# Service tax on Client Supplied Materials – Government scores a self goal? – AUG 04, 2009

**ONE** of the most contentious issues in service tax litigation, has been the one involving the levy of service tax on the value of materials supplied by clients. As is well known, the practice of the Developer / Builder buying and supplying critical materials like steel, cement, etc., for being used by the Contractor in the execution of the works contract, is a widely followed practice both in the residential as well as, in the commercial realty sectors. In most cases, either the value of the materials provided by the Developer/Builder is either reduced from the running bills of the contractor at pre-agreed rates, or the Contractor's rates are fixed taking into account the free supply of the materials by the Developer/Builder.
The Department has always been seeking to bring the value of the client supplied materials into the service tax net, right from September 10, 2004, when service tax was first levied on Commercial or Industrial Construction Services. Of course, the residential realty sector got covered from June 16, 2005 when service tax was introduced on 'Construction of Complex' services.

Most contractors had opted to avail of the benefit of the Abatement scheme, covered by Notifications Nos 15/2004-ST dated September 10, 2004, 18/2005-ST dated June 7, 2005 and 1/2006-ST dated March 1, 2006, according to which, the Contractor being the service provider is required to pay service tax on 67% of the gross amount charged, without availing of any Cenvat credit. Though these Notifications allowed Cenvat credit availment till February 28, 2008, the Notification No. 1/2006-ST dated March 1, 2006, specifically provided for the non-availment of any Cenvat credit by the service provider, as a pre-requisite for availing of the abatement benefit.

The issue related to the inclusion of the value of the client supplied materials arose, due to the Explanation which was inserted in Notification No. 1/2006 and Notification No. 18/2005, which reads as follows:

*Explanation. —The gross amount charged shall include the value of goods and materials supplied or provided or used for providing the taxable service by the service provider.*
Based on this Explanation, the Department has been issuing Show Cause Notices to the Contractors, asking them to include the value of the materials supplied by the Developers / Builders, even in the absence of a specific provision that the value of the client supplied materials is to be included for purposes of Notification No 1/2006.

The principles involved in determining the valuation of the taxable services is laid down in Section 67 of Finance Act, 1994 read with the Service Tax (Determination of Valuation of Services) Rules, 2006. It is clearly provided herein that, when service tax is chargeable on any taxable service with reference to its value, then, such value shall, in a case where the provision of service is for a consideration in money, be the gross amount charged by the service provider for such service provided or to be provided by him. The important word to note here is 'charged'. It is clear that, the value of the client supplied materials is not something which can be treated as having been 'charged' by the Contractor in a commercial sense. It is amazing to note that the Department has been interpreting the wordings used in the Explanation in a rather perverse way and has been seeking to include the value of the client supplied materials for purposes of levy of service tax on the Contractors. It seems clear that there is a conflict between Section 67 of the Finance Act and the Explanation, referred to above, in so far as it concerns the inclusion of the client supplied materials while determining the gross amount charged by the Contractor and without a doubt, the statutory provisions contained in Section 67 and the Service Tax (Determination of Taxable Value) Rules, 2006 would prevail over the provisions contained in the Notifications. Of course, it is further clear that the said Notifications do not specifically state that the value of client supplied materials is to be added for arriving at the gross amount charged by the Contractors. It is now a well settled principle of law that when two views are possible, one which favours the

assessee should be adopted. (*Bihar State Electricity Board and Another* v.*M/s. Usha Martin Industries and Another* **2002-TIOL-400-SC-CX.**

Luckily, the High Court of Madras in Larsen & Toubro Ltd v. Union of India **2007-TIOL-176-HC-MAD-ST** and the Delhi High Court in Era Infra Engineering Ltd v. Union of India… have held that, prima facie, the value of the free supply of materials by the Developers cannot be included in the gross amount charged by the Contractors, for levy of service tax. Many Tribunals have granted stay of recovery of the service tax, based on these High Court decisions.

Instead of taking the decision of the Madras High Court in the right spirit, the Department would seem to have gone on a witch hunting damage control mode by seeking to deny the benefit of abatement itself, to service providers who do not include the value of free materials in terms of communication vide F.No.137/118/2007-CX.4 dated 13-11-2007. Perhaps, the Department feels that one wrong can be corrected by another wrong.

Even as service providers are being showered with Show Cause Notices on the free supply of materials under Notification 1/2006, comes the Budget for 2009-10. The Government issues Notification No. 23/2009-ST dated July 7, 2009, as per which, the Composition Scheme for Works Contract Services, introduced in 2007 is being modified, so as to allow the benefit of optional composition scheme, only for such works contracts, where the works contractor declares the entire value of goods (whether supplied under any other contract for a consideration or otherwise) and services used in the execution of the works contract, as the `gross value' charged for the works contract. This restriction would not apply to the current works contracts where either the execution has commenced or any payment been made on or before 07.07.2009. Notwithstanding the fact that this is a rather draconian amendment for the Realty Sector where most Contractors have opted for the Composition Scheme, the fact remains that, this amendment would apply only to new works contracts and not to existing works contracts. So far, so good.

Now, the most important question is, **whether this specific amendment to the Composition Scheme affect the cases initiated by the Department against Contractors under Notification No. 1/2006?**

In my view, the answer is a strong **Yes.**

Though Notification 23/2009 relates to Works Contract services, there is no denying the fact that, service providers covered by 'Commercial or Industrial Construction' services and 'Construction of Complex' services are also entitled to the benefit of the Notification, in as much as, they are also treated as works contractors under these services, as well. And, bear in mind, the fact that the amendment related to the inclusion of value of free supply of materials is a prospective one. Hence, it would look clear that, by a comparable analogy, in the absence of a clear amendment providing for inclusion of the value of free materials in the statutory provisions governing levy of service tax on 'Construction of Complex' services and 'Commercial or Industrial Construction' services, the value of free supply of materials cannot be included for arriving at the gross amount charged.

The fact also remains that the works contracts which were earlier classified under 'Construction of Complex' services and 'Commercial or Industrial Construction' services also got covered under Works Contract services, with effect from June 1, 2007 and hence, the benefit of the prospective amendment to the Composition Scheme as applicable to the Works Contract services should also apply to the works contractors covered by the 'Construction of Complex' services and 'Commercial or Industrial Construction' services.

In my view, Works contractors classified under 'Construction of Complex' services and ' Commercial or Industrial Construction' services are entitled to take a stand that, in the absence of a specific amendment/ provision for adding the value of client supplied materials, similar to the one introduced vide Notification No. 23/2009 dated July 7, 2009, free supplies cannot be charged to service tax under the other services.

As students of law, we are exposed to the fundamental rules that a statute has to be read as a whole, to the principle of *casus omissus* and to the principle of *ex visceribus actus* as laid down by the Gujarat High Court in *CIT* v. *R.M. Amin* [1971] 82 ITR 194 (Guj.).

The Supreme Court has repeated held that the intention of the Legislature must be found by a reading of the statute as a whole and in its context which is derived from the contextual scheme. *(Doypack Systems Pvt. Ltd.* v. *Union of India* AIR **2002-TIOL-389-SC-MISC** and *Hindustan Aluminium Corpn. Ltd.* v. *State of UP* AIR 1981 SC 1649).

It would then seem that, even as the match involving the litigation between the Department and the Works Contractors is going on, extra time, the Government has managed to lose the match by scoring a self goal by introducing a prospective amendment in the Composition Scheme applicable to Works Contractors involving inclusion of value of client supplied materials.