VALIDITY OF STATES' LEVY OF SURCHARGE ON SALES-TAX

THE BIHAR Government issued a notification under section 5 (1) of the Bihar Finance Act 1981 levying a surcharge at 10 per cent of the total amount of tax payable by a dealer, whose gross turnover during a year exceeded Rs. 5 *lakhs*, in addition to sales-tax already payable. Section 5 (3) of the Act prohibited such dealers from passing on the liability of surcharge to consumers. The result was that all dealers whose turnover exceeded Rs. 5 *lakhs* in a year including the dealers in price-controlled drugs, were allowed to pass on the burden of sales-tax, but not the burden of surcharge, to consumers. This meant that the burden of surcharge cut back into the profit of dealers and manufacturers since the price of drugs was not allowed to be increased on account of surcharge.

The validity of section 5(3) was, therefore, challenged in the Supreme Court in *Hoechst Pharmaceuticals Ltd.* v. *State of Bihar*[1] on the following grounds:

(*i*) Since section 5(3) denied dealers and manufacturers from passing on the burden of surcharge to consumers, it was in conflict with section 6 of the Essential Commodities Act 1955 (a Union law), under which the Drugs (Price Control) Order 1979 was passed, which allowed manufacturers to pass on the burden of sales-tax to consumers. Section 6 of the Act provides that the order shall have effect despite anything inconsistent therewith contained in any other enactment.

In short, the argument was that the Union law would prevail over the state law in a case of conflict between respective legislative spheres as the opening words in article 246 (3) of the Constitution, namely, "Subject to clauses (1) and (2)", make the power of a state legislature to make law in respect of any matter in the state list of the seventh schedule subject to the Union's power to legislate with respect to any matter enumerated in the Union and concurrent lists.

Again, since there was repugnancy between section 5(3) of the Bihar Act (see entry 54 of the state list) and para 21 of the drug order passed under the 1955 Act (see entry 33 of the concurrent list) the latter would prevail over the former in view of article 254 (1). Para 21 dealt with the price to be charged by the retailer from consumers and that was the price fixed under the order plus local taxes which included sales-tax. Para 24 dealt with the price charged by the manufacturer or distributor from wholesalers and this was inclusive of sales-tax.

(*ii*) Section 5 (3) was discriminatory and violative of article 14 as there were two categories of manufacturers and dealers: one, the price of whose commodities was controlled; and the other, the price of whose commodities

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1. (1985) 154 I.T.R. 64.

was not subject to any control. While the latter could absorb the burden of additional surcharge on sales-tax by increasing their prices, the former could not do so. The surcharge at the rate of 10 per cent of the tax was imposed on all manufacturers and dealers whose gross turnover was Rs. 5 *lakhs* or more in a year, irrespective of the fact whether they were dealers in controlled or uncontrolled commodities.

Again section 5(3) was confiscatory in nature inasmuch as it prohibited dealers and manufacturers from passing on the burden of surcharge to consumers and put a disproportionate burden on them. It thus constituted an unreasonable restriction on the freedom to carry on their business guaranteed under article 19(1)(*g*).

(*iii*) The Bihar legislature had no power to enact section 5(1) which made the gross turnover of a dealer to be the basis of the levy of surcharge since it included transactions relating to sale or purchase of goods taken place in the course of inter-state trade or commerce or outside the territory of India. Such transactions could not be taken into consideration for computation of the gross turnover for the purpose of bearing the incidence of surcharge.

Repelling the contentions raised under (*i*), the Supreme Court observed that the question or repugnancy under article 254(1) between the Union and state laws arises only in case both of them occupy the same field with respect to one of the matters enumerated in the concurrent list, and there is a direct conflict between the two. It is only when both these requirements are fulfilled that the state law will, to the extent of repugnancy, become void. The article has no application to cases of repugnancy due to the overlapping found between the state list on the one hand and the Union and concurrent lists on the other. If such overlapping exists in any particular case, the state law will be *ultra vires* because of the *non-obstante* clause in article 246 (1) read with the opening words "Subject to" in article 246(3). In such a case, the state law will fail not because of repugnancy with the Union law but due to want of legislative competence. It is no doubt true that the expression "a law made by Parliament which Parliament is competent to enact" in article 254(1) is susceptible of a construction that repugnance between a state and a Union law may take place outside the concurrent sphere because Parliament can enact laws with respect to subjects included in concurrent and Union lists. But if article 254(1) is read as a whole, it will be seen that it is expressly made subject to clause (2) which makes reference to repugnancy in the field of concurrent list. In other words, if clause (2) has to be any guide in determining the scope of clause (1), the repugnancy between a Union and a state law must be taken to refer only to the concurrent field. Article 254 (1) speaks of a state law being repugnant to a law made by Parliament or an existing law.[2]

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2. *Id.* at 96-97.

The question of repugnancy between a Union and a state law arises only when both the legislatures are competent to legislate in the same field, that is, on a subject of concurrent list, therefore, article 254(1) comes into play only when both the laws relate to a subject specified in this list and when they occupy the same field.[3] It is often overlooked that the three lists only specify the fields of legislation of Parliament and state legislatures and the power to legislate is provided in article 246. The power of a state legislature to levy sales-tax is found in the state list and it is a tax entry. The remarkable aspect of distribution of legislative field under the Constitution is that tax entries are listed separately in one group under both Union and state lists and they do not overlap anywhere.[4] There is hardly a tax entry in concurrent list.[5]

In this view, the court reached the conclusion that since section 5(3) of the Bihar Act and para 21 of the drugs order operated in two separate and distinct fields and both were capable of being obeyed, there was no conflict between the two, and therefore, section 5(3) was a constitutionally valid legislation.[6]

Rejecting the grounds of attack as given in (*ii*) the court observed:

(*a*) From the fiscal angle, tax on manufacturers and producers of commodities involves complicated price structure They invariably pass on the burden of tax to consumers. They formulate the prices of commodities in terms of certain profit targets. Where the conventional "mark-up" leaves substantial unrealised profits, successful tax shifting is possible irrespective of the nature of the tax. Where the tax cannot be passed on to consumers, it must be shifted backwards to owners of inputs. Manufacturers and dealers regard tax as a cost and make adjustments accordingly.[7]

(*b*) There was no material on record to show that the levy of surcharge imposed a disproportionate burden on manufacturers and dealers of drugs as compared to their counterparts in other commodities. From the figures given in the sales-tax returns it was indicated that the volume of trade carried on in Bihar alone was of such a magnitude that they had the capacity to bear the additional burden of surcharge. On the basis of material on record, the burden of surcharge roughly worked out to be one *paisa* per rupee of the sale price of drugs.[8]

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3. *Id.* at 97-98.

4. *Id.* at 99-100.

5. Only one entry relates to fee, *i.e.*, entry 47, which runs: "Fees in respect of any of the matters in this List, but not including fees taken in any court".

6. *Supra* note 1 at 100.

7. *Id.* at 101.

8. *Id.* at 102. Sen J. then proceeded to show that the formula given in the order for fixation of prices of drugs left a considerable margin of profit. The "mark-up" cost in the manufacture of these drugs varied from 40 to 100 per cent. "Mark-up" as defined in para 11 of the order included distribution cost, outward freight, promotional expenses, manufacturer's margin of profit and trade commission

The main reason for the above view seems to be social and distributive justice. The court referred to an article[9] to show that 100 or so multinationals dominated the international medicine trade resulting in the dependence of the Third World countries and the problems facing India. This showed their capacity to bear the burden of tax. It added that if they felt that the burden of surcharge could not be borne by them, they could apply to the Central Government for the revision of the retail price under para 15 of the order.[10]

(*c*) First proviso to section 5(1) laid down that the aggregate of the tax and surcharge payable under the Act would not exceed, in respect of goods declared to be of special importance in inter-state trade or commerce by section 14 of the Central Sales Tax Act 1956, the rate fixed by its section 15. Under section 14, almost all commodities essential to the life of the community were declared to be goods of special importance in inter-state trade and commerce and, therefore, the maximum sales-tax leviable on sale or purchase of such goods could not exceed 4 per cent. In view of this, generally dealers having a gross turnover of Rs. 5 *lakhs* in a year dealing with commodities covered by section 14 would not have to bear the burden of surcharge under section 5 (1). But it so happened that medicines and drugs were not declared to be of special importance under section 14.[11]

The court relied upon the following passage from *Kodar* v. *State of Kerala*:[12]

> The large dealer occupies a position of economic superiority by reason of the greater volume of his business. And, to make his tax heavier, both absolutely and relatively, is not arbitrary discrimination, but an attempt to proportion the payment to capacity to pay and thus to arrive in the end at a more genuine equality.

It then observed that the economic wisdom of a tax is within the exclusive province of the legislature and the only question that the court is required to consider is whether there is rationality in the belief of the legislature that capacity to pay the tax increases, by and large, with an increase of receipts.[13] In conclusion, it found that the surcharge was in consonance with social justice in an egalitarian state.[14] Thus the contention based on article 14 failed.

The fourth ground of challenge was based on the argument that section 5(3) by not allowing manufacturers and dealers to pass on the burden of surcharge to consumers had in fact converted the sales tax, which was an indirect tax, into a tax on income which was a direct tax and hence beyond

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9. "Druggists to the Third World", *The Economist* (12-18 March 1983).
10. *Supra* note 1 at 103.
11. *Id.* at 102-03.
12. A.I.R. 1974 S.C. 2272.
13. *Supra* note 1 at 103.
14. *Id.* at 104.

the competence of state legislature. Rejecting the contention, the court observed that though ordinarily manufacturers and dealers are allowed to pass on the burden of sales-tax to consumers, this is not an essential characteristic of sales tax. If they are not allowed to do so, the sales-tax is not thereby converted into tax on income. He added that whether a law should be enacted imposing a sales-tax or validating the imposition of sales-tax when the seller is not in a position to pass it on to the consumer is a matter of policy and does not affect the competence of the legislature.[15]

Rejecting the last contention the court observed that constitutional validity of section 5 (1) which provided for the classification of dealers whose gross turnover during a year exceeded Rs. 5 *lakhs* for the purpose of levy of surcharge in addition to the tax payable by them, was not assailable. The liability to pay a surcharge was not on the gross turnover including the transactions covered by article 286[16] but was only on inside sales and the surcharge was sought to be levied on dealers who had a position of economic superiority. The definition of "gross turnover" in the Act was adopted not for the purpose of subjecting to surcharge inter-state sales or outside sales or sales in the course of import into, or export of goods out of India, but was only for the purpose of classifying dealers within the state and to identify the class of dealers liable to pay such surcharge.[17]

This case clearly indicates the trend of interpretation of tax legislation. The legislation is being judged more on the basis of its social purpose than on any technical argument based on division of powers or fundamental rights. In case the burden of tax is imposed on those belonging to the economically superior class, the tax will ordinarily be valid. If the tax payer has the capacity to bear the burden of tax, the tax on him cannot be assailed as it promotes social justice, for this very reason, as the court held, the surcharge "was in consonance with social justice in an egalitarian State".[18]

*Paras Diwan**

15. *Ibid.*

16. This article deals with restrictions as to imposition of tax on the sale or purchase of goods.

17. *Supra* note 1 at 108-09.

18. *Id.* at 104.

* Professor of Law (Retd.), Punjab University ; Advocate, Chandigarh.