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Tax and Regulatory

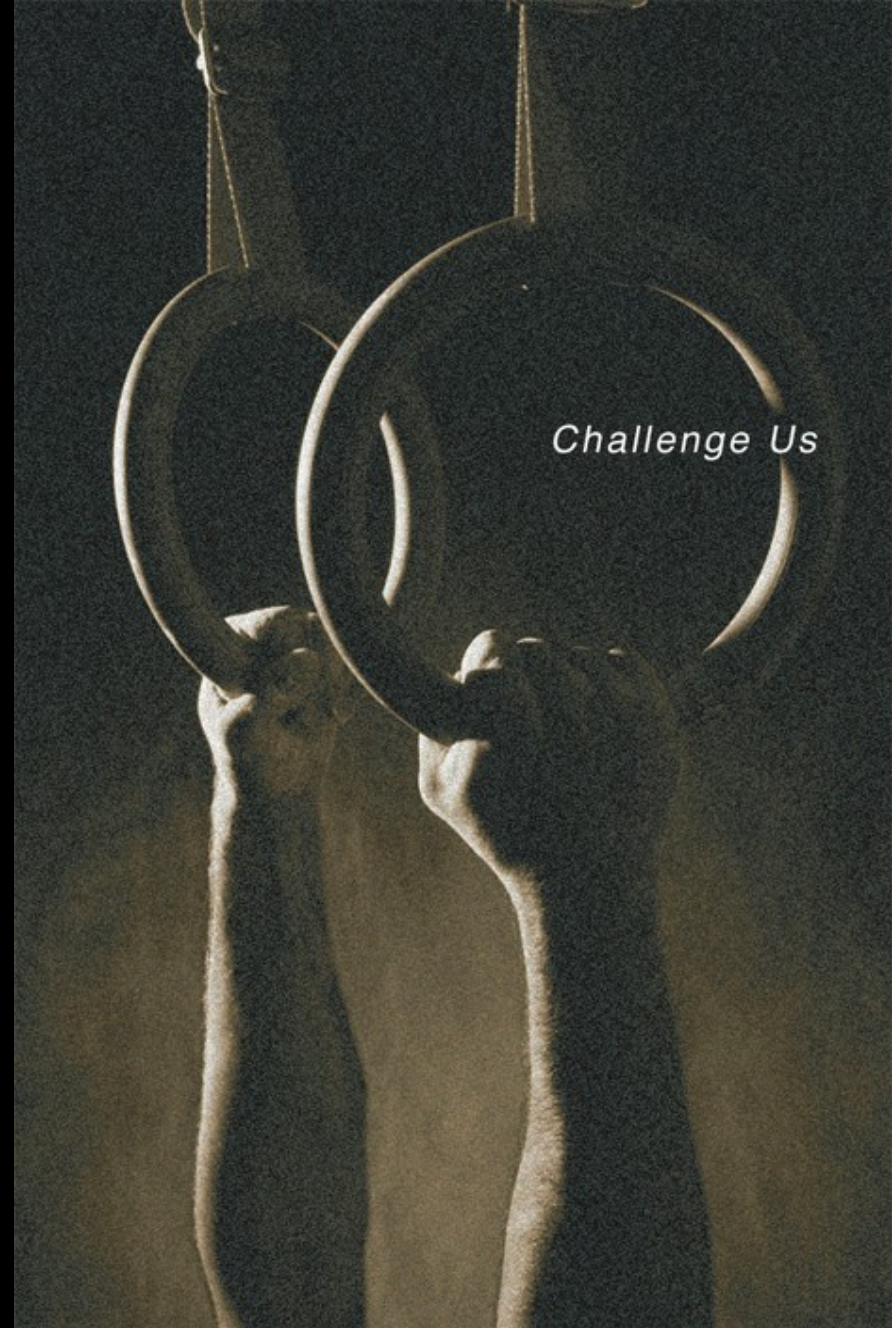
Service tax on EPC contracts – Impact of recent legislative changes

Conference on
EPC contracts Tax and Legal Imperatives
18 – 19 May 2007 | Hotel Imperial | Janpath | New Delhi | India

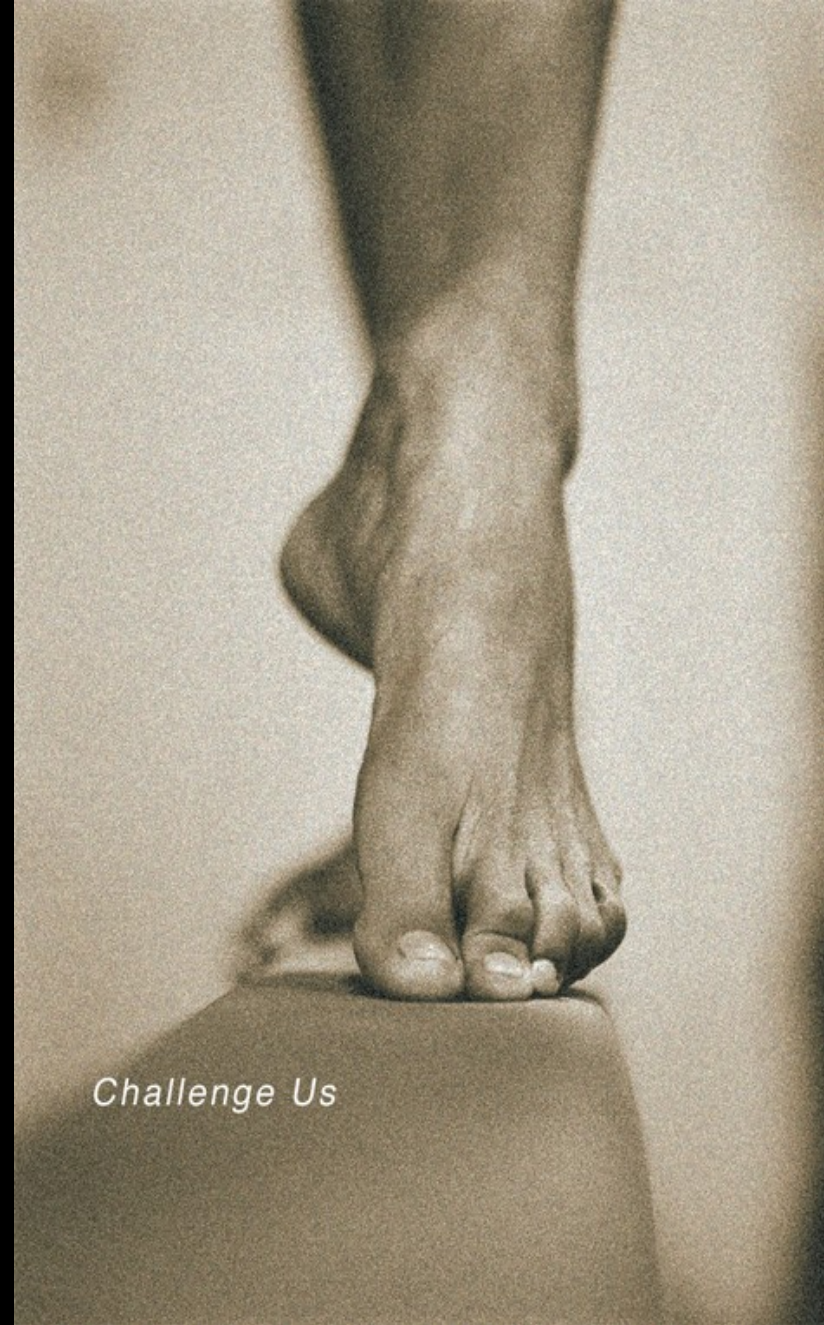
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Environment - pre Union Budget 07-08



Environment pre Budget '07

- Decision in the case of Daelim & L&T – **“composite arrangement cannot be split and then each component taxed separately”**
- Legislative intent, however suggested otherwise
- Specifically, most of the activities that could be undertaken under an EPC arrangement were made taxable (on a stand alone basis) under various taxable categories. For e.g. 
- The only part of EPC contract that was left was **Supplies** (for obvious reasons)

Activity	Taxable category
Erection, Installation, 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

Environment pre Budget '07

- Each of these taxable categories are generally executed in a turnkey and composite basis
- This may suggest that notwithstanding the decision in the case of Daelim/ L&T, the legislative intent was perhaps to tax composite contracts of specific nature
- The fact that specific abatement for supply of goods was provided in the case of Erection, Commissioning, Installation & Construction services, supports the above view

Activity	Taxable category
Erection, Installation, 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

Environment pre Budget '07

- Apart from the aspect of “legislative intent”, it could be said that blanket reliance on Daelim/ L&T may have been fraught with risk

- The reason being:
 - **Firstly**, under Daelim and other cases, the **dominant intention/ primary objective** was looked at and taxability was determined
 - The dominant intention/ primary objective was held to be construction of a facility (and not provision of consulting engineer services)
 - Now that construction services were specifically made liable, could the argument tendered by Daelim be applied ??

Environment pre Budget '07

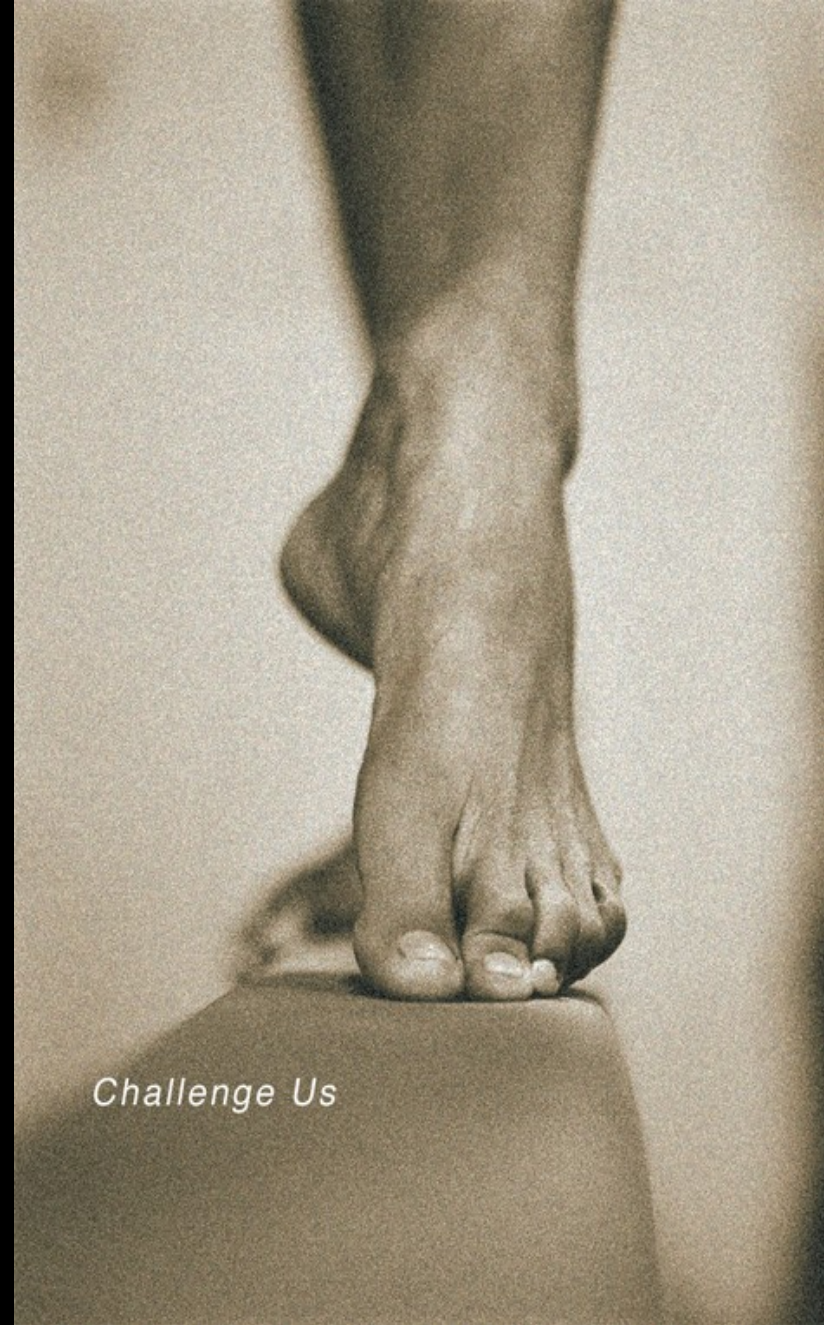
- **Secondly**, these decisions relied on Associated Hotels Case. This case was in the context of works contract. After the judgment, the Constitution was amended. Position pre and post amendment is as under

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 sale of materials	Composite works contract were deemed to be a contract for labour and sale of goods, with latter susceptible to sales tax
If separate consideration was charged for sale of material, then liability to sales tax would arise per decision of the Supreme Court in Gannon Dunkerley	No change in the stated position of law by Gannon Dunkerley

In Gannon Dunkerley case (where the court had held that material portion in works contract could not be subjected to sales tax in 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

Changes - via Union Budget 07-08



Challenge Us

The New Taxable Service

- Under the Union Budget, “**Services involved in execution of works contract**” liable to service tax from a date to be notified

- Taxable service defined as “**any service provided or to be provided to any person, by any other person in relation to the execution of a works contract**” **excluding, works contract** in respect of
 - roads
 - airports
 - railways
 - transport terminals
 - bridges
 - tunnels and
 - dams

- The term “works contracts” has been defined to mean a contract wherein
 - Transfer of property in goods involved in the execution of such contract is leviable to tax as sale of goods; and

The New Taxable Service

- Such contract is for the purposes of carrying out the following specified activities

Nature of activity
Erection, commissioning or installation of plant, machinery, equipment or structures whether pre-fabricated or otherwise
Installation of electrical and electronic devices, plumbing, drain laying or other installations for transport of fluids, heating, ventilation or air-conditioning including related pipe work, duct work and sheet metal work, thermal insulation, sound insulation, fire proofing or water proofing, lift and escalator, fire escape staircase or elevators
Construction of new building or civil structure or part thereof or of a pipeline or conduit, primarily for purposes of commerce to industry

Nature of activity
Construction of a new residential complex or a part thereof
Completion and finishing services, repair, alteration, renovation or restoration of or similar services in relation to construction (Industrial, commercial and residential)
Turnkey projects including engineering, procurement and construction or commissioning (EPC) projects

Service tax on works contracts

- JSTRU Circular with respect to new category provides the following:

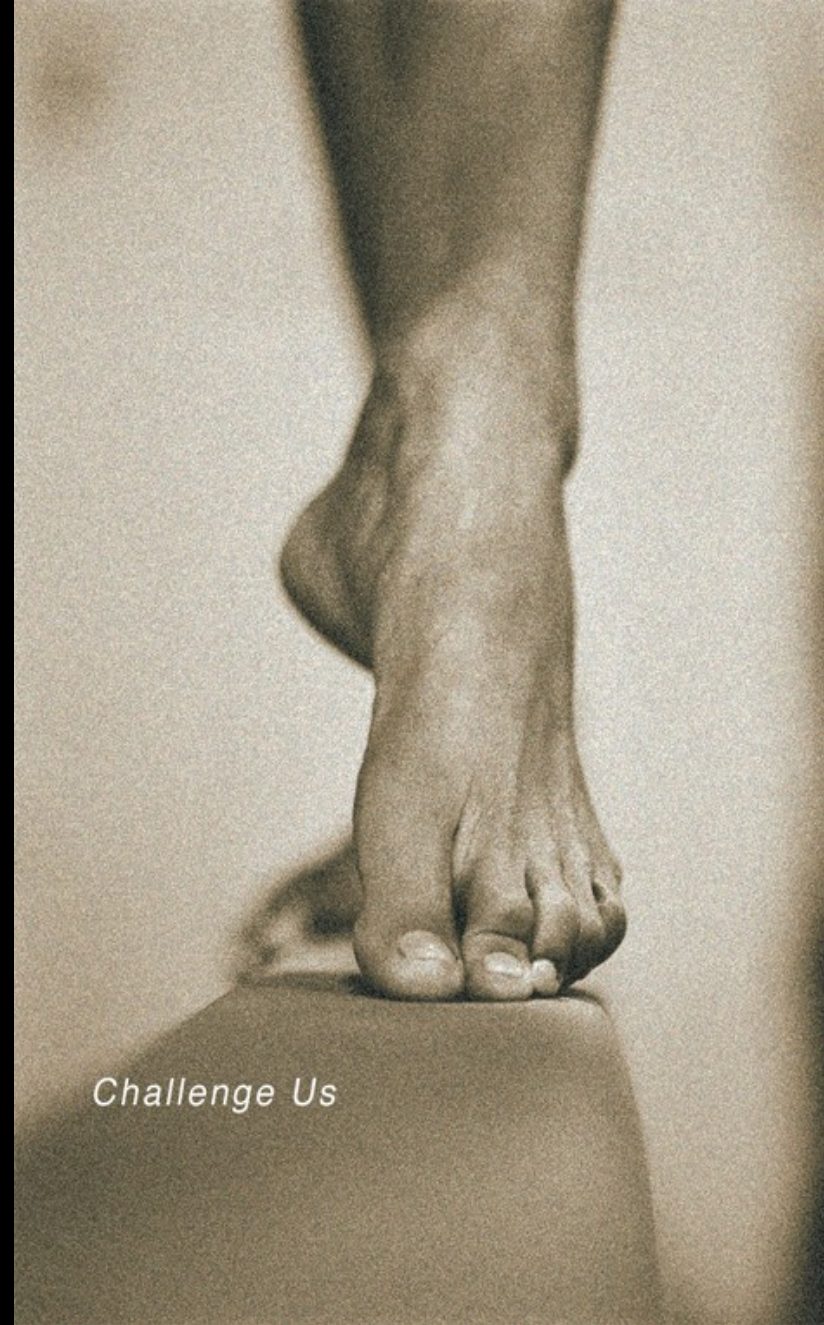
*“6.4 ...the proposed taxable service is to levy service tax on **services involved in the execution of works contract***

...

*“6.4-2 Taxable value under this service is that part of the value of the works contract **which is relatable to services**, provided in the execution of a works contract. Such value is to be determined on actual basis based on the records maintained by the assessee. However, it is proposed to give an option to an assessee to opt for a composition scheme. Under the composition scheme, the assessee is required to pay 2 percent of the total value of the works contract as service tax ...”*

- Detailed scheme for valuation of works contract to be notified separately

Controversies



Controversy No. 1

- Under the new category, service tax is leviable only where **transfer of property takes place during execution of works contract**

- Therefore, can service tax be leviable under **this category**, on pure service contract – e.g.
 - Contract for erection, installation and commissioning, where the equipment and related consumables and temporary material is supplied on FOC basis by the Owner
 - Contract for erection, installation and commissioning, where only the equipment is supplied on FOC basis by the Owner, though the contractor supplies consumables and temporary material which are incidental in nature

- If the answer is in the negative then,
 - Does it mean, service tax can never be applied on these kind of services? Or
 - If not under this category, service tax ought to be levied on these services under the existing taxable services viz “Erection commissioning or installation services” etc

Controversy No. 2

- Under the new category, service tax is leviable only where transfer of property takes place during execution of the works contract **and such contract is leviable to tax as sale of goods**

- Therefore, can service tax be leviable under the following situations:
 - Supplies effected via in-transit sales/ 6(2) sales/ E1 transactions, which do not attract any sales tax/VAT
 - Situations, where VAT has been notified as exempted by the State Government?
 - Situations, where the supplies are made via sale in the course of import, which technically is not liable to tax, but the tax authorities have imposed frivolous demand

- Distinction between leviability to tax & exemption from tax

Controversy No. 3

- While an option of paying service tax on 33 percent of the contract value at the merit rate of service tax has been provided for the existing taxable category, the new category may **have an option of 2 percent composition basis**

- Comparatively, the service tax liability under the 2 percent method is likely to be half of the tax liability that would arise if one uses the 33 percent method
 - For a 100 INR contract, using 33 percent, tax liability would be INR 4.0788
 - Using 2 percent composition, the tax liability works out to INR 2

- This suggests that
 - the contractors may want to migrate to the 2 percent method due to reduced tax liability
 - can such migration happen for a continuing contract, where tax paid in the previous FY was on 33 percent basis
 - in any case, would the Revenue want to classify the contracts under the existing taxable category owing to revenue considerations
 - are we heading towards another set of litigation !!

Controversy No. 4

- The new taxable category seeks to cover exactly the same activities viz erection, commissioning or installation of plant, machinery, for each of which there exists an existing taxable category

- This is therefore likely to raise the following concerns
 - What must be the classification that ought to be adopted by the Contractor
 - Implications under the Classification Rule –(a) Most Specific description vs general description, (b) sub clause which occurs first ie (zzd) v (zzzza)
 - Can the contractor carry forward the credits from the prior year into the new taxable category

Controversy No. 5

- The new taxable category specifically excludes levy of service tax on **works contract in respect of roads, airports, railways, transport terminals, bridges, tunnels and dams**

- This is therefore likely to raise the following concerns
 - Would construction of the above facilities be completely outside the net of service tax?
 - Or would these be taxable under the existing categories
 - If yes, then why exclude it in the first place?

Controversy No. 6

- Position 1 - No Service tax on EPC contract prior to Union Budget 07-08
- Position 2 - Prior to Union Budget 07-08, all turnkey contracts which were in the nature of construction, erection/installation/commissioning, construction were liable to service tax under the existing taxable category

However, going forward

- contracts of the above nature, continues to be taxable under the existing taxable category, provided they are pure services without involving transfer of property in goods which is being subject to sales tax
- contracts of the above nature (including those specifically listed) would be taxable under the new taxable category, where it involves transfer of property in goods which is being subject to sales tax

Discussion on each of these positions follow...

Arguments in favour of Position 1

- Recent decision - *GlaxoSmithKline Consumer Healthcare Ltd. v. CCE, Mumbai II, 2007-TIOL-514-CESTAT-DEL*, which held

When an existing Tariff definition remains the same, then the introduction of new Tariff entry would imply that the coverage under the new Tariff for purpose of tax is an area not covered by the earlier entry

- There has not been any material change in the definitions of the existing taxable services, at the time of introduction of new taxable service. Based on this, it is possible to argue that EPC contracts were never taxable in the past
- In the past, the CBEC has adopted a similar posture vis-à-vis taxation of commissioning or installation services, clarifying that these were not covered under Consulting engineering, prior to introduction of service tax on commissioning and installation services – Circular No 79/9/2004 dated May 13, 2004

Arguments in favour of Position 2

- Doctrine of purposive construction is a relevant tool for interpreting conflicting/ overlapping provisions of law
- The purpose of this principle is to ensure that the two laws that are in apparent conflict can co-exist
- As per this principle, in interpreting any statute four things should be considered
 - What was the common law before the making of the Act
 - What was the mischief or the defect for which the common law did not provide
 - What remedy did the Parliament resolve to cure the defect
 - The true reason for the remedy

- If these test are applied, the outcome could be as indicated below

Criterion	Applicability to present case
Common law before the enactment	Taxability limited to specified taxable activities, which could also be construed to be works contracts
Mischief or defect not provided for	Other works contract not falling within the taxable net
Remedy that Parliament resolved as a cure	Introduction of a separate taxable category
True reason for the remedy	To negate the ambiguity caused due to Daelim etc

Arguments in favour of Position 2

- On adoption of harmonious construction meaning must be given to both the taxable categories (prior to introduction of the new category as well as after the introduction)
- Decision of the MP High Court in the case of *Ratlam Bone & Fertilizer Co. v. State of Madhya Pradesh* 35 S.T.C. 132, could be relevant
- In this case the issue related to interpretation of the two entries "fertilizer" and "powdered bones", since fertilizers also include powdered bones. The High Court held as follows:

"The word 'fertilizer' is more general than the expression 'powdered bones'. Within the word 'fertilizer' comes all types of manures, natural and artificial, and standing alone the word is wide enough to include powdered bones. But as 'powdered bones' have been separately mentioned in Schedule II and III showing clear intention that their sales are liable to tax, the word 'fertilizer' in entry No. 22 in Schedule I must be construed to mean manures other than powdered bones. It is in this way that effect can be given to entries of 'powdered bones' in Schedule II and III as also to the entry of 'fertilizer' in Schedule I. It is true that a more careful draftsman would have excluded powdered bones from the entry of fertilizer just as oil-cakes have been excluded. But even in the absence of any specific exclusion of powdered bones from the entry of fertilizer, we reach the same result by applying the rule of harmonious construction.

Arguments in favour of Position 2

“The argument that by so restricting the meaning of fertilizer we will be reading some words in entry No. 22 of Schedule I which are not there and this cannot be done must be rejected. Whenever the scope of a general word or provision is restricted because of some specific provision made elsewhere in the Act, by applying the rule of harmonious construction, it may appear as if the court has read an exception in the general provision not specifically made in it by the legislature. But this is not really so. The exemption is made by the legislature itself in enacting the specific provision and all that the court does is to read the general and the specific provisions together so as to avoid any apparent conflict and to give meaning to both the provisions.”

- By applying the above principles, it would appear that prior to the recent amendments, turnkey contracts for erection, commissioning, construction, which were specifically indicated in the existing taxable categories were taxable (regardless of whether they involved supply of material or not)
- The above view would be in accordance with various circulars issued by the CBEC envisaging turnkey contracts involving supply of material on installation/commissioning contracts as well as the notification granting abatement for goods under the 33 percent method

Arguments in favour of Position 2

- However, post the recent amendments, even though there exists an ostensible overall doubt, by applying the rule of harmonious construction, it would appear that **going forward**
- All turnkey contracts which involves supply of goods would be covered under the new category
 - All contracts (turnkey or otherwise in nature) which are in the nature of Erection commissioning or installation services or construction services and do not involve supply of goods that is subject to sales tax, would be covered under the existing taxable categories

Concluding remarks

- Immediate need for the industry to submit representation to the CBEC on each of these issues
- If not, then foreseeable slew of litigation awaits the industry
- The Law makers need to be made cognizant of the likely impasse
- Possibility of denial of service tax reimbursements /recovery of service tax already reimbursed, by some of the project owners, for the pre amendment era



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