
Building Contract : Tax on the Transfer of Property in Goods Involved in Execution of A Works Contract of Construction of a Building

Dr. Pratibha Chaudhary

M.B.A., LL.M. (Gold Medal), Ph.D.

Position prior to the Forty sixth Amendment of the Constitution:

Prior to the commencement of the Constitution of India the power to levy sales tax had been conferred on the Provincial Legislatures by entry 48 of the List II of the Seventh Schedule to the Government of India Act, 1935 which read as "taxes on the sales of goods and on advertisements". The power to levy sales tax was conferred on the Legislatures of States by Entry 54 of List II of die Seventh Schedule to the Constitution of India which, as originally enacted, read thus: "54. Taxes on the sale or purchase of goods other than newspapers." By Constitution (Sixth Amendment) Act 1956, a limitation was imposed on the State Legislature whereby the aforesaid taxes could be levied subject to the provisions of Entry 92A of List I. By Entry 92A of List I which was inserted by the Constitution (Sixth Amendment) Act, 1956, the Parliament is empowered to levy tries on sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce. Pursuant to the power conferred on it Parliament enacted the Central Sales Tax Act, 1956.

A contract of work commonly known as works contract involves transfer of property and also an element of service or work rendered. That is why it is called composite contract. The distinction between the two types of contract sale and works which rests on the principle that a contract of sale is one whose object is transfer of property in and delivery of possession of a chattel as a chattel to the buyer. When the object of the work undertaken by the payee for a price is not the transfer of a chattel as a chattel, the contract is one of work and labour. A question arose whether the cost of the goods supplied by the building contractor in the course of the construction of building could be subjected to payment of sales tax. It was resolved by the Supreme Court in the matter of Stale of Madras v. Gannon Dunkerley & Co. (Madras) Ltd.ⁱ It was held that on a true interpretation the expression "sale of goods" meant an agreement between the patties for the sale of the very goods in which eventually property passed. In a building contract where the agreement between the parties was that the contractor should construct the building according to the specifications contained in the agreement and in consideration therefore received payment as provided therein, there was neither a contract to sell the materials used in the construction nor the property passed therein as movables. it was also held that the expression sale of goods should be interpreted as having the same meaning as in the Sale of Goods Act, 1930. Thus. tax could not be levied on the goods used in execution of works contract relating to construction of buildings being immovable properties. There cannot be any sales tax on the value of material supplied in an indivisible building or works contract, because them was no agreement to sell the material as such.

Position after the Forty sixth Amendment of the Constitution:

In order to overcome the effect of the decisions of the Supreme Court wherein it was held that a works contract was an indivisible contract and the turnover of the goods used in execution of the works contract could not. Therefore, become accessible to the sales tax, the Parliament amended Article 366 of the Constitution of India in introducing sub-clause (b) of clause (29A) by the Constitution (Forty Sixth Amendment) Act, 1982 which states that “tax on the sale or purchase of goods” includes among other things a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of works contract. This amendment enables States to levy tax on transfer of property in goods involved in the execution of works contract. The Entry amplifies the expression “sale or purchase of goods” in Article 286 and Entry 54 of List II of Schedule VII of the Constitution by legal fiction. By virtue of this amendment even in a single indivisible works contract there is a deemed sale of goods. The validity of this amendment was upheld by the Supreme Court in the case of **Builders Association India v. Union of India**.ⁱⁱ It is now settled that the present Entry 54 of List II of Schedule VII of the Constitution empowers the State Legislature to impose a tax on the sale of materials involved in the execution of works contract, such as the construction of a building. Hence, there is no longer any doubt that State Legislature is competent to levy sales tax on the materials supplied in a building contract whether there is a separate agreement or not for the sale of such material.ⁱⁱⁱ The power of the State can be exercised to bifurcate the works contract into separate contracts for:

(i) sale of goods involved therein, and (ii) supply of labour and service. only where the works contract act involves a dominant intention to transfer the property in goods and not where the transfer in property is merely an incident to the contract of service.^{iv}

Taxability of the goods involved in execution of works contract:

After the Forty sixth Amendment the works contract which was an indivisible one is, by a legal fiction, altered into a contract which is divisible into one for sale of goods and the other for supply of labour and services. It has now become possible for the States to levy sales tax on the value of goods involved in the execution of a works contract in the same way in which the sales tax was leviable on the price of the goods and materials supplied in a building contract which was entered into two distinct and separate parts.^v

Principle of accretion of property in goods:

The taxable event is the transfer of property in goods involved in the execution of a works contract and the said transfer of property in such goods takes place when the goods are incorporated in the works. The value of the goods which constitutes the measure for the levy of the tax is the value of the goods at the time of the incorporation of the goods in the works.^{vi}

Sub-contract:

Ordinarily unless there is a contract to the contrary, in the case of a works contract the property in goods used in the construction of a building passes to the owner of the land on which the building is constructed, when the goods or materials used are incorporated in the building. 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, it is subject to the contract to the contrary. There is deemed sale by the dealer executing the work. It is the sub-contractor

who effects the transfer of property in the goods. No goods vest in the contractor so as to be the subject matter of transfer. By virtue of the Article 366(29)(b) of the Constitution of India. once the work is assigned by the contractor to the sub-contractor, the transfer of property in goods would be by the sub-contractor to the contractee. The contractor ceases to execute the works contract in the sense contemplated by Article 366(29)(b) because the property passes by accretion and there is no property in goods with the contractor which is capable of re-transfer, whether as goods or in some other form.^{vii} The tax liability depends on the facts of individual contract, tax invoice and other particulars required to determine the turnover.

K Raheja Development Corporation v. State of Karnataka,^{viii}

The appellants undertook to build as developers for the prospective purchasers. Such construction/development was to be on payment of a price in various installments set out in agreement. As the appellants were not the owners, they claimed a lien on the property. Of course, they had right to terminate the agreement and to dispose of the unit if a breach was committed by the purchaser. However, merely having such a clause does not mean that the agreement ceases to be a works contract. All that this means is that if there is a termination and that particular unit is not resold but retained by the appellants, there would be no works contract to that extent But so long there is no termination, the construction is for and on behalf of the purchaser. Therefore, it remains a works contract. If the agreement is entered into after the flat or unit is already constructed. then there would be no works contract. But so long the agreement is entered into before the construction is complete it would be a works contract. The judgment of the Hon'ble Apex Court was based on particular facts of the agreement, provisions relating to works contract under the Karnataka Sales Tax Act. 1957.

The appellant entered into development agreements with owners of lands. It got the plans sanctioned. After approval it constructed residential apartments and commercial complexes. In most of the cases it entered into agreements with the intending purchasers before construction. The agreement provided that on completion of the construction the residential apartment or the commercial complex would be handed over to the purchasers, who would get an undivided interest in the land as well. The appellant was entitled to terminate the agreement and dispose of the unit if a breach was committed by the purchaser. The owners of the land would transfer the ownership of the land directly to a society which was being formed under the Karnataka Ownership Flats (Regulation of Promotion of Construction, Sales, Management and Transfer) Act, 1974. The question was whether the appellant was a dealer and liable to pay turnover tax under the Karnataka Sales Tax Act, 1957, in relation to the construction contracts with the purchasers as “works contract”.

Relevant Provisions of the Karnataka Sales Tax Act, 1957 (herein after called “the said Act”): .

Section 2(1)(k)(viii) defines a “dealer’ as follows:—

“2(1)(k)(viii) “dealer’ means any person who carries on the business of buying, selling or distributing goods, directly or otherwise, whether for cash or deferred payment, or for commission, remuneration or other valuable consideration, and includes—
.....

(viii) a person engaged in the business of transfer of property in goods (whether as goods or in some other form) involved in the execution of works contract.

Thus a person engaged in the business of transfer of property in goods (whether as goods or in some other form) involved in the execution of works contract would be a dealer.

Section 2(1)(v-i) defines a “works contract” as follows:—

“2(1)(v-i) “works contract” includes any agreement for carrying out for cash, deferred payment or other valuable consideration, the building, construction, manufacture, processing, fabrication, erection, installation, finishing out improvement, modification, repair or commissioning of any movable or immovable property.”

Thus under the Karnataka Sales Tax Act, 1957, the definition of “works contract” is very wide. It is not restricted to a “works contract” as commonly understood, i.e., a contract to do some work on behalf of someone else. It also includes any agreement for carrying out for cash, deferred payment or other valuable consideration the building and construction of immovable property; The definition is wide enough to take within its ambit any type of agreement wherein construction of a building takes place either for cash or deferred payment, or valuable consideration. 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 other 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. Under the facts and circumstances of the case the appellant was a dealer and liable to pay turnover tax under the Karnataka Sales Tax Act, 1957, in relation to the construction contracts with the purchasers as works contract.

In a subsequent case of **Assotech Reality Private limited v. State of UP**,^{ix} the Allahabad High Court held that the mere fact that the agreement to buy a fully constructed unit had been entered into prior to completion of its construction and payment for its purchase was made in installments would not make the transaction a works contract if the intent of the parties was always one of sale of a fully constructed immovable property. Based on the facts of the case, the Court held that the developer continued to remain the owner of the apartment until the sale and thus the transaction would not qualify as a works contract, so as to be liable to sales tax. The Hon’ble High Court distinguished the judgment of the Supreme Court on the basis of clauses under the agreement to sell which vouched the fact that the developer did not undertake the construction of property on behalf of the buyer but on his own behalf. The above judgment was however, set aside subsequently by the Supreme Court on technical grounds.

Tripartite agreement:

Whether the ratio of the judgment of the Division Bench in the case of **K. Raheja Development Corporation v. State of Karnataka**,^x is applicable even if the development agreement is not a works contract but it is a tripartite agreement between the owner of the plot, the developer and the prospective buyer of the flat. In the matter of **Larsen & Toubro Limited and another v. State of Karnataka and another**,^{xi} the question was whether the appellant, which was engaged in property development involving construction and building of flats and subsequent sale of completed flats, would be liable to sales tax under the Karnataka Sales Tax Act, 1957. The Division Bench of the Supreme Court was of the view that if the ratio of **K Raheja Development Corporation v. State of Karnataka**^{xii} is to be accepted then there would be no difference between works contract and contract for sale of

chattel as a chattel. For a works contract, the contractor must have undertaken the work of construction. The Division Bench of the Supreme Court in the matter of **Larsen & Toubro Limited and another v. State of Karnataka and another**^{xiii} was of the view that the judgment of the of the Division Bench in the case of **K Raheja Development Corporation v. State of Karnataka**^{xiv} needed reconsideration by the Larger Bench. The case was referred to the Chief Justice for appropriate directions.

Elements of sale:

Under the Sale of Goods Act, 1930, to constitute a valid sale, there must be concurrence of four elements, viz., (i) parties competent to contract; (ii) a thing absolute or general property which is transferred from the seller to the buyer; (iii) mutual assent; and (iv) a price in money paid or promised. In cases of transfers, supplies and deliveries of goods comprised in sub-clause (b) of clause (29A) of Article 366, the concurrence of the above four elements is not necessary, only the elements comprised in the sub-clauses of clause (29A) have to be satisfied to make the transaction liable to tax. It is deemed sale by legal fiction. But there must be two different persons in the ordinary sense of the term “person” and competent to contract, before a sale can be said to take place. Under subsection (35) of section 2 of the Rajasthan Sales Tax Act, 1994. and under subsection (38) of the Rajasthan Value Added Tax Act, 2003, the definition of sale. reads as,—

“Sale with all its grammatical variations and cognate expressions means every transfer of property in goods from one person to another for cash, deferred payment or other valuable consideration and includes—

To constitute a sale of goods. there should be transfer of property in goods from one person to another. .

Service Tax:

Residential complex construction services were first brought in the service tax net with effect from June 16, 2005. The object was to levy service tax on construction services in relation to residential property. The “Construction of Complex” service is defined under Section 65(105)(zzzh) of the Finance Act, 1994 (as amended by the Finance Act, 2005 on June 16, 2005) as “any service provided or to be provided to any person, by any other person, in relation to construction of a complex” Construction of complex includes construction of a new residential complex. Residential complex means any complex comprising of—(i) a building or buildings, having more than twelve residential units; (ii) a common area; and (iii) any one or more of facilities or services such as park, lift, parking space, community hall, common water supply or effluent treatment system, located within a premises and layout of such premises is approved by an authority under any law for the time being in force, but does not include a complex which is constructed by a person directly engaging any other person for designing or planning of the layout, and the construction of such complex is intended for personal use as residence by such person.

Construction of complex intended for personal use as residence has been excluded from the ambit of service tax.

A key issue relating to service. tax has cropped up whether a promoter/builder/developer who constructs and sells a unit in a residential complex to a purchaser under an agreement entered prior to completion of construction would be chargeable to service tax under the above

category of service. Indeed the dispute regarding service tax on the activities of residential complex construction services relates to the judgment dated 05.05.2005 of the Hon'ble Supreme Court in the case of **K. Raheja Development Corporation v. State of Karnataka**,^{xv} which was regarding sales tax liability under the Karnataka Sales Tax Act, 1957 on the transfer of property in goods in construction of residential flats or commercial complexes. The Director General of Service Taxes issued a clarification, vide V/DGST8/22/Audit/ Misc/1/ 2004/Mumbai dated February 16, 2006, holding that construction and sale of residential property were taxable as works contract. Since such contracts, inter alia, comprised of provisions of services, service tax would apply under the heading of residential complex construction service. The authorities imposed service tax on activities of construction and sale of residential property by promoters/builders/ developers in any situation, regardless of when the sale of immovable property took place. This led to significant litigation. The Director cannot preempt a judicial interpretation of the scope and ambit of a provision of the Act by issuing clarification on the subject. A circular cannot even impose on the tax payer a burden higher than what the Act itself, on a true interpretation, envisages. The task of the interpretation of the laws is the exclusive domain of the courts. Later on the Central Board of Excise and Customs (CBEC) clarified, vide 332/35/200-TRU dated August 1, 2006, that in case where the builder, promoter, developer builds a residential complex, having more than twelve residential units, by engaging a contractor for construction of such residential complex, the contractor shall be liable to pay service tax on the gross amount charged for the construction services provided to the builder/promoter/developer under "construction of complex" service falling under section 65(105)(zzzh) of the Finance Act, 1994. If no other person is engaged for construction work and the builder/promoter/developer undertakes construction work on his own without engaging the services of any other person, then in such cases, in absence of service provider and service recipient relationship, the question of providing taxable services to any person by any other person does not arise.

To have "service", there must be a "service provider" rendering services to some other person(s), who shall be recipient of such "service". In the case of **Magus Construction Pvt. Ltd. v. Union of India**,^{xvi} the Gauhati High Court has also held that when a builder, promoter or developer undertakes construction activity for its own self, then, in such cases, in absence of relationship of "service provider" and "service recipient", the question of providing "taxable service" to any person by any other person does not arise at all.'

Where a buyer enters into an agreement to get a fully constructed residential unit, the transaction of sale is completed only after complete construction of the residential unit. Where the initial agreement between the promoters/builders/ developers and the ultimate owner is in the nature of agreement to sell, it is, as per provisions of the Transfer of Property Act, only after the completion of the construction and full payment of the agreed sum that a sale deed is executed and only then the ownership of the property gets transferred to the ultimate owner. It has now been clarified by the Central Board of Excise and Customs (CBEC), vide Circular No. 108/02/2009-ST dated 29th January, 2009,^{xvii} that if the ultimate owner enters into contract for construction of a residential complex with a promoter/builder/developer, who himself provides service of design, planning and construction, and after such construction the ultimate owner receives such property for his personal use, then such activity would not be subject to service tax, because this case would fall under the exclusion provided in the definition of "residential complex". If services of any

person like contractor, designer or a similar service provider are received, then such person would be liable to pay service tax.

Service tax on the “construction of complex” service is applicable only in case where the service is provided by a commercial concern. Thus service provided by a labourer engaged directly by the owner of the property or the contractor who does not have a business establishment would not be subject to service tax.

CONCLUSION:

The taxability on transfer of property in goods involved in execution of works contract depends on the facts of the case. In the matter of **K Raheja Development Corporation v State of Karnataka**,^{xviii} the appellant was not the owner of the land on which building was constructed. K. Raheja Development Corporation, as developers, on its own behalf, and also as developer for the intending purchasers of flats, did the construction work and accordingly it was covered under the definition of dealer under the Karnataka Sales Tax Act, 1957. The Supreme Court has made a distinction between works contract commonly understood and works contract under the Karnataka Sales Tax Act, 1957. The definition of works contract under the Karnataka Sales Tax Act, 1957 is very wide and the contract was covered under the definition of works contract. An issue on similar facts, in the case of Larsen & Toubro Ltd., is still pending before the Hon’ble Supreme Court. The definition of “works contract” under the Karnataka Sales Tax Act, 1957 includes any agreement for carrying out for cash, deferred payment or other valuable consideration the building and construction of immovable property, whereas under sub-section (45) of section 2 of the Rajasthan Sales Tax Act, 1994 and under sub-section (44) of the Rajasthan Value Added Tax Act, 2003, the definition of works contract reads as,—

“Works contract means a contract for works and labour or service involving transfer of property in goods (whether as goods or in some other form) in its execution.”

The issue of tax on the transfer of property in goods involved, in construction of residential flats and commercial complexes by promoter/builder/developer is still not free from doubt.

No straitjacket formula can be laid down to determine the sale or works contract. It is to be analysed in each case whether the agreement is for transferring immovable property or for works contract. The intention of the parties has to be culled out on an overall reading of the several terms and conditions of the contract. Documents alone cannot alter true nature of the transaction. It is not the meaning of an individual recital or inference flowing from any term or condition of the contract read in isolation but an overview of the contract wherefrom the nature of the transaction covered thereby has to be determined. The intention of the seller and the purchaser will have to be decided with reference to the terms of the agreement and all surrounding circumstances. An owner of property cannot be said to be carrying on a works contract on behalf of others. Where the owner of the land himself develops the property and sells flats or commercial complexes in that property, unless the subject or context otherwise requires or it is otherwise provided under the definition of the works contract under the Act, no works contract is involved in such type of activities. The property in goods involved in execution of works contract of construction of building passes to the owner of the land. Where the agreement for sale and purchase is entered into after the flat or unit is already constructed, the property would not pass as movables even in the meaning of sale enumerated

in sub-clause (b) of clause (29A) of Article 366 and such sale would be of immovable property. In such type of cases there would be no works contract and the sale would not be eligible to sales tax. Service tax would also not be applicable in such type of transactions of sale where the unit is already constructed before the agreement to sale and purchase is entered into. Where the builder/developer engages contractor(s) for construction of the building, i.e., awards works contract for construction of a building, the contractor(s) would be liable to tax on the transfer of property in goods involved in execution of the works contract. In such cases the builder/developer is contractee (awarder) and the provisions under the Act relating to awarder will apply on the builder/developer.

END NOTES AND REFERENCES

- ⁱ (1958)9 STC 353(SC). 1959 SCR 379, AIR 1958 SC 560
- ⁱⁱ (1989) 73 STC 370 (SC); (1989)2 SCC 645; AIR 1989 SC 1371.
- ⁱⁱⁱ Gannon Dunkerley & Co. v. State of Rajasthan, (1993) 88 STC 204 SC; (1993) 1 SCC 364.
- ^{iv} Builders Association of India v. State of Karnataka, (1993) 88 STC 248; (1993) 1 SCC 409.
- ^v Building Association of India v. Union of India (1989) 73 STC 370 SC; (1989)2 SCC 465.
- ^{vi} Gannon Dunkerley & Co. v. State of Rajasthan, (1993) 88 STC 204 SC; (1993) 1 SCC 364.
- ^{vii} State of Andhra Pradesh and others v. Larsen & Tourbo Ltd. and others (2008) 17 VST (SC) ; (2008) 10 VAT Reporter 101.
- ^{viii} (2005) 141 STC 298 (SC) ; (2005) 5 SCC 162. AIR 2005 SC 2350.
- ^{ix} (2007) 7 STR 129 ; (2007)8 VST 738 (All) .
- ^x (2005) 141 STC 298 (SC). (2005) 5 SCC 162, AIR 2005 (SC) 2350, (2005)3 Vat Reporter 300
- ^{xi} (2008) 17 VST 460 (SC); (2009) 11 Vat Reporter 43
- ^{xii} (2005) 141 STC 298 (SC). (2005) 5 SCC 162, AIR 2005 (SC) 2350, (2005)3 Vat Reporter 300
- ^{xiii} (2008) 17 VST 460 (SC); (2009) 11 Vat Reporter 43
- ^{xiv} (2005) 141 STC 298 (SC). (2005) 5 SCC 162, AIR 2005 (SC) 2350, (2005)3 Vat Reporter 300
- ^{xv} Ibid.
- ^{xvi} (2008) 15 VST 17; (2009) Vat Reporter 46.
- ^{xvii} (2009) 11 Vat Reporter 2 (S. No. V 355) (Notification Section).
- ^{xviii} (2005) 141 STC 298 (SC). (2005) 5 SCC 162, AIR 2005 (SC) 2350, (2005)3 Vat Reporter 300