

TAXATION OF SERVICES BASED ON A NEGATIVE LIST OF SERVICES

CONCEPT PAPER FOR PUBLIC DEBATE

1.0 Background:

1.1 In the Parliament, while presenting the Union Budget 2011, the Finance Minister proposed that:

“Many experts have argued that it will be desirable to tax services based on a small negative list, so that many untapped sectors are brought into the tax net. Such an approach will be very conducive for a nationwide GST. I propose to initiate an informed public debate on the subject to help us finalize the approach to GST.”

1.2 Pursuant to the announcement made by the Honourable Finance Minister, it has become imperative to initiate an informed public debate on widening the tax base by introducing a negative list of services

2.0 What is a negative list?

2.1 To a lay person, not initiated into the rigors of tax policy, a negative list of services implies two things: firstly, a list of services which will not be subject to service tax; secondly, other than the services mentioned in the negative list, all other services will become taxable which fall within the definition of the ‘supply of services’. This can be contrasted from the present method of taxation that has detailed description for each taxable service and all other unspecified services are not liable to tax. The latter method of taxation is also referred to as taxation by way of a positive list.

2.2 The selective taxation of services by way of incremental additions over the years served well in the past in acclimatizing both the tax payers and tax administrators to the new levy. However, with considerable expansion of the list, the administrative challenge has multiplied manifold. Service tax has now gained considerable maturity and many practitioners of the subject believe that incremental approach to taxation is not suitable for providing a stable system for taxation of services that is at the threshold of getting subsumed into a comprehensive GST.

3.0 Contours of public debate:

3.1 Broadly the following questions can arise in a public debate on introduction of a negative list based comprehensive approach to taxation of services. Feedback based on

these questions from all stakeholders can further enlighten Government's approach to this important tax reform initiative:

- Negative vs positive list: should the country adopt a negative list? What will be the proper timing: at the time of GST or even earlier?
- How to define 'service', for the purpose of taxation?
- What are the services which should be placed in the negative list?
- How comprehensive the coverage should be while drawing the negative list? What should therefore be the policy on taxation of important sectors e.g. education, health, public services, charitable and NGOs, infrastructure etc.?
- What are the likely revenue implications?

4.0 Negative vs Positive list

4.1 The issue that which of the two lists is more desirable can be argued both ways with each having its own pros and cons. Positive list has the advantage of definitiveness, which is an essential pre-requisite for a good taxation law. However this very advantage starts getting eroded as the number of services increase. The possibilities of overlaps amongst definitions lead to innumerable administrative issues resulting in litigation and higher compliance costs. Some of the definitions could be so wide that they lead to unintended taxation requiring either clarifications or exemptions.

4.2 On the other hand the fact that many services are outside the tax net invariably leads to unintended exemptions, thus keeping the tax base narrow with all the accompanying consequences. Such unintended exemptions at intermediate stages lead to breakage of the input tax chain adding costs for the tax-payers and end-users. This will be clear from the following illustration:

Situation 1: No exemption					
	Taxable Inputs	Output	Input tax credit	Output tax@ 10%	Net liability
Origin Suppliers	0	100	0	10	10
Service provider I	100	200	10	20	10
Service provider II	200	400	20	40	20
Total					40

Situation 2: With exemption					
	Taxable Inputs	Output	Input tax credit	Output tax@ 10%	Net liability
Origin Suppliers	0	100	0	10	10
Service provider I	100	200	10	exempted	0
Service provider II	200	400	0	40	40
Total					50

4.3 It is evident from the illustration that when the Service Provider I is kept outside the tax chain the effective tax on the total supply goes up from 40 to 50 as the taxes paid at the previous stages are not available as tax credit at the subsequent stage.

4.4 As the untaxed supplies are treated exempt for the purpose of input tax credit rules, taxes paid on the inputs used in their supplies are required to be reversed under the prescribed rules. This further adds complexities both for the tax-payers and the administrators.

4.5 Such exclusions also lead to distortion of economic neutrality across similar or substitute supplies e.g. road vs. rail transportation or discourage outsourcing by incentivizing self-supplies, and are thus not conducive to making the optimal choices in the economy. Moreover the one-time taxation of the service sector obviates the need for year-after-year incremental changes.

4.6 On the other hand there are significant advantages of positive list in so far it has already attained a certain level of awareness and stability in administration. The categorizations of services is also useful for a variety of purposes e.g. import and export rules, Cenvat Rules and Point of Taxation Rules or where ever any differential treatment is required to be given to any service as also for statistical purposes.

4.7 The proper timing for the launch of negative list can also be argued either way. GST will give the advantage of a wider constitutional mandate for comprehensive taxation of goods and services. Undoubtedly that will be far more conducive for the launch of taxation based on a negative list. On the other hand there are advantages in moving towards negative list at an earlier time in order to gain useful experience in its implementation and minimize the impact of the mammoth changes that GST may usher.

5.0 Definition of Service:

5.1 As the new concept envisages taxation of the whole, unless otherwise something is excluded, it is necessary to capture that universe such that it does not infringe upon either the powers to tax of another legislature in a specific area or taxes such areas as are subjected to like taxes as goods. To initiate a public debate and obtain feedback, a definition of 'service' is proposed as follows:

5.2 A "service" means anything which does not constitute supply of goods, money or immovable property-

and includes-

- A. right to use an immovable property;
- B. construction of a complex, building, civil structure or a part thereof, including a complex or building intended for sale to a buyer, wholly or partly, except where the entire consideration is received after issuance of certificate of completion by a competent authority;
- C. temporary transfer or permitting the use or enjoyment of any intellectual property right;
- D. obligation to refrain from an act, or to tolerate an act or a situation, or to do an act;
- E. service in relation to lease or hire of goods; and
- F. right to enter any premises-

but excludes a supply-

- A. by an employee to an employer in the course of or in relation to the employment of the person;
- B. by a constitutional authority under the Indian Constitution or a member of an Indian legislature or a local self-government in that capacity;
- C. that amounts to manufacture of excisable goods or is chargeable as part of the value of goods to a duty in terms of the provisions of Central Excise Act, 1944;

5.3 In the attempted definition, a supply of service is defined as 'anything which does not constitute supply of goods, money or immovable property'. The key words are goods, money and immovable property. Tax will be imposed on supply of services. A supply is a transaction and transaction involves two persons. Transaction involving goods, money and immovable property is excluded from the meaning of supply of service. Inclusions and exclusions support and clarify the above definition of supply of services.

6.0 Exclusions:

6.1 Supplies of goods, money and immovable property are the principal exclusions, in the proposed scheme. The expression ‘goods’ as defined in *clause (7) of section 2 of the Sale of Goods Act, 1930, can continue to be part of the service tax framework as at present.* According to the Sale of Goods Act, 1930:

“Goods” means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale.

6.2 It is important to mention that supplies which are deemed to be sale of goods in terms of Article 366 (29A) of the Constitution in the case of specified contracts will stand excluded as goods. These relate to goods portion of the supplies in a works contract, contracts of hire purchase and catering. The remaining portion of the supply in the specified composite contracts shall be considered as supply of service. Under the proposed negative list approach, where supplies of services are bundled alongwith supply of goods in situations other than those stated in Article 366 of the constitution, nature of the transaction will have to be judged by what the Honorable Supreme Court has called the “dominant nature test” in the case of *Bharat Sanchar Nigam Ltd. Vs UOI [2006(2) STR 161 (SC) para 43]*. The test requires: “did the parties have in mind or intend separate rights arising out of the sale of goods. If there was no such intention there is no sale (of goods) even if the contract could be disintegrated.”

6.3 The expression “money” is meant to capture transactions where Indian legal tender is exchanged from one form to another.

6.4 The expression ‘Immovable property’ as defined in clause 26 of section 3 of the General Clauses Act, 1897 can be borrowed to support the proposed scheme:

“Immovable property” shall include land, benefits arising out of land and things attached to the earth, or permanently fastened to anything attached to the earth.”

6.5 In addition to the above, certain exclusions are provided to clarify the concept of ‘supply of service’. For instance, it is provided in the definition of ‘supply of service’ that, sale of immovable property in fully complete form i.e. after issuance of the completion certificate, will not be counted as supply of service. However, all agreements to sell a complex, building, civil structure or a part thereof to intending buyers, wholly or partly, where a part of the consideration is received before the completion certificate is

obtained shall constitute service, as is the case even at present. Similarly, it is proposed that a transaction involving right to use immovable property e.g. renting shall constitute a supply of service.

6.6 A transaction takes place between two persons. Therefore self-supplies will not constitute a service. The word "*Person*" shall include any company or association or body of individuals, whether incorporated or not (section 2(42) of the General Clauses Act, 1897) and hence services by or to unincorporated associations and joint ventures will constitute a valid transaction.

6.7 Supply of services by an employee to an employer in the course of or in relation to the employment of the person is an important exclusion. However any service rendered by an employee in another capacity will constitute a supply of service. Similar position is proposed in respect of constitutional functionaries, some of whom may not be strictly in the position of an employee, as also members of Union and State legislatures and local self-government.

6.8 Any supply that amounts to manufacture or is includible in the value of the goods under the Central Excise Act is also kept outside the purview of the definition of service as this is liable to Central Excise duty as goods.

7.0 Inclusions:

7.1 A number of specific entries have been specified in the inclusive portion to provide greater clarity to the new approach to taxation of services. Right to use immovable property falls within the domain of services. Also temporary transfer or permitting the use or enjoyment of any intellectual property will constitute supply of service. The obligation to refrain from an act, or to tolerate an act or a situation, or to do an act will also constitute service. Delivery of goods by way of hire purchase or installments is declared by the Constitution to be deemed sale of goods. But services provided in relation to lease or hire of goods have been held to be a service [Association of Leasing & Financial Services Companies vs UOI (2010-TIOL-87-SC-ST-LB)]. Right to enter any premises e.g. museums; art galleries or botanical gardens will also constitute service.

7.2 To bring certainty and clarity in certain areas where goods and services aspects may overlap, it is proposed to empower the Central Government to specify certain supplies as supply of service or otherwise, whether in full or part. Services so declared will be taxed as a supply of service notwithstanding anything to the contrary. This is not meant to be unbridled power and shall operate within the existing legal restraints on the subject.

7.3 In the light of the discussions in the previous paragraph, supplies of electricity, power, heat, refrigeration and ventilation may be specified as not comprising supply of services. Sale of SIM card with talk time [Idea Mobile Communication Ltd Vs CCEC, Cochin (2011-TIOL-71-SC-ST)], downloadable on-site software and similar supplies through the internet may be specified as services. Service element involved in the supplies in respect of works contracts, restaurants, outdoor catering may be subject to tax as services at the prescribed rates, so that goods portion falling within the taxation powers of state governments, will stand excluded.

8.0 Negative list of services:

8.1 An indicative negative list is given in the Annexure. This is only a proposition to initiate a discussion. While drawing the indicative negative list some of the considerations found relevant are as follows:

- (i) Administrative considerations: taxation of Government, difficult to tax sectors e.g. margin-based financial services.
- (ii) Under contractual obligations: Specified international bodies and diplomatic missions
- (iii) Welfare considerations: welfare of vulnerable sections of society, essential education, public health; public transport, services by non-profit entities, religious services, promotion of art, culture and sports.
- (iv) Economic considerations: transport of export goods, services meant for agriculture, animal husbandry and infrastructure development.
- (v) Explicit activities in the nature of services, which are within the taxing powers of States: betting and lotteries, tolls.

8.2 Most of the services provided by government are provided without a specific charge to the recipient and thus shall not be liable to tax. However the other supplies could be classified as follows:

- i. Where services are provided at market rates and compete with private entities;
- ii. Where services are provided at concessional rates but compete with private entities;
- iii. Where services are provided exclusively or predominantly by government.

8.3 When Government is engaged in providing services in purely commercial areas or where similar services are provided by private enterprise, it is necessary to provide equitable tax treatment. When government supplies compete with the supplies made by

private enterprise, if tax is levied only on supplies made by private enterprise, it amounts to discrimination and economic distortions will be inevitable.

8.4 Where services are provided by Government or its extended agencies more or less exclusively many experts argue that such services should also be subjected to tax. The counter argument is that such taxation would lead to increase in administrative work load without commensurate increase in net revenue when the same amount can be collected by increased user charges. With increasing privatization and outsourcing the dividing line between government functions for a fee or charge and somewhat similar functions elsewhere is diminishing. For example the driving licenses in many states are now issued by private bodies though the approval continues to be given by government agencies. It is thus proposed to confine negative list only to services provided in select few areas and the matter is left open at this stage for public debate as to what precise exclusions should be made.

8.5 Even though the definition of goods includes stocks and shares, the sale and purchase of securities and debts on a principal-to-principal basis is also separately excluded by a specific entry in the proposed negative list. This may require discussion whether mere exclusion at the definition stage of stocks and shares will capture all the various instruments that are sold and purchased on principal-to-principal basis in financial markets. However, services in relation to sale and purchase of securities e.g. stock broking will come under the tax net.

8.6 Renting of personal dwellings for the residential use of any person is commonly included in negative list in most parts of the world. Due to wide divergence in income levels in India a case is made for bringing opulent living within the tax net. A reasonably high threshold will ensure that the effect is felt largely by the very well to do sections of the society.

8.7 On the subject of taxation of health services, diverse views have been expressed in the recent past. While appreciating that health services are absolutely essential for all persons, some tax policy experts do argue that only the basic or public health services should be kept in the negative list. All health and medical services other than these health services, particularly the high-end medical services provided by private enterprise, should be brought within the tax fold. Among other arguments they justify the same on grounds of the sanctity of the tax-chain so that taxes paid at the previous stage are allowed to be set off at the subsequent stages of consumption (in particular for the health insurance sector) and the need to use the resources so made available for upgrading the facilities for the poor in the public health system. Another model of taxation could be to exempt health care up to a decent threshold so as to confine it to large entities that are commonly accessed by persons with insurance cover or other

affluent sections of society. Services provided by such establishments to needy and economically weaker sections could be exempted as per agreed criteria. Public hospitals could be kept outside the levy as they largely address the needs of the weaker sections. The issue thus requires a well-rounded debate on all the various aspects. For the moment two options are indicated but there can be many varied variants for the treatment of this sector.

8.8 Similar arguments are also made in respect of certain streams of education. Services provided by international schools and expenses recovered by certain educational institutions over and above the prescribed charges, including capitation fees or donations are areas that are often cited for the purpose of levy of service tax.

8.9 It is acknowledged that some of the areas specified in the proposed negative list require greater elaboration. However the same has not been attempted at this stage in order to obtain diverse and unbiased views during the course of the public debate.

9. Revenue Impact

9.1 It is well known that nearly 57% of India GDP comes from services. After including construction, the contribution from services will come to about 63%. At current prices the contribution from services during 2010-11 comes to about Rs 50 lakh crore.

9.2 The national income statistics do not capture the break-up of the service sector in the manner it is being taxed or sought to be taxed. However some broad indications are available of the contribution of services from certain sectors. Based on these indications contribution from services that are proposed to be kept in the negative list e.g. trading of goods, transportation of passengers, education and health sectors as also portions of construction, real estate and financial sectors can be estimated. In addition to exclusions by way of negative list, export of services valued at about nearly US\$ 130 billion at present will also remain exempt. The import of services meant for direct consumptions by individuals are at present not largely subjected to tax. Remaining services from abroad may not make any major net contribution to tax being available for credit set off.

9.3 On a rough estimate nearly 40% of the total services will come into the tax net as a result of the proposed negative list. However a large part of the informal sector would also remain outside the tax net due to the threshold exemption. This would leave only about 60% of the sector not covered by negative list actually available for tax payment. Thus the potential for effective taxation of services may be confined to about 20-25% of the service sector contribution. This is still a sizable number and will add significant numbers to the revenue though may not sound astounding as some sections believe it to be.

10.0 Conclusion:

10.1 For the purpose of operationalizing the proposed negative list, certain changes will be necessary in the current service tax framework, importantly in the rules relating to import and export of services and to a lesser extent Cenvat Credit Rules, 2004, Service Tax Rules, 1994 and Point of Taxation Rules, 2011.

10.2 Exemptions which are operational within the current positive list regime have not been discussed in this paper. It is possible that some of these may be retained by the Government of India in public interest and some others may be withdrawn as not necessary, being covered by the negative list. In this connection, remarks column of the annexure may be perused.

(This Concept Paper is placed in the public domain for the widest possible consultation, extensive debate and to seek views and feedback of all stakeholders. The Paper has been prepared by a team of officers with inputs from CII, FICCI, ASSOCHAM and PHDCI. Views expressed here do not reflect the position of the Government of India in any manner. Any comments, suggestions or feedback may be given by September 30, 2011 to Shri Shobhit Jain, OSD (TRU) at shobhit.jain@nic.in, Tel: 011-23095590; fax: 011-23093037)

Possible Negative List of Services

Sector	S. No.	Negative List	Remarks
1. By specified persons	1.	Notified services provided by: a. Government* and Judiciary; b. RBI; and c. government regulatory bodies	List of these services or the principle for exclusions will be worked out based on the outcome of the debate
	2.	Services provided by individuals to Government in relation to their representation on any council, commission or similar body set up by the Government	
	3.	Service by UN, international bodies, diplomatic missions under diplomatic and consular arrangements as per laid down conditions (details to be specified)	Services provided to such entities to remain exempt as at present.
2. Social welfare and public utilities	4.	Services provided by organizations registered as non-profit entities in matters relating to public and social welfare activities-excluding education and health (covered separately)-including charitable fund-raising events, sponsorships to charitable events and voluntary donations to charity	Public and social welfare activities will be suitably defined and may be restricted to specified fields only
	5.	Funeral, burial, crematorium and mortuary services	
3. Agriculture & animal husbandry	6.	Services directly used for growing, cultivation, harvesting of the agricultural produce, horticulture, animal husbandry, forestry, dairy, poultry farming and pisciculture (including renting of vacant land exclusively or predominantly for any such purpose)	Certain support services in relation to agriculture and allied activities may be separately exempted
4. Financial Sector	7.	Sale, purchase or acquisition of securities and debts on principal-to-principal basis	Acquisition of shares in lieu of services will be liable to tax
	8.	Interest	
	9.	Dividend on investments	
	10	Inter-bank sale and purchase of foreign currency	

5. Transport	11	Transport of passengers by: a) public transport buses on a point-to-point basis (except tourist buses) and stage-carriage basis; b) public transport in ship or vessel of less than 15 net tonnage on a point-to-point basis; d) by metered taxis or three-wheeler auto rickshaw plying within the precincts of a city	
	12	Transport of goods to a destination outside India by any means of transport	
	13	Supply of goods carriage to a person engaged in the business of transportation of goods	
6. Construction & Real Estate	14	Construction, works-contract, repair, alteration, renovation or restoration of: a) roads, airports, railways, transport terminals, bridges, tunnels, dams, canals, irrigation and flood control waterworks including watershed development and water-bodies, water treatment plants and water supply pipelines; b) buildings owned by Government, other than meant predominantly for industrial or commercial use, including government hospitals and educational institutions c) residential building comprising of a single dwelling unit; d) homeless shelter, orphanage, old-age home, rehabilitation & de-addiction centre, child day-care home or place of worship	
	15	Renting of personal dwelling for residential use of a person below a threshold (to be finalized after debate) and when used otherwise as a hotel, inn, guest house, club or campsite or similar accommodation	
7. Education	16	Pre-school, school and recognized education** and vocational training recognized by NCVT except as capitation fee, donations or similar charges in relation to admission	

8. Health	17	<p>Option 1: Services provided by a clinical establishment with a turnover below Rs 4 crore in the previous year</p> <p>Option 2: Hospital, medical care, diagnostic, para-medical services except in relation to preventive health check-up within the precincts of a clinical establishment, cosmetic or plastic surgery</p>	Services to specified sections and by public hospitals may be exempted under option 1.
9. Others	18	Copyright services of original literary, dramatic, musical and artistic works.	
	19	Services provided by independent journalists, PTI & UNI for providing news	
	20	Services provided by sportspersons, as a player, coach or referee/umpire and performing artists in that capacity (excluding as brand ambassadors)	
	21	Religious services provided by any person.	
	22	Services provided by a political party recognized by Election Commission of India	
	23	Services provided by a trade union to its members	
	24	Representational services provided by an advocate to individuals	
	25	National or international prize/award in recognition of achievement in the field of art, literature, science, sport, economics or public life	
	26	Tolls except services in relation to collection of tolls	
27	Betting and gambling except services in relation to promoting, marketing or organizing games of chance, including lottery services		

***Government** means the Union, State and local self government but shall not include any entity established under the Companies Act 1956 or any other law for the time being in force.

****Recognized education** means education leading to the award of a certificate or degree recognized by a body established by an Indian law.