

WORKS CONTRACT

*By Madhukar N Hiregange (FCA, DISA(ICAI)
& Srikantha Rao T (Bcom. ACA)*

The non compliance with service tax by the construction industry in general, added to the conflicting circulars and the decision in Daelim Industries (2004 (07) LCX 0004) case, (which has been followed recently in case of Murali Sesh Engineers Vs Commissioner of Service Tax Bangalore (2008 (02) LCX 00125)) regarding non applicability of service tax on indivisible contracts had led to this purportedly simpler alternative being introduced to encourage compliance. Initially bait of lower rate was dangled in 2007 and as expected in the 2008 budget doubled.

This entry would be legally valid if the “deemed service” concept can be legally valid. The service tax on “works contract” has been introduced w.e.f. 1.06.2007. This category seeks to tax those services wherein transfer of property in goods is involved during the execution of works contract. The tax would be on services involved in the execution of a works contract. This category however deals with only certain categories of activities and the activities not covered by this category would continue to be covered by other existing categories such as: commercial or industrial construction service, construction of complex service, erection, commissioning and installation service, interior decorator’s service, repairs and maintenance, business auxiliary etc.

Definition

“Works contract” means a contract wherein transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods and such contract is for the purpose of carrying out –

1. 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 relating pipe work, duct work and sheet metal work), thermal insulation, sound insulation, fire proofing or water proofing, lift and escalator, fire-escape staircases or elevators or
2. 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
3. Construction of a new residential complex or a part thereof or
4. Completion and finishing services, repair, alteration, renovation or restoration of, or similar services, in relation to (2) or (3) above or

5. Turnkey projects including engineering, procurement and construction or commissioning (EPC) projects.

The services provided by any person, to any other person in relation to execution of a works contract excluding works contract in respect of roads, airports, railways, transport terminals, bridges, tunnels and dams would be taxable under this head as per section 65(105)(zzzza).

The term “turnkey projects” has not been defined and one would have to be understood in common parlance until clarified.

Who is liable? To whom applicable?

This entry would be applicable to the following existing service providers:

1. Industrial and Commercial Construction
2. Construction of Complex
3. Erection, installation and Commissioning

If there are works contracts which cover activities not coming under the ones specified above, they would have to be taxed under other existing heads and consequently, the composition benefit in such cases would not be available. In such a scenario, the existing notifications such as 12/2003 ST and 1/2006 ST would have to be relied upon to get any deduction.

For pure labour services where there is no material involved the service would continue to be covered under the above categories as the definition of works contract makes it clear ***as to the requirement of transfer of property in goods for a contract to be liable under this category.***

Whether joint development liable?

One thing the assesseees have to analyse is whether there exists a service provider who provides the works contract service and a service receiver who receives such service. In the absence of such service, there would not be a liability under service tax. Sometimes, the construction activity may not be undertaken on behalf of a client/customer but may be undertaken by the builder/developer on his own account and the constructed property sold to buyers. In such situations, there would be no liability under service tax as there is no distinct service provider and service receiver and the builder/developer cannot provide service to himself. This has also been decided by the Gauhati High Court in Magus Construction (P) Ltd Vs UOI (2008 (05) LCX 0057)

The assesseees are advised to be careful even where partly constructed property plus land is transferred to prospective buyers and then the remainder of construction work undertaken on

their behalf as the entire amount involved in the project would not be liable to service tax because of the land and partly built up unit being sold/transferred to the buyers and then works contract service in relation to construction being provided. Due care is to be taken to ensure that the agreements are properly drawn up to indicate the various components and the amounts being charged for the same.

Composition Scheme

Works contract (Composition Scheme for Payment of Service Tax) Rules 2007 has been notified vide notification 32/2007 ST dated 22.05.2007 by the Central Government for the purpose of specifying the scheme for composition. The person executing works contract has the option to pay tax under the composition scheme at the rate of four percent (rate changed from earlier rate of 2% by notification 7/2008 ST wef 01.03.2008) on the gross amount charged for the works contract. Gross amount shall not include the VAT or sales tax paid on the goods transferred during the execution of such works contract. The option is to be exercised prior to payment of service tax in respect of the said works contract and once exercised, shall be in force till the completion of the works contract.

Exemption

Services in relation to execution of works contract provided by any person to any other person in relation to construction of ports or other ports has been exempted from service tax. This exemption shall not extend to services of completion, finishing, repair, alteration, renovation, restoration, maintenance or repair.

Valuation

A new Rule 2A has been inserted by notification 29/2007 ST dated 22.05.2007, which prescribes the valuation method in case of works contract service. The value of works contract service shall be equivalent to the gross amount charged for works contract less the value of goods transferred in respect of which VAT/sales tax has been paid, during the course of execution of works contract. The gross amount shall not include the VAT and sales tax paid on the goods transferred. The service provider shall ensure that the value of works contract service as aforesaid shall include the following –

- Labour charges for execution of the works
- Amount paid to a sub-contractor for labour and services
- Charges for planning, designing and architect's fees

- Charges for obtaining on hire or otherwise, machinery and tools used for execution of the works contract
- Cost of consumables such as water, electricity, fuel used in the execution of the works contract
- Cost of establishment of the contractor relating to supply of labour and services
- Other similar expenses relating to supply of labour and services and
- Profit earned by the service provider relating to supply of labour and services

Cenvat credit

Where the service provider opts for the composition scheme for the purpose of payment of service tax, he shall not take cenvat credit of duty and cess paid on inputs used in relation to such works contract. However the credit on capital goods used for providing the service as well as the input service credit (sub contractors, insurance, telephone, manpower supply, architect, security, supply of tangible goods, etc) would be available.

Where the service provider does not opt for composition scheme, he should be entitled to cenvat credit on inputs, input services and capital goods used in execution of such works contract.

Possible Issues

1. Whether the works contractor can continue under the existing entries for ongoing contracts?

Comments: Since there is a new entry it is presumed that service providers may have to choose considering the principles of Section 65A on classification. However if they do not transfer any materials they would continue under construction or erection categories. Herein it is important to note that the department letter F.No. B1/16/2007 TRU dated 22.05.2007 goes on to say that contracts which are treated as works contract for levying VAT/sales tax shall also be treated as works contract for levying service tax. However, this letter would have to be seen in the light of the explanation to section 65(105)(zzzza), which deals with the contracts which can be regarded as works contract under this category.

2. Whether the works contracts involving materials in progress can also opt for the new entry though earlier they were registered under the old entries?

Comments: Assessee may note that the department had come out with circular 98/1/2008 ST dated 04.01.2008 which clarified that where service providers had classified their services under other categories viz., erection, commissioning or

commercial or industrial construction or construction of complexes, they could not reclassify the single composite service under works contract. This circular also emphasized the fact that a works contract could not be vivisected and that the same was not legally sustainable.

3. What is a turnkey contract?

Comments: The expression has not been defined and the common understanding may have to be adopted. It may indicate contracts of bigger size having a number of sub contracts or differing nature such as erection of a plant or a town itself. These contracts earlier were covered under erection head.

4. Whether the option of availing the credit on all the inputs (cement, steel, glazing, tiles etc) and paying the service tax on the gross amount is still available?

Comments: The composition scheme is optional and the works contractor can even pay service tax on a value arrived at as aforesaid at the normal rate. The law as it stands today is silent regarding the cenvat credit on inputs in such a scenario as the credit has been expressly barred only in case of an assessee opting for composition scheme. The assessee can as per the humble view of the authors, pay service tax on the gross amount for the service which should include the value of materials transferred if they are to avail Cenvat credit of the excise duties on the materials used for the construction work/works contract service. This could enable the contractor to bring down his construction costs and the benefit of such reduced costs, can be passed on to his buyer.

5. Whether the option chosen under VAT law has any bearing for the classification or valuation under this new entry?

Comments: The WC option provides for the option of deducting the value on which VAT has been paid and on the balance the service tax would be leviable. This option if chosen would require that the regular scheme under VAT has been opted for. However for the composition scheme the method under VAT is not relevant.

6. What is the value of service for the purpose of computing Rs.10 lakhs exemption limit under the WC entry?

Comments: The value of service would be the gross value of the works contract including the material as the contract is indivisible. However the contracts executed upto 31.5.2007 would not be reckoned.

7. Whether the service providers under the specified categories were not liable for works contracts earlier to this entry?

Comments: The entry read with the department circular indicates that works contracts were not earlier covered. The purpose for which this entry was bought in also is favorable to this interpretation. Therefore it can be construed that there was no liability earlier. This view is also confirmed in the case of Dr. Lal Path Labs P Ltd. { 2006 (3) STR (711(T- Bom). This could lead to a situation where the service provider who has paid the service tax from their pockets (not recovered from the customers) could go for a refund especially if the same was done in pursuance of an investigation.

8. Whether the sub contractors would be exempt as the main contractor is paying the service tax?

Comments: The sub contractors would also have to discharge the ST under works contract or other categories and would be liable for the tax unless they are below Rs. 10 Lakhs.

These are some of the important issues, which have been covered in this article. The important gleaning from this entry is that instead of litigation this option maybe preferable from a practical viewpoint and it is expected that most of the service providers in these three categories would be opting for this scheme.