

## **WORKS CONTRACT, LEASE AND HIRE PURCHASE**

- Sales tax is leviable by the States under Entry 54 of List II of the VII Schedule to the Constitution of India
- Entry 54 – “Taxes on the sale or purchases of goods other than newspapers, subject to the provisions of Entry 92-A of List I.”
- The essential components of a sale are –
  - An agreement to transfer title
  - Supported by consideration
  - An actual transfer of title in the goods

- Article 366 (29-A) inserted by the Constitution 46th Amendment Act, 1982 expanded the scope of the words ‘tax on the sale or purchase of goods’ to include, inter alia–
  - Tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract
  - Tax on the delivery of goods on hire-purchase or any other system of payment by instalments
  - Tax on the transfer of right to use any goods for any purpose

## WORKS CONTRACTS

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- Definition under the KVAT Act –
- **“Section 2 (37) – 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 or commissioning of any movable or immovable property.”**

- What is taxable is the value of the goods transferred in the execution of a works contract. Therefore, a sale has to be executed, i.e. the property in goods must be transferred in the execution of the works contract
- Continental Builders v. State of Karnataka [64 KLJ 104 (Kar)]
- Transfer of common facilities such as roads, club house, drains, etc. amounts to a transfer of goods in the execution of a works contract. (May not be the correct position of law)

- 2 schemes available under the KVAT provisions for payment of tax for execution of works contracts –
  - regular scheme and
  - composition scheme

## Regular Scheme of assessment for works contractors

- Under the regular scheme, the charging provision under the KVAT Act reads as follows –
- **Section 4 - [Liability to tax and rates thereof**
- *(1) Every dealer who is or is required to be registered as specified in Sections 22 and 24, shall be liable to pay tax, on his taxable turnover,*
  - *(a) in respect of goods mentioned in,-*
    - *(i) Second Schedule, at the rate of one per cent,*
    - *(ii) Third Schedule, at the rate of four per cent, and*
    - *(iii) Fourth Schedule, at the rate of twenty per cent.*
  - *(b) in respect of other goods, at the rate of 12[twelve and one half] per cent.*
- *[c) in respect of transfer of property in goods (whether as goods or in some other form) involved in the execution of works contract specified in column (2) of the Sixth Schedule, subject to Sections 14 and 15 of the Central Sales Tax Act, 1956 (Central Act 74 of 1956), at the rates specified in the corresponding entries in column (3) of the said Schedule.]*
- Civil works contracts fall under the residuary Entry 23 of the VI Schedule and are taxable at 12.5%.

## Issue relating to rate of tax applicable to Iron and Steel

- Section 4 (1) (c) specifically states that the rate of tax applicable to goods transferred in the execution of works contracts is subject to the provisions of Section 14 and 15 of the CST Act.
- Section 14 and 15 of the CST Act declare iron and steel, among others, to be of special importance in inter-state trade and commerce.
- BV Subba Reddy v. DCCT [64 KLJ 204 (Kar)]  
Iron and steel used in the construction of a bridge is not in the same form and therefore cease to be declared goods and not eligible for the concessional rate of tax.

- URC Constructions v. DCCT [60 KLJ 3 (Kar)]  
Iron and steel used in the construction of a building is used in the same form and therefore are eligible for the concessional rate of tax.
- Matter filed by Larsen & Toubro Ltd. on the same issue is admitted and currently pending before the Hon'ble Supreme Court.

## Issue Relating to Deductions permissible under the KVAT Act

- The relevant provisions of the KVAT Rules providing for deduction in order to determine the taxable turnover of a works contractor are -
- **Rule 3. Determination Of Total And Taxable Turnover**
- (1) *The total turnover of a dealer, for the purposes of the Act, shall be the aggregate of.-*
- (a) ...
- (c) *the total amount paid or payable to the dealer as the consideration for transfer of property in goods (whether as goods or in some other form) involved in the execution of works contract including any amount paid as advance to the dealer as a part of such consideration;*

- *Explanation: Any amount paid as advance to a dealer as a part of consideration for transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract shall be included in his total turnover in the month in which execution of such works contract commences.*
- (2) *The taxable turnover shall be determined by allowing the following deductions from the total turnover.-*
- (l) *All amounts actually expended towards labour charges and other like charges not involving any transfer of property in goods in connection with the execution of works contract including charges incurred for erection, installation, fixing, fitting out or commissioning of the goods used in the execution of a works contract.*
- (m) *Such amounts calculated at the rate specified in column (3) of the Table below towards labour charges and other like charges as incurred in the execution of a works contract when such charges are not ascertainable from the books of accounts maintained by a dealer.*

- *Explanation-I:- In the case of a dealer executing works contract, in determining the taxable turnover during any tax period, the deduction under clause (I) shall be allowed so that such deduction is proportionate to the value of goods, the property in which has been transferred in the execution of works contract in that period, and if the total turnover is not sufficient to cover apart from other deductions, such taxable turnover and such deduction, they shall be determined and allowed proportionately to the extent of the turnover of the dealer in that period, and the balance shall be carried forward to the following tax period or any subsequent tax period to be determined and allowed in the same manner.]*

- *Explanation – II: For the purpose of clause (I), “labour and other like charges” include charges for obtaining, on hire or otherwise, machinery and tools used in the execution of a works contract, charges for planning, designing and architects’ fees, cost of consumables used in the execution of the works contract, cost of establishment to the extent relatable to supply of labour and services and other similar expenses relatable to supply of labour and services.*
- *Explanation - III: For the purpose of clause (I), gross profit earned by a dealer shall be apportionable to the value of the goods and labour and other like charges involved in the execution of a works contract in the same ratio as in the total turnover.]*

- It would be unconstitutional for the State to levy tax on any turnover which does not relate to the transfer of goods in the execution of a works contract.
  - Recent judgment of the Hon'ble High Court of Karnataka in Larsen & Toubro's case, where the Court has allowed charges collected towards depreciation of owned machinery as a permissible deduction. (Yet to be reported)
  - State of Chattisgarh v. VTP Constructions [64 KLJ 251 (SC)]
- Provision for TDS on entire turnover without providing for any deductions was held to be constitutionally invalid and struck down.

### Issue relating to deduction of sub contractors' turnover

- Rule 3 (2) (i-1) provides for deduction of sub contractors' turnover -
- (2) *The taxable turnover shall be determined by allowing the following deductions from the total turnover.-*
- (i-1) *All amounts paid or payable to sub-contractors as the consideration for execution of works contract whether wholly or partly:*
- *Provided that, no such deduction shall be allowed unless the dealer claiming deduction produces document in proof that the sub-contractor is a registered dealer liable to pay tax under the Act and that the turnover of such amounts is included in the return filed by such sub-contractor.*

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- Warsaw Engineers v. ACCT [64 KLJ 113 (Kar)]

If the principal contractor has discharged the tax liability on the portion of the contract executed by the sub contractor, then the sub contractor is eligible to reduce his turnover by that amount.

- Larsen & Toubro Ltd. v. Addl. CCT [61 KLJ 90 (Kar)]

Value of the work entrusted to the sub-contractor has to be taken into consideration in computing the total turnover of the main contractor.

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- State of AP v. Larsen & Toubro Ltd. [65 KLJ 252 (SC)]

Taxable event is the transfer of property in goods involved in the execution of a works contract and the transfer takes place when the goods are incorporated in the works. Property passes by accretion.

Therefore, it is the sub contractor who actually does the work who effects the transfer and not the main contractor. The work executed by a sub contractor is a single transaction and not multiple transactions.



- Raheja Builder's issue

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The issue relates to Joint Development agreements and whether execution of works in pursuance of such agreements amount to works contracts or sales of immovable property.

- Mittal Investment Corporation v. Addl. CCT [(2001) 121 STC 14 (Kar)]

Dealers not liable for payment of tax in respect of the building which has been constructed before entering into any agreement and sold thereafter.

Dealers not liable for tax in respect of agreements which have been entered into after the construction of the building started.

- Raheja Development Corporation v. State of Karnataka [59 KLJ 1 (SC)]

If the agreement is entered into after the flat or unit is already constructed, then there would be no works contract. All agreements entered into upto the stage of completion of construction would be liable for tax as a works contract.

- Larsen & Toubro Ltd. v. State of Karnataka [65 KLJ 225 (SC)]

The ratio laid down in Raheja Development's case has been doubted and referred to a larger Bench and is currently pending before the Hon'ble Supreme Court.

- The relevant provisions of the KVAT Act relating to the composition scheme are as under –
- *(1) Subject to such conditions and in such circumstances as may be prescribed, any dealer other than a dealer who purchases or obtains goods from outside the State or from outside the territory of India, liable to pay tax as specified in Section 4 and,*
- *[(a) whose total turnover [in a year] does not exceed an amount as may be notified by the State Government which shall not exceed fifty lakh rupees, and who is not a dealer falling under clause (b) or (c) or (d) below.]*

- *(b) who is a dealer executing works contracts; or*
- *(c) who is a hotelier, restaurateur, caterer <sup>3</sup>[or dealer running a sweetmeat stall or an ice cream parlour] <sup>5</sup>[or bakery or any other class of dealers as may be notified by the Government]; or*
- *(d) who is a mechanised crushing unit producing <sup>4</sup>[granite or any other metals];*
- *may elect to pay in lieu of the net amount of tax payable by him under this Act by way of composition, an amount at such rate not exceeding five per cent on his total turnover or on the total consideration for the works contracts executed or not exceeding two lakh rupees for each crushing machine [per annum as may be notified by the Government].*

- (3) Any dealer eligible for composition of tax under sub-section (1) may report, to the prescribed authority, the exercise of his option and he shall pay such amount due and furnish a return in such manner as may be prescribed.
- (4) Any dealer opting for composition of tax 9[under this section] shall not be permitted to claim any input tax on any purchases made by him.]
- 5[(5) Notwithstanding anything contained in 9[sub-section (1)].-
- (a) a dealer executing works contracts and who purchases or obtains goods from outside the State or from outside the territory of India shall be eligible to opt for composition under sub-section (1), and if the property in such goods (whether as goods or in some other form) is transferred in any works contract executed by him, the dealer shall be liable to pay tax on the value of such goods at the rate specified in Section 4 and such value shall be deducted from the total consideration of the works contracts executed on which an amount as notified is payable under sub-section (1) by way of composition in lieu of the tax payable under the Act;

- (b) in the case of a dealer executing works contracts and opting for composition of tax under sub-section (1), no tax by way of composition shall be payable on the 6[amounts payable or paid] to a sub-contractor as consideration for execution of works contract whether wholly or partly and such amounts shall be deducted from the total consideration of the works contracts executed on which an amount as notified is payable under sub-section (1) by way of composition in lieu of the tax payable under the Act subject to production of proof that such sub-contractor is a registered dealer liable to tax under the Act and that such amounts are included in the return filed by such sub-contractor;

- *(c) in the case of a dealer executing works contracts, after opting of composition of tax under sub-section (1), 7[who] effects sale of any goods liable to tax under the Act other than by transfer of the property in such goods (whether as goods or in some other form) in any works contract executed by him, the dealer shall be liable to pay tax on the value of such goods at the rate specified in Section 4, without any deduction for input tax on purchase of such goods made by him;*
- *(d) in the case of a dealer opting for composition of tax under clause (a) or (c) of sub-section (1), the turnover on which tax is leviable under sub-section (2) of Section 3 shall be deducted from the total turnover on which an amount as notified is payable under sub-section (1) by way of composition in lieu of the tax payable under 6[the Act;]]*
- *(e) a dealer executing works contracts and opting for composition of tax under sub-section (1), shall be liable to pay tax, if any, under sub-section (2) of section 3, in addition to tax by way of composition on the total consideration for the works contracts executed;]*

#### Salient features of the composition scheme exclusively applicable to works contractors –

- Permitted to procure goods from outside the State subject to the condition that the dealer pays tax on the value of such goods at the rate specified under Section 4.
- No tax payable on sub contractors' turnover subject to production of proof of payment of tax by the sub contractor.
- If works contractor sells goods other than in the execution of the works contract then tax is payable on such goods at the rate specified under Section 4, without avilment of input tax credit on such goods.

- Purchase tax is payable in addition to tax payable by way of composition – Retrospectivity of the insertion of Section 15 (5) (e) was struck down in the case of Mysore Constructions Co. v. State of Karnataka [66 KLJ 425 (Kar)].
- Permitted to collect tax (Rule 139) and deduct the same from the total consideration on which tax is calculable.

## LEASE TAX (TRANSFER OF RIGHT TO USE GOODS)

- Tax is leviable on the transfer of right to use goods.
- Tax is leviable only when there is transfer of effective control and possession over the goods.
- State of Andhra Pradesh And Another vs. Rashtriya Ispat Nigam Ltd., (126 STC 114).

The client, who owned the Vishakapatnam Steel Project, allotted different works to contractors. It supplied sophisticated machinery to the contractors for being used in the execution of the contracted works and the received charges for the same. The contractors were not free to make use of the machinery for purposes other than those mentioned in the contract or move the machinery out during the period when the machine was in use. Thus it was held by the High Court that the transactions between the respondents and the contractors did not involve transfer of right to use the machinery in favour of the contractors and the hire charges could not be brought to tax.

- Lakshmi Audio Visual Inc. Bangalore and Another vs. The Assistant Commissioner of Commercial Taxes, 17th Circle, Bangalore And Another, [2001] 124 STC 0426- (51 KLJ 233)].

If the customer engages the petitioner for providing audio visual services for any programme or event and the petitioner does not deliver any equipment to the customer, but takes the equipment to the site of the programme, installs them, operates them and then dismantles them and brings them back after the period of hiring, in such an event the possession and effective control never leaves the petitioner and the customer never gets the right to the use of equipment. In such an event there is no deemed sale attracting tax under section 5C.

- Antrix Corporation's Case

Authorities brought to tax the turnovers of Antrix Corporation on the ground that it had transferred the right to use bandwidth on a satellite located in space. Matter currently pending before the Division Bench of the Hon'ble High Court of Karnataka. Heard and reserved for orders.

- Onmobile's case

Authorities brought to tax the turnover of Onmobile Ltd. on the ground that it had transferred the right to use a particular software which was used to provide mobile value added services. Matter currently pending before the JCCT (Appeals) after High Court remitted the matter to the alternate remedy.

- Above 2 cases also highlight the conflict between service tax and sales tax since both the companies had discharged service tax already on its entire turnover.

- The Hon'ble Supreme Court in the case of Imagic Creative Pvt. Ltd. v. Commissioner of Commercial Taxes [(2008) 12 VST 371 (SC)] has held that service tax and sales tax are 'mutually exclusive'.

- The Hon'ble Kerala High Court in the case of Kerala Non Banking Finance Companies Welfare Association v. Union of India [(2009) 124 VST 185] has held that both service tax and VAT can be levied on leasing out or hire-purchase of equipment.
- 20th Century Finance Judgment referred to a Larger Bench of the Hon'ble Supreme Court recently. Matter currently pending. (Not reported)

Thank you