Service Tax on Builders: Issues in Classification & Valuation

Housing ranks next only to food and clothing amongst our basic requirements. It is, therefore, one of the most important commercial activities in an economy. Contribution of real estate sector to India's GDP has been estimated at 6.3% in 2013 and this segment is expected to generate 7.6 million jobs in the same period, according to a report. Therefore, the domain of real estate/construction presents a huge opportunity for indirect tax practitioners. And this is further enhanced as construction/housing strokes both sales tax as well as service tax levy. Taxes on services lie in the domain of the Central Government, while those on sale of goods in the domain of State tax. Therefore, any transaction that has elements of both sale of goods and provision of service would need to be assessed by both State VAT department and Central Excise & Service Tax department. The author in this article seeks to examine the scheme of service tax on builders with this background. Read on…

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Housing ranks next only to food and clothing amongst basic human needs. It is therefore one of the most important commercial activity in an economy. The contribution of the real estate sector to India's GDP has been estimated at 6.3% in 2013, and the segment is expected to generate 7.6 million jobs in the same period, according to a report. Naturally, therefore, real estate or construction is an area of large opportunity for indirect tax practitioners. And this is further enhanced as construction/housing strokes both sales tax as well as service tax levy.

The scheme of indirect taxes in India is that the taxes on services is the domain of the central government (*vide* residuary powers provided in

Entry 97 List I of Article 246), while taxes on sale of goods is a state tax (*vide* Entry 54 List II of Article 246). Even though taxes on sale of goods in course of inter-state trade or commerce falls within the powers of central government (*vide* Entry 92A List I of Article 246), since the central sales tax is collected and retained by the state, practically the taxes on sale of goods is a state subject. Therefore, any transaction that has elements of both sale of goods and provision of service would need to be assessed both by the state VAT department and Central Excise and Service Tax department. The transaction is, therefore, bound to become a hot potato in the area of indirect taxation.

Construction Services

We all are well aware that with effect from 1st July 2012, service tax is being levied under the negative list regime, which means that any service not exempted either under the negative list or by way of any exemption notification and provided in India (excluding J&K) is taxable. The word *service* has been defined in the widest possible manner, meaning *any activity carried by a person for another for consideration.* Construction sector has a wide range of activities including selection of a site, development, plotting, sale of land, architecture, construction, finishing, letting, sale of structure, *etc.* Thus, many aspects merit analysis under the new Service Tax regime.

The basic fundamental of taxing c*onstruction service* is gathered from the landmark judgment of the Supreme Court on *composite transaction* in *BSNL vs. UOI [2006(2) STR 161 (SC)].* It was held that apart from two exceptions provided in Article 366(29A), *viz., works contract* and *supply of food as part of service,* the State would not have the power to separate a composite contract unless the transaction in truth represents two separate contracts of sale and service, and is discernible as such. That is the transaction determined by an element which determines the *dominant nature* of the transaction, *e.g.* if a patient is given a pill in the hospital, the dominant nature is service and state cannot therefore charge VAT on the pill. Similarly, when one orders customised '*laddoos*' to be made as per specifications from a sweets shop, the dominant nature of the transaction is sale and, therefore, the Centre cannot charge service tax on the same. It is a well-settled principle of law by virtue of various court judgments that service tax and VAT are mutually exclusive. Refer to the Supreme Court judgment in *Imagic Creative Pvt. Ltd. vs. Commissioner of Commercial Taxes [2008 (9) STR 337 (S.C.)].*

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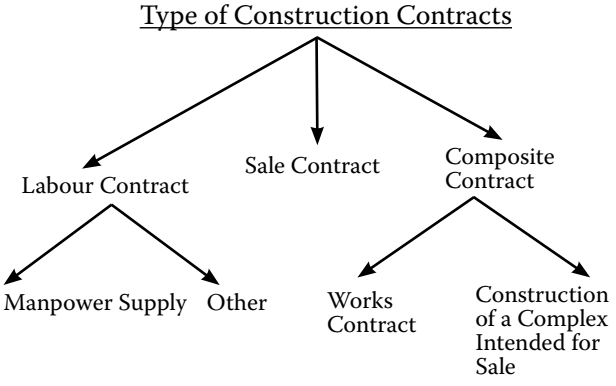
In simple terms in the context of construction services, at the outset, one has to clearly classify a contract into one of the following three *(further splitting in the chart below is explained later in the article):*



I) **Labour Contract:** A contract whereby material is provided by a person for getting the construction done and the contractor only provides labour, is a pure service contract. Therefore, gross amount charged by a service provider is liable to service tax. However, who pays service tax will be determined by a further classification of contract into a *supply of manpower* contract or otherwise. A supply of manpower contract is that whereby a contractor just provides labour and the work supervision is done by the contractee. Whereas when a contractor undertakes to accomplish a specific work, it is the latter, *e.g.* if a contract is to provide 10 labourers at a site to work under the supervision of a service receiver, it is a *supply of manpower* contract, whereas if a contract is for executing plastering of 10,000 sq. ft. of walls as per the specifications agreed, it is the latter type of a labour contract.

In case of supply of manpower for any purpose by an individual/HUF/firm/AOP, if a payer is body corporate, 75% of the service tax liability is discharged by a service receiver and the rest by a service provider. In the latter, the entire service tax shall be required to be paid by a service provider, *i.e.,* the contractor executing the work.

II) **Sale Contract:** A contract whereby an entire consideration for complex, building, civil structure or a part thereof is received after issuance of completion certificate by a *competent authority* is excluded from the purview of service tax (Section 66E). The expression competent authority means the Government or any authority authorised to issue completion certificate under any law for the time being in force and in case of non-requirement of such certificate from such authority, from any of the following, namely architect registered with the Council of Architecture constituted under the Architects Act, 1972 (20 of 1972), chartered engineer registered with the Institution of Engineers (India), or, licensed surveyor of the respective local body of the city or town or village or development or planning authority. In such case, no service tax is levied.

III) **Works Contract:** Works contract has been defined under the service tax to mean a contract wherein transfer of a property in goods involved in the execution of such contract is leviable to tax as sale of goods, and such contract is for the purpose of carrying out construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation, alteration, *etc.,* of any movable or immovable property or for carrying out any other similar activity or a part thereof in relation to such property.

The Supreme Court held in *K. Raheja Development Corporation vs. State of Karnataka AIR 2005 SC 2350* that construction of residential apartments or complexes would be a works contract, if agreement is entered into with the prospective buyers for the sale of such apartments and complexes and payment towards it is received in advance fully or partly, before the completion of the same. However, the judgment of the Supreme Court in *K. Raheja* case was doubted in the subsequent case of *Larsen & Toubro Limited vs. State of Karnataka 2008 (12) STR 257 (SC)* and the matter was referred to a larger bench of the Supreme Court. Therefore, the decision in *K. Raheja* case still holds the ground till a final verdict of the larger bench of the Supreme Court is announced. Lawmakers in order to avoid any ambiguity have specifically included construction of residential apartment or complex as a declared service. Therefore, the same has been included in a separate category below.

However, who pays service tax will be determined by a further classification of contract into a supply of manpower contract or otherwise. A *supply of manpower* contract is a that whereby a contractor just provides labor and the work supervision is done by the contractee.

IV) **Construction of Complex or Building Intended for Sale to Buyer:** Section 66E states that 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 has been declared to be a service liable to service tax. The expression *construction* includes *additions, alterations, replacements or remodeling of any existing civil structure.* It is important to note that when sale is made after completion of the complex, there would not be any levy of service tax as already discussed above.

Manner of Valuation in case of Works Contract

Options available for segregating the service portion are:

(i) Identify the transfer of material as provided under the VAT scheme and subtract the same from the gross amount charged.

(ii) If under VAT scheme, *ad-hoc* method has been adopted – one can still identify the value of goods transferred as cost record maintained and deduct the same. However, it will remain subjective and matter of dispute cannot be ruled out.

(iii) If contract cannot be dissected into material and labour portion, it can be classified as:

Original Works	Tax payable on 40%
Maintenance & Repair	Tax payable on 70%
Other works Contract	Tax payable on 60%

The Supreme Court held in *K. Raheja Development Corporation vs. State of Karnataka AIR 2005 SC 2350* that construction of residential apartments or complexes would be a works contract, if agreement is entered into with the prospective buyers for the sale of such apartments and complexes and payment towards it is received in advance fully or partly, before the completion of the same.

In all the above three cases, the CENVAT credit on the capital goods as well as input service is available.

Manner of Valuation in Construction of Complex/ Building Intended for Sale to Buyer

Since a construction activity includes two elements, *i.e.,* material and labour, an abatement/ exemption for the material is required for arriving at the service element. The same is provided *vide* Entry No. 12 of Notification No. 26/2012-ST dated 20-06-2012. The said Entry has been amended from time to time as:

Earlier, all such builders were allowed abatement of 75%, when the value of land was part of transaction in respect of construction of building intended for sale to prospective buyers with a condition that CENVAT credit benefit is allowed only in respect of input services and capital goods. Entry was amended with effect from 1st March 2013, to provide for the reduced rate of abatement for high ended homes and flats at 70% on the ground that, in such cases, component of service is greater. Higher abatement of 75% was restricted to a residential unit having carpet area up to 2,000 sq. ft. or where the amount charged in respect of such unit is less than ₹ 1 crore. Thus, if either of the conditions was satisfied, abatement of 75% was available. However, this has been amended again with effect from 8th May 2013, whereby higher exemption related to residential unit is made applicable by applying both the mentioned conditions. Thus, the current position is that both the conditions should be satisfied to claim exemption at the rate of 75%, *i.e.,* carpet area of residential unit should be less than 2,000 sq. ft. and the amount charged for such unit should also be less than ₹1 crore.

It is important to note here that that the amount charged shall include the fair market value of all goods and services supplied by the recipient(s) in or in relation to the service, whether or not supplied under the same contract or any other contract, after deducting:

(i) The amount charged for such goods or services supplied to the service provider, if any; and

(ii) The value added tax or sales tax, if any, levied thereon:

Provided that the fair market value of goods and services so supplied may be determined in accordance with the generally accepted accounting principles. The implications of the above explanation are that if any goods are supplied by the contractee to the builder-contractor free of cost or at lesser price than the fair market value of such goods, then for the purpose of calculating taxable value, gross amount charged shall include fair market value of such goods supplied after deducting the price charged for such goods and VAT, sales tax if any levied, thereon. The abatement of 70% or 75% shall then be applied on such gross amount so calculated.

The above provisions have been summarised as:

Date	Description	Abatement
Before 1st March 2013	- All	75%
1st March 2013 to 8th May 2013	- Residential unit with carpet area of < 2000 sq. ft. **or** the amount charged < ₹1 crore - Rest	75% 70%
Post 8th May 2013	- Residential unit with carpet area of < 2000 sq. ft. **and** the amount charged < ₹1 crore - Rest	75% 70%

Exemptions Relating to Construction under Service tax (Notification No. 25/2012, dated 20-06-2012)

I) Services by way of construction, erection, commissioning or installation of original works pertaining to single residential unit otherwise as a part of a residential complex or approved

low cost houses up to a carpet area of 60 sq. mtr. per house. The definition *of residential complex* has been changed with effect from 01-07-2012, whereas up to 30-06-2012, *residential complex* meant any complex comprising building having more than **twelve** residential units, now it means having more than **one** single residential unit. Thus, the scope has been enhanced considerably. Single residential unit has been defined as a self-contained residential unit which is designed for use, wholly or principally, for residential purposes for one family. It means it should have a kitchen, a living room and toilet facilities inside a residential unit. The size of a unit is not defined. However, exemption is available only when such a single residential unit is not a part of residential complex.

Service tax on construction of two floor house constructed through a contractor: service tax is payable on construction of a residential complex having more than one single residential unit. Single residential unit means a self-contained residential unit which is designed for use, wholly or principally, for residential purposes for one family. If each of the floors in the house is a single residential unit in terms of the definition, the contractor should charge service tax. If the title of each of the floors is capable of being transferred to another person by mutation in land/municipal records, both the floors may be considered as separate single residential units.

II) Services provided to the Govt. or local authority or a governmental authority by way of construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation or alteration of a residential complex predominantly meant for self use or the use of their employees or MP/MLA, *etc.* [Note: Construction of hospitals and educational institutions other than for the government or local authority or governmental authority are covered by service tax. Construction of roads for use by general public is exempt from service tax. Construction of roads which are not for the use of general public, *e.g.,* construction of roads in a factory, residential complex would be taxable.]

III) Services provided by way of construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation or alteration of a building owned by an entity registered under Section 12AA of the IT Act and meant predominantly for religious use (and not charitable use) by general public.

IV) Services by way of construction, erection, commissioning or installation of original works pertaining to post harvest storage infrastructure for agricultural produce including a cold storage for such purposes.

Bundled Service

If various elements of services are naturally bundled in the ordinary course of business, they shall be treated as provisions of single service which is the essential character of services. Therefore, preferential location and development of complex service can be treated as bundled service with construction service if not charged separately. Club house charged recovered separately – this for permitting him to use club house located in the complex. Similarly, the builder also charges for maintenance of the premises. The said two services are availed by the customer subsequent to her/his getting possession of the premises. Therefore, it is felt that this will not form part of the bundled service.

Rate of Tax

ST was chargeable at the rate of 10.3% up to 31-03-2012. However, with effect from 01-04-2012, this has been increased to 12.36%.

Conclusion

Thus, we see that the drafters of service tax have smartly included a large portion of the construction activity in the country within the ambit of service tax. It in turn opens a large area of opportunities for chartered accountants. And, we as professionals need to be aware of the basic laws relating to classification, taxability, valuation and exemptions relating to construction activity. ■

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