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Tax and Regulatory

Law Practice and Precedence – Service tax and its applicability under EPC contracts

**Conference on
EPC contracts Tax, Legal and Commercial Imperatives**
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DISCUSSION ON – IMPACT OF DAELIM AND CURRENT DEVELOPMENTS

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DAELIM ERA – APPLICABILITY OF SERVICE TAX ON TURNKEY SCOPES

Brief recap

- Service tax was sought to be applied on residual process design and detailed **engineering, commissioning of plant** under the category of consulting engineer's services
- Contentions were-
 - It was a construction contract – **did not involve consulting engineering services**
 - The design – drawings were **incidental** to the execution of the works
 - Drawings were for own purpose
 - **Dominant purpose** was execution of the de-sulpharisation plant
 - Primary objective should determine taxability and the contract **cannot be split up to determine taxability**
- **State of Punjab v. Associated Hotels** of India was relied on where the “primary objective test” was laid down in the context of works contract tax
- Several other cases have followed Daelim and held turnkey contracts to be outside the purview of service tax

RELIANCE ON DAELIM – ISSUES

- All the cases appear to pertain to a period (pre 2003)
- Several other taxable categories (in addition to consulting engineer's services) have been notified
- Revenue contention was only that taxability is under the category of consulting engineer's services. No other taxable category was invoked and hence court did not consider the taxability under other taxable categories
- Specifically, in all the judgments, the common thread of argument appears to be that a composite arrangement cannot be split and then each component taxed separately.
Therefore, for application of Daelim the contract needs to qualify as a composite contract

APPLICABILITY OF DAELIM – COMPOSITE CONTRACTS

- Key criteria for composite contracts
 - In re: Larsen & Toubro case laid down the criteria for determining if an arrangement could be said to be composite arrangement
 - Some relevant definitions were considered and it has been concluded that any turnkey contract, which contemplates a fixed lump sum price would be a composite contract, notwithstanding that
 - The mechanism of payment may be based on milestone payments or
 - With separate consideration clearly earmarked towards specific scopes
- Hence **an EPC contract is a composite contract**. Therefore, all such contracts should be covered by the judgment of Daelim
- **Does this in itself render an arrangement non taxable?**

APPLICABILITY OF DAELIM – COMPOSITE CONTRACTS

- Under Daelim and other cases, the **dominant intention / primary objective** was looked at and taxability was determined
- Dominant intention / primary objective was held to be construction of a facility (and not provision of consulting engineer services)
- What would have been the conclusion **if the dominant intention was a taxable service?**
- Important to appreciate that several other taxable categories of services have since been notified
- Larsen & Toubro Ltd. (2004 (174) ELT 322) has been appealed against and the appeal has been admitted by the Supreme Court – Developments should be closely monitored
- Was it correct to rely on Associated Hotel's case ? – Examined subsequently

APPLICABILITY OF DAELIM – COMPOSITE CONTRACTS

- Associated Hotel's case was in the context of works contract
- After the judgment, the Constitution was amended. Position pre and post amendment is as under:

Pre amendment	Post amendment
States did not have the propriety to levy sales tax on composite works contract which did not contemplate a separate consideration for the sale of materials	Composite works contract were deemed to be a contract for labour and sale of goods, with the latter susceptible to sales tax
If separate consideration was charged for sale of material, then liability to sales tax would arise per the decision of the Supreme Court in Gannon Dunkerley	No change in the stated position of law by Gannon Dunkerley

In Gannon Dunkerley case (where in the court had held that the material portion in works contract could not be subjected to sales tax in the pre amendment era), Supreme Court, in interpreting the word "sale" had relied on the definition of "sale" under the Sale of Goods Act. No such definition for services exists. Therefore, power to levy tax on services is considerably wider

SOME THOUGHTS

- The renderence of any service in an LSTK contract is not incidental/ancillary, but is an integral part of the entire deliverable and is expressly agreed upon between the parties
- Hence, the contract is as much for services (with each component having a separate price per the schedule) as it is for the final deliverable
- Most of the activities that could be undertaken under an LSTK – EPC scope of work are now liable to tax (on a stand alone basis) under various taxable categories. For e.g.

Activity	Taxable category
Installation	Erection commissioning or installation services
Commissioning	Erection commissioning or installation services
Construction	Commercial or industrial construction services, Residential construction
Engineering	Consulting engineer's services
Site formation related work	Site formation and clearance, excavation and earthmoving and demolition services

What is left thereafter is supply of material !!

SOME THOUGHTS

- Indicators that the law is leaning towards taxation of composite arrangements:
 - Introduction of services that, of necessity, involve composite arrangements as taxable services – Construction of Buildings !
 - Specific deductions towards cost of goods sold/supplied
 - Classification rules – While Daelim specifically states that a composite contract cannot be vivisected, classification rules seek to achieve this specific objective of splitting such transactions by applying the following:
 - sub clause which provides the most specific description, if not
 - service which gives them their essential character, if not
 - category which occurs first amongst the categories specified under the service tax laws
 - The classification rules have been introduced with effect from May 14, 2003. The judgment in Daelim was delivered on June 5/6, 2003. However, Daelim did not take notice of the classification rules.
 - Suggests that Daelim case is perhaps per incuriam

CONCLUDING REMARKS


- EPC Contracts are indeed composite contracts and hence covered by Daelim
- Notwithstanding, if the dominant objective of the contract is to provide a service that is taxable in nature, service tax can be imposed (Corollary to Daelim)
- Has the legislative trend consistently attempted to indicate that indivisible works contracts are services and hence liable to Service tax, thereby diluting the fact based proposition in Daelim
- Do we need a constitutional amendment (in line with sales tax) in Art. 268A to establish proprietary of the Central Government to levy Service tax in case of indivisible works contract ?
- Lastly what is **Service ???**

SERVICE TAX - VALUATION

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SERVICE TAX - VALUATION RULES

Situation	Valuation rule as per the Valuation Rules, 2006*
Where consideration in Money	Gross amount charged
Where the consideration not wholly or partly consisting of money	<ul style="list-style-type: none"> - Value shall be equivalent to the gross amount charged by the service provider to any other person in ordinary course of trade to provide similar service - Where value cannot be determined as above, the service provider shall determine the equivalent money value, which shall in no case be less than cost of provision of such services provided
Expenditure or cost 	Expenditure or costs incurred by the service provider in the course of providing taxable service shall be included in the value. However, expenditure incurred by the service provider as a pure agent of the recipient of service shall be excluded from the value subject to conditions

Consideration – Includes any amount that is payable for the taxable services provided or to be provided

Money –Includes any currency cheque, promissory note, letter of credit, draft, pay order, travelers cheque, money order, postal remittances and other similar instruments but does not include currency that is held for its numismatic value

Gross amount charged – Includes payment of cheque, credit card, deduction from account and any form of payment by issue of credit notes or debit notes **and book adjustment**

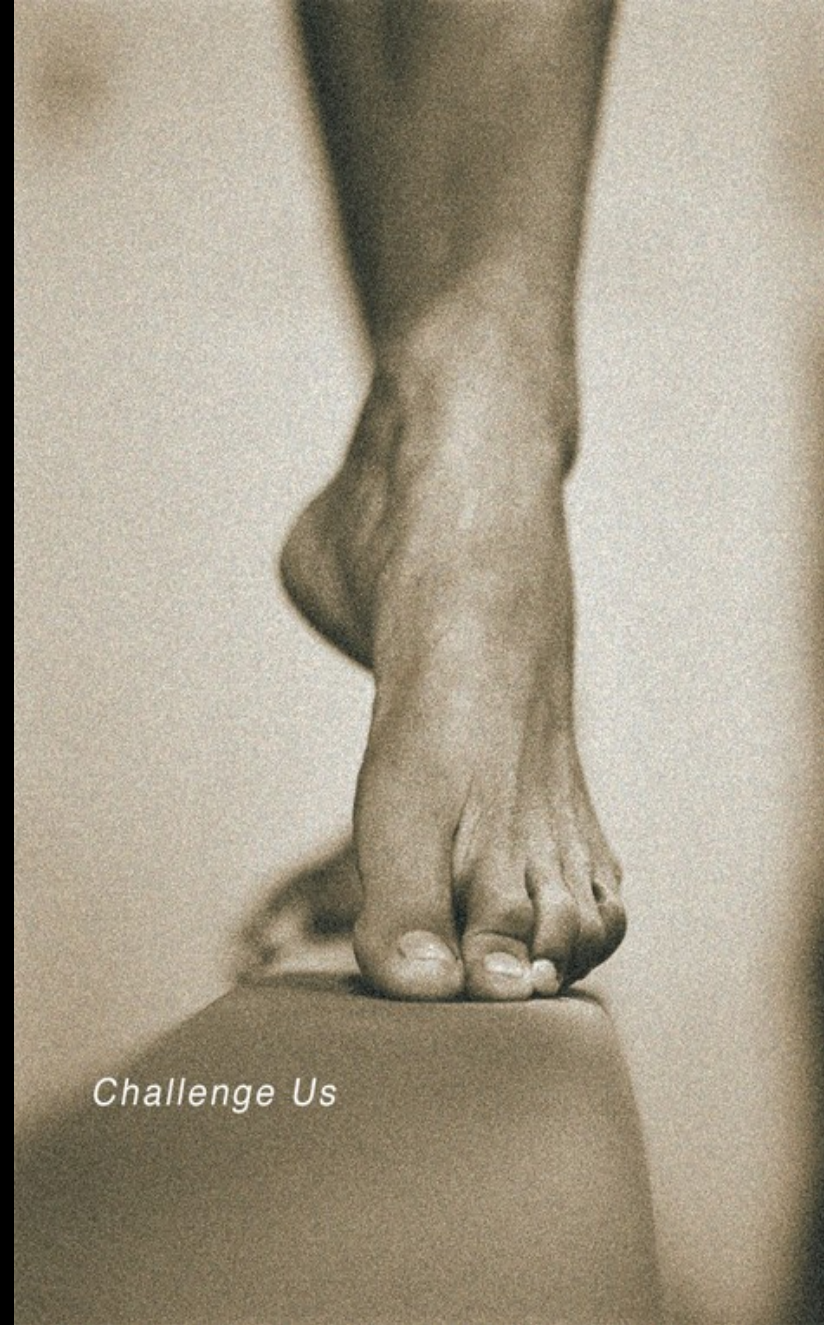
SERVICE TAX - VALUATION RULES

- Revenue granted power to scrutinize the accuracy of any information furnished or document presented for valuation
- If Revenue is satisfied that the valuation is not as per the Rules/Act, then it ask the Service provider to explain why the valuation should not be as per the value indicated by the Revenue in the notice
- Subject to the overall valuation norms, the value of the taxable service would include specified commissions / brokerages paid to the service provider viz. commission received by the air travel agent from the airline, commission paid to clearing and forwarding agent etc
- Subject to the above, the value of taxable services would not include specified amounts viz. airfare collected by air travel agent in respect of services provided by him, interest on loan
- However, deduction on account of cost of parts or other material if any sold to the customer during the course of providing erection, commissioning or installation services, maintenance or repair, not allowed as a deduction
- Exemption notification 12/2003 dated June 20, 2003 should offer deduction for the above cases

SERVICE TAX - VALUATION RULES

- The value of taxable services received under the provision fo Section 66 A, shall be such amount as is equal to the actual consideration charged for the services provided/to be provided – irrespective of whether the services are partly performed in India and partly outside India

IMPORT OF SERVICES




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IMPORT OF SERVICE

- Prior to April 18, 2006, explanation added (wef) June 16, 2005 deeming certain kinds of services as taxable services
- As per this Explanation, conditions were imposed on the service provider as also the service recipient for the deeming provision to trigger. These conditions being:
 - **Conditions relevant to service provider**

The service provider has established a business from which the services is provided; or has a fixed establishment from which the services is provided or to be provided or has his permanent address or usual place of residence in a country other than India
 - **Conditions relevant to the service recipient**

The service is received by a person who has his place of business; Fixed establishment; permanent address or as the case may be usual place of residence in India
- The CBEC vide its Circular (No. F.No.B1/6/2005-TRU, dated July 27, 2005) has sought to clarify the ambit of the Explanation. 
- The CBEC clarification indicates, some level of permanency of operation in India for the service recipient, for the Explanation to trigger

IMPORT OF SERVICE

- With effect from April 18, 2006, Section 66A has been introduced replacing the Explanation
- As per Section 66A, where a taxable service is
 - Provided/to be provided by a person who has established a business; or has a fixed establishment from which the services is provided or to be provided or has his permanent address or usual place of residence **in a country other than India, and**
 - The service is received by a person who has his place of business; Fixed establishment; permanent address or usual place of residence, **in India**such service will, be taxable services as if the recipient had provided the services in India
- However, the above would not apply to a recipient who being an individual uses the services for non business purposes
- Where the service provider has his business establishment both in a country other than India and elsewhere, the country where the establishment of the service provider directly concerned with the provision of the services is located, shall be treated as the country from which the service is provided

IMPORT OF SERVICE

- Where the service provider has his business establishment both in a country other than India and elsewhere, the country where the establishment of the service provider directly concerned with the provision of the services is located, shall be treated as the country from which the service is provided
- Where business is carried out via a PE in India and through another PE in a country other than India, such PEs shall be treated as separate persons
- Branch or agency in any country shall be treated business establishment in that country
- Usual place of business (for companies) would be the place of incorporation
- Further to be liable to service tax (under the above situations), the transaction must qualify as imports as per the Import of Services Rules, 2006

IMPORT OF SERVICE

- Under the Import of Services Rules, 2006, to constitute imports, taxable services have been categorized as follows
 - situs of immovable property in India
 - situs of service performance(partly or wholly in India)
 - situs of service recipient (located in India and used for business or commerce)
- In case of consulting engineering services, services would qualify as imports if the recipient is located in India and the service is used in relation to business or commerce
- In case of erection, commissioning or installation, service should be partly or wholly performed in India

COSTS NOT LIABLE TO SERVICE TAX

- Expenditure or costs that a service provider incurs as a pure agent of the client shall be excluded from the value if such service provider fulfills the following conditions
- Service provider acts as an agent of the recipient of the service provider when he makes payments to the third party for the goods and services procured
 - The recipient of service receives and uses the goods and services so procured by the service provider as agent
 - The recipient of services, is liable to make payment to the third party
 - The recipient of services authorizes the service provider to make the payment on his behalf
 - The recipient of services knows that the goods and services paid for by the service provider will be provided by the third party
 - The service providers payment on the service recipients behalf is indicated separately when he invoices the recipient of services
 - The service provider recovers only the actual amount he has paid to the third party; and
 - The goods or services for which the service provider pays for are clearly additional to the services he provides to the recipient of services on his own account

COSTS NOT LIABLE TO SERVICE TAX

➤ Pure agent is a person who

- Enters into a contractual arrangement with his client (recipient of service) to act as an agent of the client to incur expenditure or costs in the course of providing a taxable services
- Neither intends nor holds any title to the goods or services so provided as an agent of the client
- Never uses such goods or services provided; and
- Receives the actual amounts incurred to procure such goods or services



CBEC CLARIFICATION - EXPLANATION

- “26.3...The business establishment is the principal place of business, usually head office or headquarters or the seat from which business is run. There can be only one such place. A business may have headquarters in one country but branches in many other countries. A company may be incorporated in one country but does the business entirely from a head office in another country. In such cases, business establishment is treated to be in a country where the business is entirely done from the head office.
- 26.4 A fixed establishment is an establishment other than the business establishment. It should have both the technical and human resources necessary for providing or receiving services permanently present. A business may have several fixed establishments including a branch. If there is no business or other fixed establishment in any country and the business is a limited company or a other corporate body, it belongs wherever it is legally constituted.
- 26.5 Individuals receiving services are treated as belonging in the country where they have their usual place of residence. An individual has only one usual place of residence at any point in time. Individuals are normally resident in the country where they have set up home with their family and are in full time employment. If either the provider of services or recipient of services have establishments in more than one country, the establishment most directly connected with the particular service would be the deciding factor.”





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