Chapter 2: Policy Issues

The audit focussed on some key concepts specific to the entertainment industry and attempted to analyse the impact of methods adopted by the industry, on the taxability of the services in this sector. The aim was also to check if ambiguities in the provisions left scope for interpretation in a way that led to ingenious drafting of contractual agreements leading to escapement of revenue.

In an industry like Media and Entertainment (M & E) driven by branding, creativity and knowledge, copyrights hold significant relevance from valuation as well as business structuring perspective. The provisions regarding taxability of copyright services, types of copyright assignments in the film industry and analysis of taxability of its components have been given below:-

2.1. Taxability of Copyright Services

Copyright as defined in Section 13 of Copyright Act, 1957 subsists in (a) Original literary, dramatic, musical and artistic works; (b) Cinematograph films; and (c) Sound recordings. The provisions regarding taxability of copyright services are discussed below:-

The term "service" was defined[3] from 1 July 2012 for the first time after the introduction of service tax and every activity, except those covered under the negative list, was classified as a service and was made taxable[4]. Further, certain relaxations by way of exemptions were provided vide notification No.25 / 2012-ST dated 20 June 2012.

Analysis of the term "service" is very important to decide taxability of any activity. "Service" means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include 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) such transfer, delivery or supply of any goods which is deemed to be a sale within the meaning of clause (29A) of article 366 of the Constitution; or

(iii) a transaction in money or actionable claim;

[3] Section 65B(44) of the Finance Act, 1994
[4] Section 66B of the Finance Act, 1994

Section 18 of Copyright Act, 1957 deals with Assignment of copyright i.e., the owner of copyright in an existing work or the prospective owner of the copyright in the future work may assign to any person the copyright either wholly or partially and either generally or subject to limitations and either for the whole of the copyright or any part thereof.

The act of temporary transfer or permitting the use or enjoyment of copyright of cinematographic films and sound recording service are taxable under Copyright service as defined under Section 65(105)(zzzzt) from 1 July 2010.

During 1 July 2012 to 31 March 2013, taxability was limited to sound recordings only. All other rights in cinematographic films were exempted vide Notification No.25/2012-ST, dated 20 June 2012.

With effect from 1 April 2013, service tax is leviable[5] on copyright services except for those relating to original literary, dramatic, musical or artistic works and cinematographic films for exhibition in a Cinema Hall and Cinema Theatre.

2.2. Types of copyright assignments in the film industry

The copyrights for exhibition of cinematographic films are preceded by a series of activities which involve services that are not exempted from ST as per provisions quoted ibid. The supply chain in the industry starts with producer, then distributor and Exhibitor/Theatre owners and ends with the Consumers. Films produced by the producer are commercially exploited by assignment/licensing of copyrights of cinematographic films and/ or sound recordings in the films to distributors, typically termed as 'Theatrical' or 'Non-theatrical' rights through film distribution agreements. Under theatrical rights of copyrights, the right to distribute, sub-license, market, advertise, publicise, and exhibit the film in theatres are listed. Copyrights in films are also exploited by assignment of satellite rights, music rights; radio rights, video (DVD) rights, etc., termed as non-theatrical rights.

Such agreements provide for mutual consideration towards copyright service against the grant of the said theatrical rights on a revenue sharing basis with following general arrangements.

- Distributor, as a recipient of service, pays a Minimum Guarantee or the primary consideration to the producer towards assigned rights
- Producer pays commission to distributor for sub-licensing of assigned copyrights of the film to any third party (i.e., sub-distributors/exhibitors)

[5] Vide Notification No.3/2013-ST, dated 1 March 2013

for all major/sub-territories within the assigned territory and the distribution revenue from sub-licensing generated prior to the date of release of the film would be shared between the producer and distributor.

- The agreement also makes it obligatory on the distributor to promote the film by incurring publicity, marketing and advertisement expenses on behalf of the producer within the specified limit. These services are also in the nature of provision of Business Auxiliary Services to the producer.
- The revenue from the release and exhibition of the film is netted to retain the share of the distributor towards the minimum guarantee paid to the producer and the distribution and publicity expenses. The net revenue is then termed as 'Overflow' which is the consideration flowing only from the exhibition revenue shared between the producer and distributor in a pre-set ratio as per the terms of the transfer agreement.
- Where profit-sharing arrangements are made, the distributor provides upfront advance to the producer (to be adjusted) in some cases. Further, the distributor earns a specific percentage of the realisation from the distribution and exhibition arrangements.

The activities provided by the distributor are in the nature of services in relation to promotion or marketing of goods (copyright in this case) produced or provided by or belonging to the client (producer in this case); provision of service on behalf of the client and services incidental or auxiliary to such activity. Thus, they fall under the ambit of 'Business Auxiliary Service' as defined in clauses (i), (vi) and (vii) of Section 65(19) of Finance Act, 1994.

Thus exploitation of the theatrical rights include a series of activities of distribution, sub-licensing, advertisement, etc., which fall under the ambit of taxable services. It is only the copyright services for the culminating activity of theatrical exhibition of the films in the respective territories for the assigned period which is exempted from service tax by the intent of law. This view is also supported by judicial pronouncements as detailed below:

- In the case of M/s. AGS Entertainment Pvt., Ltd., the Madras High Court held (June 2013) that the variant modes of business transactions between the producer and distributor, distributor and sub-distributor or area distributor or exhibitor (theatre owner) are not sale of goods. From the production of cinematograph film till it is exhibited, there are host of commercial activities and service tax is the value added tax which applies to the business transactions for consideration involving commercial activities.

- In the case of M/s. Media one Global Entertainment Ltd., the Madras High Court held (June 2013) that the variant modes of transaction between the distributor/sub-distributors of films and exhibitors of movie and the revenue sharing arrangement between them are neither in the 'Negative List Services' nor exempted.

On examination of distribution agreements, we observed that the modus operandi in the Film industry for commercial exploitation of copyrights of cinematographic films was by including all activities under the term 'assignment of theatrical rights' to connote the revenue earned therefrom and claim exemption from payment of service tax under the benefit of Notification No.3/2013-ST dated 1 March 2013. The intent of legislation, however, was to exempt service income from exhibition of the cinematographic films in cinema hall or theatre, whereas agreements comprised mutual consideration towards host of other activities which are not exempted from tax. It was evident from the agreements that the income generated prior to the date of release and incidental to the sub-licensing, distribution expenses, publicity and promotion are all included under 'consideration from the transfer of theatrical rights'. These are wholly being treated as exempted and thereby escaping taxation as discussed below:

2.3. Clubbing of non-theatrical rights/other activities with theatrical rights

We noticed two cases where taxable commercial activities escaped taxation due to clubbing of theatrical rights with non-theatrical rights / other production activities. The revenue involved could not be worked out in these cases for want of required details. The cases are illustrated below:-

During examination of records of M/s Eros International Media in Mumbai ST-VI Commissionerate, we noticed that M/s. Sohail Khan Productions and M/s Salman Khan Ventures Pvt. Ltd., in Mumbai ST-IV Commissionerate, the producers of Hindi film titled "Jai Ho" and "Bajrangi Bhaijaan" respectively had claimed exemption from payment of service tax by treating the entire consideration as revenue/earnings from assignment of theatrical rights. As per the agreement, initiated during 2013-14 the licensed rights comprised of both theatrical as well as non-theatrical rights. The assessees claimed exemption from payment of service tax treating the entire consideration towards license fee of theatrical rights. Thus, the way the agreement is drafted treating the entire consideration only towards the theatrical rights, to take undue benefit of the exemption, led to escapement of revenue towards commercial activities of non-theatrical rights and the activities preceding the exhibition of the film. The consideration that escaped taxation could not be

determined in the absence of bifurcation of theatrical and non-theatrical rights.

We pointed this out (December 2016), the Ministry stated (May 2017) that due to typographical error, the term "Non-Theatrical Rights" got mentioned under the major heading of "Theatrical Rights" under Sr. No.1 of Annexure-2 of the said agreement. They further stated that they examined the ledger copy of M/s. Eros International Media Ltd., copy of invoices of M/s. Salman Khan Ventures Pvt. Ltd. and M/s. Sohil Khan Production Pvt. Ltd. and that the said consideration indeed pertained to Theatrical Rights alone.

The reply of the Ministry is not acceptable since verification of ledger and invoices by Audit revealed that "theatrical rights as per license agreement" was the term used in ledger and invoice. This does not substantiate that non-theatrical rights are not included in the ledger/invoices as the definition of theatrical rights as per agreement included non-theatricals rights also and in both invoices and ledger the term "theatrical rights as per license agreement" was used. Further, the Department has not shown any valid evidence to prove that it was only a typographical error.

2.4. Inclusion of distribution income under theatrical rights

Apart from the consideration paid to the producer for acquiring the distribution rights of films, the distributor/Music Production Company spends on behalf of the producer a specified sum to promote the film/musical work of the film on print, publicity and advertising which could be recouped from the overflow or exhibition revenue. This amount is nothing but a consideration flowing to the distributor for providing service taxable under the category 'Business Auxiliary service' which escaped taxation under the guise of 'Theatrical Rights'. Since the activity is done by the distributor before the release and exhibition of the film and also such service is not listed in Section 66D of Chapter V of Finance Act, 1994 to treat it as exempted; the service tax was liable to be recovered on such activities.

During examination of records of M/s. Arbaaz Khan Production Pvt. Ltd., M/s. Red Chillies Entertainment Pvt. Ltd., in Mumbai ST-IV Commissionerate and M/s. Eros International Media Pvt. Ltd., in Mumbai ST-VI Commissionerate, we noticed that the distributors[6] realised distribution income relating to publicity and distribution expenses of ₹ 50.56 crore during 2012-13 to 2014-15. But service tax amounting to ₹ 6.21 crore on the distribution income was not paid as the parties claimed exemption of the consideration or revenue treating the same as assignment of theatrical rights.

[6] M/s. Super Cassettee Industries Ltd., M/s. UTV Software Communication Ltd., M/s. Stellar Films Pvt. Ltd., M/s. Eros International Media Ltd., and M/s. Red Chillies Entertainment Pvt. Ltd.

We pointed this out (December 2016), the Ministry stated (May 2017) that distribution expenses publicity expenses etc., are integral part of the theatrical rights.

The reply of the Ministry is not acceptable since these services are independent services and cannot be considered as theatrical rights. As already quoted in para 2.3 (in case of M/s. AGS Entertainment Pvt., Ltd.), the Madras High Court held (June 2013) that, from the production of cinematograph film till it is exhibited, there are host of commercial activities and Service tax is the value added tax which applies to the business transactions for consideration involving commercial activities.

Drafting of agreement treating the whole consideration as theatrical rights resulted in overlooking the taxability aspect of the consideration towards the activities like Business Auxiliary Services and non-theatrical rights.

2.5. Treating copyrights transferred with limitations as transferred perpetually

To consider a transaction as sale of goods warrants the fulfilment of transfer of ownership, transfer of right of possession and transfer of right to use. Some judicial pronouncements[7] also held that so long as the producer does not fully relinquish his right over the copyright held by him, transfer of the right to use is purely temporary transfer of copyright or permits its use by another person for a consideration, and in those cases, levy of service tax for such transfer of copyright would apply.

We noticed agreements which stated that copyrights were assigned for perpetuity. But, certain features of the terms/covenants in these agreement, were in fact indicative of the fact that the distributor was being given only restrictive rights and the producer continued to have control over the copyrights.

Thus the nature of transfer of rights was conditional or restrictive and not outright sale. We noticed three cases, in which, though the rights were given with a lot of conditions, the same was treated as transfer of right for perpetual period which led to escapement of revenue from service tax. The cases have been described below:-

[7] The Supreme Court decision of B.S.N.L. Vs. Union of India, {(2006) 3 SCC 1}, and Madras High Court in AGS Entertainment Private Ltd. Vs Union of India {(2013) 32 STR 219}

2.5.1. During the examination of records of M/s. Arbaaz Khan Production Pvt. Ltd. and M/s. Red Chillies Entertainment Pvt. Ltd., in Mumbai ST-IV Commissionerate, it was noticed that the assessees assigned copyrights of the music/sound recordings of their respective films Chennai Express and Dabangg 2 to M/s. Super Cassette Industries Ltd., a Music Company for a perpetual period on consideration of ₹ six crore and ₹ nine crore during 2012-13 and 2013-14 respectively. In both instances, the assessees did not pay service tax treating the rights as granted for perpetual period. However, we noticed that the assessees did not relinquish their rights and imposed conditions on the Music Company to promote the music in film and to receive royalty share from further exploitation of the assigned rights over and above the agreed consideration. Thus, the assignment is a temporary transfer of rights, on which a service tax of ₹ 1.85 crore becomes leviable.

We pointed this out (December 2016), the Ministry stated (May 2017) that the perpetual nature of copyright transfer cannot be altered/changed based on retention or non-retention of any right or control and that the Assignors merely transferred the right of exploitation of the music to the extent as mentioned in the agreements. They also stated that such right to exploitation is different from the right owned by Assignor in the original music and that such exploitation right having been granted/assigned for an exclusive term for the entire world for perpetual period, no service tax is leviable on such transfer of copyright service.

Supreme Court of India in BSNL Vs. Union of India (2006) case laid down attributes to consider a transaction as the transfer of the right to use the goods. One such attribute is that for the period during which the transferee has such legal right, it has to be exclusion to the transferor. In the agreements assigning copyrights, certain restrictions were placed by the assignor in the clauses of the agreements. For instance in the agreement between M/s. Red Chillies Entertainments Pvt. Ltd., (assignor) and M/s. Super Cassettes Industries Ltd., (assignee) though copyright in the sound recordings and musical works was assigned to assignee, as per clause 9(f), the assignor has complete and uninterrupted rights to insert audio and/or video clip of all the songs of any duration in any programmes or future films created/produced by the assignor or by its subsidiary or sister companies for commercial or non-commercial exploitation. Hence as the condition of exclusivity was not fulfilled, the reply of the Ministry is not acceptable.

2.5.2. M/s. Arbaaz Khan Production Pvt. Ltd., in Mumbai ST-IV Commissionerate received consideration of ₹ 33 crore as refundable and non-refundable advances under pre-production agreements from different distributors viz. M/s. Stellar films, M/s. Red Sun Enterprise, M/s. Aum Movies,

M/s. Ankit Movies etc., for film Dabangg 2 released in the month December 2012. We noticed that the assessee claimed exemption from service tax on these advances by considering the same as the assignment of theatrical rights to the distributors on perpetuity during the period (i.e., July 2010 to June 2012) when 'temporary' transfer attracted service tax. However, post the release of the film (December 2012), the assessee revised the agreements with the same distributors and assigned the theatrical rights for temporary transfer adjusting the consideration received as advances. Thus different stands were adopted with the same distributor regarding the nature of transfer (viz., permanent/temporary) during the taxability period and non-taxability period of copyright services, resulting in escapement of revenue from taxation.

We pointed this out (December 2016), the Ministry stated (May 2017) that it is upon the sweet will of the contracting parties to decide the terms and conditions of an agreement entered into by them as long as the same is otherwise permitted by law.

Audit reiterates that Ministry must ensure that the intention of the Government behind granting the exemption and the purpose with which exemptions are granted to the specified service are not defeated.

The agreements regarding transfer of copyrights have contradictory provisions. On one hand it is termed as transfer in perpetuity but on the other hand there are specific provisions in the agreement which are indicative of the opposite as right to use the content of the copyright continued to vest with the producer / Assignor

---

2.6. Avoidance of tax by treating the services as exports

As per Rule 6A(1) of Service Tax Rules, 1994, the benefit of exemption from payment of service tax would be available only if all the prescribed conditions are satisfied. While determining location of service recipient under Rule 2(i)(b)(iii)of Place of Provision of Services Rules, 2012, where services are used at more than one establishment, the establishment most directly concerned with the use of service would be the place of provision.

We noticed instances of artists/producers entering into agreements with foreign entities to establish a service recipient(s) and place of provision in the non-taxable territory and thereby consideration for the portion of service

provided outside India was treated as exports, leading to avoidance of tax. Three such instances are illustrated below:

2.6.1. We noticed two instances where for the same film shot in India and abroad, the payment to artist for the portion shot abroad was arranged from foreign companies, thereby the service was made to look as export of service with no tax liability.

a) In Mumbai ST-IV Commissionerate, Mr. Ranbir Kapoor, acted in the Hindi movie titled 'Ae Dil Hai Mushkil' produced by M/s. Dharma Productions Pvt. Ltd., shot both in India and New York. He received a consideration of ₹ 6.75 crore from a foreign company, M/s ADHM Films Ltd., (UK) based in London for film shot in UK and did not pay service tax of ₹ 83.43 lakh treating the same as export of services.

Web-based information gathered from an UK Govt. official site (*https://beta.companieshouse.gov.uk/company/*), revealed that the foreign based company M/s. ADHM Films Limited (UK) was incorporated in December 2014 on the launch of the production of the movie in November 2014 at the registered address (Suite 303, 50 Eastcastle Street, London W1W 8EA) under the directorship of a foreign national (Brian Brake/Heiman Osker and two directors of Indian origin Viz., Mr. Anil Kundan Thadani and Mr. Aashish Rajiv Mehrotra). Incidentally, as seen from the website, with the same address and with same foreign national viz., Mr. Brian Brake, three firms (Bombay Film Company Ltd., Galani Entertainments Ltd., Virgo Entertainment Ltd.,) were floated with a different Indian director viz., Kohli Kunal Galani, Vijaykumar Ramdas and Vashu Lilaram Bhagnani respectively.

b) Similarly, during the examination of records of Mr. Nandamuri Taraka Rama Rao, a Cine Artiste in Hyderabad ST Commissionerate, we noticed that under an agreement (July 2015) with producer M/s. Vibrant Visuals Ltd., London, U.K, the artiste received an amount of ₹ 7.33 crore for acting in the Telugu movie titled 'Nannaku Prematho' and claimed exemption from payment of service tax of ₹ 1.10 crore treating it as export of services.

We pointed these out (December 2016), in case of Mr. Ranbir Kapoor, the ministry in its reply stated (May 2017) that the services (acting services) are provided at more than one location and not used at more than one establishment. Since the film was shot at multiple locations and the location where the greatest proportion of the service provided is outside India, hence the said service is not taxable. However, in case of Mr. Nandamuri Taraka

Rama Rao, the ministry while admitting the objection stated (May 2017) that an SCN was being issued for ₹ 1.10 crore and that all jurisdictional officers were instructed to verify if any similar exemptions were availed by any assessee in the sector.

The reply of the Ministry is not acceptable since this service (acting service) is an integral part of the movie being produced in India by M/s. Dharma Productions. Hence to hold that it was not used by the establishment in India is not right. Moreover, similar observation was accepted by the Ministry in case of Mr Nandamuri Taraka Rama Rao. Further, there is a need to examine the complete loop of transactions between all the parties (viz., M/s. Dharma Productions, M/s. ADHM Films Ltd. (UK) and Mr. Ranbir Kapoor) to verify if due service tax has been levied in this case or not.

2.6.2. During examination of records of M/s. Prime Focus Ltd., (PFL) in Mumbai ST-IV Commissionerate, we noticed that M/s. PFL is providing conversion business (visual effect, editing, etc.,)[8] in India to Indian production houses on behalf of Prime Focus World located in Netherlands.

The assessee entered into service level agreements with its overseas subsidiaries (M/s. Prime Focus International Ltd., UK) in non-taxable territory for billing the invoices in respect of the conversion business provided to the Indian Production Companies. This led to escapement of service tax of ₹ 1.34 crore during the period 2015-16.

We pointed this out (December 2016), the Ministry intimated (May 2017) that they filed an appeal in October 2016 to deny the benefit of export provisions to assessee in the earlier SCNs from 2012 to 2015 contending that performance of services are in India under Rule 4(a) of the Place of Provision of Service Rules, 2012. Further it was stated that periodical SCN for the year 2015-16 was also issued.

These instances suggest that there may be many such assessees in this sector evading taxes by providing a portion of taxable service in the non-taxable territory to take the undue benefit of provision of Place of Provision of Services Rules, 2012.

2.7. Wrongful availment of Cenvat credit under Sponsorship services

Rule 3 of the Cenvat Credit Rules, 2004, allows credit of duty on input services used by a service provider for rendering of any taxable output

[8] The software programme entitled view which is a proprietary system for the conversion of 2D audiovisual/moving images to stereo 3D audiovisual/moving images

service. As per Rule 2(p) 'Output service' excludes services, where the whole of service tax is liable to be paid by the recipient of service.

By virtue of entry 3 of Notification No. 30/2012–ST dated 29 June 2012, in case of Sponsorship services received from a body corporate, the sponsors who are the service recipients are liable to pay service tax. Hence sponsorship service cannot be considered as output service in the hands of service providers who organise the events.

During the examination of records of M/s. Royal Challengers Sports Pvt. Ltd., M/s. Entertainment Network India Pvt., Ltd. (Mumbai ST-III), M/s. Knight Riders Sports Pvt., Ltd. (Mumbai ST-IV) and M/s Wizcraft International Entertainment Ltd. (Mumbai ST-VI), we observed that the assessees are engaged in Event Management, Programme Producer Service, Sponsorship Services, etc., during 2012-13 to 2015-16. They earned revenue of ₹ 246.63 crore under sponsorship services from body corporate towards organizing several events on which service tax liability was paid by sponsors (i.e., body corporate) under reverse charge.

In all the above cases since tax liability is borne by the sponsor, being the, service recipient, the service provided by the assessee (service provider) is not an output service to the assessee in terms of rule 2(p) quoted ibid. Hence the Cenvat credit amounting to ₹ 14.71 crore availed by the assessee on input services relating to such output services is in contravention to the Rule 3.

We pointed these out (between September and December 2016), the Ministry stated (May 2017) that the exemption notifications are issued under the power vested by Section 93 of the Finance Act, 1994 and that the notification dated 29 June 2012 was not an exemption notification issued under Section 93 of Finance Act, 1994. Hence, Ministry held that sponsorship service cannot be equated to 'exempted services' on which reversal under rule 6 of the Cenvat Credit Rules, 2004 is warranted.

The reply of the Ministry is not acceptable since it is not relevant to the issue pointed out by Audit and the reply is also silent regarding rule 2(p) i.e., 'output service' which excludes services, where the whole of service tax is liable to be paid by the recipient of service.

In the case of M/s. Wizcraft International Entertainment Ltd., we further observed from the agreements entered between the assessee and their sponsors that for the subsequent period 2014-15 to 2015-16, the income earned from Sponsorship Services provided were being accounted under Promotion and Marketing services of Brand/Events. It appears that this was done due to ineligibility of availment of Cenvat credit otherwise under

Sponsorship Services as it is the liability of the Sponsors under reverse charge as recipient of service. Thus it is evident that assessee has used a different classification of service in the latter period for the benefit of Cenvat credit. Absence of the definition of Sponsorship service and promotion and marketing services of Brand/Events in the service tax statute enabled the assessee to take undue benefit of Cenvat credit.

We pointed this out (December 2016), the Ministry while admitting the objection stated (May 2017) that an SCN was being issued.

Recommendations

1. Since the assessees are exploiting the ambiguity in the terms 'theatrical' and 'non-theatrical' while drafting of agreements for transfer of rights, there is a need to bring legislative clarity for these terms.
2. Place of Provision of Services Rules need to be directly linked to service specific issues to avoid undue benefit of the interpretations and to safeguard the intent of legislation in giving export benefits.
3. Existing ambiguity in the available provisions for Cenvat Credit under Sponsorship Services in the entertainment sector needs to be clarified through relevant amendment to the Rules.

Ministry stated (May 2017) that any amendment in the present rules of Service Tax would constitute a futile exercise since "Goods and Service Tax" (GST) is to be implemented with effect from 1 July 2017 and that the recommendations were, however, noted for future compliance.

As the recommendations are relevant in GST regime also, to ensure clarity in the new legislations the recommendations made by audit should be examined by GST policy wing of CBEC.