Works Contract- Some Vital Issues

The taxability of "Works Contract" has always been a matter of debate. This debate has been renewed with the recent changes in the service tax regime. This article discusses the journey of Works Contract from the 46th constitutional amendment and onwards, current scenario under service tax, i.e., its definition and valuation. It demystifies the link between Service Tax and the Sales Tax laws. It also raises a few issues like non-exclusion of Entry tax under Rule 2A, denial of benefit to small service providers due to reverse charge. Read on…

The taxability of "Works contract" has always been a matter of debate. The concept sailed on its enduring journey through an Apex Court order in case of *State of Madras vs. Gannon Dunkerley & Co. (Madras) Ltd.,* (1958) 9 STC 353 (SC). In the course of its journey it met through the Constitutional amendment, various case laws, rules, statutory amendments, and the latest being the changes in the Service Tax regime. The debate started with respect to applicability of local Sales Tax on the material involved in the execution of the Works Contract, got extended to the applicability of CST on interstate transaction and furthermore Service Tax on the service portion in the execution of a Works Contract.

Background

The issue of applicability of Sales Tax on indivisible contracts came before the Apex Court in the case of *State of Madras vs. Gannon Dunkerley & Co. (Madras) Ltd.,* (1958) 9 STC 353 (SC). The Apex Court held that the expression "sale" in entry 54 of list II is same as that of used in the Sales of Goods Act 1930.

Section 4(1) of The *Sale of Goods Act*, 1930 defines sale as a "contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price". Accordingly a transaction, in order to be 'sale' for the levy of Sales Tax should have the following ingredients, two parties to contract *i.e.*, seller/purchaser; moveable goods, monetary consideration and transfer of property, *i.e.*, transfer of ownership from seller to purchaser.

The court held that "On the true interpretation of the expression "sale of goods" there must be an agreement between the parties for the sale of the very goods in which eventually the property passes. In a building contract, the agreement between the parties is that the contractor should construct the building according to the specifications contained in the agreement, and in consideration therefore, receive payment as provided therein, and in such an agreement there is neither a contract to sell the materials used in the construction, nor does property pass therein as moveable."

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In the concluding part of the judgment, the court further held that:

"In a building contract which is, as in the present case, one, entire and indivisible and that is its norm, there is no sale of goods, and it is not within the competence of the Provincial Legislature under Entry 48 to impose a tax on the supply of the materials used in such a contract treating it as a sale". The court had held that there is no contract to sell the materials as such and the property in them does not pass as moveable. As an outcome of this judgement, State legislature was not competent to levy tax on indivisible Works Contract. Whereas, if the contract treated the sale of materials separately from the cost of the labour, tax was to be paid on the sale of such materials. This position resulted in scope for avoidance of tax as well as loss of revenue to the state exchequer.

Later on, the matter was referred to the Law Commission to express its opinion. The Law commission in its report opined that the union has the power to tax the Works Contracts under Constitution, Seventh Schedule, Union List, Entry 97. The commission stated that the question is ultimately of the policy however before the judgment of the Supreme Court sale was usually regarded as including a Works Contract and the commission would prefer restoration of power to the states. The commission suggested three alternatives, (i) Amending entry 54 in the state list. (ii) Adding a fresh entry in the state list (iii) inserting in article 366 a wide definition of "sale" so as to include works contract.

The Government preferred the 3rd option and introduced clause 29A in Article 366 on 2nd February 1983 by 46th Constitutional Amendment. Constitutional amendment nullified the observation of the Supreme Court in the Gannon Dunkerley's case.

Works contract which was an indivisible one, by a legal fiction altered into a contract divisible into one for the sale of goods and the other for supply of labour and services. After the 46th Amendment, it has become possible for the States to levy Sales Tax on the transfer of property in goods (whether as goods or in some other form) involved in execution of a works contract irrespective of the fact that the contract might have been a composite one and the intention of the parties was not to sell goods. States amended the Sales Tax laws and included the property transferred in the execution of a Works Contract within tax net of the State VAT.

The constitutional validity of the 46th Amendment has been upheld in case of *Builder Association of India vs. Union of India* (1989) 73.

"Service" under Section 65B (44), defined for the first time w.e.f 01-07-2012, includes the declared services within its ambit. Declared Services are defined under Section 65B (22) of the Finance Act, 1994 as any activity carried out by a person for another person for consideration and declared as such under Section 66E of the Finance Act, 1994.

46th Constitutional Amendment and Interstate Sale

In another case of *Gannon Dunkerley. & Co. vs. State of Rajasthan* (1993) 88 STC-204), the apex court held that the state in exercise of its legislative power under Entry 54 of the State List read with Article 366(29-A) (b), is not competent to impose a tax on such a transfer (deemed sale) which constitutes a sale in the course of inter-State trade or commerce or a sale outside the State or a sale in the course of import or export. Whether a sale falls under these aforesaid categories, have to be determined in accordance with the principles contained in the Central Sales Tax Act and the State cannot make a departure from those principles.

The definition of "sale" under CST act, to bring in line with the Constitutional Amendment, was amended by the Finance act, 2002 .The new definition of "sale u/s 2(g) w.e.f 11th May 2002 includes "transfer of property in goods" (whether as goods or in some other form) involved in the execution of a Works Contract.

Chargeability under Service Tax

"Service" u/s 65B (44), defined for the first time w.e.f 01-07-2012, includes the Declared Services within its ambit. Declared Services are defined under Section 65B (22) of the Finance Act, 1994 as any activity carried out by a person for another person for consideration and declared as such under Section 66E of the Finance Act, 1994. It means for a service to come under the purview of Declared Services, it has to satisfy two conditions simultaneously:-

a) It must be an activity carried out by one person for another person in lieu of consideration and

b) It must be specified (*i.e.*, declared) under Section 66E.

Section 66E specifies 9 activities as Declared Services, service portion in the execution of Works Contract being one of them. Thus, the ambiguity prevailing with regard to taxability of Works Contract under Service Tax has been settled to a greater extent.

Section 65B (54) defines Works Contract as a contract wherein transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods and such contract is for the purpose of carrying out construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, 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.

Mere classification as Works Contract in VAT doesn't make an activity as Works Contract in Service Tax. Thus for classifying a service as Works Contract all the following conditions need to be satisfied:

a) There must be transfer of property in goods in the execution of such contract. For instance, a comprehensive Annual Maintenance Contract involving replacement of various spare parts, peripherals *etc*. However, the consumables used during the course of provision of service, such as in case of cleaning contracts, do not constitute transfer of property in goods.

b) Such goods must be chargeable to Sales Tax. The exemption by any notification doesn't mean that Sales Tax is not leviable.

c) Such contract is for construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation, alteration or any other similar activity or a part thereof in relation to such property.

The new definition has enlarged the scope of the Works Contract by including activities relating to movable property, in addition to immovable property, within its ambit. The new definition covers services such as composite AMC, Authorised Service Station *etc.*

Valuation – Works Contract

The new system of negative list based taxation has abolished the concept of classification to a greater extent but not in its entirety. Classification of services is vital not only for the attraction of "Reverse charge" or "partial reverse charge" mechanism but also for the valuation of few services such as Works Contract.

As soon as a service is classified as Works Contract, valuation is to be carried out as per Rule 2A of Service Tax (Determination of value) Rules, 2006. Two options of valuation are available to the taxpayer under Rule 2A, as amended by Notification No. 24/2012 dated 06th June 2012.

Valuation under Rule 2A(i) can be carried out only when payment of VAT or Sales Tax has been made on the actual value of the transfer of property involved in the execution of works contract, *i.e.*, this option is not available in case the taxpayer has opted for composition scheme or standard deduction under Sales Tax/VAT.

As per Rule 2A (i), Value of works contract =

"Gross amount " charged for the works contract	-
Less: - the value of transfer of property in goods involved in the execution of works contract.	-
Taxable value	-

The "Gross amount" shall not include Value Added Tax or Sales Tax paid on goods involved in the execution of the said Works Contract and Value of Transfer of Property in Goods shall be the value of goods adopted for the purpose of payment of Sales Tax or VAT.

Rule 2A (ii) provides for payment of tax on the composition basis although not referred as composition scheme in the notification. This option is available only when valuation cannot be done as per Rule 2A (i)Works Contract (composition scheme for payment of Service Tax) rules 2007 has been withdrawn by Notification No. 35/2012.

Rule 2A (ii) provides for the following rate:-

Works pertaining to	Value of services
Original works	40% of the "total amount" charged
Maintenance, repair, reconditioning or restoration or servicing of any goods.	70% of the "total amount" charged
In case of other contracts not included above	60% of the "total amount" charged

Original works includes addition or alteration carried out to abandoned or damaged structure to make them workable. Any alteration relating to

the structures already in use or fit to use won't be covered under original works and would be classified as maintenance or repair work.

The computation of the total amount can be explained with the help of an illustration:-

Mr. B entered into an agreement with Mr. A to construct a building for ₹1 crore. As per the agreement Mr. B will supply 1000MT cement to Mr. A @ ₹1000/MT. Sales Tax @5% is chargeable on the amount recovered on account of charges for cement supplied. The fair market value of cement is ₹6500/MT. Furthermore, Mr. B will also provide a Crane for 30 days to be used in the construction without charging any amount. Mr. B recovers ₹1000 per day for such crane from others.

Entry Tax & Rule 2A

Various states have levied tax on entry of goods into the state from outside the state, referred as Entry Tax. The tax is to be paid to the recipient state in addition of CST payable to the originating state. It is administered by the commercial taxes department of the state. Few states such as Bihar provide set-off of Entry Taxes paid on the entry of such goods with the subsequent VAT liability. The nature of Entry Tax and VAT is very much similar. While determining the 'Transaction Value' under Section 4 of the Central Excise Act, VAT as well as other taxes are excluded however Rule 2A of Service Tax (Determination of Value) Rules, 2006 provides for exclusion of VAT only. The constitutional validity of Entry Tax is under litigation at several forums. However, it is applicable in many states as of now. Exclusion of Entry tax in addition to VAT in rule 2A would have avoided undue hardship faced by the taxpayers.

Valuation under VAT/CST Regime

The valuation rule under Service Tax is dependent on the method of valuation adopted under Sales Tax/Vat rules. Three valuation options are available under VAT laws:- (1) Regular method (2) Standard deduction method (3) Composition scheme.

Regular method: The Apex Court in the case of *Gannon Dunkerley & Co. vs. State of Rajasthan* (1993) 88 STC-204) held that the value of goods involved in the execution of the works contract can be arrived at by deducting expenses incurred by the contractor for providing labour and other services from the value of the works contract.

The charges for labour and services which are required to be deducted from the value of the works contract would cover:-

(i) labour charges for execution of the works,
(ii) amount paid to a sub-contractor for labour and services;
(iii) charges for obtaining on hire or otherwise machinery and tools used for execution of the works contract;
(iv) charges for planning, designing and architect's fees; and
(v) cost of consumables used in execution of the works contract;
(vi) cost of establishment of the contractor to the extent it is relatable to supply of labour and services,
(vii) other similar expenses relatable to supply of labour and services; and
(viii) profit earned by the contractor to the extent it is relatable to supply of labour and services.

Explanation (b) to Rule 2A (1) of Service Tax (Determination of Value) Rules, 2006 provides these elements as includible for the value of Works Contract service. Thus, the elements allowed as deduction under VAT are taxed under Service Tax. After deduction of these items, tax is payable at applicable rates under State VAT. The Apex Court also held that a uniform rate of tax for various goods involved may be prescribed. Few states such as Assam, Delhi, Karnataka and Kerala have specified a uniform rate on materials involved in the execution of Works Contract other than declared goods under CST Act, 1956.

Standard deduction: Under standard deduction method, tax is payable after deduction of standard labour component as prescribed under State VAT laws. This option is not available in a few states such as Bihar.

Composition scheme: Under the composition scheme, tax is payable on the total contract value including labour at a concessional rate. It is a simple method saving a lot of effort in maintaining records however input tax credit, except in the state of Maharashtra, is not available to the dealer opting composition scheme. Few states such as Gujarat and Tamil Nadu do not allow composition if it involves interstate movement of goods. In few states this scheme is available only to the dealers having turnover less than the specified limit.

Valuation under CST Act

Proviso to Section 2(h) of CST Act provides that "sale

price" in case of sale of 'goods involved in the execution of works contract will be determined on the basis of rules that may be made by the Central Government but no rule has been framed till date. In a peculiar case of *M/s. Mahim Patram Pvt. Ltd. vs. Union of India* (6 VST 248) (SC), the appellant contended that in absence of any rule for determination of the sale price, in respect of transfer of property in goods involved in the execution of works contract, the taxable turnover u/s 8A of the CST Act cannot be determined under the act and it cannot be left to the whims and fancies of the authorities. The Apex Court didn't agree to the contention that in the absence of valuation rule, the transaction cannot be taxed and held that only because the rules have not been framed under Central Act would not mean that no tax is leviable and in absence of rules, valuation can be made on the basis of state rules.

Works Contract – Reverse Charge

Usually, the service provider is liable to pay Service Tax for the services provided except for the few services for which service receiver is liable as per Section 68 (2) of Finance act 1994, referred to as reverse charge mechanism. This mechanism has not been altogether new but the scope has been enlarged in a greater way. Furthermore, a new concept has been introduced where the service provider as well as service receiver is made liable to pay Service Tax in specified percentage for a particular service, popularly referred as "partial reverse charge."

Applicability of the reverse charge mechanism is not dependent only on the nature of services but to who and by whom also.

Description of services	Provided by	Provided to	Liability to pay
Works contract	Any individual HUF Proprietary firm Partnership Firm Association of person located in the taxable territory	Business entity registered as body corporate located in taxable territory.	SR-50% SP-50%

Denial of Benefit

Notification No.33/2012 exempts taxable services of aggregate value not exceeding ₹10 lakh in any financial year from the whole of the Service Tax leviable thereon. However, the liability of the service provider and service recipient are different and independent of each other. Thus, in case the service provider is availing exemption owing to turnover being less than ₹10 lakh; he shall not be obliged to pay any tax but the service recipient shall have to pay Service Tax which he is obliged to pay under the partial reverse charge mechanism

Specific conditions of each case rules out the possibility of a single point formula that fits to each and every situation. Applicability of CST, Service tax, VAT laws of different states as well as multitude of judicial pronouncements makes the job more complex. However proper analysis and planning of the available options to compute tax liability could prove to be a boon for organisations.

It is a common practice that the contract price entered between the Contractor and the contractee is inclusive of all taxes and duties. Service receiver deducts the Service Tax amount from the payment of contractor and deposits to the Government. In many cases at the time of entering the contract, the service provider has not considered the service tax cost in his quotation being a SSP. However, now as the SR has been made liable to pay, Contract being inclusive, SR recovers the tax and deposits the same. This is an indirect collection of Service Tax and denial of benefit to the SSP. Introduction of Reverse charge have caused undue hardship to the Small Scale Service provider and especially to the existing contracts.

Conclusion

Specific conditions of each case rules out the possibility of a single point formula that fits to each and every situation. Applicability of CST, Service Tax, VAT laws of different states as well as multitude of judicial pronouncements makes the job more complex. However, proper analysis and planning of the available options to compute tax liability could prove to be a boon for organisations.

GST may mark an end to the enduring debate surrounding the taxability of Works Contract. GST will lead to multitude of case laws and legislative history on Works Contracts becoming irrelevant. The provision of segregation of taxing power relating to Supply of Goods and Services under the constitution would become irrelevant. A simple GST regime is hence awaited eagerly. ■