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Construction mess

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1.0 Much has been written about the never ending confusions regarding levy of service tax on construction related activities. Recently, the CBEC seems to have issued a clarification to the Chief Commissioner of Central Excise and Service Tax, Visakhapatnam, which has triggered me to write one more article on the subject. (Will deal with this clarification later).

Background.

2.0 Construction activities involve an element of transfer of property in goods and undertaking the service of construction. Sometimes an ingredient of sale of immovable property may also be prevalent in the transaction. By 46th Amendment to the Constitution, clause (29A) has been introduced Article 366 of the Constitution, whereby the concept of "deemed sale" was brought in. In other words, the term "tax on the sale or purchase of goods" is sought to be defined in an inclusive manner and one such inclusion was *"a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of works contracts"*. With this amendment, the State Governments could levy sales Tax / VAT on such transfer of property during execution of works contract, as per Entry 54 of the List II of the Seventh Schedule. But, the Central Government was always having the power to levy tax on the service component in such composite contracts and the question is when this power was properly exercised by the Central Government.

Attempt to levy Service tax on construction activities.

3.0 When the scope of coverage of service tax was expanding with introduction of more and more services every year, commercial construction service was introduced in the year 2004 {Section 65 (105) (zzq)} and construction of (residential) complex service was introduced in 2005 {Section 65 (105) (zzzh)}. These activities are normally undertaken in a composite way where the service provider himself would supply all the materials / goods required for the activity. For example, the cement, steel, etc. required for the construction activity would also be procured and used by the construction contractor and ultimately the constructed building would be handed over to the customer. Let us call these composite activities as "works contract" hereafter. In some cases, all the materials required for construction would be procured by the customers themselves and supplied to the contractor and in such cases the construction contractor would merely undertake construction activity – which would be a pure service activity.

3.1 Obviously, when the Central Government introduced service tax on construction related activities in 2004 and 2005, they wanted to tax the service component of such composite works contracts also and not merely pure service activities. As the Central Government cannot levy any service tax on the component of transfer of property in goods involved in such works contract (which is in the State Governments' taxing domain as per Entry 54, List II, Schedule VII), they issued various exemption notifications to provide for 67 % abatement from

value. So, the view of the Central Government was that the service portion in a composite works contract, can be subjected to service tax levy under the above category of services, viz., commercial construction service and construction of complex service.

Works Contract Service.

4.0 Subsequently, in the year 2007 a separate taxable service by name "works contract" was introduced vide Section 65 (105) (zzzza) of the Act. Relevant valuation provisions were also introduced whereby two options were given for payment of service tax. Vide Rule 2 A of the Service Tax (Determination of Value) Rules, 2006 the value of works contract service would be the gross amount charged minus the value of transfer of property in goods. An alternative mechanism was provided under Works Contract (Composition scheme for payment of Service Tax) Rules, 2007, whereby service tax can be paid at a lesser rate on the gross value (including the value of transfer of property in goods).

Supreme Court decision in L & T Case.

5.0 The issue as to whether the service portion in the execution of composite works contracts can be subjected to levy of service tax from 2004/2005 onwards under commercial or industrial construction service / construction of complex service, or it can be subjected to service tax only from 2007 under works contract service, came up before the Hon'ble Supreme Court in the case of CCE VS L & T Limited 2015-TIOL-187-SC-ST. The Central Government's belief that the service portion in the execution of works contracts can be taxed from 2004/2005 itself was shattered by the Hon'ble Supreme Court, which has held that in as much as Section 67 of the Act, dealing with the valuation of taxable services, lays down that the gross amount charged would be the value of taxable service, on a harmonious interpretation, the taxable services of commercial or industrial construction service / construction of complex service could cover only pure service activities. If it is considered that these services would cover composite works contracts also, then as per Section 67 of the Act, the gross amount charged would be leviable to service tax, which would be violative of the Constitutional division of taxing powers, whereby the Central Government cannot levy any tax on the transfer of property in goods. The Government argued that in as much as a mechanism by of abatement to an extent of 67 % from gross value has been provided by way of exemption notification, the service portion in works contracts can be subjected to levy of service tax under these services, without violating the provisions of the Constitution. But, the nuances of law demands otherwise. The validity of the levy should be tested without any reference to any exemption notification, which are issued at the behest of the executive. A law passed by Parliament must stand on its own and not with the support of executive notification. If someday, the benefit of abatement is withdrawn by the executive, then service tax under commercial or industrial construction service / construction of complex service would be payable on the entire value, including the value of transfer of property in goods, which is constitutionally not permissible. So, disregarding the abatements granted by way of exemption notifications, the Hon'ble Supreme Court, reading the definition of taxable services and Section 67 harmoniously, came to the conclusion that only pure service activities can be

subjected to service tax under commercial or industrial construction service / construction of complex service.

5.1 When works contract was introduced as a distinct taxable service, suitable rules were framed, to levy service tax only on the value attributable to services in the form of Rule 2 A of the Service Tax (Determination of Value) Rules, 2006 and Works Contract (Composition scheme for payment of Service Tax) Rules, 2007. So, the Hon'ble Supreme Court has further held that service portion in a composite works contract can be subjected to levy of service tax only from 01.06.2007 under works contract service. The Supreme Court's verdict was delivered on 20.08.2015.

Amendments in 2010:

6.0 In 2010, the benefit of the decision of the Hon'ble Supreme Court in L & T case was not available and the Central Government was of the belief that they can levy service tax on the service constituent of works contracts, under commercial construction service and construction of complex service.

6.1 Basically, construction activities are carried out in two models in our country and the practice varies from place to place and there are also various deviations from the basic two models. The decision as to a particular model is normally based on applicable taxes / stamp duties under different models.

6.2 Let us assume that a person intends to buy an apartment from a builder. Once the project is launched by the builder, he would advertise the same and buyers would approach the builder and book an apartment by paying booking advance. If 100 apartments of 1500 Sq. Feet each are constructed in a 75000 Sq Feet land, the total constructed area would be 1,50,000 Sq. Feet (100 X 1500 Sq. Feet), in a land of 75,000 Sq. Feet. So, each flat buyer would be entitled to 750 Sq. Feet of land, which is called "undivided share of land (UDS)". In the first model, which is broadly prevalent in the southern states, the UDS, being an immovable property would be sold and registered in the name of the buyer on payment of proper stamp duty and a construction agreement would be entered into for the remaining value. The buyer is liable to make payment in agreed instalments based on stage of completion.

6.3 In the second model, stage-wise payments would be received by the builder from the buyer based on an agreement to sell a flat. Once the construction is complete, the entire flat, along with applicable UDS would be registered in the name of the buyer by executing a sale deed. This is a transaction of sale of immovable property, based on an agreement to sell, against receipt of values during the stage of construction. A question arose, as to whether these type of transactions, mainly followed in western and northern party of the country are liable to service tax under construction of complex service. Being a transaction of sale of immovable property, such transactions cannot attract the levy of service tax. This has created a regional disparity, where in certain regions the activity of purchase of flats is liable to service tax and in certain other regions the same activity is not liable to service tax, solely based on the model in which the transaction is undertaken.

6.4 In order to remove this anomaly, an Explanation was added in the definition of taxable services of commercial construction service and construction of complex service, from 01.07.2010. The Explanation reads as,

> *For the purposes of this sub-clause, construction of a complex which is intended for sale, wholly or partly, by a builder or any person authorised by the builder before, during or after construction (except in cases for which no sum is received from or on behalf of the prospective buyer by the builder or a person authorised by the builder before the grant of completion certificate by the authority competent to issue such certificate under any law for the time being in force) shall be deemed tobe service provided by the builder to the buyer.*

6.5 The effect of this Explanation is that even in a transaction of sale of immovable property, if any payments are received by the seller from the buyer, before the construction of the property in question is complete, it would be deemed as a service and liable to service tax. In such cases, as no separate value would be available for the UDS land, a higher abatement of 75 % has been provided for. Strictly speaking, this amendment and higher abatement has got nothing to do with the first model, where the UDS value is separately available and the value as per construction agreement would not include the UDS land value. On such construction agreement value, only 67 % abatement could be claimed.

6.6 The validity of the above Explanation, whereby in a transaction of sale of immovable property, an element of service was deemed, was challenged before the Courts. The Hon'ble High Court of Bombay has upheld the validity of the same in the case of Maharashtra Chamber of Housing Industry Vs Union of India – 2012-TIOL-78-HC-Mum-ST.

Different interpretation of the 2010 Explanation.

7.0 Though the purpose of the above Explanation inserted from 01.07.2010 seems to be the above, the Hon'ble Tribunal has given a dimension to it, in the case of Krishna Homes Vs CCE 2014-TIOL-402-CESTAT-Delhi. By reading the definition of taxable services before and after the insertion of the Explanation, the Hon'ble Tribunal has come to the conclusion that upto 01.07.2010, "construction of a complex" alone is taxable, i.e. if a builder constructs a "residential complex" for subsequent sale to various buyers and for this purpose entrusts the construction of the complex to a contractor, then the contractor is liable to pay service tax from 2005. But, between the builder and the buyers, where each buyer is getting only one flat in the complex, and not the entire complex, the levy of service tax would apply only from 01.07.2010. Same view has been held in some other cases also, such as Josh P John Vs CCE – 2014-TIOL-1753-CESTAT-Bang.

Negative list based Service Tax Levy

8.0 When the entire service law underwent major changes from 01.07.2012 when a negative list based comprehensive levy of service tax was introduced, the above view of the Central Government relating to taxing the construction sector continued. The term service has been defined in Section 65 B
(44) of the Act, which also includes "declared services". The term "works contract" has been defined in Section 65 B (54) of the Act. Section 66 E of the Act contains the list of "declared services" which includes inter alia,

> *(b) construction of a complex, building, civil structure or a part thereof, including a complex or building intended for sale to a buyer, wholly or partly, except where the entire consideration is received after issuance of completion-certificate by the competent authority.*
>
> *(h) service portion in the execution of a works contract.*

8.1 The above declared service under clause (b) is similar to the Explanation under commercial construction service / construction of complex service, introduced with effect from 01.07.2010. While pure construction contracts, incorporating only transfer of property in goods and services would be "works contracts", sale of immovable property during construction, by receiving payments before completion would be a declared service. The new Rule 2 A of the Service Tax (Determination of Value) Rules 2006 provided for two options to arrive at the value of service portion in the execution of works contracts. Under the first option, the value of service portion in works contract would be the gross amount minus the value of transfer of property in goods ad under the second option, the value of service would be a specific percentage of the gross value (for original construction activities, 40 % of the gross amount would be considered as the value of service portion in the works contracts).

Hon'ble Delhi High Court decision in Suresh Kumar Bansal case.

9.0 Then came another important verdict of the Hon'ble High Court in the case of Suresh Kumar Bansal Vs UOI – 2016-TIOL-1077-HC-DEL-ST, which was delivered on 03.06.2016. It was held in this case that if there is a composite contract, involving not only transfer of property in goods and services, but also an element of sale of immovable property, there is no statutory mechanism to exclude the value of transfer of immovable property and hence the levy of service tax on such composite activities is not sustainable. While coming to the above conclusion the Hon'ble Delhi High Court has followed the decision of the Hon'ble Supreme Court in L & T case. In L & T case, the Hon'ble Supreme Court has held that prior to 01.06.2007, there was no statutory mechanism to exclude the value of transfer of property in goods from a composite works contracts and hence such composite works contracts are not liable to service tax under any category of service, prior to 01.06.2007. In the same vein, the Hon'ble Delhi High Court has held that there is no mechanism to exclude the value of transfer of immovable property from a composite activity containing three elements, viz., (i) transfer of property in goods, (ii) services and (iii) transfer of immovable property.

9.1 So, notwithstanding the introduction of an Explanation to tax such composite activities from 01.07.2010, the same is not possible in as much as even after the introduction of the Explanation there is no mechanism to exclude the value of transfer of immovable properties. The ratio of this decision would apply, post 01.07.2012 also as even today there is no statutory mechanism to exclude the value of transfer of immovable property in such composite contracts. So, the second model of construction activities are not liable to service tax, even today, as per the decision of the Hon'ble Delhi High Court in Suresh Kumar Bansal case. We have to note that grant of higher abatement in such cases could not save the levy as held by the Hon'ble Supreme Court in L & T case. Further, it should also be noted that the Delhi High Court decision would not apply in respect of the first model of transactions, where the immovable property (UDS land) is separately sold to the buyer and the construction agreement is only for the transfer of property in various goods and services. Such construction agreement, by itself would be a works contract and statutory mechanism to arrive at the value of service component in such works contracts is available under Rule 2 A of the Service Tax (Determination of Value) Rules, 2006.

9.2 So, now we are back to pre 2010 situation where the applicability of service tax is based on the transaction model and the same activity would attract service tax in some places and it will not attract service tax in other places, basedon the model of transaction.

10.0 An analysis of the above history would reveal that while the Government always believes that its intention to levy service tax on construction activities is always inviolable, the Courts feel otherwise. The various circulars issued by the Government supposedly to clarify the doubts have only added to the confusion as the judicial view on the levy is significantly different from the Central Government's perception. Further the judicial view emerges at a later point of time, after the Government has perpetuated its view by all means and the Government is also not willing to concede to its judicial defeat.

A prevalent confusion.

11.0 One of the issues where there was widespread doubt was as to the applicability of 75 % abatement vis-à-vis Rule 2 A of the Service Tax (Determination of Value) Rules, 2006. In other words, whether the higher abatement of 75 % can be claimed even under the first model of transactions, where the immovable property (UDS land) is separately conveyed for a distinct value and in such case, can the builder claim higher abatement of 75 %, by including the value of UDS land also to the construction agreement value. In other words, can a transaction where the UDS land is separately conveyed and another construction agreement is entered into, be subjected to levy of service tax as "service portion in the execution of works contracts {Section 66 E (h)}" or as "construction of a complex, building, civil structure or a part thereof, including a complex or building intended for sale to a buyer, wholly or partly, except where the entire consideration is received after issuance of completion-certificate by the competent authority {Section 66 E (b)}".

11.1 If it is considered under 66 E (h), the value of UDS land could be excluded and service tax is payable on 40 % of the remaining value, under the second option of Rule 2 A. If it is considered under section 66 E (b), service tax is payable on 25 % of the total value, including the value of UDS land. In many circumstances, the quantum of service tax payable under 75 % abatement wouldbe less than the service tax payable under Rule 2 A.

11.2 Strictly speaking the above legislative history would show that the hither abatement is applicable only for the second model of transactions where no separate value is available for the transfer of immovable property, i.e. UDS Land and the said higher abatement cannot be claimed in the first model of transactions, where the UDS land is sold separately and the construction agreement is just a works contract having transfer of property in goods and services, where only Rule2 A would apply.

12.0 This issue has now been clarified by the CBEC to the Chief Commissioner of Central Excise and Service Tax, Visakhapatnam in its letter dated 05.09.2016. As usual this clarification has not at all taken into cognizance the effect of any of the decision referred to above and has been issued on the basis of the Central Government's belief about the validity of its levy.

12.1 It has been clarified in the said letter that the description of service under the Explanation to the definition of taxable services (upto 30.06.2012) and as per Section 66 E (b) of the Act (from 01.07.2012) is more specific than the definition of works contract service as per Section 65 (105) (zzzza) of the Act (upto 30.06.2012 and) as per Section 66 E (h) of the Act (From 01.07.2012). Hence, it has been clarified that the benefit of higher abatement is admissible.

13.0 This clarification has thrown up the following questions.

(a) When there is no levy of service tax on composite contracts, involving transfer of immovable property, transfer of property in goods and rendering of services, as held by the Hon'ble High Court of Delhi, what is the sanctity of abatement?

(b) Whether the clarification has been issued only with reference to the second model of transaction where no separate value is available for UDS land or the clarification can be applied to the first model also? In other words, can a builder, who separately conveys the UDS land has the option to include the value of UDS land and claim higher abatement,as per this clarification?

14.0 There are further more confusions relating to levy of service tax on construction activities (such as appropriate classification between commercial construction service / construction of complex service vis-à-vis works contract service; valuation of construction undertaken for landowners in Joint development agreements, etc.) It may take another 10 years and 100 judgements for all the prevalent confusions to die down. It would be better, if the Government accepts its mistakes in drafting legislation and graciously acknowledge the judicial view, instead of holding on to its view, albeit having lost even before the Apex Court. Such mistakes could be corrected prospectively by suitable amendments. While issuing clarifications, the law laid down by the judicial forums should be given due

respect. Unless this is done, every clarification issued by the Government wouldonly further foment trouble.

Hope the readers would not blame me for an unusually long article.(Published

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