The classification of the transfer of intellectual property rights under a franchise agreement for purposes of consumption tax (VAT): India and South Africa compared

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Abstract

Modern consumption tax systems, generally, differentiate between the supply of goods and services. As the intrinsic nature of goods and services differ, different tax rules apply to tax the sale, transfer, supply, or consumption of goods and services. Changes in science and technology, and new and innovative business trends, often lead to transactions that escape the tax collector. For consumption tax purposes, a further distinction between the various types of goods and services is necessary in order to avoid the erosion of the tax base. Also, special tax rules apply to the different classifications of goods and services. This is particularly so in jurisdictions with variable tax rates. It is, therefore, key to classify the transaction or product appropriately to apply the appropriate tax rules and rates. This article compares the classification of the transfer of intellectual property rights for purposes of service tax and sales tax in India and the classification of the transfer of intellectual property rights for purposes of value-added tax (VAT) in South Africa. In addition we briefly canvass the general classification of intellectual property rights.

INTRODUCTION

South Africa and India have shared a longstanding and friendly economic relationship since the establishment of diplomatic relations in 1993.[1] Since

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[1] Editorial 'South Africa and BRICS' 30/4 (2012) *Management Today* at 22.

its accession to BRICS,[2] South Africa's investment in India has grown steadily[3] and India is one of the top ten countries investing in South Africa.[4] This cross-border investment highlights the potential of the two countries to become serious players on the global stage.[5] Accordingly, there is a growing interest in comparative research between India and South Africa.

Cross-border investment between South Africa and India involves, *inter alia*, the transfer of intellectual property rights, or the transfer of the right to use intellectual property rights. Generally, this is achieved through purchase and sale, franchising, or licensing agreement.

Modern consumption tax[6] systems, generally, differentiate between the supply of goods and services. As the intrinsic nature of goods and services differ, different tax rules apply to tax the sale, transfer, supply, or consumption of goods and services. Changes in science and technology, and new and innovative business trends, often lead to transactions that escape the tax collector. For consumption tax purposes, a further distinction between the various types of goods and services is necessary if the erosion of the tax base is to be avoided. Also, special tax rules apply to the different classifications of goods and services. This is particularly so in jurisdictions with variable tax rates. It is therefore key to classify the transaction or product appropriately so that the appropriate tax rules and rates can be applied.

In this article we first discuss the classification of the transfer of intellectual property rights for purposes of service tax and sales tax in India. Secondly, we explore the classification of the transfer of intellectual property rights for purposes of value-added tax (VAT) in South Africa. Thirdly, we briefly

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2 BRICS is a consortium of economic powers consisting of Brazil, Russia, India, China, and South Africa. The acronym has come into widespread use as a symbol of the shift in global economic power away from developed nations to developing nations. South Africa formally joined BRICS on 24 December 2010. See http://www.bricsforum.org/sample-page/ (last accessed 20 March 2015).

3 Editorial 'South Africa and BRICS' 30/4 (2012) *Management Today* at 22.

4 *Ibid*.

5 Patel & Uys *Contemporary India and South Africa: legacies, identities, dilemmas* (2012) 17.

6 Consumption taxes are taxes on goods and services that are acquired by individuals for their private use and consumption. See Schenk & Oldman *Value Added Tax: a comparative approach* (2007) at 1; Ebrill *et al The modern VAT* (2001) 15–16.

canvass the general classification of intellectual property rights before offering our conclusions.

CONSUMPTION TAXES IN INDIA: A BRIEF OVERVIEW

To the outsider, tax legislation in India appears to be complex, disorderly, and convoluted. The Constitution of India grants authority to the government of India, by its own decrees, to levy and collect taxes, custom duties, or any other state levies.[7] The federal tax structure has three tiers – the Union government, the state governments, and the urban or rural local bodies.[8]

The indirect tax system is complicated. Indirect taxes are levied separately on goods, services, and intra-state sales.[9] We limit the present discussion of the indirect taxes levied in India to the following categories of consumption taxes: central sales tax (CST), service tax, and VAT.

CST is levied by registered dealers on the inter-state sales of goods.[10] Such a sale is deemed to occur where the sale or purchase occasions the movement of goods from one state to another, or, the sale is affected by a transfer of the documents of title to the goods during the movement from one state to another.[11] CST is levied by the central government of India. However, the tax so levied is collected by the state in which the registered dealer is established.

Service tax was introduced in 1994. It extends to the whole of the Indian Union except for the states of Jammu and Kashmir.[12] Service tax is levied on the supply of services by a person who is required to levy service tax on the supply of such service.[13] Service tax is levied, collected, and appropriated by the Union government.[14]

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7 Part XII of the Constitution of India.

8 Bernardi & Frachini 'Tax system and tax reforms in India' (2005) *Dipartiménto di Politiche Pubbliche e Scelté Collettive – POLIS* working paper nr 51 at 2.

9 *Ibid.*

10 Section 6 of the Central Sales Tax Act, 1956; Beri *Future aspects of service tax* (2012) at 61.

11 Section 3(a) and (b) of the Central Sales Tax Act, 1956; Beri n 10 above at 61; Bernardi & Frachini n 8 above at 21.

12 Section 64(1) Chapter V of the Finance Act, 1994.

13 Section 66, Chapter V of the Finance Act, 1994.

14 Section 73A, Chapter V of the Finance Act, 1994.

VAT was introduced in 2005[15] as a tax imposed at state level on the supply of goods. Services are specifically excluded from the ambit of VAT. Since its inception, thirty-three of the thirty-five states and Union territories have adopted a general VAT system. At the time of writing, the Andaman and Nicobar Islands, and Lakshadweep are yet to adopt a general VAT system. The VAT system is administered by the Commercial Taxes department of each state or Union territory.

While CST and VAT are levied on the supply of goods at Union and state levels respectively, in contrast the only tax on services is imposed at state level.

CLASSIFICATION OF INTELLECTUAL PROPERTY GOODS FOR PURPOSES OF CONSUMPTION TAXES IN INDIA

A single transaction can be subject to both direct and indirect taxes. For example, the sale of a can of soft drink can attract both an income tax and a consumption tax. The profit made by the supplier of the soft drink is subject to income tax, whilst the consumption of the soft drink by the consumer is subject to consumption tax. However, although the same transaction is effectively taxed twice, the tax burden is on different taxpayers. In the case of income tax, the profits are taxed in the hands of the supplier. In the case of consumption tax, the consumer shoulders the tax burden. While taxing the same transaction both on income and consumption is generally perceived as 'double taxation,'[16] in our example, the 'double taxation' is appropriate. In a federal system, central government and state government tax laws often overlap to grant both federal and state revenue authorities the right to tax the same transaction, income, or asset. Similarly,

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[15] Sources differ as to the exact date on which the Union Government introduced VAT. At a meeting of the Empowered Committee of State Finance Ministers held on 18 June 2004, broad consensus was arrived at to introduce VAT in all states and Union territories. Haryana was the first state to introduce VAT on 1 April 2003. See Business Knowledge Research Online *Taxation: Value Added Tax (VAT)* available at http://business.gov.in/taxation/vat.php (last accessed 23 March 2015); Tallysolutions *Value Added Tax in India* available at: http://www.tallysolutions.com/website/CHM/TallyERP9/Value_Added_Tax/VAT_in_India.htm (last accessed 4 July 2014); KPMG *VAT essentials: India* (2012) available at http://www.kpmg.com/global/en/issuesandinsights/articlespublications/vat-gst-essentials/pages/india-vat-essentials.aspx (last accessed 23 March 2015).

[16] The term 'double taxation' in this context refers to levying different types of taxation in a single jurisdiction on the same income, asset, or financial transaction. Generally, 'double taxation' is the levying of tax by two or more jurisdictions on the same declared income, asset, or financial transaction.

a single transaction can be structured so as to avoid taxes altogether. As a result, in order to prevent the non-payment of tax, some overlap of federal and state tax laws is unavoidable.

In *Imagic Creative Pvt Ltd v Commissioner of Commercial Taxes,*[17] the Supreme Court ruled that the payment of Union service tax and state VAT are mutually exclusive.[18] With a composite, indivisible transaction, there are distinct components, each attracting different taxes.[19] In the present case, the taxpayer supplied advertising services that consisted of both advertising ideas and the tangible brochures or publications. The court found that the main supply was the supply of advertising, and that the court could not, with certainty, divide the supply into identifiable and quantifiable sub-supplies of goods or services.[20] It was accordingly difficult (rather, impossible) to hold that sales tax (state VAT) should be paid on the entire contract, irrespective of the element of service supplied.[21] The court ruled that, for state VAT to be levied, the transfer of goods to the user had to take place.[22] In *Bharat Sanchar Nigam Ltd v Union of India*,[23] the question was whether electromagnetic waves by which data generated by the subscriber were transmitted to the desired destination were 'goods' for purposes of levying state sales tax. The Supreme Court ruled:

> Providing access or telephone connection does not put the subscriber in possession of the electromagnetic waves any more than a toll collector puts a road or bridge into the possession of the toll payer by lifting a toll gate. Of course the toll payer will use the road or bridge in one sense. But the distinction with a sale of goods is that the user would be [in possession] of the thing or goods delivered. The delivery may not be simultaneous with the transfer of the right to use. But the goods must be in existence and deliverable when the right is sought to be transferred.[24]

In the present case, the court found that the supply of a subscriber's identification module (SIM) was a mere tool that enabled the subscriber to

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17 *Imagic Creative Pvt Ltd v Commissioner of Commercial Taxes* 2008-TIOL-04-SC-VAT.
18 *Id* at 28.
19 *Ibid*.
20 *Id* at 10.
21 *Id* at 28.
22 *Id* at 34–35.
23 *Bharat Sanchar Nigam Ltd & Another v Union of India & Others* (2006) 282 ITR 273 (SC) (BCAJ)
24 *Id* at 22.

use the telecommunication services, and that its supply was incidental to the supply of telecommunication services.[25]

In *State of Madras v Gannon Dunkerley,*[26] the Supreme Court held that composite contracts, which did not indicate the intention of the parties to sell goods and render a service separately, could not be separated for tax purposes.[27] Practical evidence that showed that the supply was predominantly of either goods or services was required to tax the transaction appropriately.

In *Imagic Creative*, the predominant supply was advertising brochures. The nature of the ancillary supply (ideas) did not render it commercially deliverable as required if it is to attract distinct tax rules.

In *Bharat Sanchar Nigam,* it was found that a SIM, without the supply of telecommunication services, is useless in the hands of the recipient. As a result, the supply of a SIM as part of the predominant supply of telecommunication services cannot attract separate tax rules.

However, the test established in *Gannon Dunkerley* and *Bharat Sanchar* cannot be applied to all types of supply. Daniel points out that the very nature of a few exceptional transactions renders the application of the applicable tax a difficult challenge.[28] This is especially so where the right to use a trade mark is transferred. As discussed below, transactions in which the 'right to use' a patent, trade mark, or copyright is transferred are *prima facie* susceptible to both state VAT and Union service tax.

Intellectual property as 'services' for purposes of Union Service Tax

For purposes of Service Tax, 'services' is defined as–

> any activity carried out by a person for another for consideration, and includes a declared service, but shall not include –

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25 *Id* at 23–24.

26 *State of Madras v. Gannon Dunkerley* (1958) 9 STC 353.

27 *Id* as paraphrased by Venkatesh *Service tax in India* available at: http://www.hg.org/article.asp?id=4850 (last accessed 10 July 2014). See also Kumar 'Gannon Dunkerley and the test of dominant intention' (2012) 23/2 *National Law School of India Review* at 143–145; Padmanabhan and Padmanabhan 'Sale for you, service for him, both for the taxman' (2012) 23/2 *National Law School of India Review* at 79.

28 Daniel *Transfer of right to use trademark-VAT or service tax* (2013) available at www.taxonline.com (last accessed 2 July 2014).

(a) an activity which constitutes merely –
    (i) a transfer of title in goods or immovable property, by way of sale, gift or in any other manner; or
    (ii) a transaction in money or actionable claim;
(b) a provision of service by an employee to the employer in the course of or in relation to his employment;
(c) fees taken in any Court or tribunal established under any law for the time being in force.

The concept 'activity' is not defined in the Finance Act. In its ordinary meaning, an activity includes 'an action taken in pursuit of an objective, work done, a deed done, an operation carried out, and the provision of a facility'.[29] The Central Board of Customs and Excise notes that an 'activity' can be active or passive, and that it can include the forbearance to act.[30] Agreeing to the obligation to refrain from acting, or to tolerate an act, has specifically been included in the definition of 'declared services.'[31] The concept 'activity' is, therefore, given its widest possible meaning.

The term 'consideration' is, for purposes of section 67, defined as any amount that is payable for the taxable services provided or to be provided.[32] The Central Board of Customs and Excise points out that 'payable' does not restrict the counter performance to money.[33] Put differently, where the 'activity' or 'declared service' is rendered without a concomitant obligation to render a counter performance, the 'activity' or 'declared service' does not comply with the definition of 'service', and no service tax is payable on the transaction.

The types of 'declared services' are listed in section 66E of the Finance Act. For present purposes, we refer to the following services only:

(c) temporary transfer or permitting the use or enjoyment of any intellectual property right;
(d) development, design, programming, customisation, adaptation, upgradation, enhancement, implementation of information technology software;

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29 Soanes & Stevenson *Concise Oxford English Dictionary* (11ed 2008).
30 Central Board of Customs and Excise *Taxation of services: an education guide* (2012) 5.
31 Section 66E(e) of Part V of the Finance Act, 1994.
32 Explanation (a) to section 67 of the Finance Act, 1994.
33 Central Board of Customs and Excise n 30 above at 5–7.

An intellectual property right is defined as 'any right to intangible property, namely, trade marks, designs, patents or any other similar intangible property, under any law for the time being in force, but does not include copyright'.[34] As some form of tangible embodiment is required for intellectual creations to enjoy copyright protection, copyright is deemed to be 'goods'. Goods are specifically excluded from the ambit of service tax. Note also that 'intellectual property service' is defined to connote '(a) transferring, [temporarily;] or (b) permitting the use or enjoyment of any intellectual property right.'[35] Before the amendment of section 65(55b)(a) in 2005, 'intellectual property services', for purposes of service tax, included the permanent transfer of the use and enjoyment of any intellectual property right.[36] The amendment is significant: now, only the temporary transfer of a trade mark, design, patent, or similar intangible property attracts service tax.[37] Put differently, transactions that enable the transfer of intellectual property rights must be limited to the transfer of the 'right to use' for such transfer to attract service tax. Where the proprietary rights are transferred, service tax cannot be levied.

It is well known that the temporary transfer of a trade mark, or the right to use a trade mark, is often executed in terms of a franchise agreement. A taxable service, for purposes of service tax, includes, in relation to a franchise agreement, any service provided or to be provided to a franchisee by the franchisor.[38] For this purpose, the term 'franchise' connotes:

> An agreement by which the franchisee is granted representational right to sell or manufacture goods or to provide service or undertake any process identified with [the] franchisor, whether or not a trade mark, service mark, trade name or logo or any such symbol, as the case may be, is involved.[39]

Currently, there is no specific law that governs franchise agreements in India. Instead, franchise agreements are governed and regulated by multiple legal instruments. As the objects of the proprietor's intellectual property can be copied and marketed, or misused, which results in the infringement or dilution of the proprietor's goodwill, the protection of intellectual property

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34 Section 65(55a) of Part V of the Finance Act,1994.
35 *Ibid*.
36 As amended by section 88 of the Finance Act, 2005.
37 *Malabar Gold Pvt Ltd v Commercial Tax Officer* 2012 (4) KLT 907; 2012 (4) KHC 746.
38 Section 65(105)(zze) of Part V of the Finance Act, 1994.
39 Section 65(47) of Part V of the Finance Act, 1994.

rights is crucial in any franchise agreement.[40] Similarly, the agreement must provide for the know-how to be protected.[41] As a result, a trade mark licence, or a right to use, lies at the heart of a franchise agreement.[42] Internationally, there are no standard licensing provisions that fit all franchise agreements.[43] However, it is a fundamental principle that the franchisee acquires no right, title, or interest in the trade mark, goodwill, or any other intellectual property goods, other than in terms of the limited licence under the agreement.[44] Importantly, the right to use the intellectual property goods is temporary.

Intellectual property as 'goods' for purposes of state VAT

As no tax may be levied by any tier of government unless it is empowered to do so by law, the interpretation of state tax laws is subject to the Indian Constitution. Accordingly, to establish a state's VAT nexus, it is important to refer to the meaning of the phrase 'tax on the sale or purchase of goods' in the Constitution. In terms of section 366(29–A) of the Constitution

> tax on the sale or purchase of goods includes –
> (a) a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;
> (b) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;
> (c) a tax on the delivery of goods on hire-purchase or any system of payment by instalments;
> (d) a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration;
> (e) a tax on the supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration;
> (f) a tax on the supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service, is for cash, deferred payment or other valuable consideration, and such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the

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40 Sidhpuria *Retail franchising* (2009) 104.
41 *Ibid*.
42 Barkoff & Selden *Fundamentals of franchising* (3ed 2008) at 37.
43 *Id* at 40.
44 *Id* at 42.

> transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made …

Before the inclusion of section 366 (29–A) by the 46th Amendment, many transactions, by their nature, escaped tax. As a result, the six legal fictions created in this amendment provide for specific composite transactions to be subject to sales tax. However, it is uncertain whether the phrase 'transfer of the right to use' in paragraph (d) of the definition of 'tax on the sale or purchase of goods' refers to the transfer of the right to use, and/or the transfer of the right to transfer such right to use. With the transfer of the right to use in the context of intellectual property, the proprietary rights remain that of the trade mark, patent, or copyright owner – the recipient merely acquires the right to use the intellectual property. In the event of the transfer of the right to transfer a right to use, in the context of intellectual property, the right to use is transferred to the exclusion of the proprietor. Where the right to use is transferred without the concomitant transfer of the proprietary rights (for example, in a franchise agreement), the transaction can be subject to both service tax and sales tax. This, as we have indicated above, results in the inappropriate double-taxation of a single transaction.

In *Bharat Sanchar Nigam Ltd v Union of India*, the apex court ruled that, under paragraph (d) of the definition, the title of the goods remained with the transferor who transferred only the right to use the goods.[45] However, the court further ruled that the 46th Amendment did not give freedom to assume that a transaction was one of the 'sale of goods', and then to look for what would constitute 'goods' in order to subject the transaction to sales tax.[46] The amendment had to be read in the light of its purpose – only to ensure that certain transactions did not escape the tax net.[47] Notably, the amendment did not change the meaning of the word 'goods'.[48] Accordingly, what constitutes 'goods' is determined by contract and the intention of the parties. Section 366(12) of the Constitution defines goods as 'all materials, commodities, and articles'. Section 2(7) of the Sales of Goods Act,[49] in turn, defines 'goods' as

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45 *Bharat Sanchar Nigam Ltd & Another v Union of India & Others* n 23 above at 14.
46 *Ibid*.
47 Kumar n 27 above at 146.
48 *Bharat Sanchar Nigam Ltd & Another v Union of India & Others* n 23 above at 14.
49 Sales of Goods Act, 1930.

> every kind of moveable 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.

Neither definition provides a clear yardstick by which to determine whether the transfer of a right to use intellectual property constitutes the sale of goods for purposes of a sale. The state sales tax statutes have, subject to minor discrepancies, adopted a noticeably uniform definition of 'goods'. For present purposes, we limit our discussion to the definition of 'goods' in the Kerala VAT Act.[50] Section 2(f)(xx) states that the term 'goods'.

> means all kinds of movable property (other than newspapers, actionable claims, electricity, stocks and shares and securities) and includes [livestock], all materials, commodities and articles and every kind of property (whether as goods or in some other form) involved in the execution of a works contract, and all growing crops, grass or things attached to, or forming part of the land which are agreed to be severed before sale or under the contract of sale.

Whether goods are tangible or intangible is irrelevant for purposes of state sales tax. In *Tata Consultancy Services v State of Andhra Pradesh*,[51] the court concluded that something becomes 'goods' for purposes of sales tax when it bears the traits of 'goods' having regard to its utility, its capability to be bought and sold, and its capability to be transmitted, transferred, delivered, stored, and possessed.[52] Hallikeri notes that the various judges effectively took conflicting positions.[53] The court notes that computer software becomes 'goods' for purposes of sales tax as soon as it is stored on media.[54] Hallikeri questions whether it is sufficient for the thing to be capable of being abstracted, transmitted, and delivered (the capability test), or if the thing should be stored on a tangible media (the tangibility test) for it to qualify as goods.[55] The court fails to address this issue satisfactorily. Hallikeri suggests that the judgment should be read to hold that only

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50 Kerala VAT Act, 2003.

51 *Tata Consultancy Services v State of Andhra Pradesh* 271 ITR 401 (SC) (BCAJ).

52 *Id* at 12/25.

53 Hallikeri 'Taxation of software: tackling the issue of software as "goods in India"' (2008)36/3 *Intertax* at 128.

54 *Tata Consultancy Services v State of Andhra Pradesh* n 51 above at 12/25.

55 Hallikeri n 53 above at 128.

intellectual property contained in a tangible form constitutes goods for purposes of sales tax.[56]

In *20th Century Finance Corporation Ltd v State of Maharashtra*,[57] the court held that the handing over of possession was not a *sine qua non* for the completion of the transfer of a right to use.[58] The court further stated that the actual delivery of the goods was not necessary to effect the transfer of the right to use; rather, the goods had to be deliverable and delivered at some stage.[59]

In *State of Andhra Pradesh and Another v Rastriya Ispat Nigam Ltd*,[60] the supplier made machinery available for use by a contractor. Although the contractor had access to the machinery and was free to use it for the agreed purpose, the effective control remained with the supplier. Accordingly, the court held that the supply of the machinery did not constitute the supply of goods for purposes of state sales tax.[61]

By contrast, in *Agrawal Brothers v State of Haryana and Another*,[62] the court ruled that an agreement to supply shutters to be used by the contractors in the construction of buildings was deemed to be a sales agreement for purposes of levying state sales tax.[63] Note, however, that there was a clear intention in *Agrawal Brothers* that the right to use was transferred to the exclusion of the proprietor.

In *Tata Consultancy Services v State of Andhra Pradesh*,[64] the court noted that providing access to a telephone connection did not put the subscriber in possession of electromagnetic waves.[65] Similarly, a toll collector does not put a road or a bridge in possession of the toll payer by merely lifting a toll gate, or by granting the toll payer access to the road or bridge.[66] By contrast,

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56 *Id* at 132.
57 *20th Century Finance Corporation Ltd v State of Maharashtra* (2000) 6 SCC 12
58 *Id* at par 73.
59 *Id* at par 75.
60 *State of Andhra Pradesh and Another v Rastriya Ispat Nigam Ltd* (2002) 3 SCC 314.
61 *Id* at 4/315.
62 *Agrawal Brothers v State of Haryana and Another* (1999) 9 SCC 182.
63 *Id* at par 6.
64 *Tata Consultancy Services v State of Andhra Pradesh* n 51 above.
65 *Id* at par 78.
66 *Ibid*.

in *State of Uttar Pradesh v Union of India*,[67] the court ruled that the installation of a telephone and the subsequent granting of access to a telephone network to enable the user to make or receive telephone calls, amounted to a transfer of the right to use for purposes of a contract of sale.[68] This decision was criticised in *Tata Consultancy*.[69] With telecommunication supplies, there are no deliverable goods that are transferred to the recipient for its exclusive use. The telephone lines and electromagnetic waves are merely made accessible to the recipient to use with other users, including the supplier. While the recipient may grant any third party access to the telephone lines and electromagnetic waves, such access is limited to the rights so granted to the recipient by the original supplier. Accordingly, the court in *Tata Consultancy* correctly ruled that the goods had to be in existence and deliverable when the right is sought to be transferred.[70] As a result, the granting of access to a telephone connection could not amount to a sale of goods. Similarly, in our view, in the case of intellectual property the transfer of the right to use without the concomitant transfer of the proprietary rights cannot be a sales agreement for purposes of sales tax.

The transfer of a right to use under a franchise agreement: *Malabar Gold v Commercial Tax Officer*

In *Malabar Gold Private Limited v Commercial Tax Officer*, the appellant company marketed, traded, exported, and imported jewellery and similar valuables. It traded as Malabar Gold. It had entered into various franchise agreements. In terms of these agreements, a franchisee could store and sell products approved by Malabar Gold in a showroom that had to meet certain design requirements. In exchange, the franchisee had to pay a royalty calculated as a percentage of this or her annual net profit. The respective franchise agreements expressly stated that the Malabar Gold trade mark was not transferred to the franchisee. The franchisee was further prohibited from transferring the trade mark, or the right to use the trade mark, to a third party. Malabar Gold retained the right to use the trade mark. Upon termination of the franchise agreement, the franchisee was prohibited from using the trade mark any longer.

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67 *State of Uttar Pradesh v Union of India* (2003) 3 SCC 239.
68 *Id* at 12–13/14.
69 *Tata Consultancy Services v State of Andhra Pradesh* n 51 above par 78.
70 *Ibid*.

The Commercial Tax Officer, Kozhikode, proposed to assess Malabar Gold for unpaid taxes under the Kerala VAT Act on the amount of royalties received from franchisees for the use of its trade mark. However, Malabar Gold had paid service tax on the royalties under the taxable category 'Franchise Services'.[71] The Commercial Tax Officer issued revised assessments of Malabar Gold for outstanding VAT on the transfer of the 'right to use' goods (the trade mark).[72] The Commercial Tax Officer rejected Malabar Gold's objection that the transactions were subject only to service tax. On appeal, the single judge rejected Malabar Gold's submissions and held that the transfer of the 'right to use' a trade mark constitutes the sale of goods for purposes of the Kerala VAT Act.[73]

On appeal to the High Court of Kerala (division bench), Malabar Gold contended that, in view of the judgment in *Imagic Creative Pvt Ltd v Commissioner of Commercial Taxes*,[74] the payment of service tax and VAT were mutually exclusive.[75] As the transaction was clearly subject to service tax, it could not again be subject to either sales tax or VAT.[76] To substantiate this, Malabar Gold relied on the meaning of the 'right to use' as enunciated in *Tata Consultancy Services v State of Andhra Pradesh*,[77] in that the item concerned had to be capable of abstraction, consumption, and use, was further capable of being transmitted, transferred, delivered, stored, and possessed.[78] As the agreement did not permit the franchisee further to transfer the trade mark or use the trade mark exclusively to the exclusion of Malabar Gold, there was no absolute transfer to the franchisee.[79] Accordingly, the transfer of the 'right to use' the trade mark did not meet the criteria to qualify as the transfer of 'the right to use' for purposes of the Kerala VAT Act. What was being transferred was merely a licence to use. As the franchisees were not free to use the trade mark at will, and as the effective control of the trade mark remained with Malabar Gold, no 'goods'

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71 In terms of section 65(47) of the Finance Act.
72 In terms of entry 68 of the Third Schedule of the Kerala VAT Act.
73 *Malabar Gold Private Limited v Commercial Tax Officer* WP(C) 28376/2011 of the High Court of Kerala (unreported).
74 *Imagic Creative Pvt Ltd v Commissioner of Commercial Taxes* n 17 above.
75 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 7.
76 *Ibid*.
77 *Tata Consultancy Services v State of Andhra Pradesh* n 51.
78 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 8.
79 *Ibid*.

were transferred as required to meet the requirements for levying Kerala VAT.[80]

The Commercial Tax Officer argued that the transfer of know-how and of the right to use a trade mark fell squarely within the definition of 'goods' and that the transaction therefore should attract VAT.[81] Referring to the franchise agreement, the officer contended that there was no trace of any service element and, as a result, the transaction was not subject to service tax.[82] As the franchise agreement did not provide that the franchisee was an agent of Malabar Gold, but rather treated the franchisee as principal, Malabar Gold's argument that the franchisee was not granted any control over the trade mark, could not stand.[83]

The court rejected the Commercial Tax Officer's contention that the transfer of a 'right to use' a trade mark was similar to the transfer of know-how, and that such a transfer was subject to Kerala VAT, in line with the judgment in *Mechanical Assembly Systems (India) Pvt Ltd v State of Kerala*.[84] The court noted that although the amount received in *Mechanical Assembly Systems* was called a 'royalty', the transfer of know-how was distinguishable from the transfer of a right to use a trade mark.[85]

In determining the meaning of 'goods' in order to establish if the transfer of a right to use a trade mark constitutes 'goods' for the purpose of levying VAT, the *Malabar* court relied on the ruling in *Tata Consultancy Services v State of Andhra Pradesh*.[86] There the court held:

> In India the test, to determine whether a property is "goods", for purposes of sales tax, is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred,

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80 *Id* at par 10. See also *State of Uttar Pradesh v Union of India* n 67 above at 12–13/14.

81 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 12. See also *Mechanical Assembly Systems (India) Pvt Ltd v State of Kerala* (2006) 144STC 536; *Jojo Frozen Foods Private Ltd v State of Kerala* 2009 24 VST 333.

82 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 16.

83 *Ibid*.

84 *Id* at par 21; *Mechanical Assembly Systems (India) Pvt Ltd v State of Kerala* n 81 above.

85 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 21.

86 *Tata Consultancy Services v State of Andhra Pradesh* n 51 above.

> delivered, stored, possessed etc. Admittedly[,] in the case of software, both canned and uncanned, all of these are possible.[87]

The court in *Malabar* acknowledged the 46th Amendment to the Constitution, which provided for the transfer of 'right to use' to be classified as 'goods', and confirmed the judgment in *Bharat Sanchar Nigam Ltd & Another v Union of India & Others*.[88] There it was held that

> … the 46th Amendment does not give licence, for example, to assume that a transaction is a sale and then to look around for what could be goods.[89]

The *Malabar* court further confirmed the *dicta* in *Bharat Sanchar Nigam* that what constituted 'goods' had still to be determined by contract and intention.[90] It further confirmed that the goods, or what is perceived as goods, must be delivered or deliverable at the time of conclusion of the transaction to constitute the transfer of a 'right to use'.[91] For a transfer of a 'right to use' to constitute 'goods', the transferee must obtain a legal right to the exclusion of the transferor.[92] Merely granting a licence to use is not sufficient.[93] The court rejected the Commercial Tax Officer's submission that the *dicta* in *Bharat Sanchar Nigam* and *Tata Consultancy* did not apply to the facts at hand.[94] While the legal fiction created by the 46th Amendment should be given its full effect, it did not mean that it had to be applied beyond the scope contemplated by the legislature, or in a manner that would lead to anomalies or absurdity.[95] The crucial test to determine if the transfer of a 'right to use' constituted 'goods' as envisaged in the amendment was to determine whether the supplier retained effective control and possession of the items in question.[96] In the present case, the franchise agreement enabled the franchisees to use the trade mark, but it could not be said that the franchisees acquired effective control over the trade mark. The franchisees'

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87 *Id* at par 19.
88 *Bharat Sanchar Nigam Ltd & Another v Union of India & Others* n 23 above.
89 *Id* at par 43.
90 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 29.
91 *Id* at par 32–33.
92 *Id* at par 35.
93 *Ibid*.
94 *Id* at par 38..
95 *Id* at par 39. See also *Bharat Sanchar Nigam Ltd. & Another v Union of India & Others* n 23 above at par 26.
96 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 41. See also *Rashtriya Ispat Nigam Ltd v State of Andhra Pradesh and Another* (2002) 3 SCC 314 at par 4.

rights were limited. Even with the franchise agreement in place, Malabar Gold was not precluded from using the trade mark itself, or from entering into further franchise agreements with third parties. Accordingly, control of the trade mark lay with Malabar Gold. The court also rejected the Commercial Tax Officer's strongly argued submissions that the franchise agreement did not contain any element of services.[97] It highlighted that Malabar Gold provided support to a franchisee, which support included various services such as feasibility studies, site selection, interior design, and project plans.[98] In the light of these provisions, the franchise agreement clearly militated against a service agreement.[99] The type of supply did not meet the requirements for a classification as a deemed sale under the Kerala VAT Act.[100] Accordingly, the judgment in the court *a quo* was overturned: the High Court ruled that the transfer of a right to use a trade mark in a franchise agreement did not constitute a sale, or a deemed sale, in terms of the Kerala VAT Act.

In general, revenue produced by a consumption tax depends on three factors: (a) the rules describing the rates, bases, and threshold; (b) the scale of taxable activities; and (c) the degree to which the rules are complied with.[101] Ebrill notes that multiple tax rates may lead to the incorrect classification of items and consequently to a loss in revenue.[102] Similarly, the taxation of goods and services under different legislation and by different spheres of government will obviously lead to misclassification and a loss in revenue. Therefore, the classification of a sale as either a sale of goods or a sale of services is significant for both the taxpayer and the sphere of government entitled to the revenue. In some cases legislation may provide that certain composite supplies can be disaggregated and classified as multiple independent supplies.[103] However, many transactions are indivisible and no distinct element of either goods or services can be established. The supply of goods is not defined in a uniform manner in VAT statutes.[104]

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97 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above at par 43.
98 *Ibid*.
99 *Ibid*.
100 *Ibid*.
101 Ebrill n 6 above at 43 79.
102 *Id* at 43.
103 Schenk & Oldman n 6 above at 111.
104 *Id* at 126.

Internationally, however, the term 'goods' is, by and large, generally defined as something tangible.[105] By contrast, the term 'services' is generally defined by a catch-all definition which includes different types of intangible supplies.[106] Accordingly, we do not support the classification by the court *a quo* of the transfer of 'a right to use' intangible items as 'goods', as envisaged by section 366 (29–A) of the Indian Constitution. As section 366 (29–A) provides for the classification of 'a right to use' as goods, whereas the same right can be classified as 'services' under the Finance Act, a distinction is appropriate. At common law the purpose of the contract of sale is that ownership of the thing sold is transferred to the buyer.[107] Ain the Absence of the intention to transfer ownership[108] it cannot be a sale. This was echoed in both *State of Madras v Gannon Dunkerley*[109] and *Bharat Sanchar Nigam Ltd & Another v Union of India & Others.*[110] In *Malabar Gold Pvt Ltd v Commercial Tax Officer*,[111] the franchisee obtained merely a licence to use the Malabar Gold trade mark under strict conditions. Put differently, the ownership or effective control over the trade mark remained with Malabar Gold. The transaction, therefore, cannot be classified as a common-law transaction of purchase and sale. Similarly, for purposes of consumption tax, the transfer of a right to use without the concomitant transfer of ownership or effective control of the thing so transferred cannot constitute a sale of goods.

The classification of intellectual property *goods* for purposes of South African VAT

The Constitution of South Africa, 1996,[112] is the supreme law of the Republic of South Africa. Any law or conduct that is inconsistent with the Constitution is invalid.[113] While legislation and amendments to legislation are subject to constitutional scrutiny – unlike the position in India – an

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105 *Ibid.*

106 *Ibid.*

107 *Alpha Trust (Edms) Bpk v Van der Watt* 1975 3 SA 734 (A); *Plit v Imperial Bank Ltd* 2007 1 SA 315 (SCA) at 319–320; Khan, Bradfield, Lehmann (3ed 2013) *Principles of law of sale and lease* at 25–26.

108 Or at least the intention to ensure that the buyer's possession will be undisturbed by anyone with a better title to possession.

109 *State of Madras v. Gannon Dunkerley* n 26 above.

110 *Bharat Sanchar Nigam Ltd. & Another v Union of India & Others* n 23 above. See also Padmanabhan & Padmanabhan 'Sale for you, service for him, both for the taxman' (2012) 23/2 *National Law School of India Review* vol at 79.

111 *Malabar Gold Pvt Ltd v Commercial Tax Officer* n 37 above.

112 The Constitution of the Republic of South Africa, 1996.

113 Section 2 of the Constitution, 1996.

amendment of the Constitution is not required to draft new legislation or make amendments to existing legislation. The Constitution provides that an Act of Parliament must provide for the equitable division of revenue raised nationally among the national, provincial and local spheres of government.[114] In contrast to the Indian Constitution, the South African Constitution does not specifically provide for tax legislation, nor does it explicitly require Parliament to adopt legislation to impose taxes.

In South Africa, consumption tax is levied at national level in terms of the Value Added Tax Act (VAT Act).[115] While the VAT Act draws a distinction between goods and services, they are taxed at the same VAT rate.

Section 1 defines 'goods' as

> corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity but excluding–
> *(a)* money
> *(b)* Any right under a mortgage bond or pledge of any such thing or fixed property; and
> *(c)* any stamp, form or card which has a money value and has been sold or issued by the State for the payment of any tax or duty levied under any Act of Parliament, except when subsequent to its original sale or issue it is disposed of or imported as a collector's piece or investment article.

Unlike the 46th Amendment to the Indian Constitution and the meaning attached to the word 'goods' in *Bharat Sanchar Nigam Ltd. & Another v Union of India & Others*,[116] the term 'goods' for purposes of South African VAT is limited to tangible movable or immovable things, or any real right to such things. Section 1 defines 'services' as

> anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (*c*) of the definition of 'goods'.

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114 Section 214 (1) of the Constitution, 1996.
115 The Value Added Tax Act 89 of 1991.
116 *Bharat Sanchar Nigam Ltd. & Another v Union of India & Others* n 23 above; Padmanabhan & Padmanabhan n 110 above at 79.

The transfer of any right to use a trade mark, patent, copyright, know-how, design, or any similar intellectual property right, whether temporarily or permanently, falls within the ambit of the phrase 'the granting, assignment, cession or surrender of any right or the making available of any facility or advantage' in the definition of 'services' in section 1. Put differently, any such transfer of intellectual property rights should be classified as 'services' for purposes of levying VAT. We believe that the VAT Act is clear in this respect. The absence of reported case law on this issue supports our contention. It should be noted, in passing, that, to the extent that intellectual property rights are used outside South Africa, the following acts are zero rated[117]

> … [the] filing, prosecution, granting, maintenance, transfer, assignment, licensing or enforcement, including the incidental supply by the supplier of such services of any other services which are necessary for the supply of such services, of intellectual property rights, including patents, designs, trademarks, copyrights, know-how, confidential information, trade secrets or similar rights; or
> the acceptance by any person of an obligation to refrain from pursuing or exercising in whole or in part any such rights.

The classification of intellectual property rights, generally, in South Africa

In *Gallo Africa Ltd and Others v Sting Music (Pty) Ltd and Others*,[118] the appellants alleged that they were, by assignment or as original authors, the owners of the copyright in the musical and literary works that comprise the musical *Umoja*. They further alleged that the defendants had infringed their copyright by: performing the whole, or a part of, *Umoja*; by making recordings and cinematograph films of it; and by having it broadcast. The acts of infringement were alleged to have been committed in nineteen other countries, from Japan in the east to the United States of America in the west. The key issue in this case was, accordingly, the jurisdiction of a High Court to decide matters relating to foreign copyright.

For purposes of jurisdiction in respects of intangibles (incorporeals), South African law distinguishes between movable and immovable intangibles.[119]

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117 Section 11(2)(*m*).
118 *Gallo Africa Ltd and Others v Sting Music (Pty) Ltd and Others* 2010 (6) SA 329 (SCA).
119 *Id* at par [14].

The *situs* of an intangible is to be found 'where the intangible can be effectively dealt with'.[120] From this follows that the *forum domicilii* has jurisdiction in relation to movable intangibles,[121] whereas the *forum rei sitae* has jurisdiction in relation to immovable intangibles.[122] It was accordingly crucial for the court to determine the nature of copyright. It goes without saying that it is intangible. But is it movable or immovable?

Harms DP stated that '… that IPRs [intellectual property rights], including copyright, are immovable intangibles …'.[123] He found support for this conclusion in Antipodean jurisprudence[124] and *Lucasfilm Ltd v Ainsworth*.[125] The judge did note that Laddie J was not prepared to accept that it was correct to describe intellectual property rights as intangibles,[126] and that the court in *Lucasfilm* did not in so many words, state that copyright is an intangible immovable.[127] But he was satisfied that such a finding was a necessary corollary of the ratio of *Lucasfilm* in the context of our law, which is a fusion of Roman and Germanic law.

Subsequently, in *Oilwell (Pty) Ltd v Protec International Ltd and Others*,[128] Harms DP returned to consider the classification of intellectual property rights.

In this case, briefly, Oilwell had assigned the trade mark PROTEC to a company incorporated in Guernsey. The relations between the parties to the assignment deteriorated, and the assignee ran into financial trouble. Oilwell then assigned the trade mark for a second time to a different assignee. Oilwell argued before the court below that the first assignment was governed by regulation 10(1)*(c)* of the Exchange Control Regulations,[129] and that the first assignment was void for non-compliance with that regulation. (The regulation states that no person may, without Treasury permission, 'enter

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120 *Id* citing *Spier Estate v Die Bergkelder Bpk and Another* 1988 1 SA 94 (C) at 98G–J.

121 See also *MV Snow Delta Serva Ship Ltd v Discount Tonnage Ltd* 2001 4 SA 746 (SCA) at pars [9]–[14].

122 *Gallo Africa Ltd and Others v Sting Music (Pty) Ltd and Others* n 118 at par [14].

123 *Id* at par [19].

124 *Id* at par [20] and the cases cited there.

125 *Lucasfilm Ltd v Ainsworth* [2009] EWCA Div 1328 (CA).

126 Coin Controls v Suzo International (UK) Ltd [1999] Ch 33 at 44D–E.

127 *Gallo Africa Ltd and Others v Sting Music (Pty) Ltd and Others* n 118 above at par [24].

128 *Oilwell (Pty) Ltd v Protec International Ltd and Others* 2011 4 SA 394 (SCA).

129 Published in GN R1111 of 1 December 1961, in terms of s 9 of the Currency and Exchanges Act 9 of 1933.

into any transaction whereby capital or any right to capital is directly or indirectly exported' from South Africa.)

In the course of his judgment, Harms DP held that trade-mark rights, '... like all other intellectual property rights ... are … akin to immovables'.[130] As a result, they cannot be 'exported'.[131]

Two remarks

In the first instance, the judge's assertion that trade mark rights are 'akin to immovables' is a softer stance than his bold assertion in *Gallo Africa Ltd and Others v Sting Music (Pty) Ltd and Others*[132] that intellectual property rights are immovable intangibles. The later view is preferable, albeit still problematic, as we show immediately below.

Secondly, certain provisions of the Trade Marks Act[133] do not square with viewing a trade mark as immovable property. Especially, section 41(1) provides that a registered trade mark may be hypothecated by a deed of security. Section 41(4) then states, importantly, that such a deed of security has the effect of 'a pledge of the trade mark' to the person or persons in whose favour the deed of security has been granted. It is trite that only movables can be pledged.

CONCLUSION

The issue as to whether the transfer of the right to use intellectual property attracts exclusively state VAT or Union service tax remains unsettled in India. Given the complexity of the Indian consumption tax system and the court's interpretation of the 46th Amendment, this issue will probably not be settled any time soon. Tax experts everywhere advocate for simplified, efficient, neutral, certain, and fair tax legislation. This sentiment was endorsed by the OECD as early as 1998.[134] Taxing the supply of goods and services under different statutes and by different spheres of government does not conform to the OECD principles of tax simplicity, efficacy, neutrality,

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130 *Oilwell (Pty) Ltd v Protec International Ltd and Others* n 128 above at par [13].

131 *Ibid*.

132 *Gallo Africa Ltd and Others v Sting Music (Pty) Ltd and Others* n 118 above at par [19].

133 Act 194 of 1993.

134 OECD *Taxation and electronic commerce: Implementing the OTTAWA framework conditions* (2001) available at: http://www.oecd.org/tax/consumption/Taxation%20and%20eCommerce%202001.pdf (last accessed 14 August 2014).

and certainty. The fact that the items listed in the definition of 'goods' in section 366 (29–A) of the Indian Constitution and those listed in the definition of 'services' in the Finance Act overlap, opens the door to costly, prolonged litigation. From an economic, a tax administration, and a policy perspective, the levying of consumption taxes on the supply of goods and services under different legislation and by different spheres of government does not make sense. The consolidation of the consumption taxes in India under a simplified Union VAT system has been debated in the Indian parliament for more than a decade. For reasons unknown to us, a consolidated VAT Act has not been forthcoming. However, on 19 December 2014, the 122nd Constitution Amendment Bill, 2014, was tabled to facilitate the introduction of a unified goods and services tax regime. One of the objectives of the unified GST system for India is the subsuming of the various indirect taxes and levies that are currently levied at both state and central level into a unified central consumption tax system.[135] Padmanabhan and Padmanabhan correctly note that economics and law are strange bedfellows, and what may be useful for the government of India may not necessarily withstand the test of the Indian Constitution.[136] That said, we believe that the simplified distinction between goods and services as applied in the South African VAT Act may well offer a solution to untangle consumption taxes in India.

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135 Sundaram 'Constitution and the scheme of GST' *International Law Office* available at http://www.internationallawoffice.com/Newsletters/Detail.aspx?g=1bdabb94-7a48-4ce1-a796-859b1206dba2 (last accessed 9 March 2015); Visalaksh & Shah 'Interstate transitions in GST regime' *International Law Office* available at: http://www.internationallawoffice.com/Newsletters/Detail.aspx?g=59efd39b-0c9e-4e0e-8ec8-73517f9eee70&utm_source=ILO+Newsletter+-+A%2fB+Test+-+Group+B&utm_medium=email&utm_campaign=Corporate+Tax+Newsletter&utm_content=Newsletter+2015-03-06 (last accessed 9 March 2015).

136 Padmanabhan & Padmanabhan n 110 above at 77.