

## **Various Issues relating to Works Contract.**

Works contracts are composite contracts involving supply of goods and services. Both goods and services are subject to levy of taxes. The central government, by virtue of constitutional provisions, has the right to tax the services component of the composite works contract. The state governments also have the right to tax the value of goods which are used and consumed in the course of execution of the works contract.

By virtue of the 46th amendment to the constitution, amending article 269, the state governments are empowered, to artificially divide a composite contract into two parts, so as to arrive at the value of goods that are used and consumed in the course of execution of the works contract. The law has further evolved, through adjudication of litigations, that have reached the highest court of the land. Landmark judgements also helped both the taxpayer and the government to interpret the law relating to works contract.

There has been a large number of cases where the courts have constantly held that the same transaction cannot be put to two taxes. However, the courts also clearly held that the same transactions can be subject to two different taxes by two different governments, on two different aspects, as the constitution provides them with the power to tax the goods and services, respectively.

Often, we find that there is overlap. When two competing governments, at attempt to describe the value of goods and services, provided for their own rules, procedures and methods to determine the value of goods or for that manner the value of services.

Fearing that the revenue will attempt to tax a larger tax base than what is applicable to them, often attempt is made by the trade and industry to divide and indivisible works contract into two parts, one for supply of goods, and another for supply of services. Such an attempt is made, presumably to pre-empt the possibility of excessive determination in valuation of either goods or services.

However, the description of the works contract, when they are of awarded to the contractor, are so very tight and restrictive, suggesting that there are in reality, indivisible contracts, divided into two parts only for sake of convenience. For example, the description of the works contract awarded to the contractor would read "lump sum indivisible works contract towards.....". The fact that the contract is indivisible is reflected in the very opening words. The revenue Department, in the background of their own compulsions, would like to treat this division of the works contract as a device to defeat revenue. Accordingly, they would look at the contract with total suspicion, than trust.

### **Free issues and works contract.**

There are occasions where the cost of the contract is attempted to be reduced, using the provisions and privileges available in law. In the first place, the contract is awarded to the contractor, covering the value of goods and services that are required for the execution of the works contract. Later, the person awarding the works contract decides to procure certain materials from different sources at lower costs, and issue the same to the works contract for use and consumption in the course of execution of the works contract. Such issue of materials by the owner to the contractor are called free issues. In effect, the value of goods would reduce the value of the works contract to the extent of such free issues.

However, to keep a tab on the value of the contract, the contractors would raise invoices in the normal course, and allow a set off for free issues. The revenue departments do not recognize such free issues. They prefer to treat the issue made by the owner to the contractor as one sale, and the use by the contractor of the same materials in the course of execution of the works contract as another sale.

Some of the members the industry and trade are naïve to this issue, and become innocent victims in the course of assessment and revisionary proceedings. Care needs to be taken, to revise the gross value of contracts through amendments to the original contract order.

### **In transit sale and free issues**

Take an instance where the contractor has sold goods in transit, under the cover of section 6 (2) of the Central Sales Tax Act. Thus the contractor has sold the goods in the course of interstate trade, by endorsement and delivery of transportation documents, in favour of his customer against issue of C forms. The same goods are then provided by the customer to the contractor as free issues for use and consumption in the works contract.

While the revenue Department would not deny exemptions under the Central Sales Tax act, they would not recognize, the free issues, particularly in the context that such free issues are priced by the contractor, and then reduced to arrive at the value of work done.

In other words, contractors and developers are expected to fine tune their legal and accounting acumen very sharply, least they should be made victims of inconsistencies in expressions, allowing the revenue Department to unfairly interpret the transactions to their convenience.

## **Composition of Works Contract**

The local Government, has the privilege to tax the goods consumed in the course of execution of the works contract. To arrive at the sale value of the goods involved in a composite contract, the value of Labour and Labour like charges are reduced together with a share of profit, to arrive at the sale value of goods. Such an approach to determine the value of goods is called the merit approach. However, the contractor is required to lead by evidence, to claim the deductions towards Labour and Labour like charges. Many subjective issues can crop up in the course of determining the value of goods. To prevent litigation, and to provide an alternative easy method, the Governments have been empowered to offer an alternate approach to determination of tax, which should be made optional to the assessee. Such an approach is called composition approach.

Most state Governments have understood composition as a synonym for concession. Accordingly, the government's have stipulated many conditions to dealers, who desired to avail composition. Initially in the State of Karnataka, composition was made available only if the following conditions are fulfilled

- only local purchases are made
- there are no interstate sales export sales
- output taxes are not collected from customers
- input tax credits are not claimed on purchases

Therefore, when ever a dealer attempts to procure materials from outside the state, he becomes ineligible for composition benefit. For instance, if the dealer buys goods interstate, he cannot claim composition benefit. The Karnataka Value Added Tax Act was amended to permit a composition dealer, to purchase goods from outside the State and yet avail the composition benefit. However, with respect to goods that have been procured from outside the state, such goods have to be offered to tax at their selling prices, based on prevailing market prices, and full tax at 12.5 per cent has to be paid as output tax.

Many dealers are unable to comprehend the requirements of law, and commit mistakes, which invites penal consequences.

## **Composition and Labour Contracts**

Composition tax can be levied only one works contracts. Composition tax cannot be levied on pure Labour contracts. In Karnataka, composition benefit is extended to a dealer for all the contracts executed during the relevant tax period. Unlike in other states, the works contract dealer cannot choose a few contracts to be on composition, and few other contracts to be on merit basis.

Let us take an instance where the contractor has opted for a composition benefit. The dealer is required to pay the composition tax on his entire gross turnover, without any deductions. The said works contract dealer, during the same tax period also gets an opportunity to execute certain other contracts, which do not

involve the use or consumption of goods. In other words, the contractor also executes certain contracts, which are purely Labour contracts. The moot question that arises is "can the department demand composition tax on the Labour contract also"

The pure Labour contract is outside the scheme of the statute. There is no constitutional right to tax Labour transactions in the guise of composition tax. So long as they dealer can demonstrate by evidence that the contract did not involve any use or consumption of goods, and that such contract remained a pure Labour contract, then the value of such contract cannot be subject to levy of composition tax.

### **CST and Works Contracts**

A dealer executing a works contract, may procure goods locally, may procure goods from outside the state, either through import of goods or interstate purchase of goods. There can be instances where the contractor would arrange to move the goods from outside the state to the destination state where the contract is being executed. Consequent to the amendment of the Central Sales Tax Act with effect from 13th of May 2002, when the movement of goods is occasioned for purposes of execution of a works contract in another state, the originating state becomes the appropriate state for purposes of levy and collection of taxes. Therefore the same transaction cannot be put to one more tax in the destination state in the hands of the contractor. Therefore, when a contractor moves his own goods from the originating state of the destination state for purposes of consumption in the works contract executed in the destination state, then that turnover related to such a movement of goods must be excluded from the total turnover of works contract, in the destination state.

### **CST and Composition**

Some of the members in the trade and industry believe that when a dealer opts for the composition benefit in a local state, it would also cover the movement of goods interstate occasioned by the contractor for purposes of use in the works contract in the destination state. Such a view is not correct. With respect to interstate movement of goods, it is the originating state, which is the appropriate state for collection of taxes. Such a turnover should not be offered in the destination state as part of the composition turnover. Since the said turnover is taxed in the originating state, it should in fact, be excluded from the turnover offered for composition.

### **Declared Goods and Works Contract.**

Based on a constitutional privilege provided to the Central Government, Section 14 and Section 15 of the CST Act has been enacted, to identify what is called

“Declared Goods “ or goods of Special importance. Such goods cannot be put to tax beyond 4%. The local Government may exempt or tax at any rate less than 4% but has to respect the rate cap set by the CST Act.

In the construction contracts there are use of iron and steel, in the works contract. These are declared goods, and cannot be put to tax beyond 4%.. However when these goods are required to retain their character of declared goods at the point of consumption or accretion. When steel is purchased and used as steel in the works contract, the sale value of steel used in the works contract can be put to only 4% tax. This is because they are declared goods.

However in an instance where steel is purchased, fabricated into windows and grills, and are then used in the construction contract, they loose the character of declared goods. This is because what was purchased was iron and steel, and what was used in the works contract is a product of iron and steel, known by a new name and form, and normally commercially traded. Such consumption of goods would therefore attract the full rate of 12.5% tax.

**Vat audits and assessments.** The department does VAT audit, at the premises of the dealers, and cover a substantial periods. Any infirmities noticed, come to light quite late, resulting in extraordinary demands in terms of interest and penalty. Further there is no finality to tax assessments. The department has revisionary rights to revise the orders of the assessing officers and appellate authorities, leading to very painful uncertainties in the minds of the paying dealers.

Further the Central Government levies service tax on the value of construction services. Here again there is the concept of composition. However the composition schemes of the two Governments are exclusive.