‘Original Works’ under Rule 2A an ‘original’ interpretation needed : 01-04-2014

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ONE of the most confusing and litigation prone area in service tax concerns Rule 2A of the Service Tax (Determination of Value) Rules, 2006, as it stands amended with effect from 01/07/2012.

The Rule reads:

Determination of value of service portion in the execution of a works contract.

2A. Subject to the provisions of section 67, the value of service portion in the execution of a works contract, referred to in clause (h) of section 66E of the Act, shall be determined in the following manner, namely:-

(i) Value of service portion in the execution of a works contract shall be equivalent to the gross amount charged for the works contract less the value of property in goods transferred in the execution of the said works contract.

Explanation.- For the purposes of this clause,-

(a) gross amount charged for the works contract shall not include value added tax or sales tax, as the case may be, paid or payable, if any, on transfer of property in goods involved in the execution of the said works contract;

(b) value of works contract service shall include,-

(i) labour charges for execution of the works;

(ii) amount paid to a sub-contractor for labour and services;

(iii) charges for planning, designing and architect’s fees;

(iv) charges for obtaining on hire or otherwise, machinery and tools used for the execution of the works contract;

(v) cost of consumables such as water, electricity, fuel used in the execution of the works contract;

(vi) cost of establishment of the contractor relatable to supply of labour and services;

(vii) other similar expenses relatable to supply of labour and services; and

(viii) profit earned by the service provider relatable to supply of labour and services;

(c) where value added tax or sales tax has been paid or payable on the actual value of property in goods transferred in the execution of the works contract, then, such value adopted for the purposes of payment of value added tax or sales tax, shall be taken as the value of property in goods transferred in the execution of the said works contract for

determination of the value of service portion in the execution of works contract under this clause.
(ii) Where the value has not been determined under clause (i), the person liable to pay tax on the service portion involved in the execution of the works contract shall determine the service tax payable in the following manner, namely:-
(A) in case of works contracts entered into for execution of original works, service tax shall be payable on forty per cent of the total amount charged for the works contract;
(B) in case of works contract entered into for maintenance or repair or reconditioning or restoration or servicing of any goods, service tax shall be payable on seventy per cent of the total amount charged for the works contract;
(C) in case of other works contracts, not covered under sub-clauses (A) and (B), including maintenance, repair, completion and finishing services such as glazing, plastering, floor and wall tiling, installation of electrical fittings of an immovable property, service tax shall be payable on sixty per cent of the total amount charged for the works contract.
Explanation 1. -For the purposes of this rule,-
(a) "original works" means-
(i) all new constructions;
(ii) all types of additions and alterations to abandoned or damaged structures on land that are required to make them workable;
(iii) erection, commissioning or installation of plant, machinery or equipment or structures, whether pre-fabricated or otherwise;
(b) "total amount" means the sum total of the gross amount charged for the works contract and the fair market value of all goods and services supplied in or in relation to the execution of the works contract, whether or not supplied under the same contract or any other contract, after deducting-
(i) the amount charged for such goods or services, if any; and
(ii) the value added tax or sales tax, if any, levied thereon:
Provided that the fair market value of goods and services so supplied may be determined in accordance with the generally accepted accounting principles.
Explanation 2. – For the removal of doubts, it is clarified that the provider of taxable service shall not take CENVAT credit of duties or cess paid on any inputs, used in or in relation to the said works contract, under the provisions of CENVAT Credit Rules, 2004.]
It is common knowledge that most Realty players find it impractical to maintain books and accordingly determine their VAT liability and are consequently forced to go under Rule 2A(ii).
Let's discuss some examples to understand the kind of confusion that this sub-rule could create….
Case I:
++ Assume that a Developer is developing a new residential project and has entered into a construction agreement with his flat buyer, in

which case, it would be very reasonable to presume that the entire contract would suffer service tax @ 4.944%. Assume further that the Developer has contracted out the construction activity to a contractor and has also employed contractors/sub-contracts for finishing services, installation services, etc., which is a practice widely followed in the industry.

++ While the contractor rendering construction services would charge the Developer @ 4.944%, what would be the service tax rate for the sub-contractor who renders finishing services, installation services, etc. in respect of the same new residential project? The views of the Developer and the sub-contractors widely vary in this case, with most contractors insisting that, they would charge service tax in terms of Rule 2A(ii)(C), charging service tax @ 7.416% (i.e. on 60% of the value), as their work is covered under the specific definition given under this sub-rule. The view of the Developers, however, is that, since the whole project falls under 'original works', the sub-contractors undertaking finishing work, etc. should charge service tax on 40% of the gross amount charged.

Case II:

+++ Assume that the Developer has contracted out the entire activity related to the development of a new residential project, on a back-to-back basis, including construction activity and activities such as finishing, installation etc., with separate rates for each of these activities. What is the service tax rate that this back-to-back contractor is supposed to charge, for the part of the contract that deals with finishing, etc.? There is no clarity here and a view that is being taken by some Departmental officers is that whenever a separate rate is being charged for the finishing work, etc. the case would fall under Rule 2A(ii)(C) and not Rule 2A(ii)(A). This view would seem to defy logic, as the entire construction is for a new residential project.

Case III:

++++ Assume that the Developer, who is developing a new residential project, has entered into a back-to-back contract with a contractor for a single rate based on per sft basis, for the entire activity without specifying different rates for finishing work, etc. In this case, will it be safe to assume that, the entire contract would be one of an 'original works', squarely covered under Rule 2A(ii)(A), in terms of which, the service tax rate would be 4.944%. I hold this view.

The Realty Sector, as all of us with the sole exception of our Babus know, is a highly complicated industry involving multiple layers of service providers. The question that arises is, how can the Government have a rule that can create such a lot of confusion? Why can't this sub-rule (ii) simply state that for all activities related to original works, the service tax would be calculated on 40% of the gross amount charged.

By the way, I am not able to understand the meaning of 'original works'. The definition of 'original works' states that it means 'all new constructions'. Is there a concept called 'old construction'? I can

understand new projects and old projects, but not 'new construction' and 'old construction'. The definition of 'original works' also covers 'all types of additions and alterations to abandoned or damaged structures on land that are required to make them workable'.

Does the brilliant Babu in the Finance Ministry who drafted this wonderful Rule believe that there can be a moron who would make additions and alterations to abandoned and damaged structures with an intention to make them non-workable?

And, what about a case, where an existing good civil structure is completely demolished and a new project is developed? It would seem that, this case would not directly fall under the definition of 'original works' as this is not a 'new construction' and is not involving addition or alteration to an abandoned or damaged structure. Will this activity then attract service tax and be covered under Rule 2A(ii)(C)? I am at sea!

There is no doubt that the amended Rule 2A, in its present avatarwef 1/7/2012 would result in a lot of litigation with the Department questioning all cases wherein, service tax liability has been discharged on the basis of 'original works'. The Realty players would need to do a lot of 'original' thinking then, in understanding this Rule 2A, for sure.

Before parting…

The Babus working for the Central Government would do well to emulate their counterparts from the State Governments. The rules related to valuation of works contracts under the VAT law are much simpler and easier to comprehend. A case in point is Rule 3(2) of the Karnataka Value Added Rules, 2003 which provides a very simple methodology for computing the deduction that is allowed for 'labour and like charges', when such charges are not ascertainable from the books of accounts maintained by the dealer. This Rule specifies various types of works contracts and provides for deduction towards 'labour and like charges' (which, in effect, is the 'service' element of the works contract) at specified percentages of the gross amount charged for each of these works contracts and also has a residuary category for works contracts not specifically included in the table given therein. Compare this very simple VAT rule with the highly complicated Rule 2A and you can say who is a good drafter of laws.

The Bureaucracy would seem to have a vested interest in ensuring that our tax laws remain complex and Rule 2A is a classic example of this phenomenon.

The brilliant officers of the Service Tax Department can keep themselves busy and justify their positions and salaries by issuing show cause notices and passing orders, *vis-à-vis* this Rule.

But as a lawyer, I have no complaints, though. Many thanks, Rule 2A!