

Seminar on VAT Computation and assessment of Developer / Builder

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Aspects of VAT with relation to Immovable Property and Construction Contracts - An Update

In this seminar we have to discuss the legal position of tax on builders in light of recent Supreme Court judgment. The issue as to whether a Builder, who comes up with his own project and gives possession of premises to the prospective buyers can be liable to VAT as Works Contractor was under hot litigation ? The issue has chequered history. It will be useful to refer to relevant legal back ground before coming to Supreme Court judgment.

BACK GROUND

In relation to immovable properties, the first thing, which comes to our mind, is whether sale of immovable property attracts any sales tax? Under Sales Tax Laws the tax is leviable only on sale of 'goods'. As per Sales Tax Laws, only moveable goods are considered to be goods. Therefore immovable properties of any nature cannot fall in the Sales Tax net. Therefore, sale of flats/shops etc. cannot be subject matter of Sales Tax. This is uncontroverted position and hence not dealt with further. However, whether any particular transaction is for sale of immovable property or is a transaction of sale of moveable goods may become debatable.

Such issues mainly arise when along with immovable property certain movable goods in fixed condition are also disposed of. For example, while disposing of Factory building there may also be disposal of machinery fixed in it. An attempt may be made by Sales Tax authorities to say that to the extent of machinery, there is sale. However this cannot be correct in all cases. It depends upon nature of machinery installed. The situation can be seen from two angles. If along with immovable property any movable goods passes, but without separate consideration, then in such cases it can very well be said that since consideration is not bifurcated nor possible to be bifurcated, there is no sale of such moveable goods and hence no taxable event arises.

The other angle is that the moveable goods are fixed in the building and there is no intention to sever the same before transfer of immovable property. For example, the machinery is sold in fixed condition and there is no intention to sever them. In such cases, even if values of factory building and machineries are shown separately, it can very well be argued that there is sale of immovable property only and not of machinery, as there is no intention to deliver machinery separately as moveable goods. A reference can be made amongst others, to judgments of Maharashtra Sales Tax Tribunal in case of **Lyods Steel Ind. (S.A.2091 of 98 dt.23.3.2001)**, **Herdelia Chemicals Ltd. (S.A. 1826 of 1999 dt.31.10.2001)**, **Basawraj Printing Press (S.A.525 of 86 dt.30.11.87)**, **Libra Leather Ind. Ltd. (S.A.479 & 480 of 1988 dt.30.9.89)**, **Paramount Sinters Ltd.(S.A.1220 of 1995 dt.20.4.2002)** and **Pepsico India Holdings P. Ltd. (S.A.1074 of 2001 dt.19.06.2002)** etc.

However if the facts turns out to be otherwise, i.e., there are separate values as well as intention to sever items is evident, then the transaction to the extent of moveable goods can be considered as amounting to sale. A reference can be made to judgment in case of **Indoswe Engg. Co.(S.A.1357 of 98 dt.18.11.2000)**.

Similar different situations can also arise in relation to Works Contract theory and transfer of immovable property depending upon facts of each case. A reference can be made to judgment of M.S.T. Tribunal in case of **Sukhkarta Apartments (S.A.29 to 32 of 1996 dt.6.7.2002)**.

In this case appellant was arguing that the activity is not covered by the then Maharashtra Works Contract Act since there is sale of immovable property, being sale of constructed houses. Tribunal found that the agreement for sale of land and construction of building were separate, and therefore, though it was argued that it is sale of immovable property, a constructed house, Tribunal held that the construction part is liable to Works Contract, being separate construction contract.

A reference is also required to be made to the important judgment of Supreme Court in **K. Raheja Construction (141 STC 298)**. In this case the developer, constructing building, but selling the flats etc. before completion

of construction (sale under Construction), is held liable to Works Contract Tax. Though the judgment is under Karnataka Act, it will have repercussions in Maharashtra also. This aspect is discussed later.

In contrast a case can be considered where it was a composite contract for providing land with constructed tenements.

In determination order in case of **M/s.Rehab Housing Pvt. Ltd.. & Larsen & Toubro Ltd.(JV) (WC-2003/ DDQ-11/Adm-12/B-276 dt.28.6.2004)**, the Commissioner of Sales Tax Maharashtra State has held that the transaction is composite one i.e. providing land with constructed tenements and hence it is not covered by Sales Tax Provisions including Works Contract Act.

Thus, though in normal case it can be said that immovable properties are not subject matter of Sales Tax, in light of above stated contingencies it is necessary to see the implications of Sales Tax Laws on particular facts of the case. In case of sale of flats/ shops or bungalows etc. the issue of sales tax will not arise. However when the agreements are not so simple but involve two components like land and construction or a issue arise whether particular property is immovable property or not, more attention is required to be given to above aspects of Sales Tax. From 20.6.2006, the MVAT Act provides for definition of works contract, which is inserted in section 2(24). The said definition reads as under.

“(24) “sale” means a sale of goods made within the State for cash or deferred payment or other valuable consideration but does not include a mortgage, hypothecation, charge or pledge; and the words “sell”, “buy” and “purchase”, with all their grammatical variations and cognate expressions, shall be construed accordingly;

Explanation.— For the purposes of this clause,-

(a) a sale within the State includes a sale determined to be inside the State in accordance with the principles formulated in section 4 of the Central Sales Tax Act, 1956 (74 of 1956);

(b) (i) the transfer of property in any goods, otherwise than in pursuance of a contract, for cash, deferred payment or other valuable consideration;

(ii) the transfer of property in goods whether as goods or in some other form involved in the execution of a works contract including, an agreement for carrying out for cash,

deferred payment or other valuable consideration, the building, construction, manufacture, processing, fabrication, erection, installation, fitting out, improvement, modification, repair or commissioning of any movable or immovable property ----"

However inspite of above definition there will not be any change in the legal position discussed above. Unless there are separate contracts for land and construction no tax liability can be contemplated under VAT Laws.

Having above preliminary observations about sales tax on immovable properties, to my mind the more integrated issues in relation to immovable properties will arise in relation to bringing into existence the immovable properties. The discussion in this paper is restricted to issues of Works Contract Tax under Maharashtra Value Added Tax Act,2002 (VAT Act). In other words, the sales tax issues involved in relation to construction of immovable properties and construction industry are dealt with here. A brief study on above lines can be as under.

POSSIBLE SITUATIONS OF WORKS CONTRACT TAX IN RELATION TO IMMOVABLE PROPERTIES AND CONSTRUCTION INDUSTRY

Normally immovable properties mean the properties of the nature of buildings etc.. It can also include the factory buildings in which machinery etc. are embedded in it. In fact, the issue whether a property is moveable or immovable, depends upon various factors, like nature of construction, intention of parties and other relevant factors. The attempt here is not to discuss nature of movable/immovable properties as such. For this paper the discussion is restricted to contracts of construction of buildings etc. with relation to Works Contract under VAT Act. In this respect following situations can be discussed.

(i) Self construction of property

Under this situation normally a builder will develop property on his own plot. He will purchase the building materials and will construct the same. Here no question of Works Contract Tax arises since it is one's own development and no element of transfer of property in goods to other party is involved. Normally the sale will be of ready flats etc., i.e., immovable property and hence not liable to any tax. But if there is sale of any 'moveable' items like sale of discarded items etc., to that extent, liability

under VAT Act can arise. Here the issue is again required to be seen in light of judgment in case of **K. Raheja Construction(cited supra)**. The above judgment pertained mainly to Developer and its full implications are discussed later. However in this judgment the Supreme Court has observed that even if one is not developer but constructing on his own land, still in given circumstances he can be liable to tax. In other words, a dealer constructing buildings on his own land but entering into agreement for sale of flats etc. before completion of construction, can be liable to tax under VAT Act. This aspect is to be seen along with the issues discussed subsequently in relation to developer.

(ii) Construction on land belonging to other on the basis of Development agreement

Under this type, normally a builder will enter into agreement for development of land belonging to other party. It will be joint development agreement. It is assumed here that the construction is not for landlord but by joint development. Builder will be constructing a building for sale of flats/shops. The flats/shops may be sold to prospective customers when the construction is on. As averred above the construction is not for landlord but on joint development basis. Secondly even though prospective customers book the flats/shops etc. the intention is to give them possession of flats/shops as immovable property. The construction activity itself cannot be said to have been started because of any agreement from customer. Thus this activity also does not attract any Works Contract liability. The above issue is well settled by various determination orders passed by the Commissioner of Sales Tax. A reference can be made to order in the case of **Unity Developer & Paranjape Builders (DDQ 1188/ C/40/ Adm-12 dt.10.3.88)**.

K. Raheja effect

However change, if any, is required to be noted by judgment of Supreme Court in **K. Raheja Construction (141 STC 298)** in relation to above issue. The brief history of Works Contract taxation is already given earlier. However the definition of 'works contract' is not given in the Constitution. Therefore its meaning is left to be understood by the respective parties.

In certain Legislations like, Karnataka Sales Tax Act, the definition of 'Works Contract' is given while in Maharashtra Sales Tax on Transfer of property in execution of Works Contract (Re-enacted) Act,1989 no such definition was given. In Maharashtra Value Added Tax Act,2002 such definition is provided from 20.6.2006, which is reproduced earlier.

In above Supreme Court case the controversy before Supreme Court was about the meaning of 'works contract'. The Honorable Supreme Court has laid down a law which will have far reaching effects upon the builders and developers in entire India.

The facts in above case are that M/s. K. Raheja entered into an agreement with land owner for development of the land with construction of residential and commercial buildings. Pursuant to development agreement, M/s.K.Raheja also entered into agreements with its customers for sale of flats/shops. The terms included to handover the possession of flats/shops. The value of land and construction was shown separately. The assessing authorities in Karnataka levied sales tax on the said transactions, considering the agreements as 'sale' by way of Works Contract within the meaning of Karnataka Act. The definition of 'Works Contract' in Karnataka Act read as under:

"'Works Contract' includes any agreement for carrying out for cash deferred payment or other valuable consideration, the building construction, manufacture, processing, fabrication, erection, installation, fitting out, improvement, modification, repair and commissioning of any movable or immovable property."

The argument of assessee was that the construction was on his own property (because of development agreement with land owner) and the buyer is to take possession of flat/office. It was further argued that there is, therefore, no transfer of property in goods in execution of works contract, since a owner of land property cannot execute agreement for transfer of building materials while constructing on his own land. Therefore it was submitted that the sale was of flat and offices, i.e. immovable property, not liable to sales tax.

Supreme Court, however, negated above submission.

Supreme Court, relying upon the above given definition, held that the scope is wider than normal meaning of Works Contract and includes the contracts entered into while the flat/office is under construction. Supreme Court observed that constructing building on one's own land (but shown as sold separately in agreement) does not make any difference. Supreme Court further clarified that if the agreement is for sale of flats etc., after the construction is complete, then of course, it will not attract any sales tax as it will be a sale of immovable property. Therefore the above law declared by Supreme Court will bring the developers/ builders within the purview of sales tax liability if the facts are similar. To the extent of agreements entered into before Construction of flats or offices is complete, the liability as works contract can arise.

In Maharashtra, as mentioned earlier the Commissioner of Sales Tax has taken a view that in case of developers/builders constructing buildings and entering into agreements before construction is complete, there is no sales tax liability under Works Contract Act. However, now the situation may change. Upto 19.6.2006 Works Contract was not defined under the MVAT Act. From 20.6.2006 the term is defined as reproduced earlier. The effect of K. Raheja is to be seen in light of this development and if facts are similar to facts in case of K. Raheja liability can arise. As per Supreme Court, entering into agreement before the construction is complete, amounts to deemed sale, by way of transfer of property in goods in the execution of Works Contract. However it has to be kept in mind that the above judgment can apply, where the value of land and construction is separately mentioned and agreed upon. This position also gets supported from judgment of Gauhati High Court in case of **Magus Construction P. Ltd. v. Union of India (15 VST 17) (Gauhati)**, wherein the judgment in **K. Rahaja** is distinguished. In majority cases in Maharashtra composite values are shown. Therefore its applicability was expected to limited cases, where land value and construction is shown separately.

The Government inserted Rule 58(1A) for excluding value of land from the agreement value of sale of premises.

The back ground of this rule is that, in light of judgment of Supreme Court in case of **Raheja Development Corporation (141 STC 298)** the government understands that under construction contracts are liable to tax under MVAT as works contracts. Accordingly, definition of works contract is also inserted in the Act from 20.06.2006. In light of above understanding the government has thought it fit to grant deduction for cost of land, so that ultimately the tax is attracted on value of materials used in the contract. However the above understanding of government is subject to further litigation. The judgment in **Raheja Development Corporation (141 STC 298)** itself was referred to Larger Bench by Supreme Court in case of **Larsen & Toubro Limited and another Vs. State of Karnataka and another (17 VST 460)**. The amendment in MVAT Act, 2002 contemplating tax on under construction contracts was also challenged before Bombay High Court by **Maharashtra Chamber of Housing Industry and Others v. State of Maharashtra and Others**. However, pending the litigation, the government has provided above rule to give deduction for cost of land from contract value.

Hon. Bombay High Court delivered judgment in case of **Maharashtra Chamber of Housing Industry and Others v. State of Maharashtra and Others (51 VST 168)** wherein the Constitutional validity of the amendment to bring in builders within sales tax laws was upheld. Alongwith the issue arising from **K. Raheja**, which was refereed to Hon Larger Bench of Hon. Supreme Court judgment in case of **Larsen & Toubro Limited and another V. State of Karnataka and another (17 VST 460)(SC)**, Hon. Supreme Court also dealt with issue arising from judgment of Hon. Bombay High Court in case of **MCHI**. In other words Hon. Larger Bench of Hon. Supreme Court has considered issue out of MVAT Act,2002.

Judgment of Larger Bench in Larsen & Toubro Limited v. State of Karnataka, Civil Appeal No. 8672 of 2013 dated 26.9.2013 (65 VST 1)

The controversy about the tax on builders is now settled by the larger bench of Hon. Supreme Court in above judgment. The main issue which was under challenge was that the composite transaction involving materials and labour

is only included in Article 366(29A)(b) i.e. transaction involving materials and labour can only be considered as works contract under Sales Tax Laws.

Therefore, the further argument was that when an element like land is involved in the transaction and the price is composite, the said transaction is not capable of being included in Article 366(29A)(b). Accordingly, it was the contention of the builders that such transaction cannot be covered within the sales tax laws.

Alongwith the above main argument the further argument was that ultimately the buyer gets premises which are immovable property and there is no transfer of property as goods during the execution of contract.

However, the above controversy is resolved by Hon. Supreme Court in favour of department and against the builders. The conclusion of the Hon. Supreme Court is contained in para 101 of the judgment which is reproduced below for ready reference.

"101. In light of the above discussion, we may summarise the legal position, as follows:

(i) For sustaining the levy of tax on the goods deemed to have been sold in execution of a works contract, three conditions must be fulfilled: (one) there must be a works contract, (two) the goods should have been involved in the execution of a works contract and (three) the property in those goods must be transferred to a third party either as goods or in some other form.

(ii) For the purposes of Article 366(29-A)(b), in a building contract or any contract to do construction, if the developer has received or is entitled to receive valuable consideration, the above three things are fully met. It is so because in the performance of a contract for construction of building, the goods (chattels) like cement, concrete, steel, bricks etc. are intended to be incorporated in the structure and even though they lost their identity as goods but this factor does not prevent them from being goods.

(iii) Where a contract comprises of both a works contract and a transfer of immovable property, such contract does not denude it of its character as works contract. The term a "works contract" in Article 366 (29-A)(b) takes within its fold all genre of works contract and is not restricted to one specie of contract to provide for labour and services alone. Nothing in Article 366(29-A)(b) limits the term a "works contract".

(iv) Building contracts are species of the works contract. (v) A contract may involve both a contract of work and labour and a contract for sale. In such composite contract, the distinction between contract for sale of goods and contract for work (or service) is virtually diminished.

(vi) The dominant nature test has no application and the traditional decisions which have held that the substance of the contract must be seen have lost their significance where transactions are of the nature contemplated in Article 366(29-A). Even if the dominant intention of the contract is not to transfer the property in goods and rather it is rendering of service or the ultimate transaction is transfer of immovable property, then also it is open to the States to levy sales tax on the materials used in such contract if such contract otherwise has elements of works contract. The enforceability test is also not determinative.

(vii) A transfer of property in goods under clause 29-A(b) of Article 366 is deemed to be a sale of the goods involved in the execution of a works contract by the person making the transfer and the purchase of those goods by the person to whom such transfer is made.

(viii) Even in a single and indivisible works contract, by virtue of the legal fiction introduced by Article 366(29-A)(b), there is a deemed sale of goods which are involved in the execution of the works contract. Such a deemed sale has all the incidents of the sale of goods involved in the execution of a works contract where the contract is divisible into one for the sale of goods and the other for supply of labour and services. In other words, the single and indivisible contract, now by Forty-sixth Amendment has been brought on par with a contract containing two separate agreements and States have now power to levy sales tax on the value of the material in the execution of works contract.

(ix) The expression a tax on the sale or purchase of goods a in Entry 54 in List II of Seventh Schedule when read with the definition clause 29-A of Article 366 includes a tax on the transfer of property in goods whether as goods or in the form other than goods involved in the execution of works contract.

(x) Article 366(29-A)(b) serves to bring transactions where essential ingredients of 'sale' defined in the Sale of Goods Act, 1930 are absent within the ambit of sale or purchase for the purposes of levy of sales tax.

In other words, transfer of movable property in a works contract is deemed to be sale even though it may not be sale within the meaning of the Sale of Goods Act.

(xi) Taxing the sale of goods element in a works contract under Article 366(29-A)(b) read with Entry 54 List II is permissible even after incorporation of goods provided tax is directed to the value of goods and does not purport to tax the transfer of immovable property. The value of the goods which can constitute the measure for the levy of the tax has to be the value of the goods at the time of incorporation of the goods in works even though property passes as between the developer and the flat purchaser after incorporation of goods.

Thus Hon. Supreme Court has come to conclusion that even if the contract involves an element like land still the transaction can be liable to sales tax as works contract. The overall effects of above judgment can be summarized as under:

Hon'ble Supreme Court has analysed the arguments of both the sides. The main argument of the dealers was that the contract involving two elements only i.e. goods and services, can be considered as works contract under above article 366 (29A)(b). However, Hon'ble Supreme Court has held that there is no such limitation and a contract involving third element like land can also be considered as works contract.

The further argument was that there is transfer of immovable property and not transfer in movable goods to attract sales tax as works contract. In this respect also, Hon'ble Supreme Court rejected the argument observing that even if the goods used get transformed into immovable property and such immovable property get transferred to the buyer, still it will be taxable works contract for sales tax purpose.

However, Hon'ble Supreme Court observed that while taxing value of goods in the contract, no portion relating to immovable property should get taxed.

Hon'ble Supreme Court has also observed that the contract will commence from the stage when the agreement is entered into with the prospective buyer. In other words, the work completed prior to such agreement will not be taxable.

It is also held that if the sale is of completed premises then it will not be covered by the sales tax laws.

In relation to MVAT Act, 2002, Hon'ble Supreme Court observed that rule 58(1A) of the MVAT Rules, 2005 should be relooked at by the government and the effect should be clarified by the government.

It is also observed that double taxation should be avoided.

Accordingly by Notification dated 29.1.2014, Government has amended Rule 58(1), 58(1A) and inserted Rule 58(1B) and 58(1C).

The Government of Maharashtra has amended above rules relating to developers and builders with effect from 20.6.2006.

The short gist of amendment is as under:

i) In rule 58(1) amendment is made, so as to provide that the deduction as per table will be available after reduction of land cost from the contract price.

ii) In rule 58(1A) which is relating to calculation of land cost is amended and a proviso is added. It is to provide that if higher cost is proved before Department of Town & Planning and Valuation then dealer can take that higher value instead of ready reckoner value.

iii) Rule 58(1B) is inserted to provide that if the agreement is entered when some work is already completed then the value of the goods, after taking deduction for labour and land, will be as per following calculation.

Table

Sr. No.	Stage during which the developer enters into a contract with the purchaser	Amount to be determined as value of goods involved in works contract
(1)	(2)	(3)
(a)	Before issue of the Commencement Certificate.	100%
(b)	From the Commencement Certificate to the completion of plinth level.	95%
(c)	After the completion of plinth level to the completion of 100% of RRC framework.	85%
(d)	After the completion of 100% RRC	55%

	framework to the Occupancy Certificate	
(e)	After Occupancy Certificate	Nil %

(b) For determining the value of goods as per the Table of clause (a), it shall be necessary for the dealer to furnish a certificate from the Local or Planning Authority certifying the date of completion of the stage referred above and where such authority does not have a procedure for providing such certificate then such certificate from a registered RCC consultant.

(1C) If the dealer fails to establish the stage during which the agreement with the purchaser is entered, then the entire value of goods as determined after deductions under sub-rules (1) and (1A) from the value of the entire contract, shall be taxable.

In relation to above Rules, various issues arise which will be deliberated in the seminar.

It can also be noted that after above judgment of Larger Bench of Hon. Supreme Court, the Division Bench has also passed regular judgment dated 31.1.2014. As per this judgment Builders/Developers can challenge the above Rules, if required. In fact Writ Petitions are filed in the Hon. Bombay High Court which are awaiting outcome.

Conclusion

Overall it can be said that due to above judgment of Hon. Supreme Court the interpretation of "works contract" has widened and there may be number of situations where the contract relating to builder / developer can result into taxable works contract.