14 April 2023

EY tax alert

SC holds import of customized Designs and Drawings on paper was liable to service tax

EY Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

Executive summary

This tax alert summarizes the recent ruling[1] of the Supreme Court (SC) on whether the import of tailor-made engineering design and drawings on a paper would be leviable to service tax under the category of "Design Services".

Assessee in the present case procured engineering design and drawings from its overseas sister concerns. While importing these designs during the period June 2007 to September 2010, assessee filed bill of entry classifying the same as "paper" and claimed benefit of "Nil" rate of customs duty.

Revenue raised demand of service tax contending that the said activity was covered under the category of "Design Services" as per the relevant provisions of the Finance Act, 1994.

CESTAT held that the said designs and drawings were goods and not services. The taxation of goods and services are mutually and explicitly conceived levies, and therefore, the same activity cannot be taxed as both.

Disposing the appeal filed by Revenue, SC held that assessee was liable to pay service tax on import of "Design Services" under reverse charge.

SC placed reliance on the BSNL[2] judgment wherein, it was observed that there can be two different taxes/ levies under different heads by applying the aspect theory. As per the settled position of law, the same activity can be taxed as "goods" and "services" provided the contract is indivisible.

Accordingly, the impugned order passed by the CESTAT was quashed and set aside.

[1] 2023-TIOL-35-SC-ST
[2] (2006) 3 SCC 1

Building a better working world

Background

- Assessee is *inter-alia* engaged in manufacturing of wind turbine generator (WTG). It entered into an agreement with its sister concern outside India for purchase of engineering design and drawings to be used exclusively for manufacture of WTG in India.
- While importing these designs during the period June 2007 to September 2010, assessee filed bill of entry classifying the same as "paper" and claimed benefit of "Nil" rate of customs duty[3].
- Revenue issued show cause notice raising demand of service tax on the value of "Design Services" imported by assessee. The said demand was subsequently confirmed *vide* order-in-original.
- Aggrieved, assessee filed an appeal before Customs, Excise and Service Tax Appellate Tribunal (CESTAT).
- CESTAT allowed the appeals and held that the impugned designs and drawings were goods and not services. It also observed that the taxation of goods and services are mutually and explicitly conceived levies, and therefore, the same activity cannot be taxed as goods and as services.
- Revenue preferred an appeal before the Supreme Court (SC).

Revenue's contentions

- The contentions of assessee that any intellectual property put in a media at all times would only get classified as goods and never as services may not be the correct statement of law. Merely because an intellectual property is put in media, it would not *per se* make them goods.
- For example, importation of readymade drawings will constitute a sale of goods, whereas if a person engages a painter to draw a picture of his choice and specifications, then the delivery of painting, even though on a canvas duly framed, may only constitute a service.
- In the case of BSNL[4], SC distinguished between sale of goods and a contract of service and observed that the test for deciding whether a contract falls into one category, or another is, what is the substance of the contract, otherwise called, the dominant nature test.

  When a doctor writes a prescription or a lawyer drafts an opinion and delivers it to client, on payment of fees, consideration does not pass from the patient or client to the doctor or lawyer for the documents in both the cases. These are mere services and do not involve a sale.
- Therefore, what is required to be considered is, did the contracting parties intend transfer of both goods and services, either separately or in an indivisible or composite manner.

Assessee's contentions

- As per the settled position of law, supply of goods as per specifications given by the customer is also treated as sale of goods.
- In the case of Hindustan Shipyard Ltd[5], it was held that if the thing to be delivered has any individual existence before the delivery as the sole property of the party who is to deliver it, then it is a sale.

  Further, if the bulk of material used in construction belongs to the manufacturer who sells the end product for a price, then it is strong pointer to the conclusion that the contract is one for the sale of goods and not one for the labor.
- In the case of Associated Cement Companies Ltd[6], it was held that any media which contain drawings or designs would be regarded as goods under the provisions of the Customs Act and the fact that the technology or ideas is tailormade would not make any difference.
- In the case of Tata Consultancy Services[7] the question was whether canned software can be termed to be goods and as such assessable to sales tax. It was held that intellectual property, once it is put on to a media, whether it be in the form of books, canvas (in case of painting), computer discs or cassettes, and marketed, would become goods.
- It is true that different aspects of a transaction can be taxed through separate provisions. The aspect theory permits taxation of two different aspects or features of a transaction. However, in the case of BSNL *(supra)*, SC has observed that the said theory does not allow value of goods to be included in services and *vice versa*.
- Moreover, before the CESTAT, two specific grounds, *viz.,* the services (if any) rendered by a foreign entity will not fall within the purview of "design services" and the extended period of limitation cannot be invoked, were also raised.

  However, CESTAT has not dealt with those contentions and therefore assessee requested for the matter to be remanded back to CESTAT.

SC ruling

- The issue to be decided in the present case is whether the activity of import of engineering design and drawings from the sister companies is classifiable under

[3] Notification No. 021/2002 and Notification No. 020/2006
[4] (2006) 3 SCC 1
[5] (2000) 6 SCC 579
[6] 2001 4 SCC 593
[7] (2005) 1 SCC 308

taxable category of “design services” as per the relevant provisions of the Finance Act, 1994, as it stood during the impugned period.

- It is required to be noted that the said designs were tailor made and to be exclusively used by assessee in the territory of India. Such "designs" were subjected to the service tax even as per the clarification by the Board dated 18 March 2011 on the issue of applicability of indirect taxes on packaged software.

- Therefore, assessee was liable to pay service tax on the “design services” received from abroad under reverse charge.

  Despite the above, bill of entry was presented treating the same as “paper” for which the duty payable was “Nil”. Therefore, neither any custom duty, nor any service tax was paid on the said transaction.

- The order of CESTAT holding that the assessee was not liable to pay service tax mainly on the ground that the custom authorities considered the same as goods and therefore, the same activity cannot be taxed as services, is erroneous.

- In the case of BSNL *(supra)*, it was observed that there can be two different taxes/levies under different heads by applying the aspect theory. As per the settled position of law now, the same activity can be taxed as “goods” and “services” provided the contract is indivisible.

- The issue is squarely covered by the decision of SC in the case of BSNL *(supra)* against the assessee and in favor of Revenue.

- Accordingly, the impugned order passed by the CESTAT was quashed and set aside.

  However, the matter was remitted back to the CESTAT to consider other grounds raised by assessee, *viz.*, whether the services (if any) rendered by a foreign entity will fall within the purview of “design services” and whether the department was justified in invoking the extended period of limitation.

Comments

a. In light of apex court ruling, the cases where the transaction is in the nature of service but imported on media or paper, the levy and valuation aspects may have to be evaluated from customs perspective.

b. The argument taken in the past by the taxpayer that once the transaction is treated as sale of goods by the state authorities, the same cannot again be taxed as service by the central authority, or vice versa. This may not hold good considering SC’s observations.

c. SC has re-emphasized on the intent of contracting parties for determining whether the transaction is of sale of goods or provision of service.

Our offices

Ahmedabad
22nd Floor, B Wing, Privilon
Ambli BRT Road, Behind Iskcon
Temple, Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

Bengaluru
12th & 13th floor
"UB City", Canberra Block
No. 24, Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 6727 5000

Ground Floor, 'A' wing
Divyasree Chambers
11, O'Shaughnessy Road
Langford Gardens
Bengaluru - 560 025
Tel: + 91 80 6727 5000

Chandigarh
Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A
Industrial & Business Park, Phase-I
Chandigarh - 160 002
Tel: + 91 172 6717800

Chennai
Tidel Park, 6th & 7th Floor
A Block, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: + 91 44 6654 8100

Delhi NCR
Golf View Corporate Tower B
Sector 42, Sector Road
Gurugram - 122 002
Tel: + 91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad
THE SKYVIEW 10
18th Floor, "SOUTH LOBBY"
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jamshedpur
1st Floor, Shantiniketan Building,
Holding No. 1
SB Shop Area, Bistupur
Jamshedpur – 831 001
Tel: + 91 657 663 1000

Kochi
9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: + 91 484 433 4000

Kolkata
22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: + 91 33 6615 3400

Mumbai
14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: + 91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000

Pune
C-401, 4th floor
Panchshil Tech Park, Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 4912 6000

Ernst & Young LLP

EY | Building a better working world

About EY

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EYG member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is one of the Indian client serving member firms of EYGM Limited. For more information about our organization, please visit www.ey.com/en_in.

Ernst & Young LLP is a Limited Liability Partnership, registered under the Limited Liability Partnership Act, 2008 in India, having its registered office at 9th Floor, Golf View Corporate Tower B, Sector 42, Golf Course Road, Gurugram, Haryana – 122 002.