of the first-mentioned Contracting State."

2. A new paragraph 5 is inserted immediately after paragraph 4 of article 24 of the convention and the original paragraph 5 of the article is renumbered paragraph 6.

"5. The article shall not apply to any provisions of the taxation laws of a Contracting State which are reasonably designed to prevent or defeat the avoidance or evasion of taxes."

### **Article 9**

1. The Contracting States shall notify each other through diplomatic channels of the completion of the procedures required by the respective laws for the entry into force of this protocol.

2. This Protocol shall enter into force 30 days after the date of receipt of the later of the notifications referred to in paragraph 1 of this article and its provisions shall have effect :

(a) in New Zealand : for any income year beginning on or after 1st April in the calendar year next following the date on which the Protocol enters into force ;

(b) in India : for any "previous year" (as defined in the Income-tax Act,1961) beginning on or after 1st April in the calendar year next following the date on which the Protocol enters into force.

In Witness Whereof the undersigned, duly authorized by their respective Governments, have signed this Protocol.

Done in duplicate at New Delhi this twenty first day of June, 1999, in the Hindi and English languages, both texts being equally authentic. In case of divergence between the two texts, the English text shall be the operative one.

For the Government of the Republic  
of India.....  
(Ravi Kant).

For the Government of the New  
Zealand .....  
(Adrian G.Simcock)

**Notification No. S. O. 166(E), dated 5th March, 1997.**

Whereas the annexed Protocol to the Convention between the Government of the Republic of India and the Government of New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income has come into force on 9th January, 1997, on the notification by both the Contracting States to each other of the compliance with the domestic requirements as required by Article 2 of the said Protocol ;

Now, Therefore, in exercise of the powers conferred under section 90 of the Income-tax Act, 1961 (43 of 1961), the Central Government hereby directs that all the provisions of the said Protocol shall be given effect to in the Union of India.

**ANNEXURE**

PROTOCOL TO THE CONVENTION BETWEEN THE GOVERNMENT OF THE REPUBLIC OF INDIA AND THE GOVERNMENT OF NEW ZEALAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME

The Government of the Republic of India and the Government of New Zealand,

Having regard to the Convention between the Government of the Republic of India and the Government of New Zealand for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income done at Auckland on 17th October, 1986 (hereinafter referred to as "the Convention"),

Have agreed that the following provisions shall form an integral part of the Convention :

**Article 1**

Notwithstanding paragraph 3 of Article 23 of the Convention, a New Zealand resident deriving income from India, being income referred to in that paragraph, shall not be deemed to have paid Indian tax in respect of such income where the competent authority of New Zealand considers, after consultation with the competent authority of India, that it is inappropriate to do so having regard to :

(a) whether any arrangements have been entered into by any person for the purpose of taking advantage of paragraph 3 of Article 23 for the benefit of that person or any other person ;

(b) whether any benefit accrues or may accrue to a person who is neither a New Zealand resident nor an Indian resident ;

(c) the prevention of fraud or the avoidance of the taxes to which the Convention applies ;

(d) any other matter which either competent authority considers relevant in the particular circumstances of the case, including any submissions from the New Zealand resident concerned.

## **Article 2**

(1) The Contracting States shall notify each other that the domestic requirements for entry into force of this Protocol have been complied with.

(2) This Protocol shall enter into force on the date of the later of the notifications referred to in paragraph (1) of this article.

## **Article 3**

Article 1 of this Protocol shall apply to income derived on or after the 1st day of the month following the date on which this Protocol enters into force.

Done at New Delhi in duplicate this the Twenty-ninth day of August, One Thousand Nine Hundred Ninety-six in the Hindi and the English languages, both texts being equally authentic. In case of divergence between the two texts, the English text shall be the operative one.

For the Government of the  
Republic of India  
(Sd.)(G. K. Mishra)  
Chairman, Central Board of Direct  
Taxes and Ex-Officio Special  
Secretary to the Government of  
India.

For the Government of New Zealand .  
(Sd.) (Nicholas William Bridge)  
High Commissioner of New Zealand in  
India

[Notification No. 10280/F. No. 500/151/93-FTD]

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