Service tax on works contracts – post L&T decision – 07-01-2014

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I had in my two write-ups carried by TIOL on 30/09/ 2013 & 25/10/ 2013 tried to understand the historic decision of the Hon'ble Supreme Court in the *L&T case* ***[2013-TIOL-46-SC-CT-LB].*** The purpose of the present piece is to specifically look at the service tax implications arising out of this decision.

One might ask,What hasservice tax got to do with the L&T decision? After all, this is a decision given in the context of the VAT law and how can this decision have an impact on service tax law. And, vis-à-vis service tax, won't the sub-silentio concept apply?

In my view although the L&T decision has been rendered in the context of the VAT law, there can be no denying the fact that this decision will have a bearing on the service tax law on works contracts given the fact that w.e.f 1-7-2012 for a transaction to be a works contract under the service tax law, it is a pre-requisite that the same transaction should be a works contract under the VAT law as well, apart from meeting certain other requirements. Hence, it becomes clear that the service tax law on works contracts will have to follow the VAT law on service tax, with folded hands. Given this…. how can one not recognize the impact of the L&T decision on service tax levy on works contracts?

Para 115 of this decision will have a direct bearing on the levy of service tax on works contracts, vis-à-vis the VAT levy. This all important short para of the decision 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

It is clear that, in terms of Para 115, the typical civil works contract, involving construction of flats, commercial buildings, etc. can be subjected to the service tax levy, only in respect of the value addition that happens post the date of the agreement entered into with the flat buyer. 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 service tax law point of law (as well as, under 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.

While the discussion insofar as the VAT law can perhaps conclude here, a discussion on the service tax levy on works contracts would need to consider the impact arising out of a competing entry, which stands in the name of 'construction services'. Even prior to 1-7-2012, as we know, we have had these two competing entries which dictated the levy of service tax on works contracts, viz. construction services and works contract services. One would recall that while commercial construction services were brought into the service tax net from 10-9-2004, residential construction services were subjected to service tax levy from 16-6-2005. Of course, works contract services were brought into the service tax net, as a new service, from 1-6-2007. We must bear in mind that, all of these services, though seemingly overlapping, have successfully survived, independent of each other, in the pre 01-07-2012 era. Nay, it would seem that they would continue to survive, in their individual avatars, even after 1-7-2012, in terms of the description of the taxable services under Sections 66E(b) and 66E(h), of the Finance Act, 1994.

It is very interesting to note that, the word 'works contract' has not been used at all, in terms of the language used in Section 66E(b) (as well as, under the definition of 'Commercial or Industrial Construction services' and 'Construction of Complex services' as they existed prior to 1-7-2012) and this consequently, gives rise to the view that, the L&T decision would NOT have a bearing in so far as the levy of service tax on 'construction services' covered under Section 66E(b) is concerned. While Section 66E of the Finance Act, 1994 does not talk of classification of taxable services, one must bear in mind that, the constitutional validity of a similar entry in terms of the Explanations inserted to the definition of 'commercial or industrial construction' services and 'construction of complex' services was upheld by the High Courts of Bombay, Punjab & Haryana and Madras. Given further the fact that this entry is under the 'Declared List', the chances of a challenge to its legality on constitutional grounds look very bleak.

Be that as it may….. a close look at the description of services under Section 66E(b) and Section 66E(h) would indicate that, while services covered under the earlier entry could cover the services rendered under the latter entry, the converse is not true. Thus, works contracts, which are otherwise covered under Section 66E(h) could very well get covered under Section 66E(b), while the reverse is not true. Hence, there is every possibility for a 'works contract' transaction to be treated as 'construction services', in terms of Section 66E(b) and the Developer/Builder being required to pay service tax on works contracts, in terms of the entry under Section 66E(b). In terms of the law that exists now, the Developer/Builder would have the choice to opt for either of the entries under Section 66E(b) or Section 66E(h). But, in the aftermath of the L&T decision, it would seem that, there would be a lot of pressure (from the Department, of course) for the Developer/Builder to pay service tax under 'construction services' by opting for the Abatement Scheme under Notification No. 26/2012-ST, in terms of which, service tax is payable on 25% of the total value inclusive of the value of the land, subject to the condition that the carpet area of the flat is less than 2000 square feet or when the total value is less than Rs. 1 crore. Else, the service tax would be payable on 30% of the total value, inclusive of the land value, under Notification No. 26/2012-ST.

Another interesting question that would arise is, whether the Developer/Builder can continue to discharge service tax liability on 40% of the entire construction value, based on Rule 2A of the Service Tax (Determination of Value) Rules, 2006, without considering the impact of the L&T decision. This would seem to be an impossibility inasmuch as once the Developer/Builder treats his service as a 'works contract', in terms of Section 66E(h), service tax can be levied only on the value addition yet to be effected, as on the date of the agreement, in terms of the L&T decision, as the service tax law on works contracts would follow the VAT law.

In effect, post L&T decision, the Developer/Builder would seem to have two choices, viz.

++ to classify his service as a 'works contract' in terms of Section 66E(h) and pay service tax in terms of the L&T decision, on the balance value of construction completed on and after the date of the agreement.

++ to classify his service as 'construction service' in terms of Section 66E(b) and opt for the abatement scheme under Notification No. 26/2012-ST.

In my view…. the Developer/Builder would be well advised to opt for this route rather than take the risk of implementing the L&T decision and opting to collect service tax on the value of the work done post the date of the agreement and also lose the CENVAT credit for the portion of the service attributable to the pre-agreement period.Taking the above example….I would wonder if the Service Tax Department would let go of the huge drop in the service tax quantum, in terms of the service being brought under Section 66E(h) as contrasted to Section 66E(b). In the case of the former, the service tax would be leviable on Rs. 21 lakhs, while if the service is brought under Section 66E(b), service tax would be leviable on Rs. 1 crore.

Now…. how does the L&T decision affect the levy of service tax in respect of Joint Development Agreements? Let's take a look at Para 111 of the decision, which reads as under:

Quote

111. In the development agreement between the owner of the land and the developer, 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. Seen thus, there is nothing wrong if the transaction is treated as a composite contract comprising of both a works contract and a transfer of immovable property and levy sales tax on the value of the material involved in execution of the works contract. The observation in the referral order that if the ratio in Raheja Development1 is to be accepted then there would be no difference between works contract and a contract for sale of chattel as chattel overlooks the legal position which we have summarized above. 111. In the development agreement between the owner of the land and the developer, 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. Seen thus, there is nothing wrong if the transaction is treated as a composite contract comprising of both a works contract and a transfer of immovable property and levy sales tax on the value of the material involved in execution of the works contract. The observation in the referral order that if the ratio in Raheja Development1 is to be accepted then there would be no difference between works contract and a contract for sale of chattel as chattel overlooks the legal position which we have summarized above.

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There is a view that, in terms of Para 111, reproduced above, even Joint Development Agreements could get treated as works contracts under the VAT law. In this context, it would be interesting for TIOL readers to note that, the Karnataka High Court is yet to pronounce its verdict on the leviability of VAT on joint development agreements. Till the VAT law on this highly contentious subject is settled,the question of levying service tax on joint development agreements would not arise, in my view, as the service tax law on works contract would necessarily have to follow the VAT law, not-withstanding some CESTAT decisions, the Board Circular No. 151/2/2012-ST dated February 10, 2012 and the Education Guide.

I am aware that in some states there is a statutory provision in the VAT law for levying tax on joint development agreements. In such States, the service tax levy on joint development agreements would follow the VAT law. However, in the case of Karnataka, we do not have such a provision and VAT is sought to be levied on the basis of a Circular issued by the Commissioner of Commercial Taxes, Karnataka in 2009, the legal validity of which, is before the Karnataka High Court. Given this….the law on levy of service tax on joint development agreements would attain finality only after the VAT law is settled.

There is yet another service tax related valuation issue that would crop up in respect of construction contracts post the L&T decision. The Hon'ble Apex Court makes a strong statement that the ***label of payment is not decisive but the factum of the payment is***. A simple reading of this important statement could lead one to conclude that, Developers/Builders would be better off by including certain contentious items like non-refundable deposits, amounts collected towards providing water/electricity connections, etc., for purposes of valuation of the taxable services.

Before parting……

It would seem that, the safe route for the Developer/Builder would be to opt for the Abatement Scheme under Notification No. 26/2012-ST and collect and discharge service tax liability after availing the abatement benefit, rather than take the route in terms of Section 66E(h) of the Finance Act, 1994. There would, of course, be no need for reversal of CENVAT credit under Rule 6(3) of the Cenvat Credit Rules, 2004. With full CENVAT credit availability, this would seem to be a 'safe harbour' for Developers/Builders, rather than going on a litigation path vis-à-vis 'works contract' services.

Even from a practical perspective, it would seem that implementing the L&T decision would pose great challenges, especially, in terms of valuation of the work done up to the date of the agreement. Even from this angle, the Developers/Builders would be better off to opt to classify their services under 'constructions services' and avail of the entire cenvat credit. As such, there is no statutory bar for the Developer/Builder who has been paying tax under 'works contract' services to shift to paying tax under 'construction services'.

Given the fact that the L&T decision has been rendered in the context of civil construction contracts, it would not be wise to extend the implications from this decision to other works contracts like AMCs, etc.

In terms of the pure Developers, who have contracted out the complete construction activity to contractors, it is interesting to note that, the Apex Court, while referring to its own decision in *State of AP v. L&T Ltd* ***[2008-TIOL-186-SC-CT]*** which had laid down the law that it is the contractor who transfers property in goods to the property buyer who is to be treated as the 'works contractor' has not overruled this decision. Thus, while pure Developers would not be works contractors under the VAT law as well as, under the service tax, they would still be covered under 'construction services' in terms of Section 66E(b).