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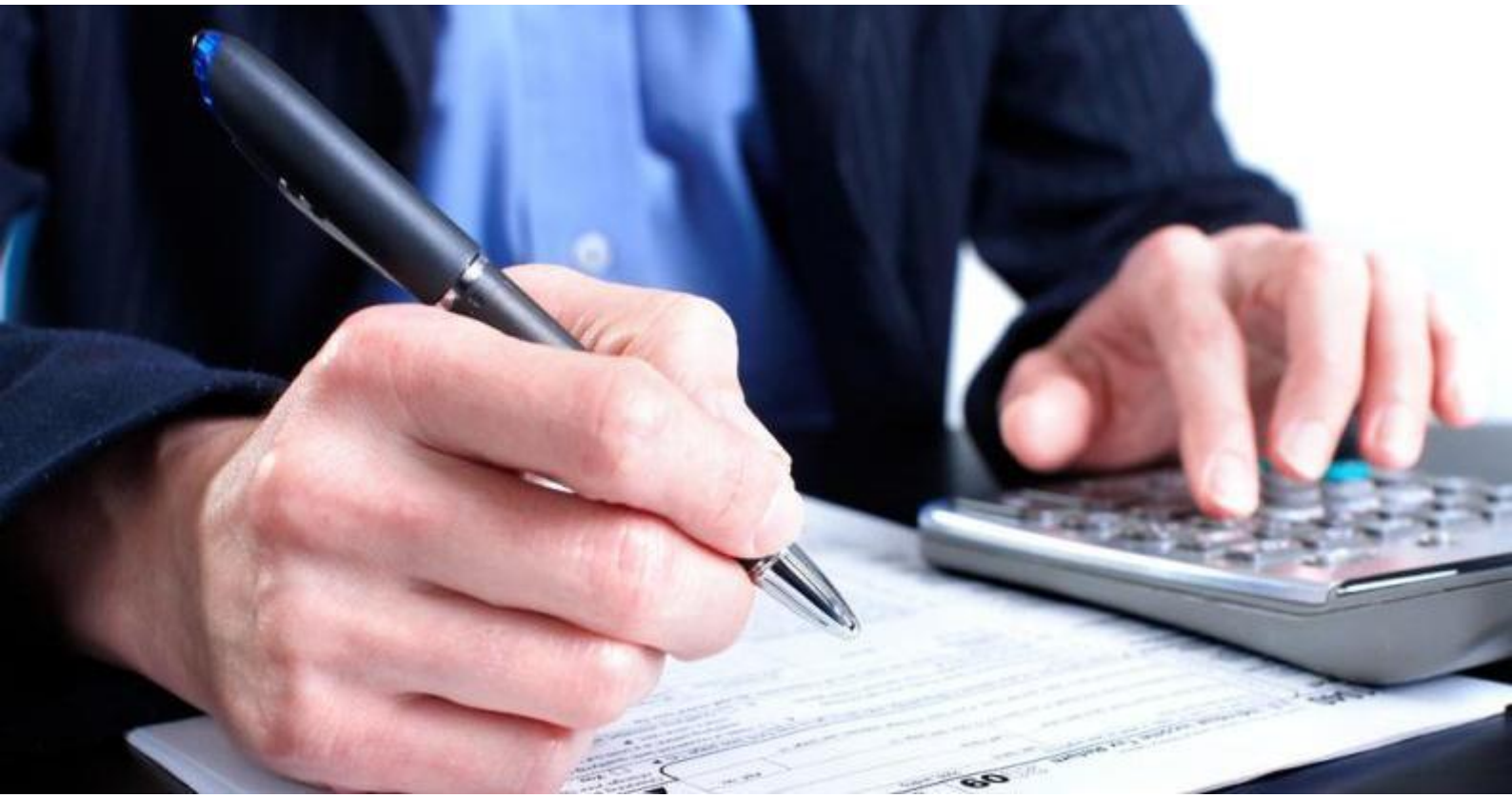

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Handling uncertainty in service tax liability

Introduction

After the closure of the VCES amnesty period, the backlash has begun. Arrests for evasion of service tax have been reported from all parts of the country. The business community is understandably anxious. The reason is that the statute is ambiguous in many respects and it is possible to entertain a bona fide conviction that an activity is not taxable, only to discover too late that it is viewed as taxable and that one has become a defaulter and evader in the eyes of the law.

Renting of immovable property: case study in ambiguity in the past

A classic case of ambiguity and uncertainty in service tax was provided by the issue of taxability of immovable property rentals. In the case of Home Solutions Retail India Private Limited, 2009 (237) STR 209 (Del), the Delhi High Court held that renting of immovable property was not liable to service tax. This was on the ground that renting out a property as such was not a service, and only services provided in relation to such renting were taxable. All over the country tenants refused to pay service tax to their landlords, who in turn stopped paying it to the government. After many twists and turns in the case, including a retrospective amendment of law in the Finance Act of 2010, it turns out that service tax is payable. Fortunately, because of the pervasive nature of the problem, government offered a solution for penalties by way of an amendment in section 80 of the Finance Act 1994 that allowed payment of the tax and interest with full waiver of penalty up to a specified date.

Exclusions of monetary and property transactions from definition of 'service': future case study on ambiguity?

A case similar in many respects to the rentals issue concerns the exceptions to the definition of 'service' in section 65B(44) of the Finance Act 1994. The clause provides that 'service' excludes activity that is a transaction 'merely' in money or actionable claims, or that is 'merely' a transfer of title in property. However the Delhi High Court in the case of Delhi Chit Fund Association v Union of India, 2013 (30) STR 347, has held that transaction merely in money is not a service at all and therefore did not need to be excluded explicitly; therefore the legislature's intention must be to exclude services in relation to purely monetary transactions. The parallel with the Home Solutions case is striking. To understand the Delhi High Court's reasoning, relevant extract from section 65B of the Finance Act 1994 is placed below:

'65B(44) "service" means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include—

a) an activity which constitutes merely,—
   i. a transfer of title in goods or immovable property, by way of sale, gift or in any other manner; or
   ii. such transfer, delivery or supply of any goods which is deemed to be a sale within the meaning of clause (29A) of article 366 of the Constitution; or
   iii. a transaction in money or actionable claim; …'

At a later part of this definition comes an Explanation 2, which clarifies as follows:
'Explanation 2. For the purposes of this clause, transaction in money shall not include any activity relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged.'

The Delhi High Court held that the Explanation 2 listed the specific services in relation to transactions merely in money that were to be subjected to service tax, and that any other services in relation to purely monetary transactions were not taxable.

If we were to extend this reasoning to the other exclusion under section 65B(44)(a), which is for activity that is purely a transfer of title in property, the Delhi High Court judgment would mean that services in relation to

transfer of title in property are excluded from service tax. This places persons like commission agents and brokers, who assist in such transactions, outside the reach of the tax net. Are such persons within their rights not to pay service tax on transactions related to property? For that matter, will a person who uses the services of a lawyer to carry out a transaction in property be exempt from paying service tax under the reverse charge mechanism?

Uncertainty is inherent in the situation. The Supreme Court may disagree with the Delhi High Court and insist that the law should be read for the meaning conveyed by the words used, which only refer to 'an activity which constitutes merely a transaction in money.' A coordinate court or even an adjudicating authority may find reasons to confine the Delhi High Court's conclusions to the facts of the particular issue before it, and not extend the reasoning to other situations. Doubts may arise about the degree of connection with the 'merely' monetary or property transactions that would qualify them for exclusion from the definition of 'service'. Therefore if a service provider proceeded on the basis of the High Court reasoning, he may find himself in trouble. On the other hand, his customer might resist the tax on the basis of the Court order.

Prognosis in adjudication

Let us look at the likely scenario that will ensue when an entity does not pay service tax and is later found liable to pay it.

The law differentiates between non-payment simplicitor, which is an innocent failure to pay service tax; and evasion of tax, which is carried out by suppression or mis-statement of facts, or by fraud or collusion, or otherwise with intent to evade tax. For the first situation, a demand of service tax is to be made by the department within a year of the date of the return that should have been filed for the amount. For the second situation, that is evasion, the demand can be made till five years elapse from that date. If it is an on-going non-payment, five years will cover a large amount of tax to be paid.

In addition there are penalties, which are capped at 50% of the tax payable in both situations (though they equal the tax payable if the case is one of incorrect entry or non-entry in records). However, 50% of the tax obviously covers a much larger amount when the tax is computed for five years.

Interest at 18% is applicable in both situations, and is computed from the date on which tax should have been paid.

Suppression of facts

The approach of the adjudicating authorities and lately even of the CESTAT, is that if service tax is not paid then the very fact of non-payment constitutes suppression of facts, because the department had no way of knowing. This approach continues despite the 2012 judgment of the Supreme Court in a customs matter of Uniworth Textiles, in which the apex Court observed that if all non-payment of duty was to be construed as suppression of fact, the normal period of limitation for demands becomes redundant. The Court emphasized that the extended period of limitation is to not to be invoked for mere failure to do something. However the lower authorities continue to rely upon a simple formula: the defaulter never contacted the department to find out his liability; therefore he has suppressed the facts intentionally. One can take it almost as a foregone conclusion that if a show cause notice is

issued, the adjudication process will culminate in a tax demand and heavy penalties based on a finding of evasion of tax. The next step is appeal against the order.

Pre-deposit in appeal

Section 35F of the Central Excise Act 1944, made applicable to service tax by section 83 of the Finance Act 1994, requires the disputed amounts to be pre-deposited as a condition of hearing the appeal. The appellate authority may waive this partly or wholly if the appellant is able to demonstrate that pre-deposit would cause 'undue hardship'. This is discretionary; increasingly, appellate authorities play safe by ordering pre-deposit of a large amount. Courts too have, of late, supported this trend: witness the case of Sri Chaitanya Educational Committee v CCE Guntur, 2012 (25) STR 584 (AP), in which the AP High Court set aside the full waiver of pre-deposit with strictures against the bench of the CESTAT that ordered the waiver.

After the hearing on pre-deposit is concluded and compliance with the order reported, the case awaits its turn for hearing, which takes about five years. During this period the amount paid remains with the government. If the case is decided in one's favour, the pre-deposit amount is returned without interest. However, conversely, if tax is found to have been payable, interest is payable by the taxable entity from the date on which tax was due.

Extreme consequences of "suppression of fact"

We have seen above that one consequence of non-payment of tax by suppression or mis-statement of facts, or fraud or collusion or contravention of rules with intent to evade payment of service tax, is that the period of limitation is extended, so that the demand of tax can cover over five years. The tax demand is thus correspondingly higher, and the penalty based on the quantum of tax is also higher.

The other consequence of 'evasion' of service tax is prosecution under section 89 of the Act. Under this, the punishment is imprisonment for a minimum of one year. However for offences involving tax evasion of fifty lakhs of rupees or more, the punishment is imprisonment for a minimum of three years. (I am not touching upon the greater punishment for collecting but not remitting the tax.) In this category of offences, arrest before trial is also possible under section 91 of the Act.

In sum, consequences of non-payment of service tax in cases of doubt

In sum, if one does not pay service tax on an activity and it transpires that tax was payable on it, then the following consequences are likely to follow:

- Allegation of suppression of facts will be made and confirmed
- Demand of service tax will go back to cover over five years
- Penalty will be fifty per cent of tax payable in situations where everything is properly recorded in books of accounts (I am not touching upon situations of actual fraud and evasion.)
- Interest will be 18% p.a. from the date on which tax became payable
- Prosecution is possible

Arrest is possible if the amount involved is over Rs 50 lakhs.

Proceeding with caution

In view of the rigour of the service tax provisions and their enforcement, it is important to have a strategy for handling ambiguity in service tax law as it impinges on a business entity.

The factors that have a bearing on a decision on how to proceed will include,

- The nature of contract with customers: can service tax, if later demanded, be recovered from them?
- The appetite for risk of the business entity, and whether it has the financial strength to pre-deposit amounts in appeal and spend on litigation to pursue the case up to the Supreme Court in a process that may take several years

- The rigour of record-keeping in the entity: will inspection by the department show that everything is properly entered? Or will there be room for allegations of non-entry or fraudulent entry of relevant facts and figures?
- The degree of confidence in the legal advice being received regarding taxability

Keeping the service tax authorities informed

After taking these and other relevant factors into account, if a decision is made not to pay service tax on an activity, it is important to place properly reasoned written information with the department regarding the fact. This will obviate allegations of suppression of facts. It may also instigate a show cause notice demanding service tax; but the limitation period will be shorter and the amount at stake including penalties will be substantially less than if the entity had allowed the "grass to grow" for the department to harvest after five years. The risk of prosecution will be zero. Further, one's customers will be enabled to take Cenvat credit of the amount of service tax if it is eventually found to be payable. (Cenvat credit is not allowed if the payment was made after a discovery of suppression of facts.) In sum, the advantages of informing the department and sidestepping allegations of deliberate evasion of service tax are:

- Reduction of the period of limitation
- Correspondingly less penalty
- No prosecution
- Customers can take Cenvat credit if the tax is eventually to be paid

Thus the risks of ambiguity in service tax law can be substantially reduced by following a policy of keeping the department informed in writing about any non-payment of tax so as to avoid allegations of suppression of fact.

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