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Service Tax on Works Contract – A storm in the (S)T cup!

Author: G. Natarajan

Though scores of movies are released in Bollywood and Kollywood, not every one becomes a super hit. Star value, story line, catchy tunes, etc. would play a major role in making a movie a super hit. Same is the case with taxable services. While the compounding confusions made the GTA levy a super hit, the hair splitting practical issues would certainly make the recently introduced "Works Contract Service", as another super hit.

No doubt, the levy came as a messiah to the construction industry, which was reeling under heavy burden of service tax, compounded further by denial of all forms of Cenvat Credit, if the benefit of abatements is claimed (Notification 1/2006). When both main contractors and sub contractors are sought to be taxed, on the premise that services rendered by any person to any other person are taxable, denial of service tax paid by the sub contractor to the main contractor, virtually led to double taxation. And now, the new levy is really the saviour.

The scope of the definition of the term "works contract" covers all contracts which are hitherto classified under different services, such as "commercial or industrial construction, construction of residential complex, erection, commissioning and installation". The problem of classification dispute has also been avoided, by virtue of the clarification to the effect that contracts which are recognized as Works Contract for VAT / Sales Tax purposes would be classified only under this new category of taxable service. Considering the composition scheme offering a 2 % service tax rate, as against the earlier levy @ 3.96 % (12 % on 33 % of gross amount – Education CESS not considered), the service tax liability has almost been halved. That too, with the benefit of Cenvat Credit on capital goods and input services. Kudos to the CBEC for this practical and industry friendly dispensation.

But, this levy is not free from scopes for varied interpretations and practical difficulties, which would surface during the course of implementation of the levy.

The million dollar question in the minds of the industry is whether they can switch over to the new levy in respect of all ongoing contracts or is it applicable only for the contracts which are to be executed only from 01.06.2007 only. The root cause of this question is Rule 3 (3) of the Works Contract (Composition Scheme for payment of service tax) Rules, 2007, which reads as under.

> *The provider of taxable service who opts to pay service tax under these rules shall exercise such option in respect of a works contract prior to payment of service tax in respect of the said works contract and the option so exercised shall be applicable for the entire works contract and shall not be withdrawn until the completion of the said works contract.*

The above provision is widely being interpreted to mean that since service tax has already been paid on the on going contracts under various other categories (commercial or industrial construction, construction of residential complex, erection, commissioning and installation), they cannot have the option of switching over the classification to Works Contract. Moreover, as per the above provision, the option is for the "entire works contract" and in as much as service tax has already been paid on the said contracts under different categories, the option of composition scheme cannot be exercised for such contracts, and they will continue to be taxed under the earlier classification.

May I differ please?

The classification of taxable services is the first step in determining one's service tax liability. As per the TRU clarification as well as on the basis of Section 65 A of the Finance Act, 1994, the ongoing contracts, which are hitherto classified under different services, will get classified only under "Works Contract Service", with effect from 1st June 2007. Once the classification is thus decided, the next question is as to whether the option of composition is applicable for the contract or not.

The condition reproduced above mandates that the option has to be exercised prior to payment of service tax on such "works contract". Having classified the service under Works Contract, with effect from 01.06.2007, a service provider is yet to pay any service tax on such "Works Contracts" and he is at liberty to choose the composition scheme. Since, the levy of service tax on "Works Contract" itself has been introduced only with effect from 01.06.2007, the contract was even otherwise a "Works Contract" as per the VAT / Sales Tax provisions, is not at all of any relevance to determine the applicability of service tax. For the purpose of levy of service tax, the contract is a "Works Contract" only from 01.06.2007 and this fact alone is relevant to determine any connected issues. The condition to the effect that the option, once exercised, shall be applicable for the entire works contract, shall also be understood only with reference to the work to be undertaken after 01.06.2007. In other words, if a service provider opts to pay service tax on composition scheme, with effect from 01.06.2007, by classifying an ongoing contract as "Works Contract", he cannot go back from that option. **Thus the payment of service tax on the said activity, prior to 01.06.2007, under a different category of service is not at all relevant to opt for the composition scheme under Works Contract Service.**

Let us see some practical issues.

Can an existing contract be switched over to Works Contract levy?

(a) A construction contract for a value of Rs.5 Crores is going on. Work to the tune of Rs. 3 crores has been completed and an amount of Rs.3 crores has been realized and service tax has been paid thereon under construction service, after availing 33 % abatement. Can the contractor pay service tax on the remaining Rs.2 Crores, under "Works Contract Service" under composition method. If so, 2 % service tax has to be paid on Rs. 2 Crores or Rs.5 Crores.

As dealt with above, the service provider can very well switch over to "Works Contract" with effect from 01.06.2007 and opt for composition scheme. The gross amount for the purpose of this levy shall only be Rs.2 Crores, as Rs. 3 Crores has already been taxed under a different category.

What if tax is paid on advance before 01.06.2007 but the work is going to be done only thereafter?

(b) A service provider has received an advance of Rs.1 Crore, against a Rs.5 Crores contract and has also paid service tax on such advance, under commercial construction service. The construction activity is going to commence only after 01.06.2007. Can he classify the service under Works Contract and opt for composition scheme and seek adjustment of the service tax already paid on the advance?

Value of taxable service, also includes amount received for services to be provided. So once an advance is received, the service is classified and appropriate service tax has been paid. Receipt of money, either by way of advance or otherwise, is the point for determination of service tax liability. Once this has already been done for the advance received, switching over the classification can be done, only with reference to the remaining portion. In other words, classification under Works Contract and opting for

composition scheme can be made with reference to Rs. 4 Crores only and the service tax already paid on the advance shall be final and cannot be adjusted against the Works Contract liability.

An alternative can also be thought of. The service provider can cancel the existing contract and enter into a new contract. He may also repay the advance already received along with the service tax collected thereon, to his client. He may enter into a fresh contract and choose the discharge service tax liability thereon, under Works Contract Service. The service tax which has already paid on the advance received in respect of the cancelled contract can be adjusted against his any other subsequent liability, as per Rule 6 (3) of the Service Tax Rules, 1994, according to which the service tax paid in respect of any service, which has not been rendered either partly or wholly, can be adjusted against any subsequent service tax liability, if the amount collected towards and value and service tax, is refunded to the client. Considering the fact that the service tax liability under the new Works Contract Service is almost 50 % (2.06%) when compared to the existing quantum of levy under construction service (4.08% = 12.36 % on 33 % of gross amount), the exercise is certainly worth a bargain!

What if the work is completed prior to 01.06.2007 but money received after 10.06.2007.

(c) A commercial construction has already been completed prior to 31.05.2007. But a major part of the consideration therefor is being received only after 01.06.2007. Can the service provider pay service tax on such receipts, under Works Contract levy composition scheme?

When the service was provided, it was classifiable only under commercial construction service and the levy of service tax on works contract was not at all in force then. The service was already a taxable service and only payment of service tax has not been done, as the consideration is not received. So, when such consideration is received after 01.06.2007, service tax has to be paid thereon, only by considering such service as commercial construction service and not under Works Contract service.

Service tax is payable even on the advances received prior to 01.06.2007, even if the levy is effective only from 01.06.2007.

(d) An EPC contract has been awarded to a service provider and he has also received an advance towards it, prior to 01.06.2007. The said contract is not covered under any of the existing taxable services, viz., construction services or erection, commissioning or installation service and hence no service tax has been paid on the advance. The work is going to be carried out only after 01.06.3007. Whether the service provider would be liable to pay service tax on the advances received prior to 01.06.2007?

To attract the levy of service tax, the time when the service is rendered is important. In this case, the service is rendered after 01.06.2007 and service tax is payable on it under Works Contract service. Prior to 01.06.2007, it was not at all a taxable service. Hence, service tax has to be paid even on the advances received prior to 01.06.2007, in respect of the service.

No levy, if the service was not taxable, when rendered, even if the payment is received after 01.06.2007.

(e) An EPC contract has been completed prior to 01.06.2007. The said contract is not covered under any of the existing taxable services, viz., construction services or erection, commissioning or installation service. A part of the consideration of the said contract is received after 01.06.3007. Whether the service provider would be liable to pay service tax on the amounts received after 01.06.2007?

The service was not at all taxable when it was rendered. So no service tax is payable, even if the consideration for the said service is received after 01.06.2007

Cenvat Credit Vis-vis Works Contract.

(f) The restriction as to availment of Cenvat credit on input services and capital goods, is not applicable for "Works Contract Service" even when composition scheme is opted. So, the credit so far not taken, can now be taken?

As per Notification 1/2006, if the benefit of abatement thereunder is claimed, no CENVAT credit can be taken in respect of the inputs, capital goods and input services "used for providing such taxable service" for which the abatement is claimed. If we take the example given under (a) above, since the service provider has opted for abatement, he would not have taken any CENVAT credit on his input services and capital goods so far (we can forget about inputs as they are barred even under the composition scheme for Works Contract).

If he opts to pay service tax on the Works Contract, on the gross amount minus value of transfer of property, where there is no restriction as to availment of any cenvat credit, Cenvat credit can be taken on all inputs, capital goods and input services, "which will be used after 01.06.2007". If any inputs / input services / capital goods have already been used completely, Cenvat credit cannot be claimed for the same, as they have been used in providing a taxable service, for which service tax has been paid by availing abatement under Notification 1/2006.

Similarly, if the service provider opts to pay service tax on composition scheme, with effect from 01.06.2007, he can take CENVAT credit in respect of the input services, which will be used after 01.06.2007 as well as capital goods. In respect of continuous services, credit can be taken proportionately, in respect of the services, which would be used after 01.06.2007.

Before parting...

The first method of paying service tax on works contract, after excluding the value of transfer of property from the gross amount, is akin to Notification 12/2003. But, in Notification 12/2003, there is a restriction to the effect that no Cenvat credit shall be taken in respect of the goods which are being sold while rendering the service. But, such restriction is conspicuously absent in Works Contract! In other words, the service provider under Works Contract can take Cenvat credit in respect of all inputs but pay service tax after excluding the value of transfer of property in respect of the goods sold. Is this bonanza intentional?