

Service Tax Valuation – FOC materials

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The concept of adding the value of free goods or services supplied by customer used in manufacture of excisable goods is not new in Central Excise. The principle that VAT and service tax are mutually exclusive adds to the confusion. [Imagic Creative – 2008(9) STR 337 (SC)] Section 67 emphasizing on the gross value of **service** has also undergone change in this Finance Act- 2015.

Valuation of services under service tax law has always been subject matter of interpretation and disputes. In this article, we examine the issue of free issue materials under service tax law especially under works contract for construction where supply of materials such as steel and cement by customers is quite common.

We need to understand the valuation options, legal provisions with respect to valuation of services and interpretation of such provisions with supporting judicial decisions.

Legal provisions

Section 67 of the Finance Act 1994 which deals with valuation services states that the value of taxable services would include both monetary and non-monetary consideration. In this Section, no reference is made to free issue materials. However, valuation provisions provide for taxation of free issue of materials. The valuation options available for the works contract service provider could be as under:

- I. The contract for supply of goods and provision of services can be separated with penal clauses for each bifurcated. In that case there would be no works contract at all.
- II. For Works Contract
 - a) Regular method
 - b) Standard deduction method

a) Regular method

Rule 2A of Valuation provides that the service portion would be as follows:

Value of works contract service = Gross amount charged for contract – Value of property in goods transferred.

For the purpose of above formula, gross amount does not include value of VAT / CST paid or payable on goods transferred in contract.

b) Standard deduction method

Standard deduction method is easier method where deduction is allowed at specified rate on total amount. It may so happen that the value of materials involved is more than the deduction allowed. In such a case, the assessee ends up paying service tax on excess value.

The deduction allowed is as under:

Sl. No.	Description of service	Deduction value of total amount	Taxable value of total amount
1	Original works which includes new construction + Erection/commissioning/installation of goods	60%	40%
2	Repair and maintenance of any goods	30%	70%
3	Repair and maintenance of immovable property and other works	30%	70%

The deduction is to be claimed on the total amount. For the purpose of this Section, “total amount” is sum total of the gross amount charged for the works contract and the fair market value of **all goods and services supplied** in or in relation to the execution of the works contract. The fair market value of goods and services so supplied may be determined in accordance with the generally accepted accounting principles.

Free of cost materials

The contractor could receive free materials like cement and steel as per the terms of contract. Sometimes, such goods need not be free but at concessional rate / reduced rate as well. In such a case, question arises as to inclusion or non inclusion of value of such free materials for payment of service tax by contractor especially when claiming standard deduction.

From the meaning of ‘total amount’ discussed above, it is clear that the intention of this law is to include value of goods and services supplied in relation to execution of works contract for discharging the service tax. However, many assesseees are not agreeing to this view as the goods do not belong to such assesseees and demand of service tax on such materials belonging to customers in their view would not be in line with Section 67 and against the decision in BSNL [2006(2) STR 161 (SC)] wherein it was held that on the value of goods service tax should not be charged and on the value of service sales tax should not be charged.

In support of such view, the larger bench Tribunal in case of *Bhayana Builders Pvt Ltd. Vs CST, Delhi 2013 (32) STR 49 (Tri-LB)* had held that the value of goods and materials supplied free of cost would be outside the taxable value or the *gross amount charged*. The tribunal concluded that goods and materials which belong to the provider which are supplied/ provided/ used would alone constitute the gross amount charged. It was also held that the free issue materials would not either constitute monetary or non-monetary

consideration for payment of service tax. Similar view was expressed in the earlier case of *Cemex Engineers v. CCE - 2010 (017) STR 0534 (Tri-)*.

Readers should note that question in litigation in this case was claiming abatement towards value of materials under Notification No. 15/2004-ST. In this said notification, Works contract service provider had the option of claiming abatement of 33% of gross amount charged. For the purpose of claiming the abatement, the gross amount shall include the **value of goods and materials supplied or provided** or used by the provider of the construction service for providing such service. The larger bench has clarified that **such gross amount charged** would not include the value of free issue materials.

Relying on this landmark judgment, the assessee engaged in construction contract with due intimation to revenue claim the deduction towards the free issue materials. The view expressed by the larger bench is also logical as in case of free issue materials no direct or indirect and no monetary or non-monetary benefit is accrued to the service provider in terms of Section 67.

Precautionary steps to be taken

As the matter is not clear and free from doubt, the assessee could ensure that following steps are taken to mitigate the implication even if held to the contrary in future:

- 1) Contracts to be on net amount with scope of customer being supply of material.
- 2) Detailed stock register be maintained with respect to quantity and value of goods and the services received from the customers. This should include even the details of goods not used and returned.

This would ensure that the value of goods could be deducted on actual basis where there is no dispute.

- 3) A letter to the department disclosing the practice being followed with respect to free materials and judgments relied should be filed and confirmation sought.
- 4) Assessee could also examine the option of taking an indemnity from customer when he has decided to rely on the larger bench decision. This would ensure that even in future, if the demand arises, the same could be recovered from the customers.

Conclusion: Cautious approach is required if the assessee wants to claim deduction towards free issue materials. One should wait for CBEC to provide clarity on this or for the decision of Supreme Court in case of *Bhayana Builders* to reach logical end to this issue.