

Service tax on Works Contract

The levy of tax on works contract is a complex subject and has been a matter of consideration in a lot of judicial pronouncements for levy of sales tax as well as service tax. Issues as to the nature of contract viz. contract of sale vs. works contract, contract for work vs. works contract, indivisible contract vs. divisible contract, whether sales tax can be levied on the transfer of property in goods involved in the execution of works contract, whether service tax can be levied on the service portion of an indivisible works contract etc. have been considered by the Courts and Tribunals.

The issue of levy of service tax on the design and engineering portion of a turnkey contract arose before the Delhi Tribunal in the case of *Daelim Industrial Co. Ltd. V. CCE, Vadodara - (155) ELT 457 (Tri-Del)* wherein the Tribunal held that the appellant's contract with IOC was a works contract on turnkey basis and not a consultancy contract and that a works contract cannot be vivisected and part of it subjected to service tax. Similar view was held in the case of *L&T Ltd. vs. CCE 2004 (174) ELT 322 (Tri - Del)*. The Supreme Court dismissed the Special Leave petition of the department in *CCE, Vadodara vs. M/S. Daelim Industrial Co. Ltd. 2004 (170) ELT A181 (SC)*. The Supreme Court did not go in to the merits of the Tribunal's order but merely stated that they saw no reason to interfere. However, in the case of *L&T Ltd.*, the appeal filed by the department has been admitted by the Apex Court in 2005(182) ELT A149 (S.C). A lot of works contractors are relying on the principle laid down in the *Daelim* case and the *L& T* case to contend that the services portion of a works contract cannot be subject to levy of service tax.

Recently, in *CCE v. BSBK (P) Ltd (CESTAT-*

New Delhi), the Tribunal, on facts held that the contracts entered into by assessee were 'divisible' in nature and therefore, assessee was held to be rendering taxable service of consulting engineer.

Proposed amendment

In this backdrop, the Finance Bill, 2007 proposes to introduce a levy of service tax on any service provided to any person, by any other person in relation to the execution of a works contract, excluding works contract in respect of roads, airports, railways, transport, terminals, bridges, tunnels and dams.

Section 65(105) of the Finance Act, 1994 defines the taxable service in respect of various categories of services. The Finance Bill, 2007 seeks to introduce sub-clause (zzzza) to clause (105) as below:

“(zzzza) to any person, by any other person in relation to the execution of a works contract, excluding works contract in respect of roads, airports, railways, transport terminals, bridges, tunnels and dams.

Explanation — For the purposes of this sub-clause, “works contract” means a contract wherein, —

- (i) transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods, and
- (ii) such contract is for the purposes of carrying out,—
 - a) erection, commissioning or installation of plant, machinery, equipment or structures, whether pre-fabricated or otherwise, installation of electrical and electronic devices, plumbing, drain laying or other installations for transport of fluids, heating, ventilation or air-conditioning including related pipe work, duct work and sheet metal work, thermal insulation, sound



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insulation, fire proofing or water proofing, lift and escalator, fire escape staircases or elevators; or

- b) construction of a new building or a civil structure or a part thereof, or of a pipeline or conduit, primarily for the purposes of commerce or industry; or
- c) construction of a new residential complex or a part thereof; or
- d) completion and finishing services, repair, alteration, renovation or restoration of, or similar services, in relation to (b) and (c); or
- e) turnkey projects including engineering, procurement and construction or commissioning (EPC) projects"

The issues that arise out of the proposed amendment are discussed hereunder:

Types of works contracts covered

Only works contracts involving transfer of property in goods involved in the execution of such contract leviable to tax as sale of goods, and being contracts of the nature specified in clauses (a) to (e) above are covered under the definition. Therefore, all other works contracts are not subject to levy of service tax under this category. For example, printing contracts, dyeing contracts, maintenance contracts, electrical or structural contracts etc., which are not in the nature of services specified above, are not taxable under this category.

Residential complex having less 12 units or less

Clause (c) above covers construction of new residential complex or a part thereof. Under construction of complex service, construction of a residential complex consisting of more than 12 residential units only is taxable. The issue arises as to whether construction of a residential complex consisting of 12 residential units or less is taxable under the category of works contract.

Section 65(91a) defines "residential complex" to mean any complex comprising of —

(i) a building or buildings, having more than twelve residential units;

(ii)

The definition is applicable only to construction of complex service. Wherever the term 'residential complex' appears in the Finance Act, it should have more than 12 residential units.

Effective date of levy of tax

In Para 154 of the Budget Speech of the Finance Minister has stated as under:

"State Govt levies tax on transfer of property in goods involved in execution of WCT. The value of such services in a WCT should attract service tax. Hence, I propose to levy service tax

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on services involved in the execution of WCT. I propose an optional composition scheme under which ST will be levied at only 2% of total value of WCT."

Vide clause 125 of the Finance Bill, 2007, the levy of service tax on works contracts is proposed to be levied with effect from such date to be notified by the Central Government in the official gazette. This strengthens the view that works contracts are not liable to service tax as on date.

Composition scheme

An option for composition to pay service tax @ 2% on entire value is likely to be provided as stated by the Finance Minister in the Budget Speech. However, the methodology of valuation or and the conditions for composition are yet to be notified. Currently, if the services are classified under the respective categories of services, the effective rate of tax under composition works

to 3.96% (excluding cess) i.e. 12.24% of 33% of the value of contract. However, providing for a composition rate of 2% for works contracts classified under clause (zzzza) would create inequality.

Classification

The services specified in clauses (a) to (d) above are already liable to service tax under separate categories as below:

Therefore, the issue as to whether the contract should be classified under the respective categories or under works contract would arise. Further, since the composition rate proposed

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is only 2% in respect of works contracts, classification under works contract may be more beneficial. The Government should ensure that such inequality is not created.

Cenvat credit

Assessees opting for the composition scheme are not entitled to avail CENVAT credit of capital goods, inputs and input services vide Notification 1/2006-ST dated 1.3.2006. Similar restriction is likely to be imposed in respect of works contractors opting for composition.

Constitutional validity

Even after this proposed inclusion of works contract, the issue as to the requirement of an amendment in the Constitution to levy service tax on the service portion of the works contract is still unresolved.

Entry 48 in List II of Sch. VII to the Government of India Act, 1935, included the item 'taxes on the sale of goods' but the definition of "sale" in

section 2(h) of the Madras General Sales Tax Act was enlarged so as to include 'a transfer of property in goods involved in the execution of works contract'. The issue arose in *The State Of Madras V. Gannon Dunkerley & Co., (Madras) Ltd. (1958) 9 STC 353(SC)*, as to whether the provisions introduced by the Madras General sales tax Act are ultra vires the powers of the Provincial Legislature under Entry 48 in List II. The Apex Court held that there is no sale as such of materials used in a building contract, and that the Provincial Legislatures had no competence to impose a tax thereon under Entry 48.

The 46th amendment to the Constitution was made thereafter to provide for a definition of 'tax on sale or purchase of goods', which includes transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract.

Even after the amendment to the constitution, the definition of sale under the Central Sales Tax Act was not amended. The levy of sales tax on inter-state works contract by the States was challenged in *Gannon Dunkerley's case (1993) 88 STC 204 (SC)* where the apex court held that State Governments were not competent to levy sales tax on inter-state works contract. The Finance Act, 2002 has also amended the definition of 'sale' under the Central Sales Tax Act, 2002 on the lines of the definition of deemed sale under the 46th amendment to the constitution.

In the context of service tax, as already stated, it has been held that works contract cannot be vivisected for the purpose of levy of service tax. The landmark cases are:

- ❖ *Daelim Industrial Co. Ltd. Vs. CCE (155) ELT 457 (Tri-Del)*
- ❖ *CCE, Vadodara vs. M/S. Daelim Industrial Co. Ltd. 2004 (170) ELT A181 (SC) – SLP filed by department dismissed*
- ❖ *Larsen & Toubro Ltd. vs. CCE 2004 (174) E.L.T. 322 (Tri. - Del.)*
- ❖ *Commissioner vs. Larsen & Toubro Ltd (182) ELT A149 (SC)- Supreme Court admitted the*

appeal filed by the Commissioner of Central Excise against the decision of the Tribunal

- ❖ *Emerson Process Management Power & Water Solution Inc. vs. CCE 2006 (3) STR 508 (Tri. - Del.)*
- ❖ *CCE vs. Larsen & Toubro Ltd. 2005 (69) RLT 62 (CESTAT-Che.)*
- ❖ *CCE vs. Shapoorji Pollanji And Co. Ltd. 2005-TIOL-892-CESTAT-DEL*

In Rolls Royce Industrial Power (I) Ltd. & Anr. Vs. CCE 2004 (95) ECC 441 (Tri-Del), it was held that service tax was not applicable in respect of an agreement for operation and maintenance of a Power Station under the category 'consulting engineer' and that the 46th Amendment and the Apex Court's decision in Builders Association of India and Ors. had no application to the case since a deemed definition similar to tax on sale or purchase of goods did not exist in the case of job work, as has taken place in regard to project contracts in sales tax.

In Builders Association of India Vs. UOI (1989) 73 STC 370 (SC) the apex court held that the 46th Amendment does no more than making it possible for the States to levy sales tax on the price of goods and materials used in works contracts as if there was a sale of such goods and materials. Sub-clause (b) of article 366(29-A) should not be read as being equivalent to a separate entry in List II of the Seventh Schedule to the Constitution enabling the States to levy tax on sales and purchases independent of entry 54 thereof. As the Constitution exists today the power of the States to levy taxes on sales and purchases of goods including the "deemed" sales and purchases of goods under clause (29-A) of article 366 is to be found only in entry 54 and not outside it.

In Geo Miller & Co. Pvt. Ltd. and others Vs. State of M.P. and others [2004] 136 STC 241 (SC), the Apex Court held that the definition of 'tax on the sale or purchase of goods' as provided by the 46th Amendment through article 366(29A) does not apply to the M.P. Entry Tax Act. The

court observed that 'sale' as it appears in article 366(29A) is with reference to the Sales Tax Act and that in the absence of definition of sale in the M.P. Entry Tax Act the Constitutional definition as provided in article 366(29A) must not be imported. Further, since the M.P. General Sales Tax Act was covered by entry 54 whereas the M.P. Entry Tax Act was covered by entry 52 it was held that both these Acts are covered by different entries in the Constitution and hence, the incidence of taxation in both cases is different.

There is a deeming fiction in the constitution to treat the transfer of property in goods involved in the execution of works contract as liable to sales tax. However, there is no such deeming fiction to provide for a tax on the service component of works contract. Therefore, the imposition of tax on the service component in a works contract can still be challenged.

Service provided by sub-contractor

The issue as to whether both sub-contractor and main contractor would be liable to pay service tax on the works contract would arise in view of the decision of the Andhra Pradesh High Court in *L & T and another Vs. State of AP - 148 STC 616 (AP)*. The Court observed that in a transaction of works contract, the property in goods passes directly to the employer by the theory of accretion and that the sub-contractor is only an agent of the contractor and the property in goods passes directly from the sub-contractor to the employer and therefore there can only be one sale which is recognized by the legal fiction created under sub-Article 29A of Article 366. The court further observed that there is no principle of law which establishes that the property in goods passes to the contractor at any stage of the execution of the works contract in the event of a contractor awarding the contract to a sub-contractor and that there are two taxable events in such a transaction, enabling the State to levy and collect tax both from the sub-contractor and the contractor. □