Concept Paper

Determination of taxable value of services from composite consideration in respect of commercial or industrial construction service and construction of complex service

1 Background

1.1 The Finance Bill 2010 proposes to insert the following Explanation to Section 65(105)(zzq) of the Finance Act, 1994 (FA, 1994) which defines taxable service in relation to **commercial or industrial construction**:

"Explanation – For the purposes of this sub-clause, the construction of a new building which is intended for sale, wholly or partly, by a builder or any person authorized by the builder before, during or after construction (except in cases for which no sum is received from or on behalf of the prospective buyer by the builder or the person authorized by the builder before grant of completion certificate by the authority competent to issue such certificate under any law for the time being in force) shall be deemed to be service provided by the builder to the buyer."

1.2 Similar Explanation is proposed to be inserted in Section 65(105)(zzzh) which defines taxable service in relation to **construction of complex**.

1.3 The taxable category of commercial or industrial construction service was introduced from 10 September 2004 and has been amended from time to time to bring to charge the activity of completion or finishing, repair, alteration, renovation, restoration, etc.

1.4 Taxable category of construction of complex services was introduced with effect from 16.6.2005 and includes completion and finishing services, repair, alteration, renovation, restoration and similar services.

1.5 Taxable service in relation to the commercial construction is covered in Section 65(105)(zzq) and for residential complex is covered in Section 65(105)(zzzh).

1.6 The issue as regards scope of taxation under this category has been subject matter of litigation. The Supreme Court in the case of K. Raheja Development Corporation vs. State of Karnataka[1] held that the activity undertaken by builders for construction of flats / buildings for and on behalf of the prospective customers for consideration in cash or deferred payment is covered under works contract and not under sale. This was a judgement under State VAT law where the Department sought to classify the specific transactions as works contract i.e. composite contracts involving supply of goods and services and the builder had classified the same as contracts of sale. A sale contract of immovable property does not attract liability to VAT whereas in a works contract, VAT is chargeable on the material element of the contract.

[1] 2005 2 STT 178)

1.7 The contracts, in that case, did not include value of land since as per the practice prevalent in the state of Karnataka, the builder sells undivided interest in the land to the buyers and the buyers then enter into separate contract for construction with the builder. However, following this judgement, substantial confusion arose with the field officers seeking to charge service tax in all cases including those where the contracts were not of the nature covered under K Raheja's judgement.

1.8 Following significant representations, the Central Board of Excise and Customs issued Circular on 29 January 2009 (108/02/2009-ST) clarifying the doubts that had arisen regarding applicability of service tax in a case where developer / builder / promoter enters into an agreement with the ultimate owner for selling dwelling unit in a residential complex at a stage of construction and where the buyer makes construction linked payments.

1.9 The Board, after examining the law relating to transfer of property and the nature of transactions clarified that service, if any, provided by the seller in connection with construction of residential complex till execution of sale deed is in the nature of self service and consequently, does not attract service tax.

1.10 The amendment now seeks to deem such self service as taxable service.

1.11 The proposed Explanation thus, deems construction of a new building / complex intended for sale, wholly or partly, to be a service provided by the builder to the buyer if the prospective buyer makes any payment before, during or after construction but before the grant of completion certificate by a competent authority.

1.12 The issue that thus arises is that though the construction, in such cases, is deemed to be service, can service tax be levied on the entire consideration?

1.13 Service tax is leviable on taxable services[2]. In case where a builder takes booking for a specified area in a new building or a complex for composite sum and / or receives any sum before receipt of the completion certificate, the same would include proportionate amount towards following three components:

i) Value of the land on which the building / complex is constructed;

ii) Goods and materials like steel, cement sold (deemed to be sold) during construction of building / complex;

iii) Services like planning, designing, services of architect / structural engineers, labour for construction, etc. deemed to be provided during construction of building / complex.

1.14 Service tax can be levied only on the third component viz. services involved in construction of new building / complex.

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[2] Section 64 of the Finance Act, 1994

1.15 Service tax in relation to commercial or industrial construction and construction of complex categories is chargeable with reference to the value of service. Provisions relating to valuation of taxable service are contained in Section 67 of the FA, 1994 which provides that the value, where provision of service is for a consideration in money, is the gross amount charged by the service provider for service provided or to be provided by him. In case the provision of service is for consideration not wholly or partly in terms of money, the value is to be determined in terms of money. Where consideration is not ascertainable, the value is to be determined in accordance with Service Tax (Determination of Value) Rules, 2006.

1.16 In certain types of transactions involving composite consideration where it is found difficult to ascertain value of service element, abatement, by way of notification, is provided to determine (on deemed basis), value of service element of the composite consideration.

1.17 *Notification No. 12/2003* dated 20.6.2003 provides for exclusion of goods and materials sold by the service provider during provision of service. However, considering the fact that bifurcation of value of goods sold during the course of construction is often difficult in composite contracts, as an option, abatement of 67% is provided to determine value of taxable service i.e. 33 % of the composite consideration is deemed to be towards value of service (Sr. No. 7 and 10 of Notification No. 1/2006-ST dated 1.3.2006).

1.18 There is, currently, no provision in service tax law to determine taxable value of service in case of construction contracts for composite consideration. Provisions of Section 67 of Finance Act, 1994 would require reference to Valuation Rules and Valuation Rules also needs to contain provisions in this regard. There is also no provision for exclusion of value of land if the consideration payable by the buyer of premises includes value of land since such transactions / components were not subjected to service tax earlier.

1.19 The transactions of construction of new building / complex can be of varied nature and as the letter *DOF No. 334/1/2010 TRU dated 26.02.2010* explains, there are varied practices in different parts of the country; in some cases, land is sold separately and the builder recovers a separate charge for construction of the super structure; in some cases, there is no separate sale of land and what the builder charges is towards consideration for specified constructed area in a building which includes proportionate value of land.

1.20 Consideration for sale of units / premises in a new building / complex, these days, in majority of the states is composite and not separate for land and super structure. As a result, a need arises to establish methodology to determine value of taxable service involved in a transaction of sale of units / premises in a new building / complex. This assumes further complexity owing to differing practices prevailing in different parts of the country, varying prices of land and cost of construction, nature of transactions and so on. To illustrate in Maharashtra, there could be sale of condominium or apartment under the Apartment Ownership Act under which conveyance of apartment, which includes proportionate undivided interest in land and specified constructed area, is made in favour of the apartment owner and thus the apartment buyer, in a sense, can be said to be purchasing a proportionate undivided interest in land. However, in case of cooperative societies, the conveyance of land and building is made in favour of the society and the buyer gets ownership right in the specified constructed area (flat / premise) by virtue of membership/shareholding in the society. The buyer thus, in a strict sense, is only acquiring shares in a cooperative society. Similarly, land and building could be conveyed to a company by the builder/developer and the buyer gets ownership rights to specified constructed area (flat / premise) by virtue of shareholding in the company. The land may be lease hold or free hold and often the conveyancing of the land and the super structure to the society/company takes quite some time after the completion of construction and handing over of possession of constructed premises to the buyer.

1.21 Thus, the issue involves significant complexities and it is extremely difficult to set out a general, standard rule for determining value of service element of such a composite contract.

2 Scope of this Concept Paper

2.1 This Concept Paper sets out possible alternatives and recommends methodology that can be adopted for determination of value of service from composite consideration for charge of Service tax. This Paper does not examine constitutional validity of the proposed Explanation and proceeds on the assumption that the addition of Explanation and levy are constitutionally valid.

3 Contributors to this Concept Paper

3.1 This Concept Paper has been prepared by the Indirect Taxation Committee of ICAI with contributions from following persons:

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4 Analysis

4.1 Determination of taxable value of service from a composite contract amount which includes elements on which service tax is not leviable can be done either by forward working method or backward working method.

4.2 Forward working is where one takes into consideration costs incurred by the service provider for providing service and makes adjustment for margin attributable to provision of service.

4.3 Backward working is where one takes the gross value of consideration and deducts value (cost + margin adjustment) of components on which service tax is not chargeable i.e. value of land and materials / goods sold during the course of providing service.

Forward Working

4.4 Application of this method in the context of construction service would require the builder to identify actual service elements of the contract and attribute total consideration to such elements. This could be substantiated on the basis of actual costs incurred for service elements of construction and profit attributable to such service.

4.5 This would be very difficult to apply in practice. A further complication would arise since a builder would find it extremely difficult to ascertain the service element of the contract upfront, at a time when the agreements are entered into and partial consideration/instalments are paid by the buyer(s).

4.6 This could work in cases where builder engages third party service providers for most of the services and is able to identify value attributable to service element of the total consideration. There again, the actual amount would be known only after the construction is over and, therefore, during the period of construction, some estimate would have to be made to determine the amount payable.

4.7 Thus, though this method would bring to charge the actual element of value of service of total composite consideration, it would be very difficult to apply in practice and may not be workable.

Backward Working

4.8 Under this method, one would start computation with total amount of consideration and exclude value of land and material / goods involved in construction. Thus, this method would require:

a) Exclusion of value of land;

And

b) From the balance consideration, exclusion of value of material / goods.

Exclusion of value of land

4.9 The value of land for the purpose of exclusion obviously, cannot be the cost of acquiring land since what is required to be excluded is the value charged by the builder as part of the total consideration. The sale could be at a consideration higher or lower than the cost of acquisition. Appreciation or depreciation in value of land should not have bearing on the value of service provided in the course of construction. Cost of acquisition for a person who acquired land long back could be low as compared to a person who acquired it in recent times. Similarly, those who have inherited the land or have received it by way of gift would have no cost whereas those who have purchased it would have cost. At the same time, exclusion of value of land on the date of sale in each individual case, if applied strictly, would mean that the service tax to be charged from one buyer to another buyer can vary depending upon the time at which booking is made and even from installment to installment if there are subsequent changes. There can be further complications where the plans change or the builder acquires additional transferable development rights and increases the area to be constructed and so on.

4.10 A builder who sells premises can determine the value of land and exclusion can be on the basis of actual value of land. But, then, it would be builder's own estimate and extremely difficult for a builder to substantiate in case of assessement proceedings as also to prospective buyers.

4.11 Circle rates or rates adopted by State Governments or provided by local authorities could be used as benchmark rates for determining value of land by builders. This would not be free from complications but could be used as guidance by the builders.

4.12 Alternative to this could be abatement at a specified percentage of total consideration towards value of land which although, adhoc could be a simpler method to determine component of value attributable to land. The value of land varies from state to state, city to city, local area to local area and even building to building. It is, therefore, very difficult to set out any general rule. Rates of abatement would have to be different for different metros and other areas.

4.13 Delhi VAT law contains a provision to exclude value of land in case construction contract includes value of land. It provides for two alternatives, one, actual basis, where recent cost of land is ascertainable from the books of account of dealer and second, deemed basis, where it is not so ascertainable. Rule (3)(a) of Delhi VAT Rules, 2005 contains this provisions and reads as follows:

"*(3) (a) In the case of works contract of civil nature where the payment of charges towards the cost of land, if any, is not ascertainable from the books of accounts of the dealer, the amount of such charges shall be calculated @ 30% of the total value of the contract except in the case of construction of commercial buildings or complexes where it shall be calculated @ 50% of the total value of the contract."*

The rates contained in this Rule can be used as rate for abatement for Delhi.

4.14 In Mumbai in Maharashtra, ready reckoner rates are available for open land as also constructed area (residential, commercial, shopping, etc.) for each survey number of municipality. These rates vary significantly. These rates establish ratio of value of land in the total value of constructed area in specified locality in Mumbai for specified use (e.g. if land rate is Rs. 7000 and that of constructed area is Rs. 14000 for a particular locality, proportion of land value would be 50% of the total consideration for constructed area). Sample –scanned copy-of the ready reckoner for Vile Parle and

Borivali areas is attached as Attachments A and B to this Paper. The ratio determined on this basis could be used for determining rate of abatement for Mumbai.

4.15 Thus, specific abatements on the basis of such available indicators could be specified for specified cities and for specified uses. One of these bases could be adopted for other areas especially those where there are no municipalities.

Exclusion of value of goods / material

4.16 The balance consideration remaining after excluding value of land would include two components:

- Value of goods/ materials sold during the construction;

  And

- Value of service provided during the course of construction.

4.17 Here again, the exclusion could be on actual basis as is currently available in terms of Notification No. 12/2003 or could be by way of abatement on deemed basis.

4.18 The State VAT laws which bring to charge goods element of a contract involving supply of goods and services often adopt an adhoc measure for the purpose and attribute 30% of the total contract value to the service element and 70% to the goods element in absence of actual break-up. In these cases, contracts do not include value of land or rights in the land.

4.19 Service tax law attributes 67% of the contract value to goods element and 33% to the service element vide *Notification No. 1/2006 ST dated 01.03.2006*. Here again, the contract value does not include value of land.

4.20 This measure could be adopted for determining service element of composite consideration after excluding value of land. Notification No. 1/2006 currently, does not allow input tax credit. That ought to be allowed to avoid cascading effect. The Notification deems certain part of the total consideration to be towards service element. The service provider incurs expenses on which taxes are paid and not to allow input tax credit of those taxes leads to cascading of taxes.

Composition Scheme

4.21 This could be an alternative scheme, a comparatively simpler method to apply, considering complexities involved in both forward working and backward working methods. Both the methods, forward and backward working methods, could lead to substantial uncertainties for both service providers and tax department. Complexities get compounded due to the nature of transactions, time of payment and as on. A buyer of the premises would also not know exactly how much is the element of service tax upfront which may fluctuate from time to time and flat to flat.

4.22 The composition method involves adoption of a flat composition rate on the total consideration like the one that is currently prevailing under works contract service where the elements involved are the goods/materials and services and not land. When the land value is included in total consideration, the flat rate would obviously be much lower.

4.23 A general inquiry with the builders indicates that in a typical sale transaction of a unit/flat/apartment (by whichever name called) in a building for composite construction, consideration towards service elements would be in the range of 15 – 20%. This aspect can be tested from other angle also. Value of land in a composite transaction is estimated to vary from 50 % to 70% in most parts of the country. Service tax law as also VAT laws estimate the component of material element to be 67 % & 70 % in composite contracts involving goods and services. Thus, if we assume the composite consideration for sale of premises to be 100 and deduct 50 or 70 as value of land, 50 or 30 remain as consideration towards materials and services. If we allocate 67 % to material element, goods element would work out to 33.5 % or or 20 % and that for service element to 16.5 % or 10 %.

4.24 Applying service tax rate of 10% to the estimated margin of 15 % - 20 % would work out to 1.5% – 2%. Making adjustment for the input tax credit attributable to the service element (estimated at about 35 – 40%), the net rate would work out to about 1% of the total consideration without input tax credit.

4.25 Though not perfect, this rate could be applied uniformly to all construction contracts whether they relate to residential, commercial or industrial from simplicity perspective. This rate ought to be applied to the sale consideration including additional consideration charged for special location and like (also known as floor rise in high rise buildings). In case of high rise buildings, builders often fix a base price which is applicable upto certain floors and then a specified rate is added per floor as floor rise. This floor rise is nothing but a consideration towards sale of premises. Interest charged for delay in payment of penalty and like not related to sale of the premises ought to be excluded for application of this rate.

5 Recommendations

5.1 Where the sale consideration for sale of premise(s) / unit(s) in a new building or complex is composite one, the value attributable to service element of the total consideration be computed by any of the following three methods, at the option of the builder.

I Direct Method

- Actual value of service element of sale consideration computed by the builder duly substantiated from records.

II Indirect Method

(A) Exclusion of value of land

At the option of the builder:

Either:

- On actual basis, if the actual value of land is available

or

- Deemed basis by way of abatement of specified percentage of the total consideration of the composite contract.

This abatement ought to be different for different places and for different uses e.g. in Delhi, the same basis is being adopted under VAT law for exclusion of land be adopted. For Mumbai, the rates of open land and constructed premises inclusive of value of land are available for most of the areas. The proportion of open land value and the constructed value of premises be adopted as basis for determining the land component of a composite contract.

(B) Exclusion ofvalue of material / goods:

At the option of the builder:

Either

- On actual basis where a builder is able to determine the actual value of the material / goods sold to the buyer in the course of providing service (Notification 12/2003); or

- On deemed basis after abatement at specified percentage - current abatement @ 67% for material / goods component be adopted (Notification No. 1/2006 ST dated 1.3.2006) – the rate is same for commercial and industrial as also residential construction.

III Composition Scheme

- 1% of total consideration including that towards floor rise and charges for any additional facilities/utilities provided by the builder for commercial, industrial and residential construction.

Village No. / Zone No.	Description	Rate of Open Land per Sq. Mtr. F.S.I. = 1	Rate of Land + Building in Rs. per Sq.Mtr. Built-up			
			Residential Building	Office / Commercial on Above floor	Shop / Commercial on Ground floor	Industrial Area
56	**MUMBAI SUBURB, TALUKA BORIVLI, VILLAGE GOREGAON** Map on page 138					
56/256	***Land:*** On North village boundary, on East creek, on South and West village boundary. **C.T.S.No.** 1pt, 1/A/1A, 1A/1A, 1A/1B, 1A/1P, 1A/1/1 to 1A/1/5, 1A/1/8, 1A/1/13, 1A/2P, 1A/3	16200	36100	45100	54100	36100
56/257	***Land:*** On North village boundary, on East Link Road, on West and South creek. **C.T.S.No.** 1A/2	25200	50300	62800	75400	50300
56/258	***Land:*** On North village boundary, on East S.V.Road, on South village boundary, on West Link Road. **C.T.S.No.** 1 to 21, 23, 24	21500	43200	54000	69200	43200
56/259	***Road:*** Swami Vivekanand Road. **C.T.S.No.** 22, 25 to 34, 36 to 40, 42, 43	31700	52900	75700	98300	52900
56/260	***Land:*** On North village boundary, on East railway line, on South village boundary, on West S.V.Road. **C.T.S.No.** 35, 41, 44 to 171, 327	27500	55000	68700	82500	55000
56/261	***Land:*** On North village boundary, on East Express Highway, on South village boundary, on West Railway line. **C.T.S.No.** 172 to 257, 275, 326	20000	40000	53700	67300	40000
56/262	***Land:*** On North, East and South village boundary, on West Express Highway. **C.T.S.No.** 258 to 274, 276 to 325, 358	11600	29600	43200	56600	29600

Revenue Generated through Ready Reckoner

Revenue generated in Mumbai from Stamp Duty and Registration Department during last few years.

Financial Year	Documents Registered	Registration Fees Rs. In Crs.	Stamp Duty Rs. In Crs.
1999-2000	61067	43.19	1036.34
2000-2001	68195	51.92	1170.40
2001-2002	78502	63.20	1223.47
2002-2003	92092	84.39	1437.58
2003-2004	108539	114.64	1715.78
2004-2005	138171	159.11	2030.79
2005-2006	155143	182.07	2323.09
2006-2007	162509	181.84	3233.55
2007-2008	171331	179.52	4406.50

Source: **Rajesh Mehta,** *CMD, Raha Realtors Pvt. Ltd.*

Village No. / Zone No.	Description	Rate of Open Land per Sq. Mtr. F.S.I. = 1	Rate of Land + Building in Rs. per Sq.Mtr. Built-up			
			Residential Building	Office / Commercial on Above floor	Shop / Commercial on Ground floor	Industrial Area
36	**MUMBAI SUBURB, TALUKA ANDHERI, VILLAGE VILEPARLE EAST** Map on page 116					
36/182	**Road:** Sahara Road.	36000	55700	63000	85600	63000
	C.T.S.No. 12pt, 14pt to 18pt, 34pt, 119, 120, 137, 138, 139, 333, 345, 346					
36/183	***Land:*** On North village boundary, on East Western Express Highway, on South ward boundary, on West railway line.	48200	80300	112200	155100	80300
	C.T.S.No. 1 to 118, 121 to 136, 140 to 332, 334 to 344, 347 to 787, 792 to 2015, 2017, 2044 to 2046, 2049					
	T.P.S.Vile Parle I F.P.No. 1, 3, 4, 5, 6, 8, 10, 13 to 31, 33 to 40, 42 to 49, 51 to 64, 66, 67, 69, 70, 72 to 84, 87, 90, 91, 95, 97, 98, 102 to 105, 109, 111 to 114, 118, 120 to 122					
	T.P.S.Vile Parle II. F.P.No.1, 2, 7, 11, 12, 19, 23, 28, 29, 32, 37, 38, 39, 41, 46, 47, 50, 54, 55, 56, 64, 65, 68, 71, 73, 74, 78A, 79, 82 to 86, 88, 89, 92 to 94, 96, 99, 100, 101, 105 to 108, 108A, 110 to 112, 114 to 117, 119, 123 to 199, 199A, 200 to 238, 238A, 239 to 254, 254A, 255 to 296, 297A, 298 to 346, 346A, 347, 348					
	T.P.S.Vile Parle No. IV, IVA F.P.No. 1, 9, 10A, 10B, 10C, 11+28, 150B					
36/184	***Land:*** On North ward boundary, on East Express highway, on South village boundary, on West railway line.	44700	74600	115500	144900	74600
	C.T.S.No. 2018 to 2038, 2040 to 2043, 2047, 2048, 2050 to 2055, 2057 to 2074					
36/185	***Land:*** On North ward boundary, on West Express Highway, on East village boundary, on South village boundary.	29200	54100	70400	88600	70400
	C.T.S.No. 2016, 2039, 2075 to 2085					
36/186	***Land:*** On North-East village boundary, on West Express highway, on South ward boundary.	17200	38200	42500	54600	48500
	C.T.S.No. 788 to 791, 2092A/1, 2092A/2, 2092A/3, 2093					