

Royalty, being a tax in nature, not leviable to service tax – CESTAT

11 January 2024



Summary

The CESTAT Chennai bench has held that service tax cannot be levied on the amount of royalty paid by the appellant to the state government for the assignment of the right to use for exploration and production of crude oil and natural gas. The CESTAT held that the royalty paid is in the nature of tax, not the consideration for services. It further held that royalty includes the element of both regulatory fees and compensatory fees. Therefore, in the absence of any mechanism to levy service tax on the amount that has the aspect of both regulatory fees and compensatory fees under the Finance Act 1994 (Finance Act), service tax cannot be levied, as royalty has a dominant element of regulatory fees.

Facts of the case

- M/s. Oil and Natural Gas Corporation (the appellant) is engaged in the exploration and production of crude oil and natural gas.
- A show cause notice (SCN) was issued to the appellant for the non-payment of service tax under the reverse charge mechanism (RCM) on the amount of consideration paid to the state government in the form of royalty for assignment of right to use for exploration and production of crude oil and natural gas.
- An order was passed by the adjudicating authority (AA) confirming the demand of service tax on the amount paid as royalty.
- Aggrieved by the order, the appellant filed the present appeal before the CESTAT Chennai bench.
- The appellant relied on the judgement of the apex court in the case of Sri Lakshmindra Thirtha Swamiar and argued that royalty charged under the Oilfields (Regulation and Development) Act, 1948 (ORD Act) squarely falls under the ambit of tax and is not a consideration for services, as such royalty amount is a: i) special impost under the ORD Act; ii) compulsory extraction from the licensee and; iii) fulfils the essential components of taxation under the ORD Act.
- The mining lease is granted by the state government pursuant to the powers provided to it by way of Entry 23 of List II of Schedule VII of the Constitution of India, which provides for the regulation of mines and minerals development. Therefore, the grant of mining lease is a regulatory function of the state government, and the amount of royalty paid is a regulatory fee.
- The appellant further argued that even if it is assumed that there is a service element in addition to the regulatory function performed by the state government, then also there is no machinery provision in the Finance Act that provides a mechanism for making a bifurcation between the regulatory fees and compensatory fees on which service tax is payable. Therefore, in the absence

Issue before the CESTAT:

Whether service tax is payable on the consideration paid to the state government in the form of royalty for the assignment of right to use for exploration and production of crude oil and natural gas?

Appellant's contentions

of any machinery provision, no service tax can be imposed.

- The appellant argued that the grant of mining lease by the state government cannot be an assignment of right to use natural resources, as the right in the land is never fully transferred by the government to qualify as an assignment. The government remains the owner of oil and natural gas that is extracted and has the right to regulate the distribution of such natural resources.
- Even if it is assumed that the grant of mining lease is a service of assignment of right to use natural resources, the taxable event for such service is a one-time event that takes place at the time of the assignment of right to use natural resources. In the instant case, the taxable event had already been occurred before such services came under the purview of service tax.
- The power to levy tax on mineral rights is provided in Entry 50 of List II, and therefore, only the state government has the power to levy taxes on mineral rights.

CESTAT Chennai's observations and judgement [Service Tax Appeal No. 41666 of 2018, order dated 9 January 2023:]

- **Royalty is in the nature of tax and not consideration for services:** The CESTAT relied on the SC's judgement in the case of India Cements Corporation Ltd and held that royalty is a tax and is not a consideration for services.
- **Payment of royalty is hybrid in nature:** Royalty is in the nature of regulatory fees, as it is paid as per the provisions contained in the ORD Act and not on the basis of an agreement between the appellant and the state

government. It can also be said to be a license fees for the right to extract the crude oil and natural gas. Therefore, royalty includes the element of both regulatory fees and license fees.

- **No mechanism to levy service tax on amounts with both elements:** The mechanism to levy service tax on the amounts that have the element of both regulatory fees and compensatory fees has not been provided in the Finance Act. The CESTAT held that royalty is dominantly in the nature of regulatory fees, as the payment of royalty is a regulation of checking the over-exploitation of resources. Therefore, the payment of royalty cannot be considered as service for the levy of service tax.
- **Exemption notification is not a charging provision and cannot create a duty liability:** The CESTAT relied on the judgement in the case of Kiran Spinning Mills, wherein it was held that the exemption notification is not a charging provision and cannot create a duty liability. Therefore, the CESTAT kept aside the mega-exemption notification and held that in terms of Section 65B (44) of the Finance Act, the given activity will fall under the ambit of 'renting of immovable property services.' Further, the CESTAT held that the department does not have a case that the activity of right to use natural resources falls within the ambit of 'lease' and amount paid as royalty is a 'rent.' Therefore, the CESTAT held that service tax cannot be levied under the RCM on the amount of royalty paid to the state government and allowed the appeal by setting aside the impugned order.

Our comments

Taxability of royalty has been one of the contentious issues in the erstwhile service tax regime and the same situation continued even in the GST regime.

Earlier, the Rajasthan High Court, in the case of the Udaipur Chamber of Commerce and Industry, had held that the royalty is nothing but a 'consideration' to have mining operations in the leased area on execution of a mining lease. However, it is pertinent to note that the SC has stayed the HC's judgement until further orders.

Post the above stay by the SC, various high courts have granted an interim stay on the order for the levy/collection of service tax on royalty.

Even under the GST regime, the Board, through FAQs issued on levy of GST on royalty, has clarified that the activity of granting rights to use natural resources is treated as supply of services and the licensee is required to pay tax on the amount of consideration paid in the form of royalty or any other form under the reverse charge mechanism. Further, the GST Council, in its 45th meeting, recommended that the services by way of grant of mineral exploration and mining rights shall attract GST rate @ 18% w.e.f. 01.07.2017. However, it is important to note that the SC has stayed the levy of GST @ 18% on royalty on mining lease until further orders in the case of Lakhwinder Singh.

Amid the current scenario, this is a significant ruling by the CESTAT Chennai bench, wherein the CESTAT has observed that royalty is not a consideration for services and is in the nature of tax. This is a welcome ruling and is likely to set precedence in similar matters.

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