SERVICE TAX – WORKS CONTRACT & VALUATION OF SERVICES
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THE DILEMMA & EVOLUTION IN JUDICIAL THINKING

Taxation of indivisible and composite contracts has not only undergone several constitutional amendments but has also has been facing judicial scrutiny ever since.

The two critical challenges being faced in taxation of indivisible composite contracts are:
1. Constitutional rights of States and Centre to levy taxes on goods and services; and
2. Valuation of goods and services embedded in such contracts.

The sale vs service debate has been examined at different judicial forum and needless to mention, it had become critical to determine whether a transaction was that of sale of goods or was that for provision of services. One landmark judgement of the Honourable Supreme Court, that led to subsequent constitutional amendment, was in the case of Gannon Dunkerly.

An incidental aspect that has more or less generally been accepted is that both VAT and Service Tax can be levied on the same contract/activity but with the safeguard that both are not levied on the same total value of the contract.

As per the Constitution of India, the taxing powers are distributed between the Sate and the Centre. Only the State has the powers to levy taxes on goods and hence VAT on transfer/sale of property is the domain of each State. However, the Centre has the authority to collect tax on services. The Larger Bench of SC in L&T Limited v. State of Karnataka has upheld levy of sales tax / VAT on construction and sale of flats, holding building contracts in the nature of works contract which involves transfer in the property of goods. This judgment is in line with the earlier judgment of the Honourable Supreme Court in the case of K. Raheja builders. However, the L&T judgment has somewhat departed from the accepted practice and has gone to clarify that construction activity undertaken by the developer would be "works contract" only from the stage when developer enters into a contract with the customer. This shift in the valuation of the indivisible composite contract for the purpose of levy of VAT can have an impact on the valuation for levy of service tax on service portion in execution of works contract, except for the fact that the inherent nature of such contracts is that they are indivisible. The issue of valuation of indivisible composite contracts has also been addressed by the Honourable Supreme Court in the case of BSNL[2006-2-STR-161].

Two recent judicial pronouncements have given a twist to the tale:
1. The Honourable Supreme Court on Works Contract in the case of Kone Elevator, and
2. The High Court of Kerala on the levy of service tax on supply of food by Restaurant.

THE JOURNEY – TILL JULY 2012

Service Tax on Construction and related activities has not been a smooth journey since the first time it was introduced in 2005 on Industrial & Commercial Construction w.e.f. 10-9-2004; immediately thereafter, we had service tax on Construction of Complex with effect from 16-6-2005. The services, as they were defined under the erstwhile provisions of Section 65(105) of the Finance Act,1994, again led to many judicial interventions, particularly on the issue of levy of service tax on sale of immovable property. In addition to the regular clarifications issued, there have been regular changes in the statutory definitions as also numerous judicial decisions on the subject. The complexity has also been

compounded due to different models and nature of transactions that is generally prevalent in the construction industry.

With reference to residential construction, it was more or less accepted by the revenue authorities as also the industry that builders, per se, are not liable to pay service tax since they are selling immovable property to their customers. The spirit of this proposition was very rightly reflected in CBEC Circular 108/2/2009-ST dated 29-1-2009.

An interest twist to the tale was in the form of the landmark judgement of the Honourable Supreme Court in the case of Daelim Industrial Co Ltd [2004-170-ELT] which led to the levy of service tax on Works Contract services, as a separate classification. This judgement itself has been a matter of judicial scrutiny in many subsequent pronouncements on the issue of vivisection of indivisible works contracts for the purpose of levy of service tax.

The revenue authorities, realizing that service tax on sale of immovable property was a difficult proposition, introduced the following explanation to the original definition of the taxable service in Section 65(105)(zzzh) with effect from 1-7-2010:

"Explanation - For the purpose of this clause, construction of a complex which is intended for sale, wholly or partly, by a builder or any person authorized by the builder before, during or after construction (except in cases for which no sum is received from or on behalf of the prospective buyer by the builder or a person authorized by the builder before the grant of completion certificate by the authority competent to issue such certificate under any law for the time being in force) ***shall be deemed to be service provided by the builder to the buyer****".*

Hence, again a deeming fiction was introduced in the statutory provisions for levy of tax.

The legislative intent and levy of service tax on such constructions had also been unsuccessfully challenged in the cases of G.S.Promoters [2011-21-STR-100- P&H H.C] and Maharashtra Chamber of Housing Industry [2012-TIOL-78- Mumbai H.C.].

SINCE JULY 2012

The system of taxation of services has undergone a shift since July 2012, after what is known as commonly known as the Negative List taxation under the Finance Act, 1994. The shift is evident by introduction of the definition of a 'service' for the first time as also combining the various exemptions under a single Mega Exemption Notification 25/2012. The sections referred are those of the Finance Act, 1994.

I. CHARGE [Section 66(B)]

Uniform rate of 12% on all services, other than those specified in the negative list, provided or agreed to be provided in the taxable territory by one person to another. The concept of 'taxable territory' has been dealt with in detail in the newly introduced Place of Provision of Service Rules, 2012, which replace the earlier provisions and notifications dealing with Export and Import of services.

II. SERVICE

Hitherto, there was no definition of service so as to indicate as to what exactly constitutes as service on which service tax is to be levied. Hence, we had classifications of taxable services with definitions of each taxable service. Now,

service encompasses all activities, including the declared services, other than those specified in the Negative List or are otherwise specifically exempt.

The definition of 'service' itself has taken precautions to exclude activities that are purely in the nature of sale or involve transfer of title in goods or immovable property, including the activities that are considered as deemed sale in terms of clause 29A of article 366 of the Constitution of India. This is to avoid all possible interpretations on the constitutional powers and litigations with reference to levy of service tax on indivisible composite transactions.

III. DECLARED SERVICE

The definition of service itself includes the Declared Services, nine of which have been specified. The inclusion of such declared services as part of a service that is liable to service tax implies that these activities are deemed to be services, with the intention that the litigations with reference to sale vs service and consequent constitutional challenges are addressed.

The two relevant declared services for the purpose of this paper include:

1. Construction, and
2. Service portion in the execution of a works contract.

Whereas 'construction' has not been defined, it includes all types of constructions; however, construction and service portion in execution of works contract have been specified as distinct declared services.

With reference to Construction, the situation that existed w.e.f. 2010 vide the explanation provided to the definitions of the erstwhile relevant taxable services continues – if entire sale consideration is received after the issuance of the completion certificate by a competent authority, the activity would not be deemed to be a service since the same would amount to sale of an immovable property.

The definition also provides that for the purpose of Construction as a declared service, the same will include additions, alterations, replacements or remodeling of any existing civil structure.

Section 65B(54) of the Finance Act, 1994 defines the term 'works contract'; the two conditions required for a transaction to qualify as a works contract are:

1. VAT should be leviable on the transfer of property in goods involved in the execution of such contract; **and**
2. The contract should be for the specified activities, which include:
   construction, erection, commissioning, installation, completion, fitting out, improvement, repair, renovation, alteration of any **movable or immovable property** or for carrying out **any other similar activity or a part thereof** in relation to such property.

IV. VALUATION

Section 67 of the Finance Act, 1994 continues to govern the valuation of taxable services with the basic principle that the value of a taxable service is the 'gross amount charged'. Subject to this broad proposition, we have the Service Tax (Determination of Value) Rules, 2006 which have been suitably modified w.e.f. 1-7-2012, particularly with reference to valuation of service portion in execution of works contract.

It is pertinent to note that the evergreen Notification 12/2003 has been rescinded, which hitherto had been used extensively in litigations to segregate the value of materials sold in the course of provision of services.

Whereas the basic principle still continues to the effect that service tax is not to be levied on value of materials transferred in the course of construction activities, the same is provided by way of an exemption abatement in terms of Notification 26/2012 dated 20-6-2012, as substituted by Notifications 2/2013 dated 1-3-2013, Notification 9/2013 dated 8-5-2013 and Notification 8/2014 effective from 1-10-2014 wherein serial no 12 provides for an exemption in value of construction activities:

1. In case of residential unit having carpet area less than 2000 sq ft and the amount charged is less than rupees one crore, the taxable value shall be limited to 25%;
2. In case of other constructions, including commercial, the taxable value shall be 30%.

The condition for this exemption abatement is that the value of land shall be included in the amount charged from the service receiver.

Service Tax (Determination of Value) Rules, 2006 provide for valuation of service, including valuation of contracts wherein deemed services are taxable:

1. Rule 2A - Service portion in works contract.
2. Rule 2B - Service portion in foreign currency transactions.
3. Rule 2C - Service portion in restaurant and outdoor catering.
4. Rule 3 – Non monetary consideration.
5. Rule 4 - Power of reject valuation.
6. Rule 5 - Inclusion and exclusion from value of certain expenditure or costs, including reimbursement of expenses and services of a Pure Agent.
7. Rule 6 - Specific inclusion and exclusion in value of services.

Rule 2A of the Valuation Rules of 2006 specifically deal with the valuation of service portion in execution of a works contract. To simplify, the rule basically provides for two options for determining the taxable value:

1. Direct - wherein the value of materials on which VAT is paid is excluded from the contract value, together with the VAT charged; and
2. Presumptive – wherein depending upon the nature of works contract executed, three different presumptive rates for valuation are prescribed:
   (a) Original Works – service tax payable on 40% of the value;
   (b) Works Contract not covered under above but including works contract for Maintenance or Repair or Reconditioning or Restoration or Servicing of any goods; Maintenance or Repair or Completion and Finishing services such as glazing or plastering or floor and wall tiling or installation of Electrical Fittings of Immovable Property – service tax payable on 70% of the value.

The two important aspects that are covered by the above valuation provisions with reference to Construction as also the service portion in execution of Works Contract:

1. Unlike the erstwhile provisions, cenvat credit is available to the service provider in respect of the Input Services and Capital Goods; and

2. Fair Market Value of the materials supplied by the recipient (commonly understood as the Free Issue of Materials) will also form part of the total value of the consideration.

   As for the issue of including the free issue of materials under the erstwhile provisions, the same has not been accepted by the LB of the Delhi Tribunal in the case of Bhayana Builders [2013-TIOL-1331].

An illustration for understanding:

Sr. No	Particulars	Amount (Rs.)
(i)	Gross amount charged for the works contract	10,00,000
(ii)	Add : Fair Market Value of goods/services (Supplied by the contractee)	7,00,000
(iii)	Less : The amount charged for such goods/ services (Supplied by the contractee)	1,00,000
(iv)	Less : the value of VAT, levied on goods supplied by the contractee	12,500
(v)	Total Amount : (i) + (ii) - (iii) - (iv)	15,87,500

V. EXEMPTIONS

The Mega Exemption Notification 25/2012 dated 20-6-12, as amended modified by Notification 6/2014 dated 11-7-2014, lists the 42 broad activities that are exempt from levy of service tax. For the purpose of this paper, Serial Nos 12-14, 25 and 29(h) are relevant; some of the specified activities which are exempt include:

1. Only if provided to the Government, a Local Authority or a Governmental Authority (each of these three have been defined in the Notification). Some such services that are exempt include – civil structure not meant predominantly for commercial use; structures for education or clinic; canal, dam etc; residential complex for self-use or for employees;
2. Infrastructure like airport, railway, port etc;
3. Roads, tunnels, bridge, etc. only if for use by general public;
4. Single Residential Unit;
5. Low Cost Housing;
6. Building for a charitable organization meant predominantly for religious use by general public; etc.

Some services that were exempt prior to 1-7-2012 but are now not exempt include:

1. Private Roads.
2. Construction for non-commercial use in general; after 1-7-2012, construction for use of religious purpose by general public continues to be exempt.
3. Construction of hospitals/schools etc for charitable institutions and not meant for commercial purpose; after 1-7-2012 exempt if construction for Government, Local Authorities, etc.
4. Residential construction of complex having 12 or less units; after 1-7-2012, only one unit exempt if for personal use.

Exemption continues to apply for services provider to SEZ developers and units in terms of Notification 12/2013 dated 1-7-2013.

VI. POINT OF TAXATION

The golden rule that the PoT will be the earlier of payment received or issue of invoice will continue to apply in case of Construction and Woks Contract execution. However, in such contracts, which qualify as 'continuous supply of service', the date of completion of provision of the service will the date of completion of each event that merits payment from the customer, which basically means the benchmarked stages, as in the normal trade practise.

However, an issue which has largely not been addressed by the Construction industry is the issue of an invoice, which is mandatory in terms of Rule 4A of the Service Tax Rules, 1994.

Subject the date of payment received, the golden rule is service tax is payable at the rate effective at the time of provision of service.

VII. REVERSE CHARGE

Service portion in the execution of a Works Contract will qualify for payment of service tax under the Reverse Charge mechanism if:

1. the provider is an individual, HUF, Partnership firm, AOP, and
2. the receiver is a Corporate Business Entity.

Both, the provider and receiver, will pay 50% of the tax determined

However, the PoT for service tax to be paid under reverse charge shall be the date of payment, provided the payment is made within three months from the date of invoice; and if not so made, the PoT shall be the date immediately following the said period of three months.

VIII. CENVAT CREDIT

Irrespective of whether the service tax is paid under Construction after claiming the valid abatement or under the Works Contract in terms of the valuation rules, cenvat credit is available of the Input Services and Capital Goods. This is a marked positive approach under the new provisions.

However, the service availed need to qualify as an Input Service. Whereas the inclusive part of the definition of Input Service defined under Rule 2(l) of the Cenvat Credit Rules, 2004 **includes** services used in relation to setting up, modernization, renovation or repairs of a factory, premises of provider of output service or an office relating to such factory or premises, the definition of Input Service **excludes**:

"service portion in the execution of a works contract and construction services including service listed under clause (b) of section 66E of the Finance Act (hereinafter referred as specified services) in so far as they are used for –

(a) construction or execution of works contract of a building or a civil structure or a part thereof; or
(b) laying of foundation or making of structures for support of capital goods,

except for the provision of one or more of the specified services;"

The apparent contradiction needs to be addressed on the basis of facts and documentation of each case. What is excluded is the construction and service portion

in the execution of Works Contract of a building or a civil structure or a part thereof. Therefore, a company may not be eligible to claim cenvat credit of service tax charged on construction of a factory building However, the exception to the above exclusion also makes it clear that if the excluded input service is used for providing one or more of the specified services, the same will be eligible for cenvat credit. As a result thereof, a builder will be eligible to take cenvat credit of the construction service provided by the contractors.

ISSUES AND CHALLENGES

In view of the diverse practises and the complexity of transactions prevalent, many issues merit consideration:

1. Service Tax on Reimbursement of Expenses

The issue assumes significance in view of the observations of the Honourable Delhi Court in the case of Intercontinental Consultants wherein it had been held that that Rule 5(1) is ultra vires the valuation sections and that the rules cannot override the sections.

2. Valuation of Completion and Finishing Services

The confusion arises because the valuation rules applicable to works contract have different valuation rates for Original Works and Other works contract. Applying the interpretation of a bundled service, if the Completion and Finishing services are in relation to a new building, and assuming that the same contractor executes the complete building, such completion and finishing services cannot be segregated from the construction and hence can continue to be valued @ 40% as applicable to original works. However, if the completion and finishing services are in respect of an existing structure and are by way of repairs/renovation, then such services need to be valued @ 70%.

3. Service Tax implications on transactions/considerations like:
   (1) Discounts received
   (2) Security Deposits in execution of contracts, rent etc
   (3) Recovery of Electricity Charges from tenant

4. Service Tax on expenses incurred by service receiver.

5. Sale of Developed Plots

Sale of an immovable property is outside the purview of the service that can be taxable. Therefore, pure sale of such developed plots may not be liable to service tax. However, the issue merits consideration if the builder/developer charges separate Development Charges in addition to the Sale Price of the plot. With reference to a dispute under the Consumer Protection law, the Honourable Supreme Court in the case of Narne Construction Pvt Ltd has observed that there is an element of service involved in sale of developed plots if the builder has committed for certain amenities or facilities [2013-29-STR-3]. However, the contractors who execute the works contract for development construction, like swimming pool/club house etc, would be liable to service tax.

6. Cenvat Credit on Sale of Residential Units after completion

It is possible that in a scheme of construction of residential units, there may not be any buyer for some units which remain unsold even after the completion certificate is received. The builder would not be liable to service tax when he sells such unsold units after receiving the completion certificate. Since the builder would have taken cenvat credit of eligible input services during the course of construction, he would not be paying service tax on such constructed properties that are subsequently sold. The intriguing issue is does the subsequent sale of units qualify as an ‘exempt service’. Justifying the spirit of the cenvat credit

mechanism, it is possible that the builder may reverse the proportionate cenvat credit; however, practical difficulties can arise if the sale is after substantial time from the completion of the project.

7. Cenvat Credit of such services received like repairs, maintenance, modifications etc of factories, office buildings etc.

CONCLUSION

In view of the evolving law and judicial thinking and the diversity in practises in the Construction sector, the service tax implications vary. A cautious approach is required based on the terms of the arrangement and agreements and the documents executed so as to clearly bring out the intention and the spirit of the transaction.