White Paper- Transfer of Right to Use Goods: VAT or Service Tax?

Ms. Radha Arun, Consultant to Udyog Software (India) Ltd.

This document contains a brief on service tax on works contracts involving goods and services.

Udyog Software (India) Ltd.

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Transfer of right to use goods: VAT or service tax?

If a company allows another to use its trade mark, does this attract service tax, or VAT / Central Sales Tax, or both?

The problem is historical in origin, based on clause (29A) of Article 366 of the Constitution, which in turn was introduced in 1982. This clause was inserted on the recommendation of the 6th Finance Commission to deem certain transactions as sale because they seemed to be providing a loophole for non-payment of tax. At that time there was no service tax.

When service tax was introduced in 1994 and slowly expanded its scope, it came to cover transactions that looked very similar to those that were deemed sales. Using the trade mark of another person is among these ambiguous transactions.

A trade mark is a sign capable of distinguishing the goods or services of one enterprise from those of other enterprises (World Intellectual Property Organisation: http://www.wipo.int/about-ip/en/). As an invented sign that performs this function, it is intangible property. In a common sense view it is not goods, because we think of goods as tangible.

However, courts have taken the view that intangible or immaterial or incorporeal property too is to be treated as goods if it has the other characteristics of goods.

The case of Vikas Sales Corporation v Commissioner of Commercial Taxes http://indiankanoon.org/doc/14349/), the Supreme Court observed as follows in paragraph 21, after examining the law and jurisprudence on the subject:

"Suffice to say that property is defined to include material things and immaterial things (*jura in re propria*) and leases; servitudes and securities etc (*jura in -re aliena*). The material things are said to comprise land and chattels while immaterial things include patents, copyrights and trademarks, which along with leases, servitudes and securities are described as incorporeal property."

As the definition of "goods" in the Sale of Goods Act 1930 is

"every kind of movable property except actionable claims and money",
the court concluded that the items in question are goods.

Moving on to the taxability of transactions in "goods" like trademarks, we see that Article 366(29A) of the Constitution of India contains a provision for taxing transfer of the right to use goods as if it is a sale of the goods:

'(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;'
Therefore, transfer of the right to use a trademark, for a consideration, would be taxable as a sale of trademark.

At the time of the amendment that inserted clause (29A) into Article 366 of the Constitution, service tax was not yet on the horizon of the Indian taxpayer. Service tax was first introduced in 1994 on a few specified services and expanded each year to cover more services. In 2004, service tax was levied under section 65(105) (zzr) of the Finance Act 1994 on service in relation to intellectual property rights, namely, trademarks, designs , patents or any other similar intangible property excepting copyright. The service was defined as follows in section 65(55b):

"(a) Transferring temporarily; or

(b) Permitting the use or enjoyment of any intellectual property right."

In 2012, a negative list of non-taxable services replaced the earlier positive list of services that were subject to tax. However, the new law contained a positive list of 'declared services' in section 66E that are clarified as being subject to tax, to obviate any doubts. Perusal of this list shows that it is a converse of the list of transactions in Article 366(29A). The list of declared services in section 66E includes –

"(c) Temporary transfer or permitting the use or enjoyment of any intellectual property right;".

It is seen that service tax law has maintained a distinction between goods and intellectual property rights. On the other hand, the deeming provision in the Constitution speaks only of transfer of the right to use goods.

Though the Constitutional provision for taxing the transaction as a sale of goods speaks of transfer of the right to use "goods", while the service tax provision speaks of temporary transfer or permission to use an "intellectual property right", we have seen that the expression "goods" includes intangible property; therefore this provision enables sales tax on transfer of the right to use intangible property including intellectual property like trademarks.

Furthermore the Constitutional provision enables sales tax on temporary transfer also, as it speaks of "transfer of the right to use any goods for any purpose (whether or not for a specified period)". At first sight there seems to be an overlap with the service tax provision, which levies service tax on "temporary transfer or permitting the use or enjoyment of any intellectual property right." To resolve the seeming confusion we have to identify the distinguishing criteria.

The definitive case law on what constitutes "transfer of the right to use" goods is the Supreme Court judgment in the case of Bharat Sanchar Nigam Limited v Union of India [Writ Petition (Civil) 183 of 2003, decided on 2 March 2006]. In paragraph 91, the Court identified the characteristics of a transaction of "transfer of the right to use goods" as follows:

91. To constitute a transaction for the transfer of the right to use the goods the transaction must have the following attributes:

a. There must be goods available for delivery;
b. There must be a consensus *ad idem* as to the identity of the goods;

c. The transferee should have a legal right to use the goods-consequently all legal consequences of such use including any permission or licenses required therefor should be available to the transferee;

d. For the 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 the right to use" and not merely a licence to use the goods;

e. 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.

In a transaction of permission to use trademark, (a), (b) and (c) are invariably present, as the existence and identity of the trademark are not in question, and the transferee would necessarily be provided with the legal permission to use the trademark. The nature of the transaction hinges, then, on points (d) and (e). Is the legal right provided by the owner of the trademark to the other party to the exclusion of his own right? And, during the period for which he gives the right to the other party, has he forfeited the right to give it to anybody else?

The criteria laid down by the Supreme Court in the case of BSNL (*supra*) have been relied upon by the CBEC in paragraph 6.6.1 of its Education Guide on service tax to elucidate what constitutes a transaction of transfer of the right to use, which are transactions excluded from service tax. Thus it is a clear and accepted position that if the right to use the property (in this case, the trademark) is transferred on such terms that the owner does not have right to it during the period for which it is transferred, and the owner cannot make the same right available to anybody else, it is a deemed sale. In any other case it is a service.

The provision of right to use trademark, specifically, came up before the Kerala High Court in the case of Malabar Gold Private Limited v Commercial Tax Officer, Kozhikode (W.A. 2213 of 2012, reported as http://www.cbec.gov.in/resources//htdocs-servicetax/ecs-st/general/2013-3-6-kerHC.pdf;jsessionid=2F0B0771EA9822E0A7A9CDB90FF8D3A5).

In this case the appellant, owner of the trademark "Malabar Gold" for jewellery, entered into franchise agreements by which the franchisees sold jewellery under this trademark. There were a number of franchisees concurrently, and they were not permitted to further transfer the right to use the trademark to anybody else.

Adjudicating on the writ appeal filed by the trademark owner against a demand for VAT on the franchise fee, a division bench of the court observed as follows:

'In the light of the principles stated in para 98 of the judgment in *BSNL's* case (supra), the provisions of the agreement, especially clauses (3) and (5) will show that the franchisor retains the right, effective control and possession and it is not a case of transfer of possession to the exclusion of the transferor. We notice that under clause (12) the franchisee has no right to sub-let or sub-lease or in any way sell, transfer, discharge or distribute or delegate or assign the rights under the agreement in favour of any third party, which is also significant. On termination of the agreement also,

going by clause 25.3, the franchisee shall forfeit all rights and privileges conferred on them by the agreement and the franchisee will not be entitled to use the trade name or materials of "Malabar Gold".'

In view of this position, the court held that there is no transfer of the right to use the trademark, and that VAT was not attracted to the transaction. The court held that the transaction was liable to service tax as "franchise service."

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Please connect with us at:

Web: www.udyogsoftware.com
Email: teammarketing@udyogsoftware.com