Larger Bench: Service tax is leviable on service element in composite contracts even prior to June 01, 2007

Tax Alert
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Larsen and Toubro Limited & Others vs. CST, Delhi & Others[1] – Larger Bench of CESTAT

JUDGEMENT OF THE LARGER BENCH

The issue is whether Service tax would be leviable on the service element in a composite contract, prior to introduction of taxing entry for works contract services (i.e. for the period prior to June 01, 2007, whether Service tax is applicable on the service portion of a contract).

The Larger Bench of the CESTAT, in a significant judgement [pronounced following a majority decision of 3:2] held that service elements in composite works contracts (involving transfer of property in goods and rendition of services), where the subject services are classifiable under the taxing entries of Commercial or Industrial Construction Service ('CICS'), Construction of Complex Service ('CCS') or Erection, Commissioning and Installation Service ('ECIS'), are liable to levy of Service tax, even for the period prior to introduction of the taxing entry for works contract services.

EVENTS LEADING TO THE REFERENCE

1. Larsen & Toubro Limited ("L&T") filed an appeal to the CESTAT, challenging an adjudication order which confirmed a demand of Service tax on the consideration received by L&T in pursuance to a turn-key contract executed by L&T. The said services were classified under the taxing entry of CICS.
2. L&T contended that there was an extant conflict among decisions rendered by two sets of Larger (comprising three members) Benches on the subject issue. Decisions of three member Benches of the CESTAT, in ***Jyoti Ltd. vs. CCE***[2] and in ***CCE vs. Indian Oil Tanking Ltd.***[3] had ruled that works contracts were taxable only w.e.f June 01, 2007, on the introduction of sub-clause (zzzza) in Section 65(105) of the Finance Act, 1994 but, not prior thereto. That these services could not be classified under the other pre-existing taxing entries and be brought to tax. Earlier, a decision by a two member Bench of the CESTAT in ***Daelim Industrial Co. Ltd. vs. CCE***[4], had taken the same position, which was later doubted and the issue referred to a three member Bench, by the President CESTAT. The said reference was answered in favour of the Revenue in ***CCE vs. BSBK Pvt. Ltd.***[5].
3. In ***BSBK Pvt. Ltd.***, the three member Bench ruled that turn-key contracts could be vivisected; and the discernible service elements therein abstracted and brought to Service tax, provided such services were capable of being regarded as taxable services, as defined under the Finance Act, 1994. However, the Larger Bench, while rendering this judgement neither analyzed nor disagreed with the operative ratio delineated in the earlier decisions by the Larger Benches (as discussed above).
4. Owing to the conflict of views and opinion between Larger Bench decisions in ***Jyoti Ltd.***, ***Indian Oil Tanking Ltd.*** *and* ***BSBK Ltd.***, the President of the CESTAT, referred the issue to the Larger Bench (five members), for its consideration and in the interests of principle of coherence of precedents.

OBSERVATIONS BY THE MAJORITY (3 MEMBERS)

The Hon'ble Members of the CESTAT observed and held that:

1. The Hon'ble High Court of Delhi in ***G.D. Builders & Others vs. UOI***[6] had examined, in great detail, the legislative history of Service tax law, various statutory provisions, judicial precedents, and upon consideration of these, came to the conclusion that service elements of a composite contract can be subjected to Service tax even prior to June 01, 2007. It was observed that *"The Tribunal being sub-ordinate to the High Court in the judicial hierarchy cannot sit in judgement on the correctness of a decision passed by the High Court notwithstanding the liberty granted. The liberty granted is conditional, that is, the larger bench has to consider first as to whether the decision in the GD Builder's case covers the issue before it and if so, the matter shall be closed"*.

[1] Service Tax Appeal No. 58658 of 2013, 550 of 2007 and 622 of 2007
[2] 2008 (9) STR 373
[3] 2010 (18) STR 57
[4] 2003 (155) ELT 457
[5] 2010 (253) ELT 522
[6] 2013 (32) STR 673 (Del.)

The decision in ***G.D. Builders*** is not based on a concession and is not *per incuriam* and consequently, is binding on all sub-ordinate courts including this Tribunal.

2. The issue of divisibility of an indivisible contract for the purpose of levy of Service tax has been confirmed and sustained by the Hon'ble Supreme Court in ***Tamil Nadu Kalyana Mandapam Assn. vs. UOI***[7] and ***Association of Leasing and Financial Services Companies vs. UOI***[8]. The contention that a composite contract consisting of supply of goods and supply of services cannot be vivisected for the purpose of taxation does not take into account the reality/substance of economic transactions which are subjected to tax.

3. There cannot be any challenge whatsoever to levy of Service tax on the service element in a composite contract merely because there exist no machinery provisions to compute or quantify the amount of tax *[it was argued by the assessee-appellants that prior to June 01, 2007, in the absence of a machinery provision prescribed for computation of tax, the levy of Service tax on a composite contract is not legally tenable*]. Section 67 of the Finance Act, 1994 (itself) provides the measure for levy of Service tax. Further, exemption notifications such as contained in Notification No. 12/2003-ST, No. 15/2004-ST and No. 1/2006-ST provide for an alternate, optional, hassle free method of quantification of Service tax subject to satisfaction of conditions stipulated therein.

4. As per various State sales tax/VAT laws, Sales tax/VAT is leviable on the sale of value of goods involved in the works contract being CICS, CCS and/or ECIS, either on actual basis or on composition basis. Therefore, the value of goods supplied in a composite contract is well known. From the total value of the composite contract, if the value for the supply of goods is deducted, the remainder would be the value of the service component. Therefore, the argument of lack of machinery provision for determination of tax liability is only a figment of imagination and has no practical relevance.

5. Reliance cannot be placed on the Union Finance Minister's speech to argue that works contract is leviable to Service tax only w.e.f. June 01, 2007 and not earlier. Statutes, more so taxing statutes, have to be interpreted based on the language used/employed by the legislature, and not on the basis of the Finance Minister's speech.

6. Consequently, the CESTAT's decision in ***BSBK Pvt. Ltd.*** holding that a works contract is a taxable service prior to June 01, 2007 is valid in law.

OBSERVATIONS BY THE MINORITY (2 MEMBERS)

1. The conclusions drawn by the Hon'ble High Court of Delhi in ***G.D. Builders*** decision that (i) works contract is a taxable service even prior to June 01, 2007 (under CICS, COCS & ECIS); (ii) that merely because no rules are framed for computation, it does not follow that no tax is leviable; (iii) the measure of the levy *per se* and in all contexts has no impact on the competence of the legislative exaction; and (iv) a deficit in a central legislation with respect to computation/valuation provisions is offset by existence of such provisions in a State legislation, are contrary to settled principles of law *qua* binding precedents which have either not been brought to the notice of the Hon'ble High Court or, the critical analyses thereunder have not been sensitized to the Court. The ***G. D. Builders*** decision is thus in error on the principles of *per incuriam* and *sub-silentio*.

2. CICS, CCS and/or ECIS read with the charging provisions contained in Section 66 of the Finance Act, 1994, the valuation provisions contained in Section 67, Valuation Rules, 2006 (prior to insertion of Rule 2A therein, w.e.f June 01, 2007) and relevant exemption notifications do not authorize a levy of Service tax on a works contract. Taxable services of CICS, CCS and/or ECIS only cover such contracts/transactions which involve pure supply labour or, rendition of services.

3. It is only since the insertion of sub-clause (zzzza) in clause (105) of Section 65, w.e.f June 01, 2007, complemented by the amended Valuation Rules, 2006 (inserting Rule 2A) and the Composition Rules, 2007 that the requisite and appropriate statutory framework, for charging, levy, collection and assessment of Service tax, supported by appropriate computation/valuation machinery on a works contract stands incorporated in the statute-book to enable the levy.

4. Rule 2A of the amended Valuation Rules, 2006 [applied exclusively to 'works contract' referred to in sub-clause (zzzza)] inserted w.e.f June 01, 2007, mandates specified exclusions/deductions from the gross amount received on execution of a works contract, and is set out in terms of the principles/norms particularized and catalogued in the landmark judgement in case of ***Gannon Dunkerley***[9].

5. The Composition Rules, 2007 [introduced w.e.f June 01, 2007] made exclusively applicable to works contract services, provide an optional composition protocol that enables availment of calibrated deductions, particularly appropriate to situations where proof of the value of sale of goods by accretion/incorporation cannot be furnished.

[7] 2004 (5) SCC 632
[8] 2010 (20) STR 417 (SC)
[9] (1993) 088 STC 0204

6. Hon'ble Finance Minister in his Budget Speech categorically stated that a new levy is proposed, to impose Service tax on works contract service clearly indicating that works contract service is not an extant taxable service and hence, the need for a new taxing entry.

ELP COMMENTS

This judgement has delivered a verdict on a contentious issue, and has resultantly opened the doors for the Revenue Department to levy and collect Service tax on the service element of a composite contract for the period prior to June 01, 2007.

The CESTAT's verdict showcases the diversity of thoughts and views on various legal propositions and issues, but, at the end of the day, assessee(s) will have to either litigate the issue further or deposit the tax demanded.

Assessees would have to challenge the said decision before the Hon'ble Supreme Court, in order to attain finality on the issue. Until such a challenge is sustained, so far as assessees are concerned, the key question is whether notices have been issued to them and the status of the ensuing legal proceedings. Expectedly the Revenue Department will, following the judgement, exert pressure to recover tax dues but where the Revenue Department had not issued notices (at the very least), the Department will find its hands tied-up for the reason of limitation.

However, when it comes to penalties, the assessees can well take refuge in the settled legal position that penalty should not be imposed in a case where the issue is one of interpretation and subject matter of divergent views.

Clearly, the last word on this subject has not yet been said.

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