SC decision in L&T case – VAT effect & ST implication – 30-09-2013

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IN what could be termed as one of the most awaited and keenly followed decisions, the Hon'ble Supreme Court has, in *L&T Limited v. State of Karnataka* **(2013-TIOL-46-SC-CT-LB)** affirmed its earlier decision rendered in the very famous K Raheja case. While heartily complimenting TIOL for bringing this very important decision with lightning speed, I have attempted to understand the broader implications arising out of this very important case, in this piece.

It would help to understand the background pertaining to the K Raheja decision, as the L & T decision is only reinforcing the Apex Court's earlier decision. In Karnataka, in the 1990s and the early 2000s, the rate of sales tax used to be rather low at around 4%, while the stamp duty rate used to be at around 15%. Some of the brightest tax brains (in Bangalore) came out with a plan to split the consideration for the sale value of the immovable property, into two agreements, viz. one, for the sale of the undivided portion of the land and the second, for the construction of the apartment and due to this, while sales tax came to be levied on the construction value, stamp duty was levied on the market value of the flat, which was lower than the total consideration for the sale of the undivided portion of the land and the value of the construction. It is obvious that, the purchaser of the apartment saved quite a bit of tax, as between stamp duty and Sales Tax, the stamp duty rate was significantly higher than the sales tax rate.

When the VAT law came into effect from 1-4-2005, the VAT rate was fixed at 12.5% initially and now stands at 14.5% in Karnataka. Of course, the stamp duty rate has been consistently coming down and is currently at 5%. What was good planning in an era where the stamp duty rate was high became a disaster, with the sales/VAT rates climbing up and the stamp duty rate falling significantly.

Some Developers and Builders tried to come out of this scenario by entering into single agreement of a future sale of the apartment on the basis of the view that, amounts received by them prior to the completion of the flat would be in the nature of advance monies for the future conveyance of immovable property and consequently, cannot be treated as 'works contracts' under the sales tax/VAT law. It was in this background that the Apex Court delivered its historic verdict in the *K Raheja case, in 2005* **(2005-TIOL-77-SC-CT)**, under the then prevailing Karnataka Sales Tax Act, 1957.

For the benefit of TIOL readers, I've reproduced the relevant paras from the L & T decision, which beautifully summarizes the issue, as under:

Quote:

The Larger Bench noted the broad facts in Raheja Development's case as:

1. Raheja Development carried on the business of real estate development and allied contracts;

2. Raheja Development entered into development agreements with the owners of land;

3. Raheja Development entered into agreements of sale with intended purchasers. The agreements provided that on completion of the construction the residential apartments or the commercial complexes would be handed over to the purchasers who would get an undivided interest in the land also;

4. The owners of the land would then transfer the ownership directly to the society formed under the Karnataka Ownership Flat (Regulation of the Promotion of Construction, Sale, Management and Transfer) Act, 1972 (for short, 'KOFA').

The following definition of "works contract" was under consideration before this Court in Raheja Development': *"works contract" includes any agreement for carrying out for cash, deferred payment or other valuable consideration, the building, construction, manufacture, processing, fabrication, erection, installation, fitting out, improvement, modification, repair or commissioning of any moveable or immovable property".*
In light of the above facts and the definition of "works contract", the question before this Court was whether Raheja Development were liable to pay turnover tax on the value of goods involved in the execution of the works contract.

The Court in *Raheja Development* held as under:
(i) The definition of the term "works contract" in the Act is an inclusive definition.

(ii) It is a wide definition which includes "any agreement" for carrying out building or construction activity for cash, deferred payment or other valuable consideration.

(iii) The definition of works contract does not make a distinction based on who carries on the construction activity. Even an owner of the property may be said to be carrying on a works contract if he enters into an agreement to construct for cash, deferred payment or other valuable consideration.

(iv) The developers had undertaken to build for the prospective purchaser.

(v) Such construction/development was to be on payment of a price in various installments set out in the agreement.

(vi) The developers were not the owners. They claimed lien on the property. They had right to terminate the agreement and dispose of the unit if a breach was committed by the purchaser. A clause like this does not mean that the agreement ceases to be "works contract". So long as there is no termination, the construction is for and on behalf of the purchaser and it remains a "works contract".

(vii) If there is a termination and a particular unit is not resold but retained by the developer, there would be no works contract to that extent.

(viii) If the agreement is entered into after the flat or unit is already constructed then there would be no works contract. But, so long as the agreement is entered into before the construction is complete it would be works contract.

Unquote:

While interpreting the K Raheja decision as well as the L & T decision, it would do us a lot of good to appreciate the fact that the definition of 'works contracts' under the VAT laws of most States are very similar to that we have in Karnataka and to this extent, this decision will apply to almost, the whole of the country.

The sum and substance of the K Raheja decision, which has been affirmed in the L & T decision, as far as I can see, is that, *even an agreement to sell an immovable property would be treated as a 'works contract' as long as, amounts are received from the prospective buyer prior to the completion of the construction, as this transaction would also be a 'works contract' coupled with a transaction involving sale of immovable property*.Though the K Raheja case actually dealt with a commercial property (located on M G Road, Bangalore), it is obvious that the law laid down by the Apex Courts applies, more importantly, to 'works contracts' involving residential properties as well.

This decision, very aptly, also refers to another historic decision of the Apex Court in, interestingly, another decision involving *L & T viz. State of Andhra Pradesh & Ors. vs. Larsen & Toubro Ltd. & Ors.;* **(2008-TIOL-158-SC-VAT)**, in Para 31 and other Paras. The Apex Court has not overruled its decision in the case of State of AP and Ors v. Larsen & Toubro Ltd and Ors and this would lead to the sustainable view that, if the Developer is not purchasing any goods and not transferring any property in goods to the prospective buyer, which is actually undertaken by the contractor appointed by the Developer, no VAT is still leviable on the Developer, under the VAT law.This argument is based on the view that, by not transferring goods, in the same or in other form, to the prospective buyer, the Developer, who has contracted out the construction activity, cannot be treated as a 'dealer' or 'works contractor' under the VAT law.

As a matter of huge relief, the Apex Court rejected the contention of the State of Karnataka that, even in the case of sale of the immovable property after completion of construction, sales tax is to be levied on the value of the materials and goods comprised in the sale consideration. Hence, sale of immovable properties, whether finished or semi-finished, are outside the purview of VAT.

Be that as it may, now… to my favourite zone… are there any service tax implications arising out of this landmark decision of the Apex Court? Well… quite a few, Sir.

Firstly … it would seem that the levy of service tax on the 'deemed service' on Developers in terms of Item No. (b)of Section 66E of the Finance Act, 1994, wherein, service tax is leviable on the amounts received from the prospective buyer, unless the entire amount for the sale of the property is obtained after the OC date, gets some legal sanction from the Apex Court. After all, this deemed service would be a works contract under the VAT law post the L & T decision and ipso facto , would also be a works contract under the service tax law.

Secondly, though this decision is not applicable to the service tax law, it would seem that, the decisions of the High Courts in the *Magus Construction Pvt Ltd Vs Union of India* - **(2008-TIOL-321-HC-GUW-ST)** and *Assotech Realty Pvt Ltd Vs State of UP* - **(2007-TIOL-297-HC-ALL-CT)**, which had held that, no service is involved when the Developer enters into an agreement of sale of a flat and receives amounts prior to the completion of the construction, would no longer be valid, as these transactions are to be treated as 'works contracts' under the VAT law and by default, would become 'works contracts' under the service tax law.

Thirdly,… I feel that, since the law laid down by the Apex Court in the State of AP v. L & T case has not been overruled, a view can still be taken by 'pure Developers' who do not effect transfer of property in goods by themselves having employed turnkey contractors, cannot be treated as 'dealers' under the VAT law and consequently, the levy of service tax would fail, notwithstanding Entry No. (b)of the Declared List of services covered under Section 66E. Of course, the constitutionality of this entry would need to be challenged both under the new law that has taken effect from 1-7-2012 as well as, in respect of the amendment brought into the service tax law, by the insertion of the Explanation, with effect from 1-7-2010, in respect of 'construction services'.

*Fourthly, ….*the concept of a joint development agreement between the Developer and the owner of the land, not being treated as a 'works contract' under the VAT law, still holds good, in my view, even after this landmark decision. This decision refers to the concept of a joint "development agreement in Para 111 and makes an observation that "direct monetary consideration may not be involved but such agreement cannot be seen in isolation to the terms contained therein and following development agreement, the agreement in the nature of the tripartite agreement between the owner of the land, the developer and the flat purchaser whereunder the developer has undertaken to construct for the flat purchaser for monetary consideration". In my humble view, given the fact that, monetary consideration is a pre-requisite for levy of VAT, no sales tax/VAT can be levied in respect of joint development agreements entered into between the Developer and the owner of the land, as these are largely 'barter' transactions involving the Developers and the Land

owners. Though non-monetary consideration might be good enough to attract service tax levy, insofar as levy of service tax on works contracts is concerned, the service tax law will have to follow the VAT law and consequently, no service tax can be levied in respect of transactions between the Developers and Landowners.

And, lastly… unlike the service tax law, there is no concept of the OC date being treated as the 'deemed' date of completion of construction of the apartment under the VAT law. There could be some instances, whereunder, the construction would have been completed but the OC would not have been received. In these cases, it is perfectly legal to take the view that, no VAT is applicable, as the construction is complete. But, the levy of service tax, in terms of Entry No. (b)of Section 66E could still survive, as the consideration has been received prior to the date of the OC. I have my serious doubts.

Before concluding…..

Undoubtedly, this much awaited decision has come as a surprise (definitely, not a pleasant surprise, Sir) to many of the tax practitioners, especially after the Apex Court had doubted the correctness of its earlier decision in the *K Raheja case, in L & T Limited v. State of Karnataka* **(2008-TIOL-186-SC-CT)**. In any case, this decision would set to rest, all controversies that are existing in the Realty Sector, on the levy of VAT and service tax on 'sale agreements', which are popularly referred to as 'single agreements' (as contrasted to the system of Developers entering into 'two agreements' involving sale of land and for construction of the apartment).

Interestingly, the Apex Court did not accept the view of the counsel that the dominant intent of the transaction should be taken into account in the case of works contracts covered by Article 366(29-A)(b) of the Constitution. (In the case of an agreement of sale, it was argued that the dominant intent is one of sale of immovable property). I don't know if this would reinforce the Apex Court's earlier decision in the *BSNL* case **(2006-TIOL-15-SC-CT-LB)**, in terms of which, the dominant intention would be a factor to determine the levy of either of service tax or VAT on a composite transaction, other than deemed sale transactions covered under Article 366(29-A).

I am not competent enough to delve into the wider ramifications arising out of this decision. It would seem that this decision would have more implications for Service Tax than that for the VAT law. Insofar as the impact on the VAT law is concerned, it would seem that this decision would not have a big impact as most Developers (at least, in Karnataka) have already shifted to the practice of entering into two agreements.