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WC, Composition, CBEC Circulars, NCC, SC – "Sea" of woes.

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The Hon'ble Supreme Court (2012-TIOL-107-SC-ST) has upheld the decision of the Hon'ble AP High Court in the case of Nagarjuna Construction Company Limited reported in 2010TIOL-HC-AP-ST. In effect, those who have paid service tax prior to 01.06.2007 under commercial or industrial construction service, or construction of residential complex service or erection, commissioning and installation service cannot switch over to the composition scheme of works contract service, after 01.06.2007. The whole issue has arisen in the context of introduction of works contracts as a separate category of taxable service from 01.06.2007, with 2 % service tax rate under the composition scheme. Though the larger issue, as to whether the works contracts, which became a distinct taxable service only from 01.06.2007 can be taxed under any other head before this date, still remains, the present dispute is only with reference to such switching over.

The service tax payable, after 67 % abatement under those categories of services was 3.3 %, whereas the composition rate was just 2 % from 01.06.2007 to 28.02.2008. Further, while no cenvat credit is admissible under the abatement scheme, cenvat credit on input services and capital goods is allowed under composition scheme.

In such circumstances, the validity of the Circular No. 98/1/2008 Dt. 04.01.2008 was challenged before the Hon'ble AP High Court. It was clarified in the said circular that after 01.06.2007, the service cannot be reclassified into works contract service, but the classification shall continue under the old services. For ready reference, the clarification is reproduced.

097.03/4-1-08	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	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

	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 the classification to works contract service from the respective classification and pay service tax for the amount received on or after 1-607 under the Composition Scheme?	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 1-6-07 and hence, is not entitled to avail the Composition Scheme

It may be noted that as per the said circular, the classification will continue under different categories of services even after 01.06.2007 for ongoing contracts and as a consequence, the composition scheme under works contract service is also not admissible. But, the CBEC has changed its stand and clarified vide its subsequent circular No. 128/10/2010 Dt.
24.08.2010 that the classification of the service will change to Works Contract Service after 01.06.2007, but the benefit of composition scheme would not be allowed for ongoing contracts. To quote,

> It has been brought to the notice of the Board that the following confusions/disputes prevail with respect to long term works contracts which were entered into prior to 16-2007 (when the taxable service, namely, Works contract came into effect) and were continued beyond that date:
>
> (i) While prior to the said date services like Construction; Erection, commissioning or installation; Repair services were classifiable under respective taxable services even if they were in the nature of works contract, whether the classification of these activities would undergo a change?
>
> (ii) Whether in such cases of continuing contracts, the Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007 under Notification No. 32/2007-S.T., dated 22-5-2007 would be applicable?

2. The matter has been examined. As regards the classification, with effect from 16-2007 when the new service 'Works Contract service' was made effective, classification of aforesaid services would undergo a change in case of long-term contracts even though part of the service was classified under the respective taxable service prior to 1-6-2007. This is because 'works contract' describes the nature of the activity more specifically and, therefore, as per the provisions of Section 65A of the Finance Act, 1994, it would be the appropriate classification for the part of the service provided after that date.

3. As regards applicability of composition scheme, the material fact would be whether such a contract satisfies rule 3(3) of the Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007. This provision casts an obligation for exercising an option to choose the scheme prior to payment of service tax in respect of a particular works contract. Once such an option is made, it is applicable for the entire contract and cannot be altered. Therefore, in case a contract where the provision of service commenced prior to 1-6-2007 and any payment of service tax was made under the respective taxable service before 1-6-2007, the said condition under rule 3(3) was not satisfied and thus no portion of that contract would be eligible for composition scheme. On the other hand, even if the provision of service commenced before 1-6-2007 but no payment of service tax was made till the taxpayer opted for the composition scheme after its coming into effect from 1-62007, such contracts would be eligible for opting of the composition scheme.

Such reclassification of the service after 01.06.2007 has been approved even in the present SC judgement.

The probable reason for not allowing composition for ongoing contracts, after 01.06.2007 could be that under the erstwhile categories of services, if the service provider has availed cenvat credit on inputs and if composition scheme is allowed after 01.06.2007, it would not be proper. But, if the service providers have opted for abatement (which invariably is the case is almost all cases), the service provider would not have availed any cenvat credit at all, as the same was not allowed under the abatement scheme as per Notification 1/2006. But, cenvat credit on input services and capital goods is allowed under the composition scheme. So, ideally, once change of classification into works contract service is allowed after 01.06.2007, composition scheme should have been debarred only for those who have availed cenvat credit on inputs prior to 01.06.2007. Unfortunately, the Hon'ble Supreme Court has also not gone into this aspect, citing it to be irrelevant.

The Hon'ble SC has observed that since Rule 3 (3) of the Service Tax (Determination of Value) Rules, has not been challenged, the circular which has been issued only in pursuance of the said rule cannot be said to be ultra vires the rules. For ready reference, the said rule is reproduced.

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.

There can be no fault in the said rule. Having classified the service under Works contract, before making any payment of service tax, the option to pay under composition scheme has to be exercised. This rule cannot at all refer to the service tax paid prior to 01.06.2007 when works contracts are not at all recognized as a distinct taxable service. So, the payment contemplated in the said rule is only the payments after 01.06.2007 and cannot be the payments of service tax made prior to 01.06.2007.

The whole chaos and havoc is created by these half-baked circulars from the Board, which is seldom a boon, but always a bane.

Before parting…

Based on the 2008 circular, all those service providers have been issued with show cause notices, demanding service tax under the old categories of services, disputing the classification under works contract service. Now change of classification into works contract service has been allowed as per 2010 circular and the same has also been endorsed by the SC. Can those notices demanding service tax under a wrong head of taxable service, stand now?