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AP HC on Composition Scheme - The Slip between the Cup and the Lip

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Readers' attention is invited to the recent decision of the Hon'ble High Court of AP, in the case of Nagarjuna Construction Company Limited Vs UOI – 2010 – TIOL-403-HCAP-ST.

The clarification issued by the CBEC, vide its Circular NO. 98/1/2008 ST Dated 01.01.2008, to the effect that ongoing contracts on which service tax has been paid prior to 01.06.2007 under any other category of service (commercial or industrial construction service, erection, commissioning and installation service, etc), service tax cannot be paid under the composition scheme of Works Contract Service, after 01.06.2007. This circular was challenged before the Hon'ble High Court of A.P. For ready reference, the said clarification is reproduced below:

Services provided in relation to execution of works contract is leviable to service tax w.e.f. 1-6-07 [section 65(105)(zzzza)]. Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007 provides option to pay service tax @ 2% of the gross amount charged for the works contract. However, the service provider opting for composition scheme for payment of service tax should exercise the option prior to payment of service tax. The issue pertains to, - (i) contracts entered into prior to 1-6-07 for providing erection, commissioning or installation and commercial or residential construction service, and (ii) service tax has already been paid for part of the payment received under the respective taxable service. Whether in such cases, the service provider can revise	Prior to 1-6-07, service provider classified the taxable service under erection, commissioning or installation service [section 65(105)(zzd)], commercial or industrial construction service [section 65(105)(zzq)] or construction of complex service [section 65(105)(zzzh)], as the case may be, and paid service tax accordingly. The contract for the service was a single composite contract. Part of service tax liability corresponding to payment received was discharged and the balance amount of service tax is required to be paid on or after 1-6-07 depending upon receipt of payment. Classification of a taxable service is determined based on the nature of service provided whereas liability to pay service tax is related to receipt of consideration. Vivisecting a single composite service and classifying the same under two different taxable services depending upon the time of receipt of the consideration is not legally sustainable. In view of the above, a service provider who paid service tax prior to 1-6-07 for the taxable service, namely, erection, commissioning or installation service, commercial or industrial construction service or construction of complex service, as the case may be, is not entitled to change the classification of the single composite service for the purpose of payment of service tax on or after 1-607 and hence, is not entitled to avail the Composition Scheme.

the classification to works contract service from the respective classification and pay service tax for the amount received on or after 1-6-07 under the Composition Scheme?	

A careful reading of underlined portion of the above circular would reveal that the clarification is applicable only when the service is rendered and completed prior to 01.06.2007 and if any payment for such service is received after 01.06.2007, service tax has to be paid only under the category under which service tax was paid already and not under the newly introduced category of Works Contract Service, where composition scheme of payment of service tax is available.

As rightly observed in the Circular classification of a taxable service is determined based on the nature of service provided whereas liability to pay service tax is related to receipt of consideration. Vivisecting a single composite service and classifying the same under two different taxable services depending upon the time of receipt of consideration is not legally tenable. In other words, classification of service shall be based on the nature of service provided and the available entries of taxable services, when the service was rendered. Just because a new service was introduced with effect from 01.06.2007, a contract concluded prior to this date, cannot be reclassified under the new service (Works Contract Service), for paying service tax on the amount received after 01.06.2007.

But when the contract was continuing even after 01.06.2007, and services are performed, the classification of such services performed after 01.06.2007, going by the nature of the services provided, shall only be under Works Contract Service. In this connection, it is also relevant to refer to the CBEC's Letter F.No.B1/16/2007 Dated 22.05.2007.

> *Various trade and industry associations have raised apprehension in respect of classification of a contract either under the newly introduced works contract service or under erection, commissioning or installation and commercial or residential construction services. Contracts which are treated as works contract for the purpose of levy of VAT/sales tax shall also be treated as works contract for the purpose of levy of service tax. This is clear from the definition under Section 65(105)(zzzza).*

As per Section 66 of the Finance Act, 1994 Service tax is payable on the value of taxable services and the taxable event is provision of service. Whenever value of taxable services are received, the services provided against such value, shall be classified and appropriate service tax thereon has to be calculated and paid. For the purpose of determining such service tax liability, appropriate classification of the taxable services is also essential. Once service tax has been imposed on works contracts, with effect from 01.06.2007, if the activity undertaken by a service provider is more specifically covered under the works contract service, any service tax liability thereon, for the value of taxable services received after 01.06.2007, for the services rendered after 01.06.2007 shall be paid only under the said works contract service.

In this context, it is relevant to compare the situations under Central Excise, where the law on this subject is settled. If the classification of a product is changed from one heading to another heading, from a particular date, even the goods manufactured during the period before such change, if cleared after such change, shall be classified only under the new tariff heading. Classification is a continuous process and has to be done, everytime when the liability for payment of service tax arises. While "manufacture" under central excise can be equated to "rendering of service" under service tax, "removal of excisable goods" under Central excise can be equated to "receipt of value of taxable service" under service tax. The concept of classification is common under both the levies, which is relevant and determined at the time of payment of duty / tax, i.e. at the time of removal of goods under central excise and at the time of receipt of value of taxable service under service tax. Hence, whenever the liability for payment of service tax arises, on account of receipt of value of taxable service, the appropriate classification of the service has to be done and appropriate service tax has to be paid.

Albeit repetitive, let it be clarified that if the services are performed prior to 01.06.2007, i.e. before introduction of Works Contract Service, for which payments are received after 01.06.2007, service tax cannot be paid under composition scheme or otherwise, available under Works Contract Service, for such amounts received after 01.06.2007, as during the relevant time when the service was performed, WCS was not at all in existence. But if a contract commenced prior to 01.06.2007 and classified under a different category of taxable service, continued even after 0106.2007, the activities performed after 01.06.2007 shall be reclassified only under WCS and payment of service tax under composition scheme or otherwise shall be applicable in that case.

Rule 3 (3) of the Works Contract (Composition Scheme for payment of Service Tax) Rules, 2007 reads as below:

> *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.*

Even in the cases where, prior to 01.06.2007 service tax has been paid on the activities under various other categories of services, that portion of service performed after 01.06.2007 shall be classified only under WCS. The service tax paid on such activities, prior to 01.06.2007 cannot be considered as "payment of service tax in respect of the said works contract", as envisaged in Rule 3 (3) ibid, as the levy on works contracts itself has come into effect only with effect from 01.06.2007. So, after 01.06.2007, the activity has to be reclassified into WCS and the service provider has to exercise his option for composition scheme or otherwise, before making his first service tax payment after 01.06.2007.

If the recent decision of the Hon'ble High Court of A.P. is looked into with the above perspective, it appears that the basic issue of re-classification of service under WCS, after 01.06.2007 has not at all been an issue in the Writ Petition.

The Hon'ble High Court has interpreted the provisions of Rule 3 of the Works Contract (Composition Scheme for payment of Service Tax) Rules, 2007 and came to the conclusion that once service tax has been paid on a works contract prior to 01.06.2007, option for composition scheme under WCS cannot be opted after 01.06.2007, in view of the above provision of the rule. The issue is basically one of appropriate classification of the services rendered vis-à-vis various entries available during the relevant time and not claiming retrospective applicability of the composition scheme of payment of service tax. Before deciding whether the composition scheme under WCS is applicable for those contracts which commenced prior to 01.06.2007 and continuing even after 01.06.2007 and service tax thereon has been paid under different other categories of services, another important factor to be decided is as to how the services commenced prior to 01.06.2007 and classified under different other categories of services prior to 01.06.2007, shall be classified after 01.06.2007. Once it is held that the service performed after 01.06.2007 has to be classified only under WCS, it automatically follows that any payments received in such case, after 01.06.2007, the service provider has an option to pay the service tax under composition scheme.

Hence with utmost respect to the Hon'ble High Court, there appears to be a proverbial slip between the cup and the lip, when the Hon'ble High Court dealt with the issue.