

Works Contract (Service Tax)

Works Contract – Genesis

- Before proceeding to delve into the concept of works contract, it is important to first understand its origin
 - Works contract term was first coined or incorporated in the sales tax / VAT
 - Entry 54 of the State List – Taxes on ‘Sale of goods’: State Governments levy VAT under this entry
 - Entry 92A of the Union List – Taxes on ‘Sale of goods’ in the course of interstate trade: Central Government levies CST under this entry
 - Sales of Goods Act, 1930: A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. There may be a contract of sale between one part-owner and another
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Works Contract – Genesis

State of Madras Vs Gannon Dunkerley & Co. AIR (1958) S.C. 560

- In a decision related to works Contract -, the Court held that expression “sale of goods” used in the entry 54 of State list of Seventh Schedule has the same meaning as in the Sale of Goods Act, 1930
 - Definition of sale under Sale of Goods Act, 1930 covers cases where the goods are sold to the purchaser. It does not covers the cases where the goods are not sold as chattel
 - In above decisions it was held that in case of indivisible works contract, it is not possible to levy sales tax on the transfer of property in the goods involved in the execution of such contract as it has been held that there is no sale of material as such and the property in them does not pass as such
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Works Contract – Genesis

State of H.P. versus Associated Hotels of India case AIR 1972 S.C. 1131

- Assessee was serving food to the person lodged in a hotel. Department demanded sales tax on the value of food served to the guest by treating it as sale of goods
 - The Supreme Court held that there is no sale involved in the supply of food or drink by a hotelier to a person lodged in the hotel
 - Transaction cannot be split into two parts i.e. one of service and other of sale of food-stuffs.
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Works Contract – Genesis

- The problem relating to the power of States to levy tax on the sale of goods was then referred to the Law Commission by the Government of India
 - Following three modes were suggested by Law Commission to overcome the problem:
 - amending State List, entry 54, or
 - adding a fresh entry in the State List, or
 - inserting in article 366 a wide definition of "sale" so as to include works contracts
 - Government accepted third recommendation of Law Commission
 - Consequently, Constitution 46th Amendment Act, 1982 was enacted and the definition of sale was widen to include certain transaction as deemed sales
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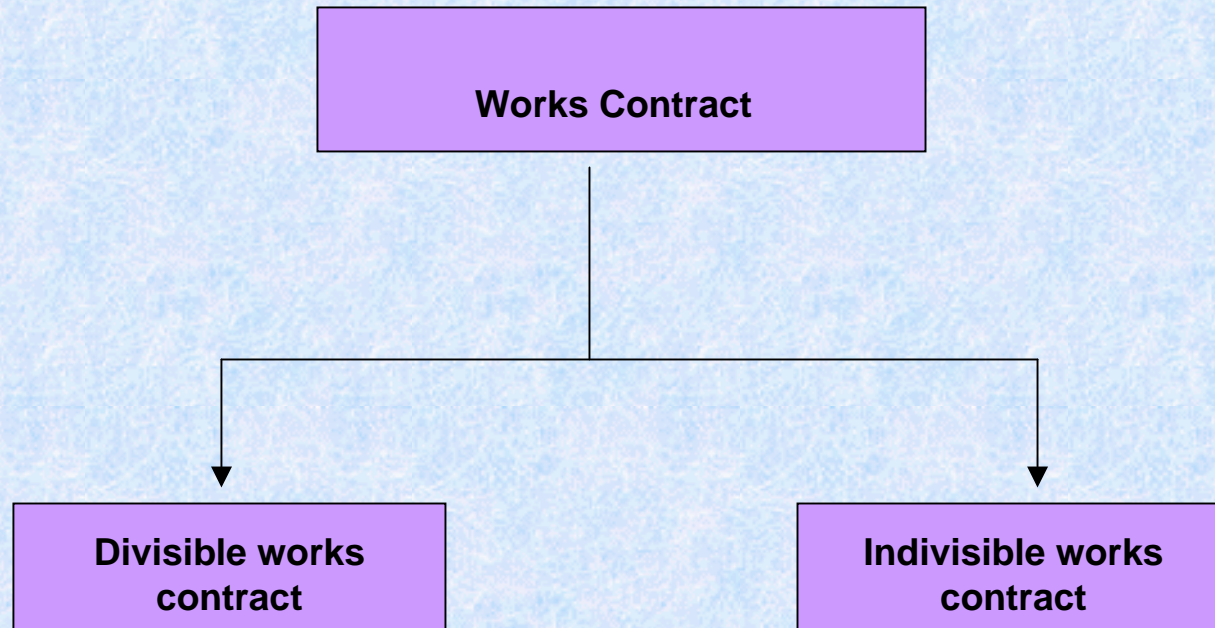
Works Contract – Genesis

- In the Article 366, a new clause 29A was inserted in 1982 to read with Article 286 to levy taxes by State inter alia on followings subjects:
 - 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;
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Works Contract – Genesis

- (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 transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made;“
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- Accordingly, above cases would be considered as sale even if the goods are not transferred as chattel
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Works Contract –Types of works contracts



- Divisible contract i.e. where the elements of sale of goods and labor are clearly segregated
 - Indivisible contracts, where the parties agree for lump-sum consideration for the entire contract. The sale consideration of the materials used in the contract and remuneration for labor is not separately identifiable
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Works Contract – Service Tax – Possible categories of various works contract

- Existing categories of taxable services
 - Commercial or Industrial Construction Services w.e.f. 10th Sep 2004;
 - Erection, Commissioning or Installation Services w.e.f. 1st July 2003;
 - Construction of Complex Services w.e.f. 16th June 2005;
 - Works Contract Services : 1st Jun 2007 : Works contract services includes all activities covered under the other taxable categories mentioned in previous slide and additional activity of EPC projects
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Works Contract – Service Tax – Salient features of works contract services

- The works contract services was brought under service tax net by Finance Act 2007 and are subject to service tax w.e.f. 1.6.2007
 - “Execution of works contract” means any service provided or to be provided to any person, by any other person in relation to the execution of a works contract, excluding works contract in respect of roads, airports, railways, transport terminals, bridges, tunnels and dams [Section 65(105)(zzza) of the Finance Act, 1994]
 - Works Contract service is defined to mean a contract:
 - Wherein the transfer of property in goods during the execution of such contract is leviable to sales tax/VAT
 - Involving works in the nature of :
 - Commercial or industrial construction of buildings, pipelines etc
 - Construction of residential complexes
 - erection, commissioning or installation of plant machinery, equipment, structures etc
 - turnkey projects including engineering, procurement and construction or commissioning contracts (i.e EPC Contracts).
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Value of Works Contract Services

General scheme

- Taxable value is that part of the value of the contract which pertains to services under the contract
 - Value of services to be computed by vivisecting the contract between goods and services
 - In terms of Rule 2A of the Valuation Rules taxable quantum equals Gross Value of Contract less Value of goods the property in which is transferred
 - Cenvat credit is available
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Rule 2A of the Valuation Rules

- As per Rule 2A(1) of Valuation Rules, the value of the works contract services is equivalent to the gross amount charged for works contract less the value of transfer of property in goods involved in the execution of works contract
 - For this purpose Gross amount shall not include VAT or Sales Tax
 - Value shall include the following:
 - Labour Charges for the execution of the works
 - Amount paid to the sub contractors for labour and services
 - Charges for planning designing and architect's
 - Charges for obtaining machinery, tools etc whether on hire or otherwise for the execution of the works contract
 - Cost of consumables such water electricity fuel etc used in the execution of works contract
 - Cost of establishment of the contractor relatable to supply of labour and services
 - Other similar expenses relatable to supply of labour and services and
 - Profit earned by the service provider relatable to supply of labour and services
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Value of Works Contract Service

Composition scheme

- Works Contract (Composition Scheme for Payment of Service Tax) Rules notified on May 22, 2007
 - Value for the purposes of levy of service tax is “Gross amount charged for the works contract”
 - Gross amount not to include VAT or sales tax paid on the transfer of property
 - Service tax leviable @ 4% on the gross amount charged
 - CENVAT Credit not available on inputs. However the service provider can avail Cenvat Credit of input services and capital goods
 - Scheme has to be opted before payment of service tax
 - No specific provision has been made for intimation of the option to the department. It is advised to file such intimation before making the service tax payment
 - Exit from the scheme is not possible before completion of the particular works contract for which composition scheme has been opted
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Impact of classification on service tax liability

Particulars	Scenario 1(Amt in Rs)	Scenario 2 (Amt in Rs)	Scenario 3 (Amt in Rs)
Value of the Contract (exclusive of VAT)	5,00,000	5,00,000	5,00,000
Value of Goods	2,00,000	3,00,000	4,00,000
Value of services, labour charges etc	3,00,000	2,00,000	1,00,000

Scenario	Service tax under Composition Scheme	Service tax under general scheme (Rule 2A)	Commercial Construction Services, Construction of Complexes Services, Erection, Commissioning and Installation Services after allowing abatement
Scenario 1	$5,00,000 \times 4.12\% = 20,600$	$3,00,000 \times 10.3\% = 30,900$	$(5,00,000 \times 33\%) \times 10.3\% = \mathbf{16,995}$
Scenario 2	$5,00,000 \times 4.12\% = 20,600$	$2,00,000 \times 10.3\% = 20,600$	$(5,00,000 \times 33\%) \times 10.3\% = \mathbf{16,995}$
Scenario 3	$5,00,000 \times 4.12\% = 20,600$	$1,00,000 \times 10.3\% = \mathbf{10,300}$	$(5,00,000 \times 33\%) \times 10.3\% = 16,995$

Works Contract – Service Tax : Comparison between various categories

	Work Contract	Commercial Construction Services, Construction of Complexes Services, Erection, Commissioning and Installation Services
1.	Separate Valuation Rules	No Separate Valuation Rules
2.	Composition Scheme available	No Composition Scheme available
3.	No abatement	Abatement can be availed
4.	When opted for Composition Scheme, CENVAT on inputs cannot be availed	When opted for abatement, CENVAT credit cannot be availed on inputs, input services and capital goods
5.	When opted under Valuation Rules, value of material to be deducted with corresponding input cenvat credit available*	If availed benefit under exemption notification no. 12/2003 the deduction of value of material may be claimed without availing the corresponding cenvat credit
6.	Option to avail Composition Scheme has to be exercised before paying service tax for each contract	Option to avail abatement has to be exercised before paying service tax for each contract

Works Contract – Service Tax : Comparison between various categories

	Work Contract	Commercial Construction Services, Construction of Complexes Services, Erection, Commissioning and Installation Services
7.	When opted for Composition Scheme, service tax rate works out to 4.12%	When opted to avail abatement service tax rate works out to 3.4%

* As per Circular No 98/2007 –ST dated 4.1.2008, in case contractor is opting for valuation under Valuation Rules, he can not avail the cenvat credit on the inputs for which deduction has been claimed

Validity of above Circular ?

- No such provision exists in the statute and relevant Rules.
 - Under Cenvat Credit Rules, 2004, inputs means all goods used for providing output services
 - Accordingly steel and other goods are inputs for which deduction should be allowed in Valuation Rules with corresponding cenvat credit available
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Works Contract – Service Tax – The most suitable category?

- All four categories as discussed earlier are in force as of now
 - Does an assessee has choice to categorise the contract under any of the category if it satisfies the requisite criterions?
 - This question gains importance as effective rate under service other than works contract service comes to 3.4% and under works contract services 4.12%
 - Is it arguable all works contract need to be categorised as works contract services and assessee does not have any choice?
 - By not opting for other taxable categories, will this not leave the other services and the respective abatements inoperative or otiose?
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Works Contract – Service Tax – Issues

Issue 1: Incidental installation services pursuant to supply of material

Facts:

- The assessee was selling medical equipment and also installing these equipment. No separate consideration for the installation services was provided
 - Whether service tax applicable on such installation services
 - Hon'ble CESTAT examined this issue in the case of Allengers Medical Systems Ltd. Vs. CCE 2009-TIOL-199-CESTAT-DEL and held that activity of installation, erection and commissioning of medical equipment are incidental to delivery of goods and hence no service tax would be leviable
 - CESTAT relied on the decision held in the case of State of Andhra Pradesh Vs. Kone Elevators (India) Ltd 2005-TIOL-30-SC-CT-LB
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Works Contract – Service Tax – Issues

State of Andhra Pradesh Vs. Kone Elevators (India) Ltd 2005-TIOL-30-SC-CT-LB

Facts:

Assessee was manufacturing lifts and supplying to customer in CKD. Once the site is ready the assessee installed the lift. The contract was a lump sum indivisible contract and property in goods passes on to customer once the lift is installed

It was held that:

It can be treated as well settled that there is no standard formula by which one can distinguish a 'contract for sale' from a 'works contract'.....

Works Contract – Service Tax – Issues

State of Andhra Pradesh Vs. Kone Elevators (India) Ltd 2005-TIOL-30-SC-CT-LB

.....Therefore, in judging whether the contract is for a sale or for work and labour, the essence of the contract or the reality of the transaction as a whole has to be taken into consideration. The pre-dominant object of the contract the circumstances of the case and the custom of the trade provides a guide in deciding whether transaction is a sale or a works contract.....

..... On the other hand, if the main object of the contract is to avail the skill and labour of the seller though some material or components may be incidentally used during the process of the end-product being brought into existence by the investment of skill and labour of the supplier, the transaction would be a contract for work and labour.....

Works Contract – Service Tax – Issues

Issue 1: Incidental installation services pursuant to supply of material

- Is Kone Elevators still a good law?
 - Can we take different interpretation of the same transaction in two different statutes i.e.
 - VAT: A contract amounts to works contract
 - Service tax: The services are merely incidental to supply of goods and hence not chargeable to service tax
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Works Contract – Service Tax – Issues

Issue 2: Chargeability of a indivisible works contract before introduction of taxable category of works contract service

Facts:

- Assessee was engaged in supply and installation of ATMs for bank. Department raised demand by treating it as Erection, commissioning or installation services.
- Assessee raised invoices on wherein no segregation was given for installation services

Decision:

- CESTAT relied on the decision held in the case of Daelim Industrial Co Ltd. Vs. CCE, Vadodra 2003 (155) ELT 457 and held that indivisible contract cannot be bifurcated and subject to service tax
 - This was held even if Daelim was in relation to Consulting Engineers services
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Works Contract – Service Tax – Issues

Issue 2: Chargeability of a indivisible works contract before introduction of taxable category of works contract service

- CESTAT rejected the contention of revenue that ATMs are equipment and hence installation thereof is taxable under Erection, commissioning or Installation services
- Above conclusion was held since the taxable service in relation to ATM installation came in to force w.e.f. 1.5.2006
- CESTAT also held that the instant activity can not be charged to service tax before 1.6.2007 as the taxable category of works contract services comes in to force from this date

Issue:

- What about cases which are squarely covered under the remaining three categories eg. Civil Construction etc.
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Works Contract – Service Tax – Issues

Issue 3: A contract in which bifurcation between material and services are given would still amount to divisible contract

Facts:

- Assessee was engaged in execution of turnkey contract. The agreement entered into by assessee was divided in to consideration for performance of services and consideration for material
 - Department raised demand on service portion under the taxable category of Consulting Engineer's services
 - Assessee contested the demand stating that contract is indivisible and only value of contract is divisible
 - CESTAT decided against the assessee in an ex-parte decision (2008-TIOL-1057-CESTAT). On filing a SLP in this respect, Apex Court referred it back to CESTAT 2008(9)STRJ29
 - CESTAT vide 2008-TIOL-1880-CESTAT-DEL refer the matter to larger bench and held following:
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Works Contract – Service Tax – Issues

Issue 3: A contract in which bifurcation between material and services are given would still amount to divisible contract

Decision:

- CESTAT relied on the decision held in the case of BSNL and noted that dominant nature test is not applicable on execution of works contract
 - If a works contract can be split in to sales and service contract separately, no different treatment to be accorded simply because the contract is on turnkey basis
 - CESTAT doubted the validity of decision held in the case of Daelim Industrial Co Ltd.
 - In case of works contract sales tax would be levied on value of material, would the remaining amount go out of service tax net. CESTAT answered in negative and refer the matter to larger bench
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Works Contract – Service Tax – Issues

Issue 4: Service tax on construction of complex etc.

- Taxability of construction activities of real estate builders was examined in the matter of K. Raheja Development Corporation Vs. State of Karnataka [(2005) 2 STT 178] wherein the Supreme Court has held that where the sale agreement for constructed units is entered prior to completion of construction, the contract would qualify as a works contract
 - The Gauhati High Court in the matter of Magus Construction Pvt Ltd Vs Union of India [2008-TIOL-321-HC-GUW-ST] has held that the activity of construction of flats by a builder for their subsequent sale is not chargeable to service tax under construction of complex services. It was further held that any advance received from prospective buyers before or during construction is against consideration for the sale of flats and not towards any service
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Works Contract – Service Tax – Issues

Issue 4: Service tax on construction of complex etc.

- Similarly in the advance ruling of Harekrishna Developers (2008-TIOL-03-ARA-ST) the advance ruling authority ruled that the agreement to sell for building residential units is subject to service tax

 - These controversies laid down to rest by Circular no. 108/02/2009-ST dtd 29th Jan 2009 wherein it is clarified that:
 - Initial agreement between promoter /builder / developer and ultimate owner is in the nature of agreement to sell;
 - The property still remains under ownership of promoter /builder / developer;
 - Purchaser becomes owner only when the sale deed is executed;
 - Accordingly, promoter /builder / developer provides services to itself and hence not subject to service tax
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Thank you