

1. What is indivisible Works Contract ?

(Difference between Normal Sale & Works Contract)

The works contracts are not normal sales. In the normal sale there is a transfer of property in definite or ascertained goods. The goods remain same before and after the delivery of the goods. However, in works contracts it does not happen. The goods before the delivery and after the execution of works contracts are different, many times in different form also. For example, at the site of construction of a building, before the Construction (works contract) commences, the goods like cement, steel, sand etc. are lying but after the Construction a building (immovable goods) comes to an existence. This is the difference between the `Normal` sale and the "deemed sale" in the indivisible works contract.

The Supreme Court of India, in its various landmark judgments has confirmed in the following wordings the difference between a normal sale (as defined under the sale of goods Act) and an indivisible / composite works contract;

"In a contract of sale, the main object is the transfer of Property and delivery of the possession of Chattel as a Chattel to the buyer, where it is not so, it is a contract of Works & Labour" (Hindustan Aeronautics Ltd. 55-STC 314-SC).

"If the thing to be delivered has any individual existence before the delivery as the property of the party who is to deliver it, then it is a sale. If the main object of the work undertaken is not the transfer of a Chattel qua Chattel, the contract is one for work and labour" (Hindustan Shipyard – 119 STC 533-SC).

"The activity is a sale or works contract depends upon the facts, the terms and conditions and the intention of the parties" (Mekenzis Ltd.-165 STC-58 SC)

In normal practice, we can identify many indivisible/composite works contracts namely construction of a Building, erection of Plant & Machinery, Processing jobs, Job works, Repair jobs, Electrical Fittings, Annual maintenance Contracts (AMCs). Installation of Elevators, Air Conditioners, Repairs of Vehicles, Re-trending of old tyres, Customized Printing Jobs, Electro Plating, electro-galvanizing, anodizing etc. We would discuss later, the levy of Sales Tax/VAT on such activities which are indivisible works contracts.

2. What is a Deemed Sale ?

Under the State Sales Tax Laws, before the 46 th Amendment to the Constitution of India, the Sales Tax was applicable only on the sales covered under the sale of goods Act (Normal sale). The indivisible works contracts were not covered under the State Sales tax Acts since works contracts were not normal sales. The Supreme Court confirmed this legal status in its land mark judgment in the case of Gammon & Dunkerely (9 STC 353). Due to this legal status, the states were denied the levy of Sales Tax on the indivisible works contracts. Such contractors were outside the clutches of sales tax laws.

The then Finance Ministers of the States have requested the then Union Finance Minister to take necessary legal steps so as to levy Sales Tax on indivisible works contracts.

Finally, the 46th amendment to the Constitution of India has been made on 2nd February, 1983 to add a sub-article (29-4) as under,

“(b) a tax on the transfer of property in goods (whether a goods or in some other form) involved in the execution of a works contract”.

After the said 46th Amendment to the Constitution, the States were empowered to levy Sales Tax / Works Contract Tax on such sales, called as “Deemed sales” involved in the execution of works contract. Due to the said amendment, the concept of ‘Deemed Sale’ was introduced. The important features of deemed sales are as under,

(a) It is not a normal sale as defined under sale of goods Act but a deemed sale of goods subject to sales tax by the States.

(b) In the ‘deemed sales’ the states can levy Sales tax only on ‘the transfer of property in goods’. In other words, the states can levy Sales Tax / VAT only on the ‘Material Value’ of the works contract and not on the ‘labour portion’ of the works contract.

(c) If in a contract there is no transfer of property in goods from the contractor to the contractee, then No sales tax is applicable on such contracts, called as “Pure Labour Jobs”.

(d) Under the deemed Sale, an artificial break up of indivisible works contract has to be made to arrive at the ‘material’ value and the ‘labour’ value of the contract.

Therefore, after the 46th Amendment to the Constitution of India, the States are empowered to levy sales tax (now VAT) on such deemed sales but only on the ‘Material Value’ of the works contract. The High Courts and the Supreme Court have suggested methods on “How to arrive at a material value from the total Contract Price”. (Gannon Dunkerly’s SC Judgement 1993) (88 STC 204).

The Supreme Court has also allowed the States to come out with an alternative method to levy Sales Tax on Works contract, if to arrive at material value is difficult. The states have come out with an alternative method called as “Composition Tax” method to tax the indivisible works contract, which is a non-legal /alternative method. The small percentage like 1%, 2%, 4%, 8% as Composition Tax is levied but on the total contract price without any deduction which is available in the legal options under the State Sales Tax / VAT Acts. After, the said amendment to the Constitution certain States a namely Maharashtra & Delhi have come out with separate ‘Works Contract’ Acts. The other states incorporated the separate provision to levy Sales Tax on the deemed sales in the works contracts. Under the State Sales Tax Acts or separate Works Contract Acts, No contractor or contractee were entitled to claim any set off of Sales Tax paid to their vendors. There was a double taxation in the hands of Contractors in the Sales Tax Regime.

3. Post VAT Scenario – Levy of VAT on Indivisible Works Contracts (Deemed Sales)

The states have introduced the new value Added Tax (VAT) System from 1st April 2005.

All the VAT States have incorporated in their respective State VAT Acts, the provisions of ‘Works Contracts’ for levying the Sales Tax /VAT on the deemed sales involved in the execution of works contracts. There is no Works Contract Tax (WCT) now; it is a VAT on the Works Contract transactions (Deemed Sales). The Advantage to the Contractors is that under the VAT system, the Contractors like manufacturers can avail VAT set off / Credit of the VAT paid to the local vendors, which was not available in the Pre-VAT Regime.

Please note that there is a Uniform Scheme of Taxation for levy of VAT on Works Contracts under all the State VAT Acts. There is no separate or different taxation scheme in different

States like in pre-VAT period for works contracts. There is uniformity under the works contract provisions in the Post VAT Regime. This is a positive factor for Contractors under VAT Regime. In all the State VAT provisions, there are three options available for the Contractors to levy VAT on deemed sales (Works Contracts) and VAT is leviable on the 'Material Value' of the Contract. The said three options (Uniform in all the VAT States) are as under,

A-1 – Actual Labour Deduction (Legal Option)

A-2 – Standard Labour Deduction (Legal Option)

B - Composition Tax (Non Legal or Alternative Option)

Under the legal options A-1 and A-2, the State Governments can levy VAT only on the 'Material Value' of the Contract and not on the 'Labour Portion' of the Contract. Please note that the States are empowered to levy tax on "Material Value" and not on "Material Cost" in the works contract. For example, VAT is applicable on 'Cement Block Value' and not on 'Cement Cost'. Similarly, VAT is applicable on 'Wooden Furniture Value' and not on 'Timber/Wood Cost' in the hands of the Contractor.

I have explained below, the said three options available for the Contractor, executing indivisible Works Contract under the State VAT Acts (Uniform Across the States). Except the Rates of Composition Tax, the Rates of TDS deductions, Returns and Payment dates, most of the Major Provisions are Similar / Uniform under the State VAT Acts;

Actual Labour Deduction Option

A-1 Option (Levy of VAT on Works Contracts in the hands of the Contractor)

Under the legal option A-1, the VAT is payable on the 'Material Value' of the Contract. The deductions are available for arriving at the Material Value from the total contract price. Such deductions are specified in the corresponding provisions of the state VAT Acts which are based on the guidelines given by the Supreme Court in the case of Gannon Dunkerley (88 STC 204) or the Contractors can arrive at the Material value / price of the Contract by adopting cost + value Addition method. In this method, the Contractor adds to the 'Material Cost' which is determined by considering all the purchase bills of the materials (imports, outside the State and within the State), the margin on such material cost plus any incidental expenses attributed towards the material value. In other words, the Contractor determines the Material Price after adding Material Cost and Margin to such cost.

The 4% or 12.5% VAT would be applicable on such Material Value /Price, depending upon the classification of such materials (Steel 4%, others 12.5% VAT) in which the property passes to the contractee. In this option A-1, the Contractor can avail full VAT set off / credit of the VAT paid to the local vendors (Not on CST paid to the outside the State Vendors) provided he obtains corresponding 'Tax Invoices' from his local vendors. Therefore, the cost of VAT is zero for the Contractors in this legal option. Similarly, the Contractee /Customer also can avail the full benefit except on the purchases covered under the Negative list under the State VAT Act on which No VAT set off/Credit is available. Mostly the Civil Works, Construction jobs, erection of immovable property (Structures) are covered in the Negative lists. On the other works contract purchases, the full VAT set off / Credit is available to the contractee /customer. The T.D.S. (works contract) provisions are applicable to the contractee in this option which are discussed later.

In nutshell, in the option A-1 (Legal), the Contractor gets full VAT set off / credit on the VAT paid on the inputs and the Contractee also gets the credit, if it is not in the Negative list (Like processing Jobs, Job works, Printing Jobs, Repair Jobs etc.) The Contractors are benefited under VAT System as the Contractors can avail full set off / credit.

However, in this option the Contractor has to maintain proper books of accounts and the other records to identify the material value of the Contract.

A-1 option is the Best option available since the Contractor levies VAT only on the 'Actual Material Value' of the contract, even though it is litigation prone option. Many Contractors who execute big indivisible works contracts, Turnkey Jobs opt for legal option A-1.

Option A-2 (Standard Labour Deduction)

(Legal) (Levy of VAT in the hands of the Contractor)

Under the legal option A-2, the VAT is payable on the 'Material Value' of the Contract. The Material value is calculated after deducting the 'Labour Portion' from the total contract value / Price.

However, in this option a table is available in the State VAT Act / Rules which shows 'Standard Labour portion' attributed to the various works contracts. The Contractor has to deduct such 'Standard Labour portion' shown in such tables from the total Contract price to arrive at the 'Material value'. The Contractor would charge 12.5% VAT, on such material value. Each State has provided the said 'Standard Labour' table, under this option. (Like in Maharashtra for Civil Works it is 30%, for Plant & Machinery 15%, for AMCs 40% and for others 25% (Residuary)).

The advantage in this option compare to the A-1 option is that it is litigation free. The Sales Tax Departments would allow the said 'labour portion deductions' as the same are provided in the VAT Rules itself. Also no identification record has to be maintained by the contractor for the materials used in the contracts. However, the Contractor has to consider both the options A-1 and A2 in the case where the Contractee/ Customer does not get the VAT set off / credit and then selecting the cheaper option.

Like in A-1 option, in A-2 option also, the Contractor gets full credit / set off on the VAT paid on the inputs and the Contractee also gets full set off of the VAT paid provided the said purchases are not in the Negative list of VAT set off / credit. The TDS provisions are applicable to the contractee in this option also which are discussed later.

Option-B -- Composition Tax (Alternative / Non legal option)

(Levy of VAT in the hands of the Contractor)

Option B is the "Composition Tax" option. This is a non legal alternative option, simpler option for those Contractors who cannot maintain the proper Accounts, Record of the material and other portion in their contracts. The contractee / customer prefers this option as small amount of Composition Tax 2% / 4% is payable to the Contractor instead of 12.5% VAT payable in legal options. A-1 and A-2. However, VAT credit/set off is not be available to them in this option (in this option, VAT Credit is available only in the state of Maharashtra).

Under the "Composition" option, the Contractor has to pay Composition Tax (VAT) on the total Contract value / price, No deduction of labour is available in this option. Similarly, No

VAT set off / Credit is available on the purchases of inputs to the Contractors and the same is not available to the Contractees also. (Except under Maharashtra VAT Act/Rules, partial VAT Credit is available to both Contractor and Contractee in the Composition Tax option). The Rates of Composition Tax differ from state to state. Generally it is 2% (for civil contracts) @ 4% for other Contracts. However, exception is in Maharashtra State where the Rate of Composition Tax is 5% on Civil Contracts and 8% on other Contracts. In Maharashtra, in this option, in excess over 4% Credit is available on the input purchases for civil contracts (where composition Tax Rate is 5%) and 64% of the total credit available for other Contracts (where Composition Tax Rate is 8%). Thus, partial VAT Credit is available to the Contractors in the Composition Tax option. However, full credit is available to the Contractee in this option in Maharashtra provided such purchases are not included in the Negative list under MVAT Rules.

Therefore, except in Maharashtra, in all other states No VAT set off / credit is available to both the Contractor and the Contractee in the Composition tax option. The TDS provisions of Works Contract are applicable to Contractee in these options which are discussed later.

In Short, in all the States only the said 3 options (A-1, A-2 and B) are available in the hands of the Contractors for levy of VAT on the local works contract transactions in the VAT system. If no VAT set off/Credit is available to the Contractee / Customer, then the Composition Tax option is the Cheapest since the Rate of Composition Tax is lower than 12.5% VAT. Therefore, if the Contractee / Customer can not avail the VAT set off / Credit in all the three options, then, the VAT / Composition Tax paid to the contractor is the cost to such Contractee /Customer, hence in such cases the Contractor and Contractee should select the Best option available after considering the Actual Figures in all the three options.

The States have provided separate sections / Rules under the respective State VAT Acts for the works contracts transactions which include said three options of levy of VAT, TDS, VAT Credits and Negative lists.

4. General Negative list Items for Works Contracts under State VAT Act & Rules

(a) Purchases effected by way of works contract where the contract results into an immovable Property.

(b) Purchases of Building material which are not resold but are used in the activity of Construction. (Free issues)

(c) Purchases of works contracts made by the Contractee in Civil Contracts.

(d) Any purchases of Consumables or of goods treated as Capital Assets by the Contractor/dealer where he is principally engaged in doing job work or labour work and is not engaged in the business of manufacturing of goods for sale by him.

(Please refer to the specific provisions of works contracts under the relevant state VAT Acts for such Negative lists)

5. Tax deducted at source (TDS) provisions of works contracts under the State VAT Act & Rules

In most of the State VAT Acts, the provisions of Tax deducted at source (TDS) are incorporated. The logic behind the TDS (WC) provisions is that the Contractors are not organized in many cases and they do not pay taxes on time , therefore in this provision the

contractee / customer deducts the prescribed % of TDS from the Contract Price and pays the same before the prescribed dates, directly, to the respective State Government through the specified challan. The TDS is to be deducted by the specified customers only as notified by the State Governments. Generally, the dealers registered under the State VAT Acts, State and Central Governments, Corporations, Government Undertakings, Co-operative Societies only have to deduct the said TDS (WC) and not by all the Customers. The monetary limit of the turnover is prescribed between Contractor and Contractee for such deduction in the hands of the Customer in most of the VAT Acts.

It is responsibility of the Contractee / Customer to deduct the prescribed % of TDS (As provided in the relevant VAT Act & Rules) and pay the same to the State Government before the prescribed date, otherwise interest / penalty is leviable on such Contractees / Customers.

However, as per the State VAT Act provisions, the Seller (Contractor) is liable to pay VAT, if No TDS is made by the Contractee/Customer. The State Governments have prescribed different VAT Forms under the provision of TDS (WC). In certain States, the Contractee has to obtain TANS (Tax deductible Account Number) and file Annual Returns of TDS under the TDS provisions.

In Maharashtra, under MVAT Act, 4% TDS is applicable (instead of 2%) in the case where the Contractor has not obtained the VAT TIN certificate (URD Contractor).

6. Provisions of Works Contract for Main and Sub-Contractor under the State VAT Laws.

The following two types of VAT levies are provided for the transactions of works contracts between the Main contractor and the Sub-Contractor,

- In certain States, (like Maharashtra) Main and Sub Contractors are treated as single legal Entity. Therefore, there is no VAT/TDS applicable between the transactions of the Main and the Sub-Contractor. The VAT Forms are exchanged between the Main and the Sub Contractors to declare that they have discharged VAT liability for their portions of the Contracts. In such cases, the Main Contractor gets the deduction of the value of the work executed by the Sub Contractor. The main and the Sub Contractor are jointly and severally responsible for the compliance under the works contract provisions of the VAT Act.
- In certain states (other than Maharashtra), the Main and the

Sub Contractors are treated as separate legal Entities, like separate two dealers under the VAT Act. Therefore, in such provisions, Sub contractor charges applicable VAT/Composition Tax to the Main Contractor, avails Credit of the VAT paid on the inputs and the Main contracts also charges VAT/Composition Tax applicable to the Contractee/Customer and avails the Credit available to him against the VAT paid to the Sub-Contractor. They are assessed / audited separately under the State VAT Act provisions.

It is advisable that the Main Contractor and the Sub Contractor should discuss all the relevant VAT provisions before opting for the specific method of levy of VAT / Composition Tax to avoid complications at a later date.

7. VAT & Service Tax, both, Applicable on certain Works Contracts.

On certain Works Contracts both VAT (WC) & Service Tax are applicable on the Contract price since there involves the transfer of property in goods (sale of goods / materials) subject to VAT levied by the State Government and rendering of Taxable Service subject to

Service Tax levied by the Central Government. Thus, the both the state & the Central Governments levy VAT & Service tax on the same taxable base i.e. Contract Price, respectively.

The Contracts /Taxable services where both VAT and Service Tax are applicable are shown as under,

- Construction contracts, Civil Jobs
- Annual Maintenance Contracts (AMCs)
- Erection of Plant and Machinery etc.

Please note that in such Works Contracts / Taxable Services, the working for levy of VAT & Service Tax is to be done, separately, as per the provisions of VAT & Service Tax. Only in the case where the Contractor opts for A-1 legal option of actual labour deduction method, he can pay Service Tax on the actual labour portion and VAT on actual Material value. Otherwise only A-2 (Standard deduction) and B (Composition Tax) options are available under VAT and No deduction for levy of Service Tax for the Contractor. The Abatements are available under the Service Tax law for specific Taxable Services towards the value of material / goods involved in the same. Like 67% Abatement from the contract value is available under the Construction Services.

• **Concept & Levy of C.S.T. on Inter state Works Contracts**

The Central Government amended the definition of `Sale' under the Central Sales Tax Act, 1956 from 11.5.2002. With the said amendment, the states are empowered to levy C.S.T. on the interstate works contract. By the said amendment, the concept of `Interstate works contract' was introduced in the C.S.T. Act by inserting in the definition of `Sale', the words "Transfer of Property in goods involved in execution of works contract".

When the Contractor dispatches his goods from one State to another under an individuals works contract, it is an interstate works contract. The sections 3,4,5 of the C.S.T. Act are applicable to such deemed sales in the interstate works contract. Accordingly, the State of dispatch can collect the Central Sales Tax on such deemed interstate sales. The Contractors may not be allowed the interstate depot transfers in the cases of indivisible works contracts since such dispatches are made to the sites of the contractee situated in other state and the same are earmarked for the specific contractee. The Contractor would invoice to the Contractee from the state of dispatch and would charge CST as applicable, with or without C/D Forms.

Recently, the CST Act was further amended to explain, the deductions available on the total contract price to the Contractor to arrive at the material value. Please note that in interstate works contracts also, the C.S.T. is payable only on the Material Value/Price' of the Contract and not on the Labour' portion of the Contract.

The examples of interstate works contract would be that of Contractor from Mumbai, dispatching goods from his Mumbai plant to the site in Chennai (Tamil Nadu) under a indivisible works contract or A Manufacture in Mumbai dispatching his own material to a processor in Surat and the processor returns back the processed material back to the Mumbai Manufacturer. The Surat processor would charge 4% CST against `C' form on the material value of his invoice amount being an interstate works contract in his hands.

Please note that when it is an interstate works contract, the Contractee would raise an invoice on the Customer situated in other state with applicable rate of CST on the Material

value of the contract, but the Customer would not deduct any amount towards TDS since there is no provision of T.D.S. under the CST Act. TDS is to be deducted only in the local works contracts where the Contractor has charged VAT/Composition Tax.

In short, if the Contractor dispatches goods from his state to the State of the Contractee (Customer) under an indivisible works contract, it is an interstate Works contract in the hands of such Contractor subject to levy of CST which is collected by the state of dispatch. However, in the interstate works contracts also, C.S.T. is payable only on the 'Material Value' of the Contract.

9. How the Contractee / Customer should look into the Works Contract purchases for Minimum cost.

Under the VAT System, the Contractee/Customer can avail the full VAT Credit/Set off of the VAT paid to the Contractor through the tax Invoices, provided such purchases are not in the Negative list of set off/VAT Credit.

However, in the cases where the Contractees / Customers do not get any VAT set off / Credit, they should note the following points to reduce their VAT Cost,

(a) To decide the Best option of "Levy of VAT/Composition Tax" before the execution of the Works Contract Commences.

(b) To insist the Contractor to buy maximum inputs from local vendors only and the VAT Credit thereof should be passed on to the Contractee by reducing his sale price, accordingly.

(c) In case of free issues supplied by the Contractee / Customer to the Contractor , if the price of the contractor is 'Net off' the material value supplied by the Contractee then there is no negative VAT impact to the Contractee . Otherwise, there is VAT cost in the hands of the contractee with regards to the VAT paid on the purchases made by the Contractee and given as free issues to the Contractor.

(d) Prescribed % of TDS payment to the government and timely issuance of TDS certificates to the Contractors.

(e) To insist the Contractor to show the VAT applicable, separately on the invoice (Tax Invoice, in the case if the Contractee can avail the credit)

(f) To add the clause in the agreement with the Contractor, "If any additional liability on Account of VAT (WC) arises at a future date shall be borne by the Contractor".

10. The summary of the Main Points with regard to provisions of levy of VAT/Composition Tax under the State VAT Act & Rules.

- Deemed Sales (WC) are taxed under the provisions of the State VAT Act, there are no separate Works Contract Acts.
 - For local works contract transaction State VAT (WC) is applicable and for interstate works contract transaction, the Central Sales Tax (C.S.T.) is applicable as covered under the CST Act.
 - No VAT/CST is applicable on the pure labour Jobs (No material of the Contractor / Job worker is involved)
 - Under the State VAT Acts, VAT is applicable on the `Material Value` of the Contracts only as determined by the three options as discussed earlier and under the C.S.T. Act also CST is applicable on the `Material Value` only.
 - In the contracts, `where both the sale of goods and rendering of Taxable service are involved, both VAT & Service Tax is payable on the same contract price subject to the relevant provisions under both the VAT & Service Tax Laws.
 - Proper clauses of VAT/CST should be incorporated in the Agreements between the Contractor and Contractee to avoid litigation.
 - Under the VAT System both the Contractor and the Contractee can avail full VAT set off/Credit subject to the Negative List.
 - The Contractee should ask for the price reduction from the Contractor to pass on the `VAT Benefit` availed by the Contractor on his local purchases.
- I am sure all of you will get useful information in this article on "VAT & Works Contracts"
This will help all of us to plan works contracts transactions in a better and cheaper way in future.