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By

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Dear Readers,

Greetings for the season!

In this edition, we bring you an article on indirect tax implications on mining rights. Majority of the readers would know that there was a reverse charge obligation on businesses for support services received from government. The tax authorities using this particular obligation has tried to fasten liabilities on mining rights taken by the businesses from the government. Whether a mining right can be called as a 'tax' or 'consideration for service' is currently pending before 9 member bench at Honourable Supreme Court. We have comprehensively discussed about the said issue pending the outcome of judgment.

The next article is on domestic transfer pricing regulations. With the introduction of Section 115BAB, the said domestic transfer pricing regulations have come again to the surface. In this part, we have dealt with the basic overview of the domestic transfer pricing regulations and in the upcoming parts, we are going to take certain case studies for deliberation.

I hope that you will have good time reading this edition and please do share your feedback. I will also urge clients to mail us topics or issues on which you want us to deliberate in our future editions, so that we can contribute to the same.

Thanking You,

Suresh Babu S
Founder & Chairman

GST

COMPREHENSIVE ANALYSIS OF SERVICE TAX & GST IMPLICATIONS ON MINING RIGHTS

Contributed by CA Sri Harsha & CA Manindar

Introduction:

At the time of introduction of negative list-based taxation under service tax law[1] effective from 01.07.2012, only selected services provided by Government are subject to service tax and the rest are covered under the negative list. With effect from 01.04.2016, the negative list contained in section 66D was amended to exclude all services provided by Government from negative list and to bring them under levy. Further, these services were subjected to reverse charge requiring the recipient to pay tax.

Since then, applicability of service tax over royalty paid by mining companies to State Governments towards mineral rights has been a subject matter of debate. The industry is of the view that royalty payable on mineral rights itself is in the nature of tax and service tax cannot be levied on such tax amount. The matter was examined by Rajasthan High Court in Udaipur Chambers of Commerce and Industry[2] and ruled the issue in favor of Revenue. The same has been challenged before the Supreme Court[3] which is pending for disposal.

Government continued the same tax policy even under GST regime requiring the recipients to pay tax on royalty paid over mineral rights. Therefore, the ambiguity prevailing on service tax applicability continued under GST regime as well. As large amounts are being paid as royalty towards mining rights, the tax exposure under service tax and GST are on a higher side and reeling the industry players. In this backdrop, an attempt is made to comprehensively analyze service tax and GST implications over the royalty payments on mining rights.

Is Royalty on extraction of minerals a tax?

Before we delve upon the issue whether royalty levied on mineral extraction is in the nature of tax or not, we will first try to understand the legislative background under which royalty is going to be collected under mineral rights.

Legislative Background on collection of Royalty, Dead Rent and DMF charges:

Section 9 of the Mines and Mineral (Development and Regulation) Act, 1957 provides that the person who has been conferred with mining lease shall be required to pay the royalty. In terms of Section 9A of the said Act, the holder of mining lease is also required to pay either dead rent/seigniorage charges or royalty whichever is higher.

[1] Finance Act, 1994
[2] 2018 (8) GSTL 170 (Raj)
[3] Udaipur Chambers of Commerce and Industry v. Union of India –[2018 (10) G.S.T.L. J167 (S.C.)]

Section 9B of the said Act provides that the State Government is required to set up District Mineral Foundation (DMF) for any district affected by mining-related operations. Sub-section (2) of section 9B provides that the object of the DMF shall be to work for the interest and benefit of persons and areas affected by mining-related operations in such manner as may be prescribed by the State Government. In terms of sub-section (5) of section 9B of the said Act, the holder of a mining lease shall, in addition to royalty, be required to pay to DMF of the district in which the mining operations are carried out, on an amount equivalent to such percentage of the royalty paid (not exceeding 1/3rd of such royalty) as may be prescribed.

Section 15 of the said Act provides that the State Government is empowered to make rules for grant of quarry leases, mining leases or other mineral concessions in respect of minor minerals and the purposes connected therewith. Sub-section (1A) of the said section provides that such rules shall also provide for various matters listed thereunder which include the fixing and collection of rent, royalty, fees, dead rent, fines and other charges. Under the said Act, Central Government retains the power to make rules in connection with all other minerals.

Meaning of the words 'Royalty', 'Dead Rent' and 'DMF Charges':

Therefore, granting of mining rights over minerals are subject to royalty, dead rent (seigniorage) and DMF charges. Though all of them are charges collected in relation to mining, there is subtle difference between them which is explained as under:

The word "royalties" signifies, in mining leases, that part of the reddendum which is variable, and depends upon the quantity of minerals gotten or the agreed payment to a patentee on every article made according to the patent. Rights or privileges for which remuneration is payable in the form of a royalty.{Stroud's Judicial Dictionary of Words and Phrases (Sixth Edition, 2000, Vol.3, page 2341)}

Since the mining lease confers upon the lessee the right not merely to enjoy the property as under an ordinary lease but also to extract minerals from the land and to appropriate them for his own use or benefit, in addition to the usual rent for the area demised, the lessee is required to pay a certain amount in respect of the minerals extracted proportionate to the quantity so extracted. Such payment is called 'royalty'.

It may, however, be that the mine is not worked properly so as not to yield enough return to the lessor in the shape of royalty. In order to ensure for the lessor a regular income, regardless of whether the mine is worked or not, a fixed amount is provided to be paid to him by the lessees. This is called 'dead rent'.

'Dead rent' is calculated on the basis of the area leased, while 'royalty' is calculated on the quantity of minerals extracted or removed. Thus, while dead rent is a fixed return to the lessor, royalty is a return which varies with the quantity of minerals extracted or removed[4] . It is because of this reason, Section 9A of the Mines and Mineral (Development and Regulation) Act, 1957 provides that the holder of mining lease is also required to pay either dead rent/seigniorage charges or royalty whichever is higher.

[4]InD.K. Trivedi & Sons, and Ors. v. State of Gujarat and Ors 1986 (Supp) SCC 20, the distinction between 'Royalty' and 'Dead Rent' is explained in the above manner. The authors recommend reading of the above judgment for more clarity.

DMF charges are collected as a percentage of royalty paid which is earmarked to work for the interest and benefit of persons and areas affected by mining-related operations. With this understanding of the terms 'Royalty', 'Dead Rent', 'Seigniorage Charges', we will examine the service tax/GST implications collectively by referring to these payments as royalty.

Fields of Legislation under Seventh Schedule of Constitution:

The issue whether royalty is a tax has been examined by the courts whenever a challenge was made against a tax or cess that was proposed by State Governments on the royalty paid towards mining leases. In view of this reason, let us now understand the fields of legislation under Seventh Schedule of Constitution.

Entry	Description
Entry 54 of Union List	*Regulation of mines and mineral development to the extent to which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.*
Entry 23 of State List	*Regulation of mines and mineral development subject to the provisions of List I with respect to regulation and development under the control of the Union.*
Entry 50 of State List	*Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.*

In view of the above reproduced fields of legislation under seventh schedule, entry 54 of Union List provides that Parliament is entitled to make law to regulate mineral and mines development. Further, entry 23 of State List provides power to State Legislature to make law to regulate mineral and mines development in the absence of any law from the Parliament. Entry 50 of State List confer power on State Legislature to make a law to levy of taxes on mineral rights subject to limitations if any imposed by Parliament. Thus, the powers of State Legislature in so far as regulation and taxation of mineral rights is subject to power of Parliament.

In the matter of India Cement Ltd v. State of Tamil Nadu[5] :

In the above case, the Honourable Supreme Court considered the issue whether royalty paid on extract minerals is a tax or not in order to examine whether levy of cess on royalty is within the competence of State Legislature. Section 115 of the Madras Panchayats Act, 1958 provided for levy of a local cess at the rate of 45 paise on every rupee of land revenue payable to Government in respect of any land. An explanation to the said section provides that the term 'land revenue' is defined to mean public revenue due on land and includes water cess payable to the Government for water supplied or used for the irrigation of land, royalty, lease amount or other sums payable to the Government in respect of land held direct from the Government on lease or licence. In view of this explanation, cess is intended to be levied on royalty for mineral rights also by considering it as land revenue.

[5] 1990 AIR 85

It was argued on behalf of the State of Tamil Nadu that the language of Entries 23 and 50 in List II clearly subjects the authority or jurisdiction on the State Legislature to any enactment made by the Parliament. Entry 23 talks of regulation and Entry50 talks of taxes on mineral rights. It therefore could not be disputed that if the cess imposed under section 115 of the Madras Village Panchayat Act is a cess or tax on minerals then that jurisdiction could be exercised by the State Legislature subject to the law enacted by the Parliament. The Parliament in Section 9(1) of the Mines and Minerals (Regulation and Development) Act, 1957has fixed the limits of royalty on the mining rights. It was therefore contended on behalf of the State that in fact what is imposed under Section 115 is not a cess on the mining rights or on royalty but isa tax on land which clearly falls within the authority of the State legislature in Entry 49 of List II.

In this context, while examining the validity of the local cess on royalty, the seven-member bench of the Supreme Court held as under:

*In any event, **royalty is directly relatable only to the minerals extracted and on the principle that the general provision is excluded by the special one, royalty would be relatable to entries 23 & 50 of list II, and not entry 49 of list II. But as the fee is covered by the Central power under entry 23 or entry 50 of list II, the impugned legislation cannot be upheld.** Our attention was drawn to a judgment of the High Court of Madhya Pradesh in Miscellaneous Petition No. 410/83--M/s Hiralal Rameshwar Prasad & Ors. v. The State of Madhya Pradesh & Ors., which was delivered on 28th March, 1986 by a Division Bench of the High Court. J.S. Verma, Acting Chief Justice, as His Lordship then was, held that development cess by s. 9 of the Madhya Pradesh Karadhan Adhiniyam, 1982 is ultra vires. It is not necessary in the view taken by us, and further in view that the said decision is under appeal in this Court, to examine it in detail. In the aforesaid view of the matter, **we are of the opinion that royalty is a tax, and as such a cess on royalty being a tax on royalty, is beyond the competence of the State Legislature because s. 9 of the Central Act covers the field and the State Legislature is denuded of its competence under entry 23 of list II. In any event, we are of the opinion that cess on royalty cannot be sustained under entry 49 of list II as being a tax on land. Royalty on mineral rights is not a tax on land but a payment for the user of land. (para 34)***

***Whether royalty is a tax is not very material for the purpose of determination of this question in this case. It is admitted that royalty is charged on the basis of per unit of minerals extracted.** It is no doubt true that mineral is extracted from the land and is available, but it could only be extracted if there are three things: (1) Land from which mineral could be extracted. (2) Capital for providing machinery, instruments and other requirements. (3) Labour It is therefore clear **that unit of charge of royalty is not only land but land + Labour +Capital. It is therefore clear that if royalty is a tax or an imposition or a levy, it is not on land alone but it is a levy or a tax on mineral (land), labour and capital employed in extraction of the mineral.** It therefore is clear that royalty if is imposed by the Parliamentit could only be a tax not only on land but no these three things stated above*

It is not in dispute that the cess which the Madras Village Panchayat Act proposes to levy is nothing but an additional tax and originally it was levied only on land revenue, apparently land revenue would fall within the scope of entry 49 but it could not be doubted that royalty which is a levy or taxon the extracted mineral is not a tax or a levy on land alone and ***if cess is charged on the royalty it could not be said to be a levy or tax on land and therefore it could not be upheld as imposed in exercise of jurisdiction under Entry 49 List II by the State Legislature. Thus it is clear that by introducing this explanation to Section 115 clause (1) widening the meaning of word 'land revenue' for the purposes of Section 115 and 116****. When the Legislature included Royalty, it went beyond its jurisdiction under entry 49 List II and therefore clearly is without the authority of law. But this also may lead to an interesting situation. This cess levied under Section 115 of the Madras Village Panchayat Act is levied for purposes indicated in the scheme of the Act and it was intended to belevied on all the lands falling within the area but as this cess on royalty is without the authority the result will be that the cess is levied so far as lands other than the lands in which mines are situated are concerned but lands where mines are situated this levy of cess is not in accordance with that law. This anomaly could have been averted if the Legislature in this explanation had used words 'surfacerent' in place of royalty. Even if the lands where mines are situated and which are subject to licence and mining leases even for those lands there is a charge on the basis of the surface of the land which is sometimes described as surface rent or sometimes also as 'dead rent'. It could not be doubted thatif such a surface rent or dead rent is a charge or an imposition on the land only and therefore will clearly fall within the purview of entry 49 List II and if a cess is levied on that it will also be justified as tax on land falling within the purview of entry 49 and it will also be uniform as this cess would belevied in respect of the lands irrespective of the fact as to whether the land is one where a mine is situated or land which is only used for other purposes for which land revenue is chargeable*

(emphasis supplied)

In view of the above excerpts of the decision of Honourable Supreme Court in the case of India Cements (supra), the following are the key findings:

- Entry 23 of List II of seventh schedule confer power on State to regulate mines and mineral development. Further entry 50 of List II of seventh schedule confer power on State to impose taxes on mineral rights. Both these entries are subject to limitations if any imposed by Parliament by law relating to mineral development. Entry 54 of the List I confer power on Centre towards regulation of mines and mineral development and exercising this power, Parliament by law made Mines and Mineral (Development and Regulation) Act, 1957. As Parliament has made a law on mines and mineral development, the power of the State under entry 23 and entry 50 of List II is limited and is subject to law made by Parliament.

- The Supreme Court held that royalty is directly relatable only to the minerals extracted and on the principle that the general provision is excluded by the special one, royalty would be relatable to entries 23 & 50 of list II, and not entry 49 of list II. But as the fee is covered by the Central power, the impugned legislation of State cannot be upheld.

- The Supreme Court under para 34 opined that cess on royalty cannot be sustained under entry 49 of list II as being a tax on land. ***Royalty on mineral rights is not a tax on land but a payment for the user of land.*** Having said this, in the same para the Supreme Court used the expression **"we are of the opinion that royalty is a tax**, and as such a cess on royalty being a tax on royalty, is beyond the competence of the State Legislature because s. 9 of the Central Act covers the field".

Thus, under para 34 of the decision, the seven-member bench of the Supreme Court on one side held that Royalty on mineral rights is not a tax on land but is a payment for use of land. On the other side, in the same para, under the above quoted words, the court opined that royalty is a tax. Thus, the judgment appears to self-contradictory.Subsequently, various other decisions that after this judgment followed this judgment and concluded that royalty is a tax.

In the matter of State of West Bengal vs Kesoram Industries Limited and Others [6]:

In this case, the issue whether cesses can be levied by State Governments on coal, brick earth and minor minerals came up for consideration. In the said decision, the five-member bench of Supreme Court took a view that in the decision of India Cement (supra), there was an error in drafting the judgement either attributable to stenographer's devil or to sheer inadvertence. The court opined that majority wished to say and in fact said is 'cess on royalty is a tax' but not 'royalty is a tax'. The relevant extracts of the Judgement is reproduced as under:

(A version from main issue) Royalty, if tax?

We Would like to avail this opportunity for pointing out an error, attributable either to a stenographer's devil or to sheer inadvertence, having crept into the majority judgment in India Cement Ltd.'s case (supra). The error is apparent and only needs a careful reading to detect. We feel constrained - rather duty-bound - to say so, lest a reading of the judgment containing such an error - just an error of one word - should continue to cause the likely embarrassment and have adverse effect on the subsequent judicial pronouncements which would follow India Cement Ltd.'s case, *feeling bound and rightly, by the said judgment having the force of pronouncement by seven-Judges Bench.* ***Para 34 of the report reads as under : "In the aforesaid view of the matter, we are of the opinion that royalty is a tax, and as such a cess on royalty being a tax on royalty, is beyond the competence of the State legislature because Section 9 of the Central Act covers the field and the State legislature is denuded of its competence under Entry 23 of List II. In any event, we are of the opinion that cess on royalty cannot be sustained under Entry 49 of List II as being a tax on land.***

Royalty on mineral rights is not a tax on land but a payment for the user of land."(underlining by us) In the first sentence the word 'royalty' occurring in the expression - 'royalty is a tax', is clearly an error. What the majority wished to say, and has in fact said, is - 'cess on royalty is a tax'. ***The correct words to be printed in the judgment should have been 'cess on royalty' in place of 'royalty' only. The words 'cess on' appear to have been inadvertently or erroneously omitted while typing the text of judgment. This is clear from reading the judgment in its entirety. Vide para 22 and31, which precede para 34 above said, their Lordships have held that 'royalty' is not a tax. Even the last line of para 34 records 'royalty on mineral***

[6]Appeal (civil) 1532 of 1993

rights is not a tax on land but a payment for the user of land'. The very first sentence of the para records in quick succession '.....as such a cess on royalty being a tax on royalty, is beyond the competence of the State legislature...'. What their Lordships have intended to record is '.....that cess on royalty is a tax, and as such a cess on royalty being a tax on royalty is beyond the competence of the State Legislature....'. That makes correct and sensible reading, *A doubtful expression occurring in a judgment, apparently by mistake or inadvertence, ought to be read by assuming that the Court had intended to say only that which is correct according to the settled position of law, and the apparent error should be Ignored, far from making any capital out of it, giving way to the correct expression which ought to be Implied or necessarily read in the context, also having regard to what has been said a little before and a little after.*

(emphasis supplied)

Thus, the five-member bench of Supreme Court in the case of State of West Bengal vs. Kesoram Industries Limited and Others (supra) doubted the seven-member bench decision of Supreme Court in the case of India Cements (supra) on the point whether the said decision has held that royalty is a tax.

In view of this reason, subsequently, in order to examine whether seven-member bench in India Cements (supra) held that royalty is a tax or otherwise, the Supreme Court, in the case of Mineral Area Development Authority etc vs. Union of India & Ors[7] , referred the matter to nine-member bench. Thus, what has been referred to the nine-member bench of Supreme Court is on the point whether the seven-member bench in the case of India Cements (supra) opined that royalty is a tax or otherwise as doubted by the five-bench of Supreme Court in the case of Kesoram Industries Limited (supra).

Having said this, it is also worth to note the issues involved and the eventual outcome of five-member bench decision of Supreme Court in the case of Kesoram Industries Limited (supra). In this case a batch of matters raising few questions of constitutional significance centering around Entries 52, 54 and 97 in List I and Entries 23, 49, 50 and 66 in List II of the Seventh Schedule to the Constitution of India as also the extent and purport of the residuary power of legislation vested in the Union of India. In the said case, one of the issues involved was the power of State Legislation to impose cesses on coal bearing land. The Supreme Court held that royalty paid may not be tax under common parlance but going by the definition of 'taxation' under article 366(28) of our Constitution, royalty payable on extraction of minerals being in the nature of statutory impost come under the purview of taxation. The relevant extracts are as under:

"Such a question may not strictly arise for consideration in this case as royalty is a statutory impost. Royalty stric to sensu and in common parlance may not be a tax.

But having regard to the definition of taxation contained in Clause 28 of Article 366 of the Constitution of India, there may not be any dispute that royalty being a statutory impost would come within the purview thereof.

A royalty may not be a tax in its usual sense as has been held in Quarry Owners' Association v. State of Bihar and Ors. [(2000) 8 SCC 655] but the question as to whether it will come within the purview of Clause 28 of Article 366 of the Constitution of India or not has not been considered in any of the judgments.

[7]CIVIL APPEAL NOS. 4056-4064 OF 1999

The Second Schedule appended to the 1957 Act states that the royalty would be payable at the rates specified on each tonne of coal. It is, therefore, a levy on the extraction or produce by weight. When the cess is levied on the royalty, the levy, which remains on extraction by weight, is enhanced or incremented. It is, thus, an incremental addition to the royalty. Its nature and character is the same as that of royalty. The value of the coal or for that matter of green tea has a direct nexus with the weight thereof. Thus, there may not be any significant distinction in principle between the levy in India Cement's case and levy in the present one.

The rate of royalty etc. under the 1957 Act is fixed by the statute and not by agreement between the parties. Rate of royalty may be revised subject to the limitation contained in Sub-section (3) of Section 9 of the 1957 Act in respect whereof the lessees have no say in the matter. Even the principles of natural justice are not required to be complied with. The lessee even cannot surrender the leasehold. The amount of 'Royalty' received by the State is expended as general revenue."

(emphasis supplied)

The definition of the term 'taxation' under article 366(28) is of wide meaning and includes the imposition of any tax or impost, whether general or local or special, and tax shall be construed accordingly. In view of this wide definition given for the term 'taxation', the Supreme Court in the case of Kesoram Industries Limited (supra) even though doubted the findings of India Cement Limited (supra) that royalty is a tax in common parlance but concluded that it is a compulsory impost and is in the nature of tax considering the meaning of the word 'taxation' under article 366(28) of our Constitution.

In the matter of Federation of Indian Mineral Industries & Otrs v. Union of India & Anr[8] :

The provisions of section 9B were originally brought into the statute by way of Ordinance dated 12th January 2015 which was replaced with the Mines and Mineral (Development and Regulation) Amendment Act, 2015. The said amendment act was notified on 27th March 2015 retrospectively from 12th January 2015. On 16th September 2015, Central Government issued a direction to all State Governments to issue notifications establishing DMFs with retrospective effect from 12th January 2015. Pursuant to this direction of Central Government, several State Governments have notified the establishment of DMFs with retrospective effect in order to collect DMF charges retrospectively as a percentage of the royalty paid. In this context, the retrospective validity of collection of DMF charges was questioned before the Honorable Supreme Court and in the above case, the Honorable Supreme Court considered the imposition of DMF charges as a tax and struck down the levy on the reasoning that essentials components of tax levy i.e. subject of tax, person liable to pay tax and rate at which tax is levied are not clearly defined as there is a real ambiguity in the levy as DMF was not constituted on the date on which levy was brought into effect and rate of DMF charges was vaguely provided as not exceeding 1/3rd of the royalty amount payable under the law. The relevant extracts of the judgment of the Honorable Supreme Court are reproduced as under:

[8](Indian Kanoon - http://indiankanoon.org/doc/73517911/)

32. In view of the decision of the Constitution Bench of this Court that the specification of the rate of tax (or any compulsory levy for that matter) is an essential component of the tax regime, it is difficult to agree with the learned Additional Solicitor General that specifying the 12th 14 edition revised by Justice A.K. Patnaik, former Judge, Supreme Court of India, page 876 maximum amount of compensation to be paid to the DMF in terms of Section 9B of the MMDR Act, ***being an amount not exceeding one- third of the royalty, satisfies the requirements of law. What is required by the law is certainty and not vagueness not exceeding one-third could mean one-fourth or one-fifth or some other fraction. It is this uncertainty that is objectionable.***

33. Therefore, our answer to the second question is that the petitioners are not liable to make any contribution to the DMF from 12thJanuary, 2015.

(emphasis supplied)

In view of the above extracts of the judgments of Supreme Court in the case of Kesoram Industries Limited (supra) and Federation of India Minerals Limited (supra), it is clear that though the Supreme Court doubted the view whether royalty by its nature is to be understood as tax in common parlance, a view has been consistently taken that it is in the nature of compulsory impost and come within the meaning of 'taxation' as defined under Article 366(28).Thus, even without waiting for the outcome of nine-member bench decision in the case of Mineral Area Development Authority (supra), it can be said that royalty is in the nature of tax in view of wide definition given for the term 'taxation' under our Constitution.

Royalty Being Tax – Whether amounts to 'service' or 'supply'?

Having concluded that royalty is in the nature of tax, we will now examine the tax implications under Service Tax Law[9] and GST laws.

Levy under Service Tax:

Levy of tax under Service Tax is on provision of service. The term 'service' has been defined under section 65B(44) to mean any activity undertaken for consideration. As royalty is in the nature of compulsory impost being unilaterally decided by Government (not as price fixed under a contract between parties), it is in the nature of tax and there by it will not come within the meaning of 'service' as defined to attract service tax.

Levy under GST Law:

Levy of GST under GST laws is on supply of goods or services. The term 'supply' is defined under section 7 of the CT Act[10] in an inclusive manner and it includes all activities undertaken for consideration unless expressly excluded under schedule III. As mentioned, royalty paid towards extraction of minerals is in the nature of tax and cannot be considered as consideration. In such circumstances, it cannot be said that Government has received consideration to grant rights over the mine for mineral extraction. In such circumstances, it cannot be said that State Government has supplied the service of granting rights for mineral extraction to come under the ambit of supply and thereby no GST can be levied on royalty and DMF charges paid towards mineral rights.

[9]Finance Act, 1994

[10]Central Goods and Services Tax Act, 2017

Granting of Mineral Rights – Whether a sovereign/statutory function would attract tax?

Even assuming that royalty paid is not in the nature of tax, levy of service tax on the royalty amounts paid towards extraction of minerals cannot be considered as activity for consideration to come under the ambit of service.

The Government is conferring mineral rights for payment of royalty by virtue of the statutory duty conferred by law made Parliament under Mines and Mineral (Development and Regulation) Act, 1957. Thus, granting of mineral rights for royalty is in the nature of sovereign and statutory functions. These sovereign and statutory functions are not the subject matter of service tax under the law that was in force prior to 01.07.2012. The amounts paid towards sovereign and statutory functions cannot be considered as consideration for a service in order to subject to service tax as per the erstwhile charging section under section 66 of the Service Tax Law. This position was also clarified by Central Board of Indirect Taxes and Customs (herein after referred as 'CBIC') vide their Circular No. 89/7/2006, dated 18-12-2006. The relevant extracts are reproduced as under:

1. *A number of sovereign/public authorities (i.e. an agency constituted/set up by government) perform certain functions/ duties, which are statutory in nature. These functions are performed in terms of specific responsibility assigned to them under the law in force. For examples, the Regional Reference Standards Laboratories (RRSL) undertake verification, approval and calibration of weighing and measuring instruments; the Regional Transport Officer (RTO) issues fitness certificate to the vehicles; the Directorate of Boilers inspects and issues certificate for boilers; or Explosive Department inspects and issues certificate for petroleum storage tank, LPG/CNG tank in terms of provisions of the relevant laws. Fee as prescribed is charged and the same is ultimately deposited into the Government Treasury. A doubt has arisen whether such activities provided by a sovereign/public authority required to be provided under a statute can be considered as 'provision of service' for the purpose of levy of service tax.*

2. *The issue has been examined.* ***The Board is of the view that the activities performed by the sovereign/public authorities under the provision of law are in the nature of statutory obligations which are to be fulfilled in accordance with law. The fee collected by them for performing such activities is in the nature of compulsory levy as per the provisions of the relevant statute, and it is deposited into the Government Treasury. Such activity is purely in public interest and it is undertaken as mandatory and statutory function. These are not in the nature of service to any particular individual for any consideration.*** *Therefore, such an activity performed by a sovereign/public authority under the provisions of law does not constitute provision of taxable service to a person and, therefore, no service tax is leviable on such activities.*

(emphasis supplied)

In view of the above extracts of the circular, CBIC has taken a view that the fee collected for performing sovereign and statutory functions cannot be considered as compulsory levy as per the provisions of relevant statute and deposited into Government Treasury. Such fee collected cannot be treated as consideration for a service.

Under the Negative list regime effective from 01.07.2012, the term 'service' has been defined under section 65B(44) to mean any activity undertaken for consideration. In case of non-existence of consideration, the activity involved cannot be considered as service to attract service tax. As amounts collected towards statutory and sovereign functions cannot be considered as consideration for an activity, then the functions undertaken by Government cannot be said to be of the nature of service as defined under Service Tax law to attract service tax. Thus, in the humble opinion of the paper writers, service tax cannot be levied on royalty paid towards mineral rights which is sovereign or statutory function. Further, this view is supported by catena of judgments. Several of them are reproduced hereunder for ready reference:

a. In the case of CCE vs. Maharashtra Industrial Development Corporation[11] , wherein MIDC was collecting charges from plot holders for providing various services. The Department issued a show cause notice to recover service tax on such charges under the category of 'Management, Maintenance and Repair Services' which was confirmed by adjudicating authority and later on by Commissioner (Appeals) during the first appeal. The respondent, in this case, preferred the second appeal before the Honorable CESTAT which has decided the matter in their favour and now the Bombay High Court considered the appeal of the Department on this issue. In this context, the Bombay High Court held as under:

12. We have already referred to Section 14 of the MID Act which provides that the function of the MIDC is not only to develop industrial areas but to establish and manage industrial estates. The role of MIDC is not limited only to establishing industrial estates and allotting the plots or buildings or factory sheds to industrial undertakings. ***The function and obligation of the MIDC is also to manage and maintain the said industrial estates as provided in Section 14. Therefore, it is the statutory obligation of the MIDC to provide amenities as defined in clause (a) of Section 2 of the MID Act to the industrial estates established by it. Thus, it is the statutory obligation of MIDC to provide and maintain amenities in its Industrial estates such as roads, water supply, street lighting, drainage, etc. Thus, we find that the activities for which the demand was made are part of the statutory functions of the MIDC under MID Act. As stated earlier, the demand is in respect of service charges collected from plot holders for providing them various facilities including maintenance, management and repairs. As provided in the circular dated 18th December, 2006, for providing amenities to the plot holders, the service fees or service charges collected by MIDC are obviously in the nature of compulsory levy which is used by MIDC in discharging statutory obligations under Section 14. We find that even in the Order-in-Original, there is no finding of fact recorded that the service rendered for which Service Tax was sought to be levied was not in the nature of statutory obligation.***

13. Therefore, we find no error in the view taken by the Appellate Tribunal. No substantial question of law arises.

(emphasis supplied)

[11] 2018 (9) GSTL 372 (Bom)

b. In the case of McLeod (Russel) India Limited vs. UOI [12], the petitioner was a public limited engaged in the business of tea owning tea plantations in the state of Assam. The tea estates corridor is disturbed and there is a constant threat of damage to the tea gardens, the establishments connected with them and their owners and staff from miscreants. Their acts of vandalism are often carried out with terrorist-like precision. The petitioner and other owners approached the State Government of Assam for security and the State Government created a force called Assam Tea Plantation Security Force (ATPSF) to provide security. The State Government charged some amount from the petitioner and other owners for this purpose. The Service Tax department demanded service tax on the charges collected by the Assam Government under reverse charge by considering the service as a support service. In this context, the Kolkata High Court vide para 19 has held as under:

> In the absence of any assertion in the affidavit-in-opposition, this Court cannot take into account any statement made from the bar. ***Therefore, the statement of the writ petitioner that the appointments to this force, its management, control, finance, discipline, etc., are regulated by the Government is un controverted. That the nature of its function is to protect the tea plantations and the personnel working therein against unlawful acts is also un controverted. Therefore, prima facie there is every indication that the service rendered by this force is sovereign and hence not a "support service".***
>
> **(emphasis supplied)**

c. In the case of Karad Nagar Parishad vs. CCE[13] , the CESTAT examined the applicability of service tax on slaughterhouse fees and amounts collected as advertisement tax by Municipal Corporation was examined. In this context, it was held vide para 4 as under:

> *As regards the slaughter house fees* ***we observed that as per the Schedule Twelfth of Article 243W, regulation of slaughter houses is the sovereign function of the Municipal Corporation. Therefore, the fees collected towards the regulation of slaughter houses, the demand of Service Tax is hereby set aside. The service tax demand was also confirmed on the amount collected by the appellant towards advertisement. It is the submission of the appellant that it is not the service charges collected towards providing advertisement service by the appellant to the various persons, but it is an advertisement tax which is a statutory levy and collected for display the advertisement by any person at any place whether the place owned by the Corporation or by any individual therefore the advertisement tax being a statutory levy cannot be chargeable to service tax.*** *It is observed from the receipt of the Municipal Corporation i.e. appellant that the amount towards so called advertisement was collected as 'Jahirat Kar (Advertisement Tax)'.* ***We are of the view that the advertisement tax being statutory tax levy by the Municipal Corporation should not be liable to service tax. Hence, we set aside the demand of service tax on this count.***
>
> **(emphasis supplied)**

[12] 2015 (39) STR 8 (Cal)
[13] 2019 (20) GSTL 288 (Tri-Mumbai)

Thus, in view of the above decisions and the legal position clarified by CBIC Circular, even without course to the view that royalty is in the nature of tax, it can be said that royalty paid towards mineral rights is in the nature of sovereign and statutory function and cannot be subject to service tax as an activity undertaken for consideration.

In the humble opinion of paper writers, as fee collected towards sovereign and statutory functions cannot be considered as consideration received for an activity, the sovereign and statutory functions cannot come within the meaning of Supply under GST laws as well. Therefore, the above legal position would also come handy to plead that no GST is payable on royalty paid towards mineral rights.

Contrary Judgments and Rulings:

The Rajasthan High Court in the case of Udaipur Chambers of Commerce and Industry vs UOI [14] has held that service tax is leviable on royalty paid over mineral rights. The relevant extracts under para 22 are reproduced as under:

"Taking into consideration all these principles relating to "consideration", we are of considered opinion that the royalty is nothing but a "consideration" to have mining operations in the leased area on execution of a mining lease. It is a part of agreement arrived between the parties to have lease of a mining area to undertaking mining operations. The royalty being "consideration" certainly places assignment of right to use natural resources deposited in the leased area as a "service" as defined under Section 65B(44) of the Act of 1994, according to which, any activity carried out by a person for another for consideration is a service. The finding arrived by us as above is sufficient to say that the notification dated 13-4-2016 is not at all in conflict with its enabling Act i.e. the Finance Act, 1994 and the same does not suffer from any illegality."

The above decision is under challenge before the Supreme Court and is not based on sound examination of all aspects surrounding the issue including the above discussed aspects viz. royalty itself is in the nature of tax and royalty paid is towards sovereign and statutory functions.

Similarly, the issue has been examined in several advance rulings[15] under GST law as well but none of them have examined the applicability of levy by considering the aspects that royalty is a tax and is conferring mineral right for royalty is a sovereign or statutory function.

[14] 2018 (8) GSTL 170 (Raj)

[15] In Re: NMDC LTD, 2020 (32) G.S.T.L. 357 (AAR - GST - Kar), In Re: Naren Rocks and Mines Pvt. Ltd, 2019 (31) GSTL. 122 (AAR – GST-Kar),

Conclusion:

In view of the above discussion and going by the evolved jurisprudence under Mines and Mineral (Development and Regulation) Act, 1957on the aspect that royalty is in the nature of tax and under Service Tax law on the aspect that sovereign and statutory functions are not liable to service tax, it can be said that royalty paid to Government towards mineral rights may not come under the ambit of service or supply to attract service tax to attract service tax or GST as the case may be. There is a high probability that this issue may get settled in favor of taxpayers. Having said this, one may not guarantee the eventual outcomes of litigation. Further, no one can rule out the possibility of Revenue coming out with retrospective amendments to overcome the courts decisions in favor taxpayers. Considering this, it is advisable to avoid this litigation under the GST regime in all cases where the tax paid under reverse charge on such royalty is entitled for input tax credit. With respect to past transactions where tax has not been paid, one can rely on the above aspects and challenge the levy.

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INCOME TAX

DOMESTIC TRANSFER PRICING – A BIRD'S EYE VIEW

Contributed by CA Sri Harsha & CA Narendra

The concept of transfer pricing was introduced in the IT Act through Finance Act 2001 in order to make sure that appropriate amount of income is subject to tax in India and to curb the practice of tax avoidance. The Honourable Finance Minister in his budget speech for the year 2001 has stated as under:

176. The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November 1999 to examine the issues relating to transfer pricing. Their report has been received, proposing a detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendation[1]

As mentioned above, a new set of regulations from Section 92 to Section 92F have been introduced in the IT Act with effective from April 01, 2002.Further, transfer pricing regulations have been made effective only with regard to international transactions entered into by the tax payer.

However, the Honourable Supreme Court, while deciding the matter in the case of **CIT v. Glaxo SmithKline Asia (Private) Limited**[2] **,** has recommended the Government to amend certain provisions of the Act viz. Section 40(2), Section 80 -IA (10) etc. to empower the assessing officer to extend transfer pricing regulations to such transactions between related parties in India.

By following the above recommendations, Central Government, through the Finance Act 2012, has amended transfer pricing regulations to bring-in certain transactions between the related parties within India under the purview of transfer pricing regulations. In this regard, Section 92 of IT Act has been suitably amended to provide that allowance for an expenditure, interest or cost or income in relation to specified domestic transactions (for brevity 'SDT') shall be computed having regard to arm's length principle.

For the purpose of transfer pricing regulations, the expression 'specified domestic transactions' has been defined under Section 92BA. Presently, after excluding the transactions covered under Section 40A(2) from the ambit of Section 92BA,domestic transfer pricing provisions are made applicable to transactions covered under section 80-IA (8), section 80-IA (10) and any other transaction under chapter -VI-A and section 10AA in respect of which provisions of section 80-IA (8) or section 80-IA (10) are applicable.

[1]Budget Speech for Finance Bill 2001.
[2][2010] 195 TAXMAN 35 (SC).

Further, Government, in order to promote manufacturing industry in India, vide Taxation Laws (Amendment) Act, 2019, has inserted Section 115BAB into the IT Act. Section 115BAB of the IT Act provides that the income of domestic manufacturing companies which are covered under section 115BAB may be computed at the option of the assessee at the rate of 15%. Further, section 115BAB provides that once the option is validly exercised by the assessee by filing Form 10-ID, same cannot be withdrawn in subsequent assessment years. Section 115BAB also provides similar provisions as stated in Section 80-IA to expand transfer pricing provisions to transactions covered under Section 115BAB.

With this introduction, let us proceed further to understand the applicability of domestic transfer pricing regulations and procedure for compliance thereunder.

Applicability of Domestic Transfer Pricing:

Section 92 of the IT Act provides that where in a SDT, two or more AEs enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the ALP of such benefit, service or facility, as the case may be.

Section 92 of the IT Act further provides that any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the ALP. However, it is further provided that transfer pricing regulations donot apply in a case where, by applying the transfer pricing regulations, there is a reduction of income of increase in loss to the assessee. Given the above, domestic transfer pricing is broadly applicable to specified domestic transactions in relation to:

- Allocation of expenditure, which is incurred for services or facility availed, between two/more AEs.
- Computation of income from such specified domestic transactions.
- Allowance of any interest or any other expense with regard to such specified domestic transactions.

Having said that the domestic transfer pricing is applicable to specified domestic transactions between AEs, let us proceed to understand the phrases, specified domestic transaction and associated enterprise would mean.

Meaning of Specified Domestic Transaction:

Section 92BA of the Act defines the expression 'specified domestic transaction' to mean following transactions not being an international transaction:

- any transaction referred to in section 80A
- any transfer of goods or services referred to in Section 80-IA(8)
- any business transacted between assessee and other person as referred to in Section 80-IA (10)
- any transaction, referred to in any other section in Chapter VI-A /Section 10AA, to which provisions 80-IA (8) or (10) are applicable
- any business transacted between the persons referred to in Section 115BAB(6)
- any other transaction as may be prescribed

and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of twenty crore rupees.

In other words, in order to considera transaction as specified domestic transaction, such transaction shall not be covered under the definition of'international transaction' as defined under Section 92B and the aggregate value of transactions as referred above shall exceed INR 20 Crore in the year.

Now, let us proceed to understand each transaction specified above in detail:

i. any transaction referred to in section 80A:

Section 80A of IT Act provides various conditions for claiming deduction under chapter VI-A of IT Act. Section 80A(6),which deals with transfer of goods between in connected persons, provides that in respect of section 10A, section 10AA, section 10B or section 10BA or any other provisions of Chapter VI-A under the heading C i.e., section 80H to 80RRB, where any good or services are held for the purpose of the undertaking or unit or enterprise or eligible business are transferred to any other business carried out by the assessee or vice-a-versa, the consideration shall be computed having regard to ALP.

ii. any transfer of goods or services referred to in Section 80-IA(8):

Section 80-IA provides exemption from profits earned from eligible business of the assessee being industrial undertaking. As assessee is claiming deductions from profits, section 80-IA (8) provides that where goods or services are held for the purpose of eligible business are transferred to any other business carried on by the assessee or vice-a-versa, the consideration for such goods or services shall be at Fair Market Value (for brevity 'FMV'). FMV under this section to mean price that such goods or services would ordinarily fetch in the open market or ALP where such transaction is considered as SDT.

iii. any business transacted between assessee and other person as referred to in Section 80-IA(10):

Section 80-IA (10) provides that where owing to close connection between the assessee carrying on eligible business and any other person, the course of business transaction between themis so arranged which produces more than ordinary profits to such assessee carrying eligible business, the assessing officer can take profits which may be reasonably deemed to have been derived therefrom for the purpose of providing deduction.

iv. any transaction, referred to in any other section under Chapter VI-A/section 10AA, to which provisions of Section 80-IA(8) or (10) are applicable:

In simpler words, it means that any other section under Chapter VI-A or section 10AA which provides similar condition as referred to in section 80-IA (8) or section 80-IA (10), such transaction shall also cover under SDT. Following sections under chapter VI-A, important sections among the others, provides that provisions of section 80-IA(8) and section 80-IA(10) are applicable while computing the deduction allowed under respective sections:

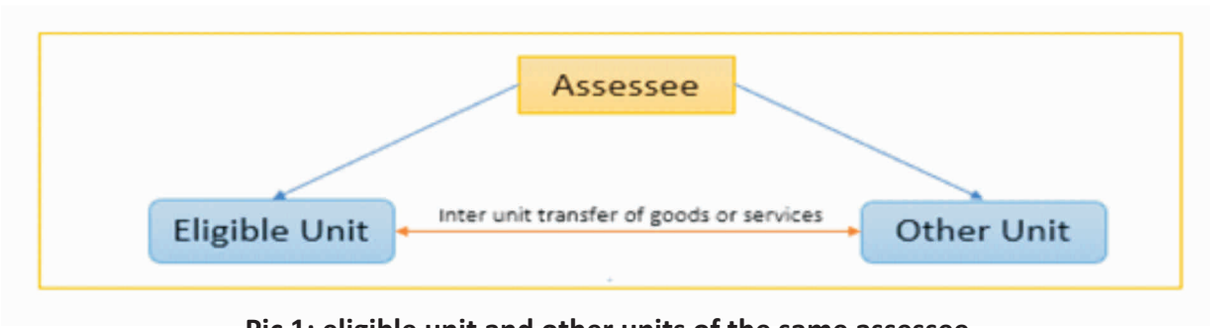
Section	Nature of business
Section 80-IA	Profits or gain from Industrial undertaking or Infrastructure development.
Section 80-IAB	Profits or gains from development of SEZ.
Section 80-IAC	**Profits or gains of eligible start-up.**
Section 80-IB	Profits or gains from certain industrial undertaking other than industrial undertakings.
Section 80-IBA	Profits or gains from development of certain housing projects.

v. any business transacted between the persons referred to in Section 115BAB(6):

Section 115BAB is inserted with lower tax rate of 15 percent for companies which are engaged in manufacturing of certain goods in India. As the tax rate applicable to manufactured companies covered under section 115BAB is 15%, there is involved a risk of shifting profits from other persons to companies covered under 1115BAB and thereby avoidance of tax to the revenue. In order to tackle this issue, section 115BAB read with section 92 and section 92BA provides that such transactions between related parties shall be computed having regard to arm's length principle.

Further, if such transaction is not entered at ALP, such excess income as determined having regard to arm's length principle shall deemed to be the income in the hands of the assessee covered under section 115BAB and such excess income shall be subject to tax in the hands of such assessee at the rate of 30%. Given the above consequences, it is very much required to comply with transfer pricing regulations by the company covered under section 115BAB in order to avoid any undesirable consequences.

From the above discussion, transactions under domestic transfer pricing can broadly be classified as transactions between



Pic 1: eligible unit and other units of the same assessee

Pic 2: assessee and other enterprise which has close connection

Meaning of Associated Enterprise:

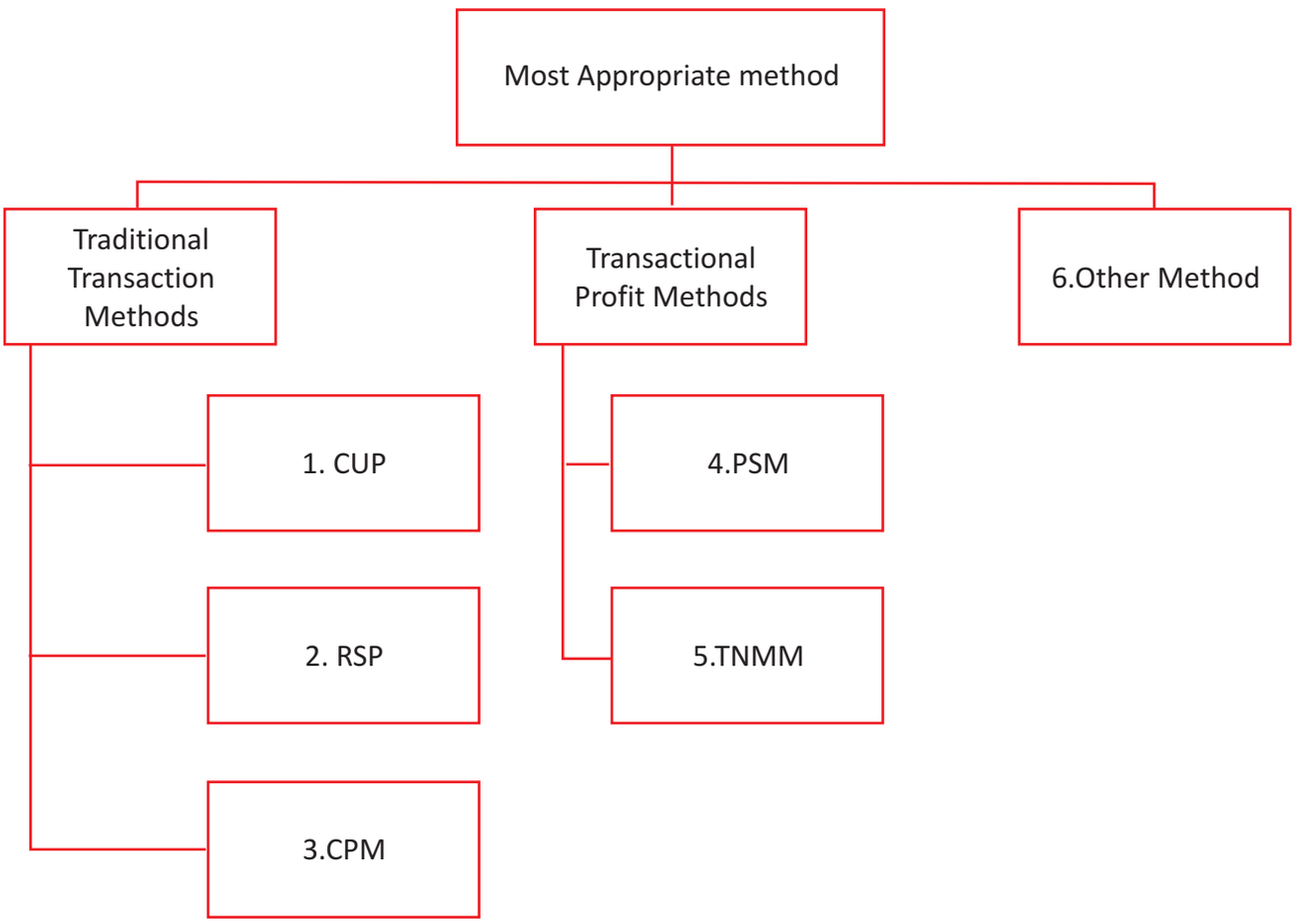
Section 92 states that any specified domestic transaction between AEs shall be computed having regard to the ALP. Hence, it is required to understand the word 'associated enterprise'.Section 92A defines the word 'AE'. However, the definition provided in section 92A is applicable only with respect to 'international transactions' entered into by the assessee. For the purpose of domestic transfer pricing, meaning of AE was provided in Rule 10A which states that in relation to a specified domestic transaction entered into by an assessee, AE means,

- other units/undertakings/businesses of such assessee in respect of a transaction referred to in section 80A or, as the case may be, section 80-IA(8)
- any other person referred to in section 80-IA(10) in respect of a transaction referred to therein
- other units, undertakings, enterprises or business of such assessee, or other person referred to in sub-section (10) of section 80-IA, as the case may be, in respect of a transaction referred to in section 10AA or the transactions referred to in Chapter VI-A to which the provisions of sub-section (8) or, as the case may be, the provisions of sub-section (10) of section 80-IA are applicable.

From the above, it is evident that Rule 10A simply refers to respective specified domestic transactions for the purpose of defining the word 'AE'. Hence, any person having close connection with the assessee is treated as 'AE' for the purpose of domestic transfer pricing. However, the word close connection is not defined under IT Act and any controlling interest with the other entities can be considered as close connection. Which means that having investment to the extent of 20% percent in other enterprises or vice-a – versa, such relation is to be considered as having close connection. Hence, even though a person is not covered under the definition of AE under section 92A, such person may be considered as AE under domestic transfer pricing.

Methods specified for computing the ALP:

Section 92C provides the following methods for computing the ALP which are applicable for both international transactions and SDT.



Maintenance of Documentation:

Section 92D read with Rule 10D states that every person who has entered into specified domestic transactions shall maintain documentation as specified under Rule 10D with respect to specified domestic transaction entered.

Reporting of SDT:

Similar to the international transactions, SDT is also required to be reported Form 3CEB. Part 'C' of Form 3CEB, which covers clause 21 to clause 25, is applicable for domestic transfer pricing.

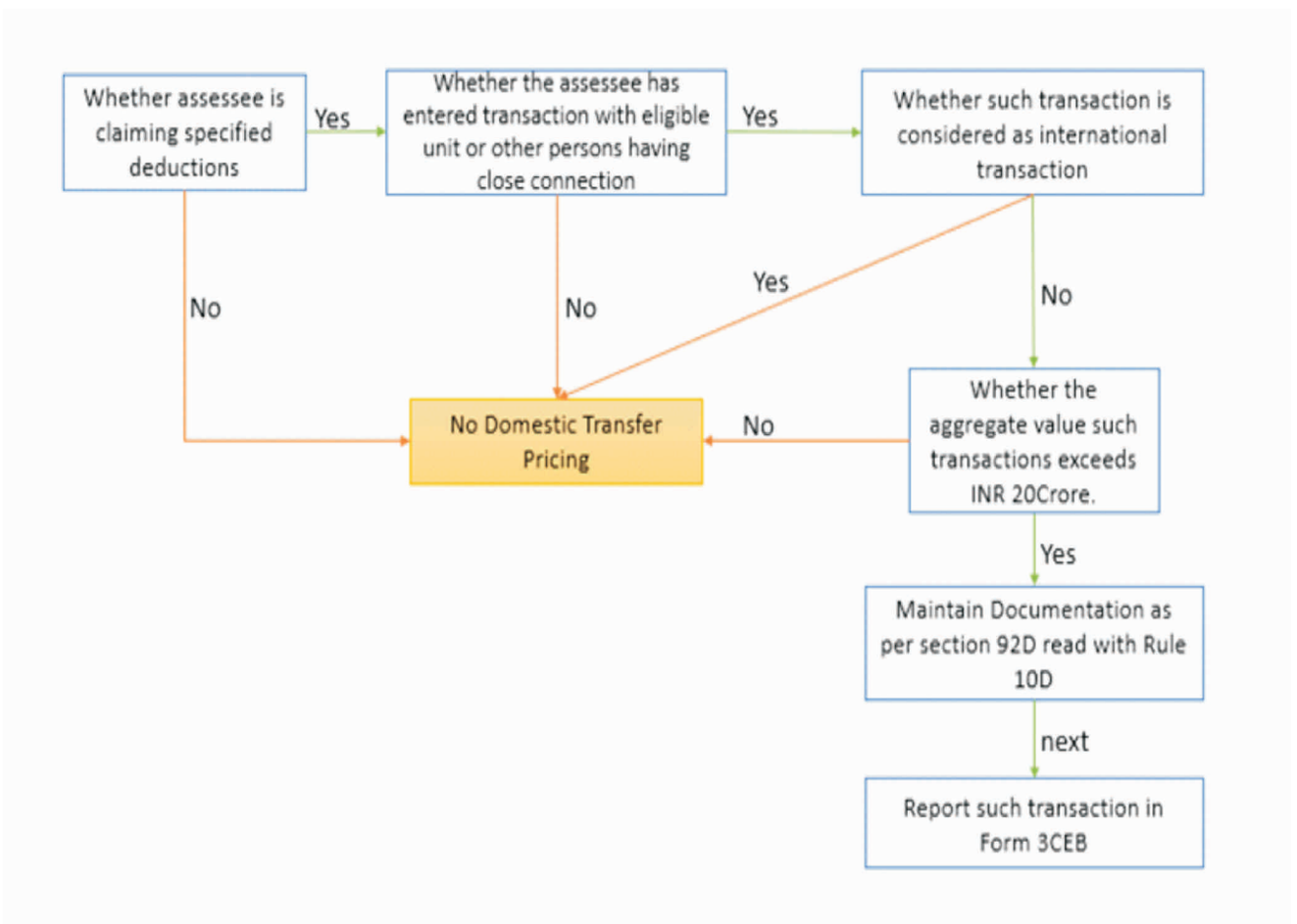
Clause	Description of the Clause	Remarks
21	List of AE with whom the assessee has entered into specified domestic transactions, with the following details:	Provide the details of AE enterprises with whom the assessee entered into SDT.
22	Particulars in respect of transactions in the nature of transfer or acquisition of any goods or services: Has the eligible unit under section 80-IA (8) or section 10AA has transferred any goods or services to other units of the assessee or vice-a-versa?	Provide the details of transfer of such goods or services viz. i. name and details of the business, ii. description of the goods or services, iii. amount paid or received as per books of account and corresponding ALP, and iv. method used for determining such ALP.
23	Particulars in respect of specified domestic transaction in the nature of any business transacted: Has the assessee entered into any business transaction with other entities which has resulted in more than ordinary profits to the assessee?	Unlike other clause in Form 3CEB, these clauses pose a question 'whether transaction with the other entities has resulted in more than ordinary profits?' If one chooses 'yes' to this question, it may imply that the assessee has earned more than ordinary profits and has to make adjustment. It may be practically viable to select 'No' to these clauses, if assessee has not earned more than ordinary profits. However, owing to stringent and onerous penalties, it is advisable to report such transaction in residuary clause 25.
24	Particulars in respect of specified domestic transaction in the nature of any business transacted between the persons referred to in sub-section (6) of section 115BAB: Has the assessee entered into any business transaction with other entities which has resulted in more than ordinary profits to the assessee?	
25	Particulars in respect of any other transactions: Has the assessee entered into any other specified domestic transaction(s) not specifically referred to above, with an AE?	Provide details of any other SDT which are not specifically referred in above clauses.

Penalties for non-compliance:

Section	Nature of Failure	Amount of Penalty
271AA	Failure to report any transaction in report. i.e., in Form 3CEB.	2 percent of the value of specified domestic transaction.
	Failure to maintain documentation as specified under section 92D.	
	Furnishes incorrect information or documentation.	
271AA	Failure to furnish report under section 92E. i.e., Form 3CEB	Rs.1,00,000.
271G	Failure to furnish documentation to AO.	2 percent of the value of specified domestic transaction.

Note: The above penalties are in addition to penalty leviable under section 270A for under reporting of income.

A flow chart of determining the domestic transfer pricing is provided below for ease of understanding:



In this part, we have dealt with a broad overview on the provisions of domestic transfer pricing. In the next part, we shall be dealing with certain case studies on domestic transfer pricing.

Glossary:

Term	Description
AE	Associated Enterprise
ALP	Arm's Length Price
CPM	Cost Plus Method
CUP Method	Comparable Uncontrolled Price Method
FMV	Fair Market Value
Government	Central Government of India
IT Act	Income Tax Act, 1961
PSM	Profit Split Method
RPM	Resale Price Method
SDT	Specific Domestic Transaction
TNMM	Transactional Net Margin Method

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