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Taxation of Services in India: An Overview

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ABSTRACT

Service sector is very wide in its range. It includes, inter alia, health care, education, social security, leasing, entertainment, credit rating agencies, telecommunications, transport, publicity and advertising, insurance, banking, legal and financial services.
From equity point of view, services should be taxed in the same way as goods. Taxation of goods and exclusion of services distorts the relative prices of goods vis-à-vis services, encouraging artificially the demand for services. In the process, the allocation of resources is also distorted. If tax is imposed on goods and not on services, a relatively high rate of tax would be required on goods to generate a given amount of revenue. If tax is imposed both on goods and services, a moderate tax rate can yield the given revenue. Administratively, taxation of both goods and services is desirable because it would reduce disputes pertaining to distinction between goods and services. Like goods, services can also be classified into two broad categories: essential services (e.g. health and education) and luxury services (e.g. entertainment and tourism). The rationale for exemption/lenient tax treatment of essential services is the same as for essential goods. Similarly, luxury services should be taxed at a high rate like luxury goods. This paper explains and examines the functioning of service tax in India

***Keywords**: Service tax, State taxes, Services, Tax revenue.*

1.0 Constitutional Provisions

A scrutiny of List II (State List) in the Seventh Schedule of the Constitution of India shows that State Governments are empowered to tax entertainment and professional services (Entries 16 and 18 of List II). The Central Government had no specific powers to tax services when it introduced service tax on select services in 1994. It was done under its residual powers of taxation vide entry 97 of List I (Union List) in the Seventh Schedule. The collection of service tax was entrusted to the excise department.

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However, the Constitution (Eighty-eighth Amendment) Act, 2003 put service tax in the Union List by inserting entry 92C in that List. Furthermore, service tax was put under Article 268A of the Constitution which specifies that the principles of collection and appropriation of taxes on services will be determined by Parliament. In other words, revenue from service tax is outside the purview of the Finance Commission.

2.0 Growth of Service Sector in India

The composition of national income has changed steadily over the planning era. While the share of agriculture and allied activities in the gross domestic product (GDP) has declined, that of the tertiary sector has increased. The expansion of services has not only been conducive for employment generation but also for better efficiency of the system and better quality of life. As a result of significant fall in the share of agriculture in GDP, the aggregate GDP has become relatively less sensitive to fluctuations in agricultural performance. Highlighting the changes in the sectoral composition of GDP over the years, the *Economic Survey*, 2011-12 observed, “The structure of the economy has also undergone significant changes over time. Between 1950-51 and 1980-81, the industrial sector registered a higher growth rate than the services sector. The converse has been the case since then. This resulted in the share of the industry sector in GDP increasing by around 9 percentage points from 16.6 percent to 25.9 percent during the period from 1950-51 to 1980-81. The share of the services sector increased from 30.3 percent in 1950-51 to 38 percent in 1980-81. It started growing rapidly thereafter and this phenomenon became more pronounced in the 1990s. Consequently, since 1980-81, the share of the industry sector has remained in the range of 26 to 28 percent of GDP, while the entire decline in share of agriculture has been balanced by an increase in share of the services sector. Thus, the resilience of the economy to shocks owes to the services sector which has the largest share and most consistent growth performance.” (*Economic Survey*, 20011-12, p. 8)

The Document further noted, “Notwithstanding the declining trend in agriculture’s share in GDP, the importance of the sector to the economy is best understood with reference to its share in employment and in terms of its criticality for macroeconomic stability. While the former was well known, the latter became manifest with rising growth in incomes since the mid-2000s. Hence, growth in agriculture and allied sectors remains an important objective and a ‘necessary condition’ for inclusive growth.” (*Economic Survey*, 20011-12, p. 9) The changes in relative shares of various sectors in GDP are shown in the Table 1.

The compositional shift in favour of the service sector, brought about by the rapid expansion of the service sector, is in line with the development experience of a number of countries. It is well-known that as an economy develops, the shares of industrial and service sectors in GDP increase at the cost of the agricultural sector.

Table 1: Changes in the Sectoral Composition of GDP

Year	Agriculture	Industry	Services
1950-51	53.1	16.6	30.3
1960-61	48.7	20.5	30.8
1970-71	42.3	24.0	33.8
1980-81	36.1	25.9	38.0
1990-91	29.6	27.7	42.7
2000-01	22.3	27.3	50.4
2010-11*	14.5	27.8	57.7
2011-12**	13.9	27.0	59.0

* Quick estimates.

** Advance estimates.

Source: Government of India, *Economic Survey*, 2011-12, p. 8.

The need to tax service sector is well recognised by the Government. To quote, "The tax revenue from the agricultural sector being negligible, the industrial sector continues to constitute the only principal tax base though it has suffered a reduction in the share of GDP over the period. Despite the fact that the services sector has shown substantial buoyancy, its contribution to the exchequer is not significant in relation to its sizeable share in GDP. Thus, in order to impart buoyancy to the revenue receipts and to provide consistency and equity in the tax structure via-a-via the composition of income, it is imperative to bring a major part of the services sector under the tax net." (Reserve Bank of India, 1998-99, p. V-6)

Although the contribution of service sector to GDP has increased over the years, the tax system has remained confined mainly to commodity production. In this connection, the Finance Minister observed in his 1994-95 budget speech, “There is no sound reason for exempting services from taxation when goods are taxed and many countries treat goods and services alike for tax purpose.” (*Budget Speech of the Finance Minister, 1994-95, Part B,* p. 24. The Tax Reforms Committee (TRC) [Chairman: Raja Chelliah], 1991 also recommended imposition of tax on certain select services, viz. advertising, non-life insurance and telephone services and services of stock brokers.

3.0 Present Structure of Service Tax

In view of the need for additional resources, rising contribution of service sector to GDP and the recommendations of TRC, a modest effort was made in the 1994-95 budget when a 5 percent tax was imposed on telephone and non-life insurance services and services of stock brokers with effect from July 1, 1994. The coverage of service tax was extended to advertising, courier and radio paging services from November 1, 1996. In his 1997-98 budget speech, the Finance Minister maintained that services are products as much as manufactured goods and hence both must bear taxes. With these considerations in view he extended the service tax to the services provided by the following: transporters of goods by road, consulting engineers, custom house, steamer and clearing and forwarding agents, air travel agents, tour operators and car rental agencies, outdoor caterers, *pandal* contractors and *mandap* keepers, and manpower recruitment agencies.

In the 1998-99 budget, service tax on the transportation of goods by road, outdoor caterers, and *pandal* contractors was abolished. However, its net was extended to services provided by architects, interior decorators, management consultants, chartered accountants, cost accountants, company secretaries, private security services, real estate agents and real estate consultants, market research agencies, credit rating agencies, underwriting agencies, and slaughter houses using mechanised means for large animals.

Acknowledging the potential of service tax, the Finance Minister in his 2000-2001 budget speech announced the setting up of an Expert Group to go into all its aspects and make suitable recommendations. The net of service tax was greatly expanded when the following 15 services were added to the list of taxable services in the 2001-02 budget.

1. Specified banking and financial services.
2. Authorised service stations for servicing of vehicles including two wheelers.
3. Port services.
4. Broadcasting services.
5. Photographic services.
6. Convention services.
7. Sound recording services.
8. Scientific and technical consulting services.
9. Telex services.
10. Telegraph services.
11. Facsimile services.

12. Online information and data base retrieval services.
13. Video tape production services.
14. Services auxiliary to insurance.
15. Services provided to lease circuit line holders.

In his 2004-05 budget speech, the Finance Minister announced the inclusion of some more services under the service tax ambit. These were the following.

1. Business exhibition services.
2. Airport services.
3. Services provided by transport booking agents.
4. Transport of goods by air.
5. Survey and exploration services.
6. Opinion poll services.
7. Intellectual property services other than copyright.
8. Brokers of forward contracts.
9. *Pandal* and *shamiana* contractors.
10. Outdoor caterers.
11. Independent TV/radio programme producers.
12. Construction services in respect of commercial or industrial constructions.
13. Life insurance services to the extent of the risk premium.

In the 2005-06 Budget, the following 9 items were added to the list of taxable services.

1. Transport of goods through pipeline or other conduit.
2. Site preparation and clearance, excavation, earth moving and demolition services, other than those provided to agriculture, irrigation and watershed development.
3. Dredging services of rivers, ports, harbours, backwaters and estuaries.
4. Survey and map making other than by Government Departments.
5. Cleaning services other than in relation to agriculture, horticulture, animal husbandry or dairying.
6. Membership of clubs or associations.
7. Packaging services.
8. Mailing list compilation and mailing.
9. Construction of residential complexes having more than twelve residential units of apartments together with common areas and other appurtenances.

The 2005-06 Budget also expanded the scope of certain existing services in the following manner.

1. Commercial or industrial construction service to include renovation of such building or civil structure, post construction completion and finishing services for such

building or civil structure, construction, repair, alteration, renovation or restoration of pipeline or conduits.

2. Erection, commissioning or installation services to include specified installation services.
3. Maintenance or repair services to include maintenance or management of immovable properties, maintenance or repair including reconditioning or restoration undertaken as part of any contract or agreement.
4. Broadcasting services to include charges recovered by broadcasting agencies from multi-system operator and provision of direct to home signals to the customers.
5. Sound recording to include recording of sound on any media and includes post-production services such as sound mixing or re-mixing.
6. Video-tape production to include recording of any programme, event or function on any media and includes post production services.
7. Taxable services provided by authorised service station to include reconditioning or restoration of motor-cars, two wheeled and light motor vehicles.
8. Beauty parlour services to include all services provided by beauty parlours.
9. manpower recruitment service to include supply of manpower, temporary or otherwise.
10. franchisee service to cover all agreements by which, the franchisor grants representational rights to franchise to sell or manufacture goods or provide services identified with the franchisor.
11. business auxiliary service to include production or processing of goods for or on behalf of the client.
12. outdoor catering service to include catering from a place or premises provided, by way of tenancy or otherwise by the person receiving such services.

The Budget for 2006-07 added the following new services under the service tax net.

1. Service provided by a Registrar to an issue.
2. Service provided by Share Transfer Agent.
3. Automated Teller Machine operations, maintenance or management.
4. Service provided by recovery agent.
5. Sale of space or time for advertisement, other than in print media.
6. Sponsorship services provided to anybody, corporate or firm, other than sponsorship of sports events.
7. Transport of passengers, other than economy class passengers, embarking on international journey by air.
8. Transport of goods in containers by rail by any person, other than Government railway.

9. Business support services.
10. Auctioneers' service, other than auction of property under directions or orders of a court of law or auction by the Central Government.
11. Public relation service.
12. Ship management service.
13. Internet telephony service.
14. Transport of persons by cruise ship.
15. Credit card, debit card, charge card or other payment card related services.

In the 2007-08 Budget, service tax net was extended to the following services.

1. Services outsourced for mining of mineral, oil or gas;
2. Renting of immovable property for use in commerce or business; however, residential properties, vacant land used for agriculture and similar purposes, land for sports, entertainment and parking purposes, and immovable property for educational or religious purposes will be excluded;
3. Development and supply of content for use in telecom and advertising purposes;
4. Asset management services provided by individuals; and
5. Design services.

The Budget for 2011-12 retained the service tax rate at 10 percent (increased to 12 percent in Budget 2012-13) and focused on achieving a closer fit between the present service tax regime and the proposed GST. This was sought to be done by (a) adding a few new services on the ability to pay principle, (b) expanding or rationalizing the scope of existing services, (c) rationalizing certain provisions relating to important services and valuation, (d) modifying provisions of the Cenvat credit scheme seeking to effect the right balance between input credits and output tax, and harmonizing the provisions of the scheme across goods and services, incentivizing honesty and penalising dishonesty in compliance, and adoption of point of taxation rules to facilitate accrual basis of the collection.

Detailed below are the major initiatives of Budget 2011-12 in respect of service tax:

Service tax was imposed on the following services:

1. Services provided by air-conditioned restaurants having a licence to serve alcoholic beverages in relation to serving of food and/or beverages.
2. Short-term accommodation provided by a hotel, inn, guesthouse, club or campsite, or any other similar establishment for a continuous period of less than three months.

Scope of certain existing services was expanded or altered as under:

1. Scope of ‘life insurance service’ widened to cover all services provided to a policy holder or any person, by an insurer, including re-insurer carrying on life insurance business. Tax to be charged on the portion of the premium other than what is allocated

for investment, when the break-up of premium is shown separately in any document given to the policy holder. The rate of composition increased from 1 percent to 1.5 percent.

2. Scope of 'club or association service' expanded to include service provided to non-members within its ambit.
3. Scope of the service of 'authorized service station' expanded to: (a) include services provided by any person; (b) cover all motor vehicles other than those meant for goods carriage and three-wheeler scooter auto-rickshaws; and (c) cover decoration and other similar services in respect of vehicles along with the services already covered.
4. Definition of 'business support services' amended so as to include services provided by way of operational or administrative assistance in any manner.
5. Scope of legal consultancy services expanded by bringing within their ambit (a) service provided by a business entity to individuals in relation to advice, consultancy, or assistance in any branch of law, in any manner; (b) representational service provided by any person to any business entity (representational services provided to individuals to continue to be exempt); and (c) 'arbitration' service provided by an arbitral tribunal to any business entity.
6. In commercial training or coaching services, the definition of 'commercial training or coaching centre' amended so as to bring all unrecognized courses within the tax net, irrespective of the fact that such courses are conducted by an institute which also conducts courses that may lead to grant of a degree or diploma.

Certain exemptions were extended as follows:

1. Exemption provided to services rendered in relation to business exhibitions held abroad.
2. An abatement of 25 percent from the taxable value provided for the purpose of levy of service tax under 'transport of goods through coastal and inland shipping'.
3. Exemption provided to 'works contract' service rendered for construction or finishing of new residential complexes under the Jawaharlal Nehru National Urban Renewal Mission and Rajiv Awaas Yojana.
4. Exemption provided to services rendered within a port or other port or an airport under 'works contract' service for specified areas.
5. Exemption provided to the Rashtriya Swasthya Bima Yojana under general insurance service.
6. Value of air freight included in the assessable value of goods for charging customs duties excluded from taxable value for the purpose of levy of service tax under 'transport of goods by air' service.
7. Services related to transportation of goods by road, rail, or air when origin and destination are located outside India exempted from service tax.

8. A modified scheme introduced to refund service tax to SEZ units and developers.
9. Some existing exemptions on domestic and international travel and club or association services were withdrawn.

For the financial year 2013-14, the standard rate of service tax is 12 percent.

Keeping in view the social objectives of state policy, the Government of India has refrained from taxing services in the field of health and education. (In the case of excise and sales tax also, commodities such as medicines and books are either exempt or taxed at very low rates). Table 2 records the growth in revenue from service tax in India.

Table 2: Trends in the Relative Significance of Service Tax in Gross Tax Revenues* of the Central Government: 1994-95 to 2011-12

(Rs. crore)

Year	Gross Central taxes	Revenue from service tax	Col. 3 as % of Col. 2
1	2	3	4
1994-95	92,297	407	0.4
1995-96	1,11,224	862	0.8
1996-97	1,29,762	1,059	0.8
1997-98	1,39,220	1,586	1.1
1998-99	1,43,797	1,957	1.4
1999-00	1,71,752	2,128	1.2
2000-01	1,88,603	2,613	1.4
2001-02	1,87,060	3,302	1.8
2002-03	2,15,905	4,122	1.9
2003-04	2,54,348	7,891	3.1
2004-05	3,04,957	14,200	4.7
2005-06	3,66,151	23,055	6.3
2006-07	4,73,513	37,598	7.9
2007-08	5,93,147	51,301	8.6
2008-09	6,05,298	60,941	10.1
2009-10	6,24,527	58,422	9.4
2010-11	7,93,072	71,016	9.0
2011-12	8,89,176	97,509	11.0

* Before transferring States' share in Central taxes.

Sources: Government of India, Ministry of Finance, *Explanatory Memorandum on the Budget of the Central Government* (various years); *Receipts Budget* (various years).

To sum up, the Indian tax system has traditionally relied on commodity taxation for generating revenue for the Central and State Governments. The two major commodity taxes of the Central Government are excise duties and customs duties while at the level of the States, sales tax/value added tax (VAT) is the main commodity tax of States' own tax revenues. The extension of excise duties to more and more commodities of the industrial/manufacturing sector has now reached a saturation point. However, the service sector remained outside the tax net till 1994. This pattern of tax structure development in India was contrary to the experience of most other countries where taxation of commodities and services grew hand in hand.

The introduction of service tax in 1994-95 ushered in a major structural change in indirect taxes in the form of a wider tax base and facilitated the process of rationalization of excise duties, resulting in lower tax burden on productive sectors. Over the years, there has been an increase in the number of services and the rate of service tax leviable. The expanding base of service tax has provided a promising source of revenue, but there are some caveats which have to be kept in mind. First, the scope for expanding the service tax net to more and more services gets narrower as the net is widened. The contribution of the expanding net will, therefore, reduce over time. Second, the preponderance of small service providers below the taxable limit of turnover constrains the scope of revenue mobilization beyond a certain level.

Presently, service tax is levied on as diverse services as credit rating on the one hand and mechanised slaughter houses on the other. It is clear that service sector in India constitutes a tax base with vast potential which has not been exploited as yet. To quote in conclusion, **"**Central Service tax reform and extension must be designed to integrate it with the CENVAT by the end of the 10th Plan, keeping in mind the ultimate objective of a National VAT. All services, particularly modern production services such as transport, communication and financial services, under the tax authority of the centre should be subject to the same basic CENVAT rate. Similarly the tax paid on any services used as input into the production of excisable services or goods should be given set-off. Any comprehensive Service Tax law must keep these objectives in view." (Srivastava, 2005)

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