

## **Real Estate Works Contract: determination of material and service values**

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December 23, 2013

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Works Contract is a vast subject and covers a wide range of contracts relating to immovable and movable property. The objective of this article is to understand and identify works contract value in composite contracts of sale of immovable property (constructed “*pursuant to a contract*” in this article) and further dissection of the works contract to arrive at the goods value and the service value in a works contract and possibility of differential margin’s in each such activity. In case of a works contract, Value Added Tax (“VAT”) is a tax levied by state government on the goods (material) value of a works contract and Service tax is levied on service portion of works contract.

In case of real estate projects the builder/developer normally sell undivided share in land, transfer the goods like cement ,steel ,tile ,sanitary fittings and provides construction services which broadly includes design of building, structure, construction activity, finishing activity, etc. In case of real estate projects the builder/developer will supply material or may sub-contract to other agencies with or without material. One would seldom find a real estate developer who would not be covered under the state VAT law as there will normally be supply of material by builder/developer. Accordingly, the builder/developer is likely to be a works contractor under the VAT laws. For the purpose of Service Tax, Services provided by the real estate developer would be covered under either of the two declared services:

1. Construction of complex, building, civil structure or a part thereof, including a complex or building intended for sale to a buyer, wholly or partly, except where the entire consideration is received after issuance of completion-certificate by the competent authority
2. Service portion in the execution of works contract

Following the principles laid down in section 66F relating to interpreting specified ‘description of service’, services of a real estate developer/builder liable under VAT laws will be covered by the latter category of declared service, i.e. service portion in execution of works contract.

Once the Real estate developer/builder is identified as a work contractor the next step is to segregate value of land, material and services in a composite contract. It is important to understand here that as per the various legal judgments over the years it is well established that a works contract is a contract of material and service. Rule 2A of the Service tax (determination of value) Rules, 2006 considers two elements in a works contract that is material and service. Hence land value is never a part of the works contract value and is separate and distinct from the works contract.

The real estate developer charges a gross amount including land, material and services. Such composite contract includes sale of land and works contract i.e. labour and material. The land value is not a part of the works contract value. Works contract value has two parts that is material value and construction service value.

Let us explain this with an example – A builder- works contractor constructs bungalow scheme of which he sells each bungalow pursuant to a contract for 100 million. He charges 70 million towards land and 30 million towards construction. In the given circumstance the works contract value is 30 million. Now the break-up of works contract and Land value is as under:

*(Amount INR million)*

Works Contract Value			Land Value		
Material –Steel	5		Land Cost	56	
Material Cement	10				
Services	12				
Total Cost	27				
Profit	3	10% on Works Contract Value	Profit	14	20% on Land Value
Sales/Works contract Value	30		Sale value of Land	70	

In above example profit margin on land is 20% while the margin in works contract is 10%. The pertinent issue here is that can a builder being a works contractor have a higher margin on sale of land while the margin on works contract is 10%. In case of sale of an immovable property being a bungalow there is works contract of Rs. 30 million, the state government has the right to tax the sale of goods in a works contract under the VAT laws, the central government has the right to tax the service portion in works contract under Service Tax. The concept of divisibility of a works contract is well settled by the land mark judgment of Supreme Court in BSNL's case [2006(2) STR 161 (SC)].

Hence there is sale of land, service and material. These are three different activities clubbed together. The margin in case of business of sale of land is generally better than in case of sale/trading of material or rendering of services. The margin on sale of material should correspond with the margin earned in the business of trading of cement & steel. The margin in labour activity should correspond with the margin in such activity and can have differential margin than in the business of trading of cement and steel.

Hence the margin in land value can be different than the margin in works contract value. In the given circumstance the differential margin on sale of land and works contract are in accordance with legal frame work and established commercial practices.

As a natural extension to the above discussion we can say that there can be differential margins on service activity represented in this case by service portion in a works contract and trading activity represented by sale of goods/material transferred in a works contract. Considering the legal frame work and margin associated with different types of activity we can further bifurcate the works contract as under:

*(Amount INR million)*

<b>Works Contract Value</b>	<b>Material Sale- Trading Activity</b>	<b>Construction Service-Service Activity</b>	<b>Works Contract value</b>
Material Steel	5		5
Material Cement	10		10
Services		12	12
Total Cost	15	12	27
Profit	0.75	2.25	3
Sales/Works contract Value	15.75	14.25	30

In the above example the over all margin on works contract is 10%. However the margin on material value is only 5% and material value is 15.75 million whereas the margin on the service element in works contract is 16% and service value in works contract is 14.25million. Each activity and margin in each line of activity should be according to the margin in such lines of activity. In case of a trader of cement and steel the normal margin would be 5%. In the given circumstance the mark up of 5% would be reasonable to cover all material value for purpose of VAT. Similar rule applies to service value in works contract.

The example in the foregoing paragraphs explains concept of different streams of activity within a given contract and its bifurcation based of cost and margin in such lines of activity to arrive at value of each line activity. The concept explained by citing the example of a bungalow scheme is equally applicable to other kinds of real estate project including residential apartments, commercial buildings, warehouses etc.

In practice considering the multitude of materials and services used and absence of a well-developed recording mechanism followed by builders/developer, most state governments provide for a Composition scheme under Vat which differs from state to state. Similarly Service tax has an abatement provisions. However the incidence of tax is likely to increases on opting for Composition scheme.