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Budget 2010-11 and it Impact on 'Construction of Residential Complex' Service

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The year 1994 earmarked the introduction of 'Service Tax' into the Indian legal system under the enacting legislation The Finance Act, 1994. Initially, it covered only three services but today it covers more than 118 services. Since liberalization in 1991, the Government has unshackled its controls over various sectors and introduced a self-regulation regime instead, which marked a spur in various activities. One such activity was the construction industry which has grown manifold and has, in fact, become one of the most promising and fast developing sectors in today's economy.

Today, the real estate sector is trying to recover after the debacle it suffered in 2008. However, its fledgling recovery is being viewed by the government with remarkable short sightedness and the sector, it would appear, is being treated as the proverbial goose that lays the golden eggs- only. The government is voraciously trying to kill the goose to retrieve all golden eggs (if there are any) instead of allowing the goose to continuously lay golden eggs. The real estate sector, which has been trying to recover, will be hamstrung by levy of taxes as proposed in the Budget 2010-11. In order to understand the impact of the levy proposed by the Budget 2010-11 and its effects, the legislative history of this service must be understood.

Legislative History:

The Construction Sector came within the purview of Service Tax in the year 2004 under the generic heading 'Construction Services'.[1] Essentially the heading covered: (a) construction of a new building/ a civil structure/a part thereof; and, (b) repairing/restoration services and other similar kind of services

* Director General of Service Tax – the centralized authority which deals with Service Tax issues pan India, under the Central Board of Excise & Customs (Now C.B.E.C and S.T.)

[1] Finance Act of 2004, Sec. 65 (30a)

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or work; which was primarily intended for commercial or industrial purpose. As would be apparent, this classification caused services relating to commercial or industrial purpose only and did not include residential complex services.

The Construction sector was witnessing high upward growth rates and consequential growth in revenue stream. As was expected, the Government, on a constant lookout to increase its tax base, made an attempt a year later when it bifurcated the generic heading of "Construction Services" into

two independent categories of taxable services which are distinguishable by their nature and character, namely:

(a) 'Commercial or Industrial Construction' under Section 65 (25b); and

(b) 'Construction of Complex' Services under Section 65 (30a).

In terms of Section 65 (25b) the scope of Construction Services with respect to commercial or industrial use was expanded as compared to 1994. Simultaneously, the entire gamut of construction services related to "residential complexes" [as defined under Section 65 (91a)] was brought under the service tax net in terms of Section 65 (30a).

This article is an attempt to analyse the service taxability of 'construction of residential complex' in the light of the recent ruling made by the Authority for Advance Rulings and other similar rulings pertinent to this issue.

The Service

The Construction of Complex service is defined in terms of Section 65 (30a) as under:

"Construction of Complex means—

(a) construction of a new residential complex or a part thereof; or

(b) completion and finishing services in relation to residential complex such as glazing, plastering, painting, floor and wall tiling, wall covering and wall papering, wood and metal joinery and carpentry, fencing and railing, construction of swimming pools, acoustic applications or fittings and other similar services; or

(c) repair, alteration, renovation or restoration of, or similar services in relation to, residential complex;"

A basic reading of the Section shows that it covers the activity of construction; and completion and repairs (in all their respective hues) of a residential complex.

The term 'residential complex'[2] has been defined under Section 65 (91a) and, as would be apparent, to qualify as a residential complex, the building or buildings should have more than twelve residential units, a common area, any one or more facilities or services like lift, parking space, community hall

etc. all located within a common premises with the layout of such premises being approved by an authority under any law for the time being in force. This definition had specifically excluded a complex intended for 'personal use' as a residence by a person.

The Clarification

Upon the inclusion of "Construction Services" within the Service Tax net in 2004, the Ministry of Finance, Department of Revenue had issued a Circular[3] which addressed the taxability of services rendered. It was clearly stated in the Circular that Estate Builders who construct buildings/civil structures for themselves (for their own use, renting out or for selling it subsequently) are not taxable Service Providers. However, if such real estate owners hire contractor/contractors, the payments made to such contractor(s) would be subject to Service Tax under this head provided the contractor (s) is a Commercial concern.

Subsequently, upon the bifurcation of the entry relating to Construction Services, the Department had come out with a further clarification[4]. However, there was no deviation from the position stated in the Circular, dated 17.09.2004, and possibly, the position relating to "construction for self" remained unaltered as not covered under service tax.

[I] The case of the 'Raheja Builders'

In the year 2005, merely a year after construction services were covered under the Service Tax net, the Supreme Court of India took up for hearing, and decision, an appeal filed in the year 2000 before it by M/s Raheja Developers.[5]

The question which arose for consideration of the Hon'ble Court was "whether the appellants (K. Raheja Development Corporation) are dealers and are liable to pay turnover tax under the Karnataka Sales Tax Act?"

[2] Sec. 65 (91a) of Finance Act, 1994
[3] Circular dated 17.09.2004, Issues pertaining to Service Tax – regarding the Finance Bill, 2004
[4] F.No.B1/6/2005-TRU, New Delhi dated 27.07.2005
[5] K. Raheja Development Corporation v. State of Karnataka, AIR 2005 SC 2350

A relevant incidental question which arose, while deciding whether K. Raheja would qualify as a "dealer", was whether the contract between K. Raheja and the prospective purchaser would constitute a "works contract" or not? While answering in the affirmative, the Hon'ble Court held that:

"It is thus to be seen that under Karnataka Sales Tax Act the definition of the words "works contract" is very wide. It also includes "any agreement for carrying out either for cash or for

deferred payment or for any other valuable consideration, the building and construction of any movable and immovable property" (emphasis applied). The definition would therefore take within its ambit any type of agreement wherein construction of a building takes place either for cash or deferred payment, or valuable consideration. To be also noted that the definition does not lay down that the construction must be on behalf of an owner of the property or that the construction cannot be by the owner of the property. Thus even if an owner of property enters into an agreement to construct for cash, deferred payment or valuable consideration a building or flats on behalf of anybody else it would be a works contract within the meaning of the term as used under the said Act.

We have heard the parties, perused the various documents and considered the cases cited at the bar. As has been rightly submitted by Mr. Hegde the definition of the term `works contract' in the said Act is an inclusive definition. It does not include merely a works contract as normally understood. It is a wide definition which includes "any agreement" for carrying out building or construction activity for cash, deferred payment or other valuable consideration. The definition does not make a distinction based on who carries on the construction activity. Thus even an owner of the property may also be said to be carrying on a works contract if he enters into an agreement to construct for cash, deferred payment or other valuable consideration. We, therefore, do not need to go into the question whether the Appellants are owners as even if the Appellants are owners to the extent that they have entered into Agreements to carry out construction activity on behalf of somebody else for cash, deferred payment or other valuable consideration, they would be carrying out a works contract and would become liable to pay turnover tax on the transfer of property in the goods involved in such works contract. Further under the said Act there is no distinction between construction of residential flats or commercial units. Thus, a works contract, within the meaning of the term in the said Act, can also be for construction of commercial units. For the purposes of considering whether an agreement amounts to a works contract or not, the provisions of the Karnataka Ownership Flats (Regulation of Promotion of Construction, Sales, Management and Transfer) Act, 1974 will have no relevance.

It must be clarified that if the agreement is entered into after the flat or unit is already constructed, then there would be no works contract. But so long as the agreement is entered into before the construction is complete it would be a works contract."

Thus, as would be seen, the Court held, in terms of the typical definition of "works contract" under the Karnataka Sales Tax Act, that the particular agreement entered into between the Parties would qualify as a works contract. Further, the appellants (K. Raheja) would qualify as dealers and be liable to tax.

As would be apparent, the matter did not: (i) Pertain to Service Tax; or (ii) Construction Services; or (iii) even deal with the relevant period (after 2004, introduction of Service Tax on Construction

Services). Thus, to read any relevance of the same for the purposes of service tax would clearly be fallacious.

The Over-Kill

Forever on the lookout for more revenue, the Department issued a Circular, which contained departmental instructions relating to the Construction of Complex Services in the backdrop of the Raheja case decided by the Supreme Court. Completely overlooking: (1) the peculiar definition of "works contract" under the Karnataka Sales Tax Act; and (2) the typical transaction entered into between the parties in that case, the Circular stated as under:

"*In a recent decision of Supreme Court in case of M/s. Raheja Development Corporation v. State of Karnataka [2005 NTC (Vol. 27)-243 (copy enclosed) the Hon'ble Court has clarified "that the activities undertaken by builders for construction of flat/building for or on behalf of the prospective customers for consideration in cash or deferred payment is covered under the works contract and not under sale".*

Considering the above decision, if the construction is undertaken by the builder for prospective customer under an agreement for sale and after construction, the rights in property have been transferred to the said prospective purchasers, the activity will amount to "work contract" or taxable service is covered under the Service Tax and not sale…

It is viewed that Circular No. 80/10/2004-S.T., dated 17-9-2004, has no applicability with reference to "Construction of Complex Services" which was brought under service tax net only w.e.f. 16-6-2005, as an independent service. The definition of taxable service under section 62(zzh) includes "Any service provided or to be provided to any person by any person in relation to construction of complex, and is wide enough to include estate builders. In such cases, the tax liability is posed on both builders and hired contractors being independent service providers"

Thus it was directed by the Department that: (i) since, such sale of residential units amounted to a works contract; (ii) such works contract also included certain services; (iii) hence, such contract was subjected to levy of Service Tax under the category of 'Complex Construction' services. In effect, the Department annulled its earlier Circular, dated 17.09.2004, and brought the activities of Estate Builders with respect to residential complexes within the Service Tax net which was non-taxable in the earlier Circular.

The intention behind the Circular becomes apparent by the following lines:

"10. The all India tax collection under the service head of 'Construction of Complex' service is reportedly too low. Please initiate proactive measures to realize service tax on this service especially when 43 days are now left in the current fiscal".

This controversy bought the entire Construction Sector into a state of hysteria. There emerged an urgent requirement for the Government to put forth a consistent position and ensure some sort of

stability, which they did by way of a Circular, issued by the Department in 2007[6], wherein it was stated:

(i) If the builder/developer causes the construction of a residential complex, having more than twelve residential units, by a contractor then the contractor in the capacity of being the taxable service provider is required to pay service tax;

(ii) if the builder/developer engages no other person for such a construction then –

(a) service provider and receiver relationship would not exist.

(b) Moreover, the services provided would be in the nature of a self-supply. Hence, question of service tax liability would not arise at all.

This Circular, therefore, dealt with the relationship, if any, that existed between the contractor and the developer. However, it did not deal with the relationship between the developer and prospective purchaser.

Thus, as would be apparent from the above position emanating from the legislative history as well as the Clarifications / Circulars issued by the Department from time to time, the position pertaining to the relationship existing between a Contractor/Construction Agency on the one hand and the Land Owner / Developer on the other is quite well clarified. However, the relationship between the Developer / Land Owner on the one hand and the prospective purchaser on the other has not been clarified at all and is subject to substantial confusion. The added twist in the story could be a possible tripartite relationship between the Developer on the one hand; the Land Owner on the other and the prospective purchaser on the third. A manifestation of this confusion is quite apparent in the ruling made by the Authority for Advance Ruling in the matter of Harekrishna Developers[7].

[II] <u>Harekrishna Developers Case</u>

The Authority for Advance Ruling in this matter was not concerned with –

[6] Circular No. 96/7/2007-ST, dated 23.08.2007
[7] 2008 (10) STR 357 and 2008 (10) STR 341

(a) The relationship between a Contractor on the one hand and the Developer / Land Owner on the other; or

(b) A relationship between the Developer / Builder on the one hand and the Land Owner on the other.

The sole question which arose for consideration before the Authority in this matter pertained to the relationship between the Developer / Land Owner on one hand and the prospective purchaser on the other.

The Authority, while dealing with a situation where: (i) the Developer / Land Owner had entered into an Agreement contracting to sell a built up residential unit to the prospective purchaser; (ii) had collected monies from the prospective purchaser on agreed terms; and (iii) had to deliver a completed residential unit of the accepted specifications, unambiguously held that the fact that title or ownership in the property did not pass to the prospective purchaser in terms of the said Agreement was irrelevant in so far as the determination of the question whether the Developer/Land Owner was providing construction services to the prospective purchaser was concerned. In fact, the Authority held that once the Agreement was established between the Developer / Land Owner and the prospective purchaser, the construction activity undertaken by the Developer / Land Owner was for, and on behalf of, the prospective purchaser.

It is the most respectful and humble opinion of the Author that the ruling rendered by the Authority for Advance Rulings pertained to the facts presented before the Authority and may not apply universally. The Author submits that by equating an Agreement to Sell a constructed residential unit with a sale deed pertaining to the land over which such a unit is to be constructed, the ruling fell in a grave error.

Of the various permutations and combinations possible in a typical transaction relating to real estate, this Article shall be concerned with the following three possibilities:

1. The Land Owner / Developer sells the land to a prospective purchaser and simultaneously agrees to construct the dwelling unit on such land. The agreement relating to such a transaction may be a composite one or may be by way of two separate agreements.

2. The Land Owner / Developer having already constructed the dwelling unit on the concerned piece of land sells the completed unit against valuable consideration.

3. The Developer / Land Owner enters into the understanding or agreement with the prospective purchaser for the purchase of a completely constructed dwelling unit at some future point in time against valuable consideration which is to be paid in a staggered manner commencing from the

execution of the understanding or agreement and ending with the final document (sale deed) evidencing the transfer of the property with respect to the fully constructed dwelling unit to the prospective purchaser.

In so far as situation one is concerned, clearly these are two separate agreements whereby the first evidences the transfer of land in favour of the prospective purchaser thus making him the land owner.

Thereafter, the second agreement evidences the obligation of the Developer (not the land owner now) to construct the dwelling unit in consideration of the payments to be made (in a staggered manner). It is relevant to note that the payments made by the purchaser are specifically meant for the construction of the dwelling unit. The utilisation of the funds is clearly defined and they are meant to facilitate the construction of the dwelling unit.

As would be apparent, the first agreement (relating to the sale of land) would be an agreement for the sale of immovable property and would not be covered under Service Tax. However, the second agreement would clearly constitute an agreement in which the developer (not the land owner now) is the provider of construction services to the prospective purchaser (who is the land owner now) – i.e. the Service Provider - would be covered under Service Tax.

In so far as the second possibility is concerned, the Developer / Land Owner has concluded the construction of the dwelling unit and is now merely selling the completed immovable property. This agreement clearly pertains to the sale of immovable property and would not be covered under Service Tax at all.

This brings us to the third possibility, which fell for consideration before the Authority for Advance Rulings in the Hare Krishna Developers' case. The transaction envisaged in the third possibility is a two stage transaction. In the first stage, the Land Owner / Developer enters into an understanding or agreement with the prospective purchaser whereby the Land Owner / Developer agrees to make available to the prospective purchaser the entitlement to purchase or acquire the constructed dwelling unit (as and when it is completed) in consideration of the prospective purchaser agreeing to make staggered or interim payments in terms of the agreed schedule to the Land Owner / Developer. Thus, at this stage all that the prospective buyer is entitled to is another document or another act from the seller which would result in the prospective buyer acquiring ownership of the property. It is relevant to mention over here that at this stage the prospective purchaser does not enjoy or hold any of the

attributes of ownership in its favour. Undisputedly, the land is owned by the Developer / Land Owner and he continues to be in possession thereof. The prospective purchaser does not have any access to the site, except with the prior permission of the Developer / Land Owner. The design is formulated by the Developer / Land Owner and he merely informs the prospective purchaser of the stipulated design. There is no requirement of the Developer / Land Owner seeking the approval, much less prior approval, of the prospective purchaser before embarking on the construction of the residential units. In the same light, the specification to which the unit is to be made are for the sole discretion of the

Developer / Land Owner. To a given extent, the Developer / Land Owner may, of his own choice, allow some participation by the prospective purchaser in this regard; however, the same is usually neither mandated nor obligatory upon Developer / Land Owner.

Most important of all, it is necessary to appreciate at this juncture that the entire risk, which normally goes with the ownership of the asset unless specifically agreed or stated so otherwise, lies with the Developer / Land Owner. Any loss occasioned, during the construction of the residential units is to the account of the Developer / Land Owner and the prospective purchaser does not participate in it at all. The Insurance Policy, granting protection against any such harm or loss, is also usually in the name of Developer / Land Owner and not any or each of the prospective purchasers. Thus, as would be apparent, the entire ownership of the asset lies with the Developer / Land Owner and any construction services rendered during this time are in fact are rendered to self thus nullifying the possibility of any relationship such as a service provider and service recipient existing at all.

Thus, the question of the Developer / Land Owner carrying on construction activity for and on behalf of the prospective purchaser does not arise at all. In stage two of this transaction, once the dwelling unit has been completed and the Land Owner / Developer has fulfilled his obligation in terms of the understanding or agreement and the prospective purchaser has continued to make the payments (staggered in terms of the agreed schedule) to the Land Owner / Developer and has thus fulfilled its obligation under the agreement, a sale deed is executed by the Land Owner / Developer in favour of the prospective purchaser thus transferring all right, title and interests in the duly constructed dwelling unit. We would do well to recall here that the Developer / Land Owner, under an Agreement to Sell, merely makes available an entitlement to purchase the dwelling unit at a later date on a pre-determined value to the prospective purchaser. The Developer / Land Owner does not sell the dwelling unit at the time of agreement itself.

At the conclusion of the second stage the ownership of the asset, which is now an immovable property comprising the residential unit as per design / specification passes to the prospective purchaser who is now the owner. The entire risk in the property also transfers to the prospective

purchaser alongwith the ownership. Clearly, this is a sale of an immovable property and would not fall within the purview of the Service Tax.

Remedial Action

In line with the argument proposed in this Article, the CBEC has considered it fit to issue Circular No. 108/02/2009-ST dated 29.01.2009 clarifying the position viz Construction of Residential Complexes. It has been clearly enunciated in the said Circular that an Agreement to Sell does not create any title in favour of the proposed purchaser and the title remains in favour of the developer / builder / promoter only. As such no Service Tax would be payable on service provided to self by the developer / builder / promoter. The view expressed by the CBEC reaffirms the argument proposed in this Article.

Budget 2010-11

In the Budget, it is proposed that the below given Explanation be inserted after Section 65(zzzh).

"For the purpose of this sub-clause, the 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 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."

In effect, the Explanation, clears

(i) an agreement to sell as a Sale Deed;

(ii) the entitlement of an allottee or proposed buyer to buy a particular allotted space agreed to be sold subject to the performance of certain obligations as having matured and fructified into an ownership right; and

(iii) the service of construction provided by the developer as a service provided to the proposed Buyer.

Conclusions

With the changes in the 'Construction of Complex' service, as proposed in Budget 2010, the government is clearly trying to supersede the Hare Krishna Judgment rendered by the Authority on Advance Ruling. It will not only under mine the efficacy of the Authority on Advance Rulings (AAR) but it also puts the authority of the Judiciary in question. Time and again, the government has amended laws in order to nullify the effect of the judgment passed by any judicial authority. This is a clear abuse of power and it brings us to crossroads, leaving us in a dilemma, are the legislature and judiciary pillars of democracy or mere catapults of power?