SC decision in L&T case – VAT effect & ST implication – Part 2 – 25-10-2013

By S Sivakumar, LL.B, FCA, FCS, ACSI, Adv.

WHILE writing on the historic decision of the Hon'ble Supreme Court in the L&T case **[**2013-TIOL-46-SC-CT-LB**]**, I was careful enough to mention that this decision could have manifold ramifications. After writing my piece in TIOL, when I sat down to understand the nuances of this decision, I have been struck with several ramifications which would change the manner, VAT and Service tax are levied on the Realty Sector. Indeed, this decision goes much beyond the law that was laid down in the *K Raheja* case **[**2005-TIOL-77-SC-CT**]**, for sure.

One of the most important paragraphs contained in this decision, is Para 115, which is reproduced below:

Quote

115. It may, however, be clarified that activity of construction undertaken by the developer would be works contract only from the stage the developer enters into a contract with the flat purchaser. The value addition made to the goods transferred after the agreement is entered into with the flat purchaser can only be made chargeable to tax by the State Government.

Unquote

The implications arising out of this para, which is a binding precedent, in my view, could have far reaching implications on the Realty Sector. Consider these…

As per Para 115, it is clear that the concept of 'works contract' would arise only from the time an agreement is signed between the Developer and the flat purchaser. The value of work done upto the date of agreement would then be a transaction in immovable property.

We can try and understand this with an example -

Let us assume that the total value of a flat is Rs 100 lakhs, with Rs 30 lakhs being treated as the value of the land. Further assume that, as on the date of the agreement between the Developer and the flat purchaser, 70% of the work has already been completed in the flat. In terms of the L&T decision, only Rs 21 lakhs representing 30% of Rs 70 lakhs can be treated as a works contract, while Rs 49 lakhs representing 70% of Rs 70 lakhs would be treated as the value of sale of immovable property by the Developer/Landowner. From the VAT law, it is then clear that, the States can levy sales tax/VAT only on the portion of the value that is attributable post the date of the agreement.

Going forward… every Developer/Builder would need to estimate the quantum of work that has been completed in respect of each of the flat and treat the value of the constructed portion (up to the date of the agreement) as a transaction of sale of immovable property and offer only the balance consideration (on and from the date of the agreement) for purposes of VAT levy. In effect, every agreement could have the consideration attributable to the sale value of the undivided portion of the land, the value attributable to the portion of construction that has already been completed as of the date of the agreement and the balance consideration, which would be exigible to the levy of VAT.

Before we get into a discussion on the implication of Para 115 on service tax, we must bear in mind the fact that, the L&T decision would have retrospective effect, given the fact that, the decision involves interpretation of the term 'works contract' under the Karnataka Sales Tax Act, 1957 and subject to limitation, the case would involve reworking of the sales tax/VAT liability in most States, as Developers/Builders would have paid sales tax/VAT on the entire construction value, based on the *K Raheja* decision. The State Governments, would of course, be flooded with refund applications from the flat purchasers, who can now claim a refund of the sales tax/VAT paid on the value of the construction part completed, as on the date of the agreements. This could turn out to be a nightmare for most States for sure.

Per se… it would appear that States would lose quite a bit of tax revenues, if they are only allowed to levy sales tax/VAT on the construction value, post the date of the agreements. To what extent, this would be to the liking of the State Governments is anybody's guess. It seems that there is little that they can do now as the definition of the term 'works contract' is based on the phraseology used in Article 366(29-A) of the Constitution and unless the Constitution is amended, there is no way the States can get over this historic decision. Of course, there are several other issues involving reversal of input tax credit on the element of the value of the sale of the immovable property, which could create huge problems and issues for Developers and Builders.

How could Para 115 affect service tax?

Can a view be taken that, post the L&T decision, the same concept would work for the service tax law as well, and that, only the value of the construction post the date of the agreement between the Developer and the flat purchaser can be subjected to service tax levy? Perhaps, yes, if the transaction is considered as a works contract under the service tax law.

But, there is another issue in service tax, involving the Realty Sector. Most transactionsinvolving construction and sale of flats would also get covered under Section 66E(b) of the Finance Act, 1994, which reads as under:

(b) construction of a complex, building, civil structure or a part thereof, including a complex or building intended for sale to a buyer, wholly or partly, except where the entire consideration is received after issuance of completion certificate by the competent authority.

Given the fact that this entry can also cover transactions which are not works contracts, Developers and Builders could get caught under this entry, in terms of which, service tax might have to be paid on the entire construction value, including the value of the construction attributable to the period, prior to the date of the agreement, subject, of course to abatement.

In effect we could have a scenario wherein, a transaction of construction and sale of a flat could get treated quite differently, under the VAT law and the Service tax law. In my view, with several High Courts upholding the constitutional validity of a similar entry which came into being from 1-7-2010, due to the insertion of the Explanation to the definition of the then prevailing 'Construction of Complex' services and 'Commercial or Industrial Construction' services, it seems unlikely that the constitutional validity of Section 66E(b) can be called into question.

Before concluding…

We must bear in mind the fact that the ramifications arising out of the L&T decision on the Realty Sector would be far and wide and certainly much more than that of the *K Raheja*decision. In effect, the L&T decision travels much beyond the *K Raheja* decision.

It would perhaps take weeks, if not months, for the Realty Sector to fully digest the impact arising out of the L&T decision, as there could be several other unintended ramifications.

This decision could have no implications in so far as the levy of stamp duty by the States is concerned, as the stamp duty is paid, invariably, on the valuation adopted by the Sub-Registrars in terms of the area-wise rates prescribed by the State Governments.

It would be interesting to see how the States would react to this historic decision in general and Para 115 in particular.

The L&T decision would also impact works contracts like maintenance contracts, erection contracts, etc. in very much the same manner.