

WORKS CONTRACT – CONCEPT AND VALUATION



BACKGROUND



COMPOSITE CONTRACTS

SIMPLE EXAMPLE

Product	VAT Rate	Case 1 (Grocery Store)		Case 2 (Eating House)	
Bread	0.00%	50.00	0.00		
Butter	12.50%	50.00	6.25		
Tomatoes	0.00%	25.00	0.00		
Sandwich	4.00%			125.00	5.00
TOTAL		125.00	6.25	125.00	5.00

- Can the Grocery Store pay tax of Rs. 5/- as sale of sandwich
- Can the eating house be called upon to pay tax of Rs. 6.25 on “butter component” of the sandwich
- Can the eating house exclude “bread and tomatoes” components of sandwich since they are exempt from tax?
- What if the eating house charges Rs. 10 extra for extra butter on the sandwich? What will be the tax rate on the same?

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Composite Contracts : Key Traits...

- Multiple Constituent Elements
- Customer interested in single outcome

- Most of the Constituent Elements are not outcomes in themselves but a means to achieve the outcome
- Various Combinations Possible
 - ▣ Supply of Multiple Goods
 - ▣ Supply of Goods with Ancilliary Services
 - ▣ Diverse Spectrum of Services
 - ▣ Services with incidental use of materials
 - ▣ Works Contracts

Composite Contract for Supply of Multiple Goods



- Assembled/Manufactured Product
 - ▣ Sandwich / Computer
 - Packing Materials and Accessories
 - ▣ Milk packed in bottles
 - ▣ Safety Kits along with motor cars
 - Diverse Set of Goods
 - ▣ Biscuits and Toys
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Composite Contract for Supply of Goods with Ancillary Services

- Sale of Jewellery
 - ▣ with Customised Gift Packing
- Sale of Refrigerator
 - ▣ with warranty
- Sale of Microwave
 - ▣ with training on use of the microwave
- Supply of Food by Restaurant
 - ▣ With Home delivery

Provision of Diverse Spectrum of Services

- A stock broker not only buying and selling securities for the investor but also advising him on potential transactions
- A transporter also assisting in the loading and unloading of the goods and the clearance of the goods at the octroi check-post
- A hospital offering cable connection
- A credit card company offering accident cover

Provision of Service involving ancillary use of materials

- A chartered accountant submitting an audit report
- A doctor also dispensing some medicines from his own dispensary
- A coaching class providing study materials to the students
- A testing agency using chemicals to test the product

Performance of Work involving transfer of materials



- Construction Contracts
 - Repair Contracts
 - Turnkey Assignments
 - EPC Contracts
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Gannon Dunkerley:

Genesis of “Third Breed”

The expression sale of goods in entry 48 in List II of Seventh Schedule to the Government of India Act, 1935 has the same meaning as the said expression had in the Sale of Goods Act 1930 essential ingredients being an agreement to the movables for a price and property passing thereon pursuant to that agreement.

In a building contract which is entire and indivisible, there is no sale of goods because in such a contract the agreement between the parties is that the contractor should construct the building according to the specifications contained in the agreement and in consideration therefore receive payment as provided therein and in such an agreement, there was neither a contract to sell the materials used in the construction nor does the property pass therein as movables

Works Contract : Variations

- A composite contract should not be vivisected to levy a tax on a specific component of such a contract but should be analysed as a whole
 - ▣ State of Madras vs. Gannon Dunkerley & Co 9 STC 353 (SC)
- Even in cases where the agreements provide for progressive payments based on individual milestones
 - ▣ Sentinel Rolling Shutters & Engg. Co. vs. CST 4 SCC 260 (SC)
- Even if specific price breakup is given for individual milestones
 - ▣ Daelim Industrial Co. Ltd. vs. CCE 155 ELT 457 (Tri) as approved by SC
- Even if there are separate agreements
 - ▣ CIT vs. Sundwiger Empg & Co. 262 ITR 110 (AP)

Works Contract: General Understanding

- “Transfer of Property” by means of:

- Accretion
- Accession
- Blending

- Is Works Contract:

- Sale + Service (V1) OR
- Service (with a Deemed Sale) (V2)

46th Constitution Amendment

- (29A) tax on the sale or purchase of goods includes-
 - (b) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;
- and such transfer delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made;

How to “measure” the tax? -- BAI

- Since the taxable event is the transfer of property in goods involved in the execution of a works contract and the said transfer of property in such goods takes place when the/goods are incorporated in the works, 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 the works and not the cost of acquisition of the goods by the contractor.

How to measure – Specifics...


Argued by Contractors	Defined by SC (BAI)
i) labour charges for execution of the works;	Should be reduced
ii) amounts paid to a sub-contractor for labour and services;	Should be reduced
iii) charges for planning, designing and architect's fees;	Should be reduced
iv) charges for obtaining on hire the machinery and tools used in the execution of the works contract;	Should be reduced
v) cost of consumables such as water electricity, fuel etc.	Should be reduced
vi) transportation charges for transport of goods to the place of works;	Cannot be reduced
vii) overhead expenses of the head office and branch office including rents, salary, electricity, telephone charges, etc. and interest charges to bank and financial institutions;	To be apportioned
viii) profits expected on such contract.	To be apportioned

SERVICE TAX



Welcome “Service Tax Legislation”



- Gradual Expansion of the Scope of Taxable Services:
 - Consulting Limb [1997-1998]
 - Executionary Limb [2004-2005]
 - Works Contracts [2007]
 - Declared Service - Negative List Regime [2012]
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The Pie gets divided?


- Whether Service Tax can be imposed on composite works contracts? If yes,
 - ▣ From which date?
 - ▣ On What Value?
- BSNL –
 - ▣ The aspect theory would not apply to enable the value of the services to be included in the sale of goods or the price of goods in the value of the service.
- The deeming fiction by 46th Constitutional Amendment valid only for the said lists and not beyond that
 - ▣ Geo Miller & Co vs. State of MP 5 SCC 209 (SC)
 - ▣ BSNL vs. UOI 3 SCC 1 (SC)

Negative List : Declared Service

- Service portion in execution of a works contract
 - ▣ Contract wherein transfer of 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 of any moveable or immovable property or for carrying out any other similar activity or a part thereof in relation to such property
- Envisages vivisection
 - ▣ Value of goods liable for VAT
 - ▣ Service Component can be taxed under Service Tax

Generic Issues:



- Difference between general concept of works contract and as defined under service tax law
 - Position of Builders and Developers
 - ▣ Impact of Larsen & Toubro's case
 - Applicability of Partial Reverse Charge Mechanism
 - Concerns over Point of Taxation
 - Interpretation of Exemption Notifications
 - Valuation
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VALUATION



Important Principles:

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- Section 67:
 - Gross amount charged by the service provider
 - for such service provided or to be provided by him
- No Notional Valuation Rules, however, non monetary consideration taxable
- Dominant Intention Test Important in contracts other than works contracts and catering contracts
- Rule 2A to determine the value of service portion in works contracts

How to measure?

Deduction from Value of Goods	Inclusion as Value of Services
labour charges for execution of the works;	labour charges for execution of the works;
Amounts paid to a sub-contractor	Amounts paid to a sub-contractor for labour and services
charges for planning, designing and architect's fees;	charges for planning, designing and architect's fees;
charges for obtaining on hire the machinery and tools used in the execution of the works contract;	charges for obtaining on hire the machinery and tools used in the execution of the works contract;
cost of consumables such as water electricity, fuel etc. used in the execution of works contracts, the property in which is not transferred in the course of execution of works contract	cost of consumables such as water electricity, fuel etc. used in the execution of works contracts
Cost of establishment to the extent to which relatable to supply of labour and services	Cost of establishment to the extent to which relatable to supply of labour and services
Profits earned to the extent to which relatable to supply of labour and services	Profits earned to the extent to which relatable to supply of labour and services

Concept....

	To be offered to VAT	To be offered to Service Tax
Purchase of Goods	Value of Goods incorporated in works	Consumables not incorporated in works
Direct Expenses	To the extent incorporated in Goods so transferred	To the extent not incorporated in Goods so transferred
Overheads	Proportionate Basis	Proportionate Basis
Profit	Proportionate Basis	Proportionate Basis

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GROSS CONTRACT VALUE

Valuation...

Valuation Options

Rule 2A(i)

Gross Amount Charged for works contract

Less the value of property in goods transferred

Rule 2A(ii) : where the value has not been determined under clause (i)

Calculate total amount charged - Rule 2A(ii)(D)


Presumptive Value of Service defined

Presumptive Valuation : Current Provisions

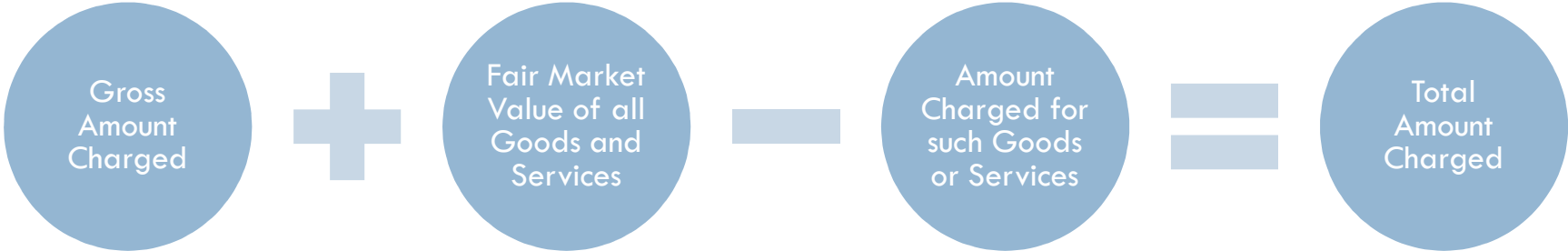
Nature of Works Contract	Presumptive Value	Service
Execution of original works	40% of the total amount charged	
Works contracts connected with moveable properties	70% of the total amount charged	
Works contracts, other than contracts for execution of original works, including contracts for completion and finishing services such as glazing, plastering, floor and wall tiling, installation of electrical fittings.	60% of the total amount charged	

Valuation: Issues



- If value can be determined, can presumptive method be adopted?
 - If value is not adopted by the State VAT Authorities, can the actual method be adopted?
 - What is the scope of “original works”?
 - What is the scope of inclusion of free issue materials and services?
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Calculation of Total Amount Charged



Gross Amount Charged	Fair Market Value of all Goods and Services
For the works contract	Supplied in or in relation to the execution of the works contract
	Whether or not supplied under the same contract or any other contract

Presumptive Valuation: Historical Perspective

Description	Rate/Value	CENVAT on Inputs	CENVAT on Input Service	CENVAT on Capital Goods	FIM to be added?	Completion Service
Abatement Option						
10.09.2004 to 28.02.2005	V= 33%	No	Yes	No	No	Yes
01.03.2005 to 15.06.2005	V= 33%	No	Yes	No	Yes	Yes
16.06.2005 to 28.02.2006	V= 33%	No	Yes	No	Yes	No
01.03.2006 to 30.06.2012	V= 33%	No	No	No	Yes	No
Composition Option						
01.06.2007 to 28.02.2008	R = 2%	No	Yes	Yes	No	Yes
01.03.2008 to 07.07.2009	R = 4%	No	Yes	Yes	No	Yes
08.07.2009 to 30.06.2012	R = 4%	No	Yes	Yes	Yes	Yes

Bhayana Builders...

- Free supplies to construction service provider - They are outside taxable value or gross amount charged, within meaning of expression in Section 67 of Finance Act, 1994
- Exemption Notification cannot enjoin condition that value of free supplies must also go into gross amount charged for valuation of the taxable service
- Consideration for transfer of property in goods from seller to buyer - For levy of sales tax, consideration for transfer of property in goods from seller to buyer is relevant and tax must be levied on consideration for transfer of property - This is unlike in case of Excise duty where levy is event based and irrespective of whether goods are sold or captively consumed, liability inheres even where manufacturer is not owner of raw material or finished goods - This principle is equally applicable to levy of Service Tax under Finance Act, 1994 and in particular in context of specific language in Section 67 of Finance Act, 1994

THANK YOU