Service Tax on Construction Activities – The recent findings of Bombay High Court

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BACKGROUND

The Finance Act, 1994 was amended by the Finance Act, 2010 to introduce an explanation to Section 65(105)(zzq) and Section 65(105) (zzzh) of the 1994 Act. Besides, a new provision was introduced in the form of Clause (zzzzu) in Section 65(105). In these proceedings, there is a challenge to the constitutional validity of those provisions. In the Finance Act of 2004, Clause (zzq) was introduced in Section 65(105) in order to bring within the fold of the expression *taxable service* any service provided or to be provided to any person by a commercial concern, in relation to construction service. The expression 'construction service' was defined in Clause (30a) to mean *inter alia* the construction of a new building or civil structure or repairs, alteration or restoration of a building or civil structure, used, occupied or engaged or to be used, occupied or engaged primarily in commerce or industry. By the Finance Act of 2005 Clause (zzzh) was introduced into Section 65(105) so as to bring within the purview of the expression taxable service, a service provided or to be provided to any person by any other person "in relation to construction of complex". Simultaneously, Clause (25b) was introduced to provide for a definition of the expression "commercial or construction service".

By the Finance Act of 2010, an explanation has been inserted into Clause (zzq) and Clause (zzzh) of Section 65(105). Clause (zzq) relates to a service provided or to be provided to any person by any other person in relation to commercial or industrial construction and Clause (zzzh), a service in relation to the construction of a complex. Both bear the following explanation:

> Explanation industrial - 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 authorised 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 authorised 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.

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Clause (zzzzu) has been introduced in Section 65(105) as a result of which a service provided or to be provided of the following nature is also brought in within the purview of a taxable service:

> (zzzzu) to a buyer, by a builder of a residential complex, or a commercial complex, or any other person authorised by such builder, for providing preferential location or development of such complex but does not include services covered under sub-Clauses (zzg), (zzq), (zzzh) and in relation to parking place.

Explanation - For the purposes of this sub-clause, "preferential location" means any location having extra advantage which attracts extra payment over and above the basic sale price.

The constitutional validity of the explanation which was inserted into Clauses (zzq) and (zzzh) of Section 65 (105) and of Clause (zzzzu) is assailed in this writ petition.

Defining Issues

Whether amendment is beyond the legislative competence of Parliament since the subject matter of the tax falls within the legislative power of the States under Entry 49 of List II to the Seventh Schedule of the Constitution?

Whether the provisions of Section 65(105) (zzzzu) are unconstitutional because - (a) No element of service is involved whatsoever since the advantage that is sought to be brought to tax attaches to the preferential location or development of the property; (b)There is no voluntary act of rendering service; (c) The tax must be regarded as a tax on land per se, because it is a tax on location; and (d) What is the preferential location or an extra advantage or a payment over and above the basic sale price is not defined?

Arguments Advanced - Petitioners Grounds

(i) The amendment is beyond the legislative competence of Parliament since the subject matter of the tax falls within the legislative power of the States under Entry 49 of List II to the Seventh Schedule of the Constitution. Explanation would indicate that it is a transaction of sale or an agreement to sell an immovable property yet to be constructed or under construction and not certified to be complete by the appropriate authority which is sought to be taxed. Unless there is a transaction which involves a transfer of immovable property or a contemplated transfer and a receipt of money, no charge would arise. Hence, the tax is directly one on the transfer of land or buildings and would fall within the legislative competence of the State legislatures under Article 246(3) read with Entry 49 of List II;

(ii) By the explanation to Clauses (zzq) and (zzzh), the construction of a new building or complex is by a deeming fiction treated to be a service when - (i) The construction is intended for sale and (ii) some receipt is envisaged before the grant of a completion

certificate by the appropriate authority. According to the Petitioners the tax in pith and substance is not on construction but on the sale of land and the element of sale is essential to fasten the charge. The sale of immovable property before, during or after construction but before a completion is granted can by no stretch of imagination be regarded as a service. Once a completion certificate is received, there would be a sale pure and simple. In substance, the tax is on the transfer of land and buildings and therefore a tax on land and buildings within the meaning of Entry 49 of List II;

(iii) The provisions of Section 65(105)(zzzzu) are unconstitutional because:

(a) no element of service is involved whatsoever since the advantage that is sought to be brought to tax attaches to the preferential location or development of the property;

(b) There is no voluntary act of rendering service;

(c) The tax must be regarded as a tax on land *per se* because it is a tax on location; and

(d) What is the preferential location or an extra advantage or a payment over and above the basic sale price is not defined.

The provision is therefore vague and suffers from the vice of an excessive delegation of legislative power since the enforcement of the provision is left to the unguided discretion of the administrative authority;

(iv) Between a builder and a contractor who constructs a building, there may be a service element involving a service provider and receiver. Between the builder and a buyer there is no provision of service. The title to the building which is under construction vests in the builder. After construction is complete and a final transfer of title takes place, there can in any event be no provision of service;

(v) The explanation has brought in two fictions of a deemed service and a deemed service provider which will fall foul of the provisions of Sections 67 and 68 of the Finance Act.

Union of India's Grounds

(i) The explanation to Clauses (zzq) and (zzzh) does not tax a transfer of property at all. The subject matter of the tax is the service rendered during the course of construction. Construction is an activity on land or a user of land which does not fall within the ambit of Entry 49 of List II;

(ii) The explanation to Clauses (zzq) and (zzzh) was enacted to plug a loop hole and to obviate a seepage from the value added net of agreements which intrinsically involved service during the course of construction;

(iii) In the alternate even if the explanation was to be construed to bring within the ambit of the tax a transfer of property, it is a settled principle of law that a tax on the transfer of property does not fall under Entry 49 of List II;

(iv) Construction reasonably construed does involve an element of service. Even if arguably it were to be suggested that no element of service was involved, that would not impinge on the power of parliament as long as it does not trench upon a subject reserved to the States in the state list of the Seventh Schedule;

(v) Clause (zzzzu) was introduced to cover diverse services which builders provide under different heads for which charges are levied separately. Parliament has intervened in order to ensure that they do not slip out of the value added tax net. If no charge is levied for a service, no liability would arise. Builders do charge for providing preferential locational and other development amenities which form part of service rendered. There is no vagueness or arbitrariness in the provision.

Decision of the High Court

Explanation inserted by the Finance Act of 2010 clearly brings within the fold of taxable service a construction service provided by the builder to a buyer where there is an intended sale between the parties whether before, during or after construction. The explanation was specifically legislated upon to expand the concept of taxable service. Thus, reaches out to service provided by builders to buyers in pursuance of an intended sale of immovable property before, during or after construction. The principles which emerge from various Supreme Court precedents expounding Entry 49 of List II are:

(i) A tax on land and buildings is a tax which is imposed on land and buildings as units;

(ii) In order to be a tax on land and buildings, the tax must be directly imposed on land and buildings;

(iii) A tax on a particular use of land or of a building or an activity in connection with land or buildings is not a tax on land and buildings;

(iv) A tax on a contract or arrangement in relation to land or buildings is not a tax on land and buildings;

(v) A tax on income which arises from land or buildings is not a tax on land and buildings; and

(vi) A tax on a transaction involving a transmission of title to or a transfer of land and buildings is not a tax on land and buildings under Entry 49 List II.

The charge of tax under Section 66 of the Finance Act is on the taxable services defined in Clause (105) of Section 65. It is on the rendering of a taxable service. The taxable event is

the rendering of a service which falls within the description set out in Sub-Clauses (zzq), (zzzh) and (zzzzu). Parliament, in bringing about the amendment in question has made a legislative assessment to the effect that a service is rendered by builders to buyers during the course of construction activities. The legislative assessment does not impinge upon the constitutional validity of the tax once the true nature and character of the tax is held not to fall within the scope of Entry 49 of List II. So long as the tax does not fall within any head of legislative power reserved to the States, the tax must of necessity fall within the legislative competence of Parliament. The legislative assessment on the basis of which a service tax is levied on the value addition which builders provide to buyers in the form of service rendered in the course of construction and construction related activities can by no stretch of imagination be regarded as so manifestly absurd so as to impinge on the constitutional validity of the provision. Accordingly, the submission that the explanation brings in two fictions and is *ultra vires* the provisions of Sections 67 and 68 of the Finance Act held to be completely lacking in substance. The levy under Section 66 is on the value of taxable services. Section 65(105) defines taxable services.

Clause (zzzzu) of Section 65(105) of Act, brings in, services provided to a buyer by a builder of a residential complex or a commercial complex for providing a preferential location or development of such complex, but to the exclusion of services covered under sub Clauses (zzg), (zzq) and (zzzh) and those in relation to parking places. A preferential location is defined to mean any location having extra advantages which attracts extra payment over and above the basic sale price. The circular issued by the CBEC dated 26.2.2010 takes note of the fact that in addition to activities involving construction, completion and furnishing repair, alteration, renovation or restoration builders of residential or commercial complexes provide other facilities and charge separately for them. These charges do not form part of the taxable value for charging of tax. The facilities include (i) Prime/preferential location charges for allotting a plot or commercial space according to the choice of the buyer; (ii) Internal or external development charges which are collected for developing and maintaining parks, laying of sewage water pipelines, providing access roads and common lighting and other like charges. Since these charges are in the nature of service provided by the builder to the buyer over and above the construction service, they were brought within the purview of Clause (zzzzu). As rightly contended by Revenue, if no charge is levied for a preferential location or development, no service tax would be attracted in the first place. Builders, however, follow the practice of levying charges under diverse heads including preferred development of the property intended to be sold or in terms of a preferred location which is made available to the buyer. Clause (zzzzu) only intends to obviate a

leakage of revenue and plugs a loophole which would have otherwise resulted. If no separate charge is levied, the liability to pay service tax does not arise and it is only where a particular service is separately charged for that the liability to pay service tax arises. The fact that the service is rendered in the context of a location, does not make it a tax on land within the meaning of Entry 49 of List II. The tax continues to be a tax on the rendering of a service by the builder to the buyer. There is no vagueness and uncertainty. The legislative prescription is clear. Hence, there is no excessive delegation.

Comment

Background

The service tax provisions relating to construction services cover two types of services - (a) Commercial or industrial construction which is taxable w.e.f. 10th September, 2004 and (b) Construction of complex (residential complex of more than 12 residential units) which is taxable w.e.f. 16th June, 2005.

If works contract tax is payable on these construction activities, these services would get covered under "works contract service" w.e.f. 1st June, 2007.

Initially, there were disputes regarding services provided by a builder or a developer for construction of residential complex or commercial premises.

However, on basis of Court decisions and CBE&C circulars, it was settled that a builder entering into contract for sale of flat or industrial unit (gala) or shop or a developer entering into contract for construction of an individual flat for personal residential use of client are not liable to pay service tax.

The basic reason is that the contract of customer with builder or developer is for sale of a ready flat or industrial unit or shop. It is not a construction contract, i.e. it is not contract for provision of construction service.

1.1 Change made in Budget 2010

In the Finance Act, 2010, an explanation has been added w.e.f. 1st July, 2010, to the definition of 'commercial or industrial construction' and 'construction of residential complex', as follows:

> Explanation. For the purposes of this sub-Clause, construction of a complex which is intended for sale, wholly or partly, by a builder or any person authorised 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 a person authorised by the builder before the 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.

In case of commercial or industrial construction service, the words used are "construction of a new building" in place of "complex". Otherwise, the wording is identical.

Thus, by a "deeming provision", an activity which is not "service" as per Court decisions and CBE&C's own earlier circulars will be a 'deemed service' for the purpose of levy of service tax.

Explanation being added is not a valuation provision.

1.2 Effect of the change made by the explanation

The effect of the change is that the service tax will not apply *only* when a builder sales a ready flat or shop or industrial unit (gala) after Building completion certificate is obtained from local authority (like Municipal Corporation, Municipality, Gram Panchayat, etc.) and *entire* consideration is obtained only after building completion certificate is obtained.

In all other cases, the builder will be liable to pay the service tax. It is well known that in most of the cases, builder constructs buildings mainly on raising funds from prospective buyers. Further, even after building is completed and ready for occupation, there is delay in obtaining building completion certificate from the authorities.

Thus, practically in all cases, the builder/developer will be liable to pay service tax, except in case of few flats or shops or commercial galas, which he usually keeps for sale at a later date at higher prices. Even in that case, the builder/developer will not be liable only if entire transaction (including receipt of money) takes place after obtaining 'completion certificate' from municipal or other competent authority.

1.3 Amendment does not apply to works contract service

The amendment will *not* apply if the contract is covered under works contract service i.e. where Vat/Sales tax is payable on the contract.

1.4 Authority to issue building completion certificate

Government has issued MF(DR) order No. 1/2010 dated 22-6-2010 for 'Removal of Difficulty'. The order is effective from 1-7-2010 and it clarifies that building completion certificate can be issued by Architect, Chartered Engineer or Licensed Surveyor who is authorised under any law for the time being in force, to issue a completion certificate in respect of residential or commercial or industrial complex, as a precondition for its occupation.

CENVAT Credit

Builder/developer can get and utilise Cenvat credit of all the input services and capital goods only if he is paying service tax on the value of services at 10.30 per cent. If the builder is paying service tax under simplified scheme on 25 per cent/33 percent of total value, he cannot avail any CENVAT credit at all.

If service provider is providing both taxable and exempt service, then it is advisable to avail CENVAT credit only in respect of input services directly attributable to taxable services. If CENVAT credit is availed of common input services, then rigors of proportionate reversal or payment of 6 per cent 'amount' on exempted services, as contained in Rule 6 will apply.

Preferential location and development of complex service

As per section 65(105)(zzzzu) of Finance Act, 1994 (inserted w.e.f. 1-7-2010), any service provided or to be provided, to a buyer, by a builder of a residential complex, or a commercial complex, or any other person authorised by such builder, for providing preferential location or development of such complex but does not include services covered under Sub-clauses (zzg), (zzq), (zzzh) and in relation to parking place, is a "taxable service".

Explanation - For the purposes of this sub-clause, ''preferential location'' means any location having extra advantage which attracts extra payment over and above the basic sale price.

On these services, tax is payable at full rate of 10.30 per cent without any abatement.

The Punjab and Haryana High Court has recently in the case of *Shubh Tim Steel Ltd.* v. *Union of India And Others* 2010-TIOL-765-HC-P&H-ST upheld the validity of levy of service tax on 'Renting of Immovable Property Service' with retrospective effect from 1st June, 2007. Now, the same High Court in its recent judgment delivered on 1st December, 2010 in case of *G.S. Promoters* v. *Union of India & Anr.* 2010-TIOL-813-HC-P&H-ST has upheld the validity of the Explanation inserted in Section 65(105) (zzzh) of the Finance Act that defines the terms "taxable service" in relation to "construction of complex service". This amendment has come into force on 1st July, 2010.

Conclusion

Residuary power to legislate on a field of legislation which does not fall within exclusive domain of the States is vested in Parliament under Article 248 of Constitution read with Entry 97 of List I. Legislative assessment on the basis of which a service tax is levied on the value addition which builders provide to buyers in the form of service rendered in the course of construction and construction related activities can by no stretch of imagination be regarded as so manifestly absurd so as to impinge on the constitutional validity of the provision. The tax is on value addition involved in rendering of service.