

# NEWSLETTER

## TAX AND REGULATORY UPDATES

## FEATURED ARTICLE

*Chargeability of Service Tax Vis-à-vis VAT on Sale of Food in a Restaurant*

## CASE LAW HIGHLIGHTS

Direct & Indirect Taxes

## EDITORIAL

### Uphill task of economic recovery for new government and countdown to Budget 2014

As the new government begins to function in India, it has been burdened with the challenging task of bringing a floundering economy back on its feet. This is easier said than done as the current government faces a plethora of problems, from dwindling economic output to persistent inflation.

In its short span of functioning, the new government has managed to garner sufficient support and a positive response from the industry. The expectations of the industry from this government are pretty straightforward; a strong revival in business confidence, attracting investments in sectors such as healthcare and education, fast-tracking of reforms and implementation of the GST.

The government has been receptive to the needs of the industry and has responded with a flurry of initiatives. Some of the key steps taken to ensure the effective functioning of the government include the convergence of cabinet ministries such as Telecom and Law, Finance and Defence for greater coordination across ministers. One noteworthy difference in the new government is a leaner, more efficient cabinet. The Prime Minister has also empowered his ministers by scrapping their predecessor's policy of referring all contentious issues to the GoM (Group of Ministers). These ministers have been empowered to directly take decisions, instead of delaying them.

A slew of measures are being debated by the government to kick start their agenda of economic growth. The government has

indicated that it favours avoiding retrospective taxation. Also implementation of GST is considered a priority. The government is keen to get the ball rolling on promotion of FDI. They aim at stabilizing foreign investment policies in order to minimize uncertainty for foreign companies investing in India. Also on the agenda is a hike in the limit of FDI in Defence, Railways, Infrastructure and Construction sectors, so as to promote foreign investment.

The new government comes in with extreme expectations. Capitalizing on the positive sentiments of the nation and implementing clear cut policies that provide impetus to businesses will surely guarantee them an additional 5 years term in the next Lok Sabha elections.

The Annual Budget is due to be announced on July 10, 2014 which is likely to see many key proposals being tabled before the parliament in the budget session that is to begin in the week beginning July 7, 2014. This budget is being watched by the world at large with great anticipation and expectations.

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## TAX AND REGULATORY UPDATES

**Cost inflation index hiked by 9.05% for 2014-15 by CBDT:** The value for the cost inflation index (used for indexing cost while computing Long Term Capital Gain/Loss) has been increased from 939 (2013-14) to 1024 for 2014-15, resulting in a 9.05% hike for FY2015 when compared to FY 2014.

**SEBI declares the participation of FPIs (Foreign Portfolio Investors) in the Currency Derivatives segment:** As per the SEBI circular released in June 2014, FPIs can now trade in the currency derivative segment of the stock exchange subject to certain terms and conditions.

**Investment in Securities by FPIs (Foreign Portfolio Investors) will be a part of \$51 billion Debt Capital:** As per SEBI, the investments made by FPIs (Foreign Portfolio Investors) in

debentures or non-convertible shares will be included within the \$51 billion limit for corporate debts.

**SEBI declares the Minimum Assets under Management (AUM) for Debt Oriented Schemes:** As per the SEBI circular:

a) The minimum subscription amount of debt oriented and balanced schemes at the time of new fund offer shall be at least INR 20 crore and that of other schemes shall be at least INR 10 crore.

b) An average AUM of INR 20 crore on half yearly rolling basis shall be maintained for open ended debt oriented schemes.

c) The existing open ended debt oriented schemes shall comply with point (b) stated above within one year

from the date of issue of this circular (June 20<sup>th</sup> 2014).”

**Limit for carrying currency notes outside India increased:** As per the circular released by the RBI in June 2014, “all residents and non-residents (except citizens of Pakistan and Bangladesh and travelers coming from and going to Pakistan and Bangladesh) are now allowed to take out Indian currency notes up to a value of INR 25,000 while leaving India.” Earlier the limit was set at INR 10,000.

**Key changes in forms for filing of income tax returns:** CBDT (Central Board of Direct Taxes) has recently notified new forms that are applicable for filing of tax returns for the tax year 2013-14.

## FEATURED ARTICLE

### Chargeability of Service Tax Vis-a-vis VAT on Sale of Food in a Restaurant

Recently, the restaurant industry has been abuzz with amendments in the legislation and various judgments revolving around the applicability of Service Tax and VAT. The Constitution has declared supply of food in restaurant as ‘deemed sale’, whereas Service Tax legislation considers this as ‘declared service’. The hospitality industry has been paying Service Tax and VAT both on sale/ serving of food. However, there has been ambiguity in deciding the valuation of sale and service element in supply of food. The Central Government has taken care of not charging Service Tax on full value and giving relief towards sale part of the transaction. The service portion is assumed to be only 40% of total value. However, State VAT laws seem to have overlooked this aspect while demanding VAT on full value.

In the recent past, there are rulings on chargeability of both Service Tax and VAT on restaurant service from three different High Courts. The Bombay High Court upholds the constitutional validity of charging Service Tax on serving of food under Section 66E(i) of

Finance Act, 1994 in the case of *Indian Hotels and Restaurant Association*.

This judgment differed from the decision of the Kerala High Court in the case of Kerala Classified Hotels and Resorts Association wherein levy of Service Tax on restaurant was held to be beyond the legislative competence of the Parliament. The writ petition was dismissed by Hon’ble Bombay High Court based on following major observations:

- Supply of food was covered under the definition of ‘sale’ vide clause (f) of Article 366 (29A) to legislate that State is empowered to tax on such sale. However, this does not rule out an element of service in the transaction. As per the provisions of Finance Act 1994, service tax is levied on taxable services provided by a Restaurant having air-conditioning facility and a license to serve liquor. The Parliament levies Service Tax when a service is rendered by a restaurant owner.
- Service tax is a complete distinct tax. It should not be and cannot be

equated with a tax on sale or purchase of goods.

In the case of *Hotel East Park & Another*, the Chhattisgarh High Court also rendered a view similar to the Bombay High Court and upholds the constitutional validity of levy of Service Tax on restaurant service. It stated that:

- Service Tax cannot be levied on sale and vice versa.
- Tax on sale and purchase of food and drinks are within the exclusive domain of State Government. The Parliament has no legislative competence to impose tax on goods sold within State. Similarly, State has no power to impose tax on a service. The intention of the legislature while inserting Article 366(29A)(f) was to separate sale of food or drinks from the service part. The Article cannot be interpreted in a way that the service part is subsumed in the sale of the food and drinks.
- The definition of ‘service’ read with declared service of serving

foods [Section 65B(44) and Section 66E(i) of the Act] only charge Service Tax on service part and not on sales part. Hence, Section 66E(i) is constitutionally valid and not violating Article 366(29A)(f).

- While upholding levy of Service Tax on restaurant, HC accepted difficulties in arriving at value of sale and service element and mentioned that value on which Service Tax has been charged cannot be subject to VAT. Taxpayers can object levy of VAT on full value. Further, HC advised State Governments to issue clarification so that customers are not doubly taxed on the same amount and there is co-ordination between the State and Central Government.

Uttarakhand High Court in the case of *Valley Hotel & Resorts vs. The Commissioner of Commercial Tax, Dehradun*, has held that VAT cannot be levied on 40% of the value of invoice raised by restaurants on which Service Tax is paid. The High Court in this case observed that -

- VAT can be imposed on goods and not on service. Only Service tax can be levied on services under Service Tax law.
- The State Government has not challenged the Service Tax levy on

the restaurant service by the Central Government. Accordingly, the Central Government also has authority declare what is to be considered as service.

- Hence, VAT cannot be levied on the service element of total billing made at Restaurants which is brought under the Service Tax net.

Pursuant to these judgments, it would be more prudent to mention that if the State Governments accept the suggestions and issue required clarification or amend the Sales Tax laws accordingly, the end consumer will definitely benefit. Another aspect is that once the State Government would agree not to levy sales tax on service portion, it would have an impact on all the 'deemed sales' including works contract service.

Under Service tax law, a service provider adopting abatement is allowed to CENVAT credit subject to certain conditions. A similar provision is, generally, not available under the State VAT Laws. Currently, many State VAT laws prescribe composite rate (concessional rate of tax generally with a condition that no/ partial input tax credit shall be available) of tax for the restaurant industry. If the composite rate is presumed to be factoring the service portion then there is no propriety in not allowing full input tax

credit like the counterpart in Service Tax law.

These judgments have rightly made the distinction between applicability of VAT and Service Tax and held that VAT cannot be levied on service portion. Post these judgments whether Hospitality Industry gets relief from VAT on service portion is to be monitored by observing how State VAT laws react to the judgments. The matter would get more clarity if taken to a higher judicial forum.

With three High Court judgments in a row taking the same view on levy of both Service Tax and VAT on restaurant service, Hospitality industry is expecting some concrete amendment in Service Tax and VAT laws obviously with a hope of extrication from tax clutches.



## CASE LAW HIGHLIGHTS - DIRECT TAXES

### 1. Authority for Advance Rulings (AAR) denies import of "make available" clause into India France DTAA and concluded that management services are taxable as FTS

The issue before AAR in the case of Steria (India) Ltd (Steria India) was whether the payments made for management services provided by Group Steria SCA (Steria France) are taxable in the hands of Steria France as per India - France DTAA. AAR denied import of "make available" clause and concluded that the management services provided by Steria France would be Fees for Technical Services (FTS) as per India - France DTAA

### 2. Sum paid as a guarantor of a Joint Venture not deductible from taxable income

On the issue involving admissibility of the claim with respect to sum paid to certain banks / financial institutions, in the capacity of guarantor of the loan availed by the joint venture company ('JVC'), the Mumbai bench of Appellate Tribunal in the case of LML Limited held that such sum cannot be allowed as deduction in computing taxable income of the taxpayer. The Tribunal rejected the contention of the taxpayer that JVC was formed for the taxpayer's own business. The Tribunal held that the present case was akin to write off of irrecoverable loan (emanating from

earlier business obligation) which cannot be treated as deductible business loss or expenditure and therefore, the same can only be treated as a capital loss. Additionally, the Tribunal observed that the said sum was disclosed as sum recoverable from joint venture company in the books of taxpayer. Accordingly, in absence of write off of such sum in the books, the claim of bad debts was also disapproved by the Tribunal.

### 3. Cost allocations without mark-up cannot be claimed to be at arm's length without undertaking transfer pricing benchmarking

Hon'ble Delhi High Court in the case of Cushman and Wakefield (India) Private Limited held that allocation

of costs by foreign affiliate to Indian taxpayer, even if, without any mark up, cannot be considered to be at arm's length in the absence of transfer pricing benchmarking analysis since cost itself is a tainted item in a related party transaction. Such benchmarking is to be backed by a detailed cost benefit analysis rather than allocation on the basis of revenue generated and not on a scientific basis. Further, the High Court also held that the authority of the jurisdictional tax officer also includes an inquiry into the actual receipt of services and the benefits derived therefrom, even after the specialist Transfer Pricing Officer has concurred with the taxpayer on determination of the arm's length price of such services.

#### 4. Taxing provisions in relation to slump sale of an undertaking are not attracted in absence of monetary consideration in an exchange

In an issue involving taxability of income arising from transfer of business undertaking in exchange of

preference shares and bonds (under a court approved scheme), the Bombay High Court has dismissed an appeal filed by the Revenue Authorities in the case of Bharat Bijlee Limited. Earlier, the Mumbai Tribunal had decided the issue in the favour of the taxpayer by holding that the taxing provisions in relation to slump sale of an undertaking are not attracted in absence of monetary consideration in an exchange. The Tribunal also considered the fact that sale consideration and cost of acquisition of the various assets of the undertaking are not ascertainable and therefore the mechanism of computing capital gains tax fails in the present case. The Bombay High court has delivered the ruling after distinguishing the recent decision of Delhi High Court on this subject.

#### 5. Residual Profit Split Method (PSM) to be preferred over the Transactional Net Margin method

#### (TNMM) in relation to interlinked and interconnected transactions

The ITAT Delhi Tribunal in the case of Global One India Private Ltd held that residual profit split method (PSM) should be preferred over the transactional net margin method (TNMM) in relation to transactions that are interlinked and interconnected; and that the existence of unique intangibles is not a pre requisite to apply PSM. The Tribunal also observed that in the absence of external comparables to benchmark the residuary profits as required under the Indian Transfer Pricing Regulations, reference can be made to OCED Guidelines and UN TP Manual. The Tribunal also held that the 'Other Method' introduced with effect from April 2012 can be made applicable retrospectively to avoid practical difficulties in the application of Indian transfer pricing provisions.

## CASE LAW HIGHLIGHTS - INDIRECT TAXES

#### 1. Composite activity of manufacturing, erection and installation amounts to 'works contract' and not 'sale'

The Supreme Court Constitutional Bench recently overruled the 3 judges bench decision in the case of *Kone Elevators India Pvt Ltd*, holding that the composite activity of manufacture, erection and installation of elevator will amount to 'Works Contract' and not 'Sale' and the taxation will be done accordingly.

The Hon'ble Apex Court also observed that, installation of lift is not mere assembling and cannot be said to be part of manufacturing process.

The Apex court stated that "dominant intention test" or "degree of intention test" is not applicable in the context of composite contracts which have all attributes of works contracts and is covered under clause 29A(b) of Article 366 of the Constitution. It

was held that once the contract has the characteristics of a works contract, then the incidental part as regards labour/service pales into total insignificance for determination of the nature of the contract. Any additional obligation incorporated in the contract would not change the nature of the contract.

#### 2. Shortfall in tax payment (for the first 50%) declared under VCES cannot be waived or relaxed

Gujarat High Court in the case of *Ramilaben Bharatbhai Patel vs. U.O.I.* upholds rejection of taxpayer's declaration under Service Tax Voluntary Compliance Encouragement Scheme, 2013 (VCES) owing to shortfall in depositing 50% of declared tax dues by December 31, 2013 as prescribed u/s 107(3) of Finance Act, 2013.

#### 3. If entire CENVAT Credit reversed with interest, provisions of Rule

#### 6(3) of CCR, 2004 will be inapplicable

In a recent judgment, Mumbai Bench of CESTAT in the case of *Nagar Urban Co-Operative Bank Ltd vs. CC, CE & ST* has held that, reversal of credit taken on the entire input service along with interest amounts to non-availing of credit and therefore, provisions of Rule 6(3) of CENVAT Credit Rules, 2004 will not be attracted.

In this case the taxpayer was providing exempt services as well as a taxable service which was very nominal, but he did not maintain separate account and availed entire CENVAT Credit on common input services. Therefore, the department was seeking reversal at 6% / 8% of the value of exempted service.

#### 4. Trading activity is neither 'Service' nor 'Exempted Service' prior to 1 April 2011

The Hon'ble CESTAT, Delhi in the case of HCL Infosystem Limited (taxpayer) has held that before 1 April 2011, trading was neither a service nor an exempted service and therefore CENVAT credit availed on an input service/inputs used in trading cannot be considered as credit earned on exempted service. Explanation to Rule 2 of CENVAT Credit Rules 2004 (CCR) added in 2011, wherein it was clarified that exempted services include trading, has prospective effect and hence trading would be comprehended within the scope of an exempted

service only w.e.f. 01.04.2011, the enforcement date of the said Explanation.

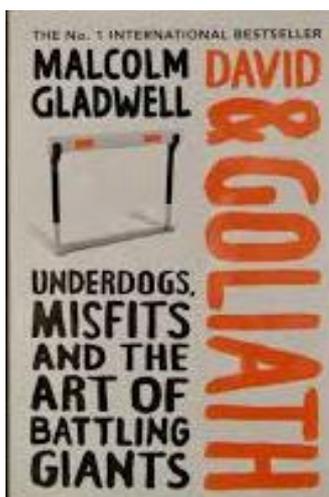
#### 5. Refund of SAD allowed without endorsement on commercial invoice

In the case of Chowgule & Company the reference was made to larger bench of CESTAT, Mumbai as, whether the refund of SAD can be allowed without endorsement on commercial invoice. While answering the reference the bench held that a trader, who has paid SAD, discharged VAT/ST liability and issued commercial invoices

without indicating any details of the duty paid, would be entitled to the benefit of exemption under Notification No. 102/2007-Cus. Further, the bench also held that the condition relating to endorsement on invoice is merely procedural one and the purpose and object of such endorsement could be achieved when duty element was not specified in the invoice and hence mere non-making of the endorsement cannot undermine the purpose of the exemption.

## BOOK REVIEW

### "David and Goliath" by Malcolm Gladwell



This latest book of Malcolm Gladwell has so far left many critics unconvinced of this pop sociologist's writing techniques and his latest theories. His latest offering, "David and Goliath" is largely a representation of his theory of why a nimbler, David, is able to overcome challenges and win. It

explains the advantage of having a disadvantage and how individuals with a disadvantage can benefit from it.

In his latest book, Gladwell uses certain examples to illustrate his point, such as that of David Boies, a current super lawyer from humble beginnings, who faced mighty obstacles and overcame them in order to achieve success. Here, Boies is the "David" - able to overcome challenges and emerge victorious not due to luck alone, but due to his dyslexia.

These examples of successful individuals with dyslexia are thought-provoking and there is a good deal of common sense in Gladwell's observation that the quick accurate David had an advantage over Goliath. However, some of his theories come across as very unconvincing such as the one which suggests that people losing

their parents early in life are at an advantage. To emphasize this point he gives the example of Emil J. Freireich, who made significant advances in childhood leukemia. The argument that the early childhood loss of his parent gave him the strength to put some of the children through hell in order to cure them, may not necessarily hold true. Gladwell does try to back these theories with studies conducted by researchers in order to provide them with some credibility. However, not all of this research comes across as very inclusive.

What Gladwell mainly presents in this book are musings about human behaviour and certain intriguing facts regarding the same. It is up to the discretion of the reader to be convinced by these theories or to discredit them completely.

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