Whitepaper on Service of Sub-Contractor: Taxable?

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This paper contains a brief on whether Service of Sub-Contractor is Taxable or not.

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Service of Sub-Contractor: Taxable?

The CESTAT, Hyderabad bench, in an appeal filed by Visesh Engineering, has set aside a demand of service tax on services provided by the appellant as a sub-contractor to the main contractor, NGRI. The appellant established on the basis of documents obtained through recourse to the Right to Information (RTI) Act that NGRI had paid service tax on the full value of service including the sub-contracted portion.

The issue of whether a sub-contractor has to pay service tax on the value of his service has been the subject of prolonged controversy. In the context of works contract in VAT the Supreme Court held in the case of Larsen & Toubro that VAT is on sales effected by transfer of property by accretion in the course of the work, and that this happened only once, not twice; therefore the VAT could be levied only once in the course of the contract on the same goods.

The CBEC has issued circulars on the subject of service tax on sub-contractors. In master circular dated 23 August 2007 on technical issues, the CBEC clarified as follows:

999.03/ 23-8-07	A taxable service provider outsources a part of the work by engaging another service provider, generally known as sub-contractor. Service tax is paid by the service provider for the total work. In such cases, whether service tax is liable to be paid by the service provider known as sub-contractor who undertakes only part of the whole work.	A sub-contractor is essentially a taxable service provider. The fact that services provided by such sub-contractors are used by the main service provider for completion of his work does not in any way alter the fact of provision of taxable service by the sub-contractor. Services provided by sub-contractors are in the nature of input services. Service tax is, therefore, leviable on any taxable services provided, whether or not the services are provided by a person in his capacity as a sub-contractor and whether or not such services are used as input services. The fact that a given taxable service is intended for use as an input service by another service provider does not alter the taxability of the service provided

The CBEC's clarification in 2007 thus required payment of tax by a subcontractor on input services used by the main service provider for completion of his work.

Again in 2011 the CBEC reiterated these instructions in response to a representation by Jaiprakash Associates, Noida. The facts were narrated in the instruction as follows:

> "The Works Contract service (WCS) in respect of construction of Dams, Tunnels, Road, Bridges etc. is exempt from service tax. WCS providers engage sub-contractors who provide services such as Architect's Service, Consulting Engineer's Service, Construction of Complex Service, Design Services, Erection Commissioning or Installation Service, Management, Maintenance or Repair Service etc. The representation by Jaiprakash Associates Limited seeks to extend the benefit of such exemption to the sub-contractors providing various services to the WCS provider by arguing that the service provided by the sub-contractors are 'in relation to' the exempted works contract service and hence they deserve classification under WCS itself."

In this case again, for provision of the service, which was exempt, the contractor used various services provided by sub-contractors, which were of a different nature from the main service. Pointing this out,

CBEC Circular No. 138/7/2011-ST dated 6 May 2011 opined that every service has to be classified and taxed in terms of its specific description and not in terms of a more general description.

As a follow-up to the issued discussed above, clarification was further sought as to the taxability of works contract service (WCS) provided by sub-contractors for dams, tunnels, etc. which were exempted and for which the contract was awarded to the main contractor. The CBEC clarified that:

> "in case the services provided by the sub-contractors to the main contractor are independently classifiable under WCS, then they too will get the benefit of exemption so long as they are in relation to the infrastructure projects mentioned above. Thus, it may happen that the main infrastructure projects of execution of works contract in respect of roads, airports, railways, transport terminals, bridges tunnel and dams, is sub-divided into several sub-projects and each such sub-project is assigned by the main contractor to the various sub-contractors. In such cases, if the sub-contractors are providing works contract service to the main contractor for completion of the main contract, then service tax is obviously not leviable on the works contract service provided by such sub-contractor."

The above clarifications issued by the CBEC make it clear that there are two categories of sub-contractors for works contract services: (i) those to whom the support services are outsourced and (ii) those to whom part of the main work is outsourced. Work done by (ii) is treated as work of the same nature as the service of the main contractor and the same exemption is available for such work. On the other hand, sub-contractors of category (i) provide services that are different in their nature, and these are treated differently. They are, at best, input services for the main works contract service.

These clarifications were issued by the CBEC to set at rest the controversy over whether service provided to the contractor for the works contract would enjoy the same status of non-taxability as available to the main contractor for certain categories of works contracts (e.g., dams, tunnels, etc). The CBEC's stand was that the service of the sub-contractor was a separate service provided to the contractor and is to be assessed on its merits. If it is in the nature of works contract for dams, tunnels etc., it is exempted; otherwise it is taxable as an input service provided to the contractor. The stand of the CBEC was based on the concept of privity of contract (which is between the sub-contractor and the main contractor), though it did not explicitly invoke the concept. On the basis of two different contracts, it viewed the service of the subcontractor to be different from the service of the main contractor, though they may not be separable on the ground.

The concept of privity of contract was invoked by the state of Andhra Pradesh (AP) in the context of VAT in the case of Larsen & Toubro (L&T). The said L&T subcontracted part of the work in a works contract undertaken by it. The subcontractor used goods, which became part of the immovable property in the course of construction. The state of AP demanded VAT on these goods, in addition to VAT paid by L&T on the whole value of the project which included the subcontract value; it was as if the goods changed hands twice by accretion in the course of the same work.

At the same time, the VAT provisions did not allow input tax credit on deemed sale in works contracts. This second demand of tax on the same goods came before the Andhra Pradesh High Court in Writ Petition 12124 of 2006. The case made by L&T was summarised by the Court as follows:

> "4. The substance of the petitioner's case is that the execution of the various contracts referred to above, was entrusted to various "sub-contractors" either wholly or partially. Wherever such execution was entrusted to a sub-contractor, the State can either collect the tax under the A.P.V.A.T. Act, from the sub-contractor or from the petitioner and in the event of the State deciding to collect the tax from the petitioner, the amount of tax, if any, collected from the concerned sub-contractor, must be given credit to while determining the tax liability of the petitioner. This contention of the petitioner is on the legal premise that notwithstanding the fact that the works contract was executed by the petitioner through a sub-contractor, there can only be one taxable event for the purpose of the A.P.V.A.T. Act..."

Upon going through the legal provisions and precedents the High Court observed in its order dated 12 October 2006 that the property in the goods passed by accretion directly from the sub-contractor to 'A' and did not pass to the contractor at any time. Therefore, it was incorrect to demand tax as if there were two taxable events.

The AP government appealed to the Supreme Court, filing CA 5239 of 2008 against this decision of the High Court. The contention of the government was summarised by the Supreme Court as follows in its judgment:

> "18. As stated above, according to the Department, there are two deemed sales, one from the main contractor to contractee and the other from sub-contractor(s) to the main contractor, in the event of the contractee not having any privity of contract with the sub-contractor(s)."

The Response of the Supreme Court to this contention of the government was that –

> "…even if there is no privity of contract between the contractee and the sub- contractor, that would not do away the principle of transfer of property by the sub-contractor by employing the same on the property belonging to the contractee. This reasoning is based on the principle of accretion of property in goods. It is subject to the contract to the contrary. Thus, in our view, in such a case the work, executed by a sub-contractor, results in a single transaction and not as multiple transactions."

The Supreme Court thus laid down the law as being that when the tax was leviable on the passing of property by accretion in the works, the recipient of the property was the deemed buyer, and the person who used the property in the works was the deemed seller. This fact overrode the concept of privity of contract.

The law as laid down in L&T applies for service tax on works contracts, because service tax and VAT go hand in hand in their application to works contracts. But in the context of other subcontracted services we must keep in mind that the Supreme Court's ruling is based on the principle of accretion of property in goods in works contracts and that there is room for distinguishing it in other situations.

To return to the case of Visesh Engineering with which this piece began, the Rs 4.8 crore contract that NGRI had undertaken was for "conduct of drilling shot holes, seismic job services and topographical survey", and NGRI paid service tax on the full value of the contract. Part of the work, valued at Rs 2.38 crores, was sub-contracted to Visesh Engineering. The order does not specify the exact nature of the work done by Visesh Engineering, and does not make that into a relevant concern. Following the decision of the CESTAT in the case of Nana Lal Sutar the order only observes that the Supreme Court held in the L&T case (supra) that tax can be demanded either from the contractor or the subcontractor and not from both; therefore, when NGRI paid service tax on the whole value of the contract, separate demand on Visesh was not tenable.

This still begs the question of the relevance of privity of contract and the identification of who is providing service to whom so as to attract service tax. These determinations would become relevant in the light of the Place of Provision Rules if the customer is in Jammu & Kashmir or abroad and the contractor and subcontractor are in India.

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