

WC – Leakage Plugged

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Service tax was introduced on specified works contracts, with effect from 01.06.2007. It has come as a major relief to the sector, due to various reasons.

- a) High incidence of tax under other categories of services (construction services, erection, commissioning and installation of services), due to denial of input services credit, if abatement is claimed.
- b) Optional composition scheme for payment of service tax, at a much lower rate of 2 % (later raised to 4 %).
- c) Availability of cenvat credit on input services.

The term works contract has also been defined as below:

For the purposes of this sub-clause, "works contract" means a contract wherein, —

(i) transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods, and

(ii) such contract is for the purposes of carrying out, —

(a) 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 related 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

(b) 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

(c) construction of a new residential complex or a part thereof; or

(d) completion and finishing services, repair, alteration, renovation or restoration of, or similar services, in relation to (b) and (c); or

(e) turnkey projects including engineering, procurement and construction or commissioning (*EPC*) projects.

The composition scheme for payment of service tax on works contracts is contained in Rule 3 of the Works Contract (Composition scheme for payment of service tax) Rules, 2007, which is reproduced below:

RULE 3. (1) Notwithstanding anything contained in section 67 of the Act and rule 2A of the Service (Determination of Value) Rules, 2006, the person liable to pay service tax in relation to works contract service shall have the option to discharge his service tax liability on the works contract service provided or to be provided, instead of paying service tax at the rate specified in section 66 of the Act, by paying an amount equivalent to [four per cent.] of the gross amount charged for the works contract.

Explanation. — For the purposes of this rule, gross amount charged for the works contract shall not include Value Added Tax (VAT) or sales tax, as the case may be, paid on transfer of property in goods involved in the execution of the said works contract.

(2) The provider of taxable service shall not take CENVAT credit of duties or cess paid on any inputs, used in or in relation to the said works contract, under the provisions of CENVAT Credit Rules, 2004.

(3) 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.

It may be observed from the above, that in order to be classified as a works contract for the purpose of payment of service tax, it is necessary that transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods. The term gross amount charged is also defined, whereby the VAT payable on the transfer of property has been excluded. It may be observed that the quantum of materials involved in such transfer of property is not indicated, thereby paving way for probable tax avoidance, as explained below.

If a composite contract for supply, erection, commissioning and installation of a big plant, totally valued at Rs.50 Crores is awarded to a person, strictly speaking the composition scheme of payment of service tax would require payment of service tax @ 4 % on Rs.50 crore. But, if the supply portion is excluded and if a separate contract is entered for such supply, say for a value of Rs. 30 crores, the remaining amount of Rs.20 crores would be for erection, commissioning and installation services. It may be noted that the second contract by itself also involves transfer of property in goods, as many goods like cement, steel, etc. would be required for such erection, commissioning and installation. By this method, service tax under composition scheme would be paid only on Rs.20 crores and not on Rs.50 Crores.

Further, since the relevant provisions refer only to gross amount "charged" if any materials are supplied by the client themselves, the same would also not suffer service tax under composition scheme, if the remaining scope of the service provider also involves transfer of property in some goods.

Notification 23/2009 ST Dated 07.07.2009, seeks to substitute a new explanation under Rule 3 (1) *ibid*, which reads as below:

Explanation : For the purposes of this sub-rule, gross amount charged for the works contract shall be the sum, -

(a) including -

(i) the value of all goods used in or in relation to the execution of the works contract, whether supplied under any other contract for a consideration otherwise; and

(ii) the value of all the services that are required to be provided for the execution of the works contract;

(b) excluding -

(i) the value added tax or sales tax as the case may be paid on transfer of property in goods involved; and

(ii) the cost of machinery and tools used in the execution of the said works contract except for the charges for obtaining them on hire.

Further, a new sub rule (4) has also been appended under Rule 3, which reads as

(4). The option under sub-rule (3) shall be permissible only where the declared value of the works contract is not less than the gross amount charged for such works contract.

The rationale of this amendment has also been explained in the CBEC's letter D.O. F.No.334/13/2009 TRU Dated 06.07.2009, in the following words.

5.1 Changes in the Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007. These rules provide a simplified procedure for working out the tax liability by the service providers providing works contract service. Instead of working out the service element from the value of works contract and paying service tax at full rate (i.e. 10 %), the service provider is allowed to pay 4 % on the "gross amount charged" for the works contract. The reason for prescribing the lower rate under the scheme is that the service provider need not bifurcate the gross value of works contract. It was expected that the gross value should be shown to include the total value of materials as well as services used in providing the taxable services. However, it has been reported that in certain cases, the taxpayers are not including the full value of the goods required for execution of works contract for working out service tax liability under the composition scheme by either excluding the value of goods received free of cost from their client or splitting the contract into a

sale contract (for a portion of goods required to execute the works contract) and works contract (for only a portion of the total value of goods and the labour charges), thus reducing the value of works contract for the purposes of calculating service tax. In order to plug this loophole, the Explanation appearing in sub-rule (3) is being amended to provide that the composition scheme would be available only to such works contracts where the gross value of works contract includes the value of all goods used in or in relation to the execution of works contract whether received free of cost or for consideration under any other contract.

The effect of this amendment can be understood with reference to the following example.

S.No.	Details	Amount
1	(A) Value of supply contract, given by A to B	Rs.5,00,00,000
	(B) Value of erection, commissioning contract, given by A to B	Rs.3,00,00,000
	(C) VAT payable by B, on supply contract	Rs.20,00,000
	Value for payment of service tax under Composition scheme (A) + (B) - (C)	Rs.7,80,00,000
2	(A) Value of supply contract, given by A to B	Rs.5,00,00,000
	(B) Value of erection, commissioning contract, given by A to B	Rs.3,00,00,000
	(C) Value of materials supplied by A to B, free of cost	Rs.1,00,00,000
	(D) VAT payable by B, on supply contract	Rs.20,00,000
	Value for payment of service tax under Composition scheme (A) + (B) + (C) - (D)	Rs.8,80,00,000
3	(A) Value of erection, commissioning and installation contract, given by A to B, which also involves use of materials for such erection, commissioning and installation.	Rs.10,00,000
	(B) Value of the plant and machinery, to be erected / commissioned / installed, supplied by A to B	Rs.5,00,00,000
	Value for payment of service tax under Composition scheme (A) + (B)	Rs.5,10,00,000

It may also be noted that the above amendments would not apply to the works contracts, where the execution under the said contract has commenced or where any payment, except by way of credit or debit to any account, has been made in relation to the said contract, on or before the date of these amendments, i.e. 07.07.2009.

By virtue of these amendments, the composition scheme of payment of service tax under Works Contracts service can be said to have lost its charm. It would be better to exclude the value of goods under Rule 2 A of the Service Tax (Determination of Value) Rules, 2007 and pay service tax @ 10.3 % on such value, rather than including the value of plant, machinery, etc. and pay 4 % on such value, where the value of such plant, machinery, etc. is substantial.

The following example would highlight the above.

Liability under Composition scheme, before amendment		Liability under Composition scheme, after abatement		Liability under non compounding method	
Details	Amount	Details	Amount	Details	Amount
Case - I					
(A) Value of plant and machinery, supplied by client	Rs.1 Crore	(A) Value of plant and machinery, supplied by client	Rs.1 Crore	(A) Value of plant and machinery, supplied by client	Rs.1 Crore
(B) Value of E/C/I Contract, which also involves goods and hence WC	Rs.20 Lakhs	(B) Value of E/C/I Contract, which also involves goods and hence WC	Rs.20 Lakhs	(B) Value of E/C/I Contract, which also involves goods and hence WC	Rs.20 Lakhs
Service tax payable @ 4.12 % on (B)	Rs.82,400	Service tax payable @ 4.12 % on (A) + (B)	Rs.4,94,400	Value of materials, included in (B) above, say	Rs.2,00,000
				Service Tax @ 10.3 % on (B) - (C)	Rs.1,85,400
Case - II					
(A) Value of supply contract	Rs.50 lakhs	(A) Value of supply contract	Rs.60 lakhs	(A) Value of supply contract	Rs.50 lakhs
(B) Value of ECI Contract, which also involves goods and hence WC	Rs.50 lakhs	(B) Value of ECI Contract	Rs.40 lakhs	(B) Value of ECI Contract	Rs.50 lakhs
Service Tax payable @ 4.12 % on (B)	Rs.2,06,000	Service Tax payable @ 4.12 % on (A) + (B)	Rs.4,12,000	(C) Value of materials involved in (B), say	Rs.5 lakhs
				Service Tax payable @ 10.3 % on (B) - (C)	Rs.4,63,500

Moral of the table: The option for payment of service tax has to be exercised prudently, for each and every contract, depending upon the value of materials vis-à-vis value of service.

Before parting...

It may still be prudent in some cases, to enter into a separate contract for the service portion alone, without involvement of any materials and pay service tax under the categories of commercial or industrial construction service / residential construction service / ECI service and paying service tax @ 10.3 % on such value, instead of falling into the vexatious WCS!