

Works Contract – Levying tax on ‘service portion’ by exempting ‘goods’ portion – A great step forward – May 15, 2012

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FOR many of us who have been handling indirect tax matters for the Realty Sector, this Budget has some welcome news, in so far as the levy of service tax on works contracts is concerned.

For the first time, the Government has made it clear that, it would only levy service tax only the ‘service’ portion of works contracts. This is a great step forward, considering the fact, all along, the Government has always been talking of exempting the ‘goods’ portion of the works contract. Notifications such as those bearing Nos1/2006 and 12/2003, which have been relied upon by the works contractors for years now, talk of providing an exemption, in terms of the value of goods and materials used for providing the taxable service, by the service provider. The question that one always had was this... if the Government could not levy service tax on the goods portion of the works contract, how could it exempt that portion. After all, the power to exempt would arise only when there was a power to tax, in the first place.

Notwithstanding the fact that the Central Government never had a right to levy tax on the goods portion comprised in works contracts, we must compliment it for the proposed Section 66E, which lists down the ‘declared services’, where there is a specific head which reads ‘service portion in the execution of a works contract’. The Central Government would seem to come back on track, albeit belatedly, by declaring that it can levy service tax only on the service portion of the works contract. It has taken the same view, in terms of the supply of goods such as foods, drinks, etc. in the case transactions involving catering, hotels, eateries, etc.

One is very happy to see the words ‘service portion’ being repeatedly used in the TRU Circular issued after the Budget, perhaps, for the first time ever.

So far so good

The Central Government, as we know, has explicitly stated that, it would now allow for the deduction to be made, in respect of the value of goods sold/transferred, in respect of other composite contracts.

Of course, there are still certain major issues in the Central Government holding that the benefit of levying service tax on the service portion is available only to limited transactions, in as much as, the definition of ‘works contract’ under the new service tax law is rather narrowly defined to mean works contracts involving civil, erection, commissioning activities, etc. A lot of disputes would still arise on the Central Government’s plans to tax service tax on the entire transactional value in respect of other works contracts which are recognized as such, under the VAT law. For instance, the Sixth Schedule to the Karnataka Value Added Tax Act, 2003 lists down 22 specific works contracts with a residual category in Item No. 23. This Schedule lists down software development as a works contract. As we know, the term ‘works contract’ is widely defined under the VAT law, to include 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 movable or immovable property’.

Contrast this broad definition of works contract under the VAT law with the very narrow definition proposed under the service tax law. It is clear that, with the proposed withdrawal of Notification No.12/2003, large quantum transactions which are treated as works contracts under the VAT law, would also get subjected to the levy of service tax, resulting in double taxation of many composite transactions.

Be that as it may.... the Central Government's newly enlightened view on charging service tax only on the 'service ' element of works contracts, would also help in the cenvat credit area. Till now, some Departmental officers were taking the view that, in terms of the revised definition of 'exempted services' effective from 1-4-2011, cenvat credit attributable to the goods portion of the works contracts would have be reversed/paid back to the Department, in terms of Rule 6(3), on the basis that, the 'goods portion' represents that ' exempted value' of the taxable services involved in works contracts. This view cannot hold water any longer, with the Government holding the view that, it can tax only the 'service portion'.

The Government's change in view of 'levying' tax on the service element of works contracts from the earlier view of exempting the value of goods involved in the execution of the works contract is a highly welcome step, nevertheless.

Before concluding ...

One only wishes that the Central Government had come out with this idea of taxing the 'service portion' of works contracts much earlier, given the fact that this view has been taken on the BSNL case of 2006. This would have saved a lot of litigation which has remained 'unabated since' 2004/05. Better late than never.

In my humble view, the law laid down in the BSNL case, will have to be applied to the particular circumstances of the case in as much as, the concept of the 'dominant nature' test is to be applied only when it is not otherwise possible to bifurcate the value of goods and services. There is no justification for the Central Government to radically change the current law of exempting the value of goods involved in a composite contract for service tax purposes, in terms of Notification No. 12/2003 and to cite the BSNL case for this, would be unjust. To levy service tax on the basis of the dominant nature test is one way to understand levy service tax, in respect of composite contracts. To state that the dominant nature test is the only basis on which service tax can be levied for composite contracts would not be a correct interpretation of the law laid down in the BSNL case.

Where is the need for the Central Government to bring about these radical changes in service tax on levy of composite contracts when the FM makes a statement that GST would be introduced from August 1, 2012? If the Central Government's view on the service tax levy on composite contracts is followed by the assesseees, no VAT would be payable on a number of composite contracts... Are the States willing to forego the VAT levy on composite contracts?

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