CHD DEVELOPERS LIMITED, KARNAL V. STATE OF HARYANA AND OTHERS – FOLLOWING THE *LARSEN* FOOTPRINT?

- **AnandVardhan Narayan***

ABSTRACT

The Punjab and Haryana High Court in its watershed pronouncement, recently, held that the value of land related to a building contract has to be deducted from the tax levied as per the Haryana Value Added Tax Act, 2003. The Court, whilst delivering a novel judgment on building contracts, debated on the issues of the legislative history pertaining to the taxability of 'works contracts', the pre-conditions and subject for levy of VAT on such form of a contract – outlining the method of determining taxable turnover in such cases and adjudicating the constitutional validity of certain provisions in this regard; thereby also reiterating the Larsen case's verdict that building contracts are a species of works contract. The decision has attained great significance since it not only points out the lacunae in the existing legislation, but also serves as a relief to the builders who were rendered helpless by the ambiguous law. Furthering the deliberation, the authors have attempted a critical and multi-dimensional analysis of the impact that this judgment will have on all the concerned stakeholders – the builders, the customers and the Government. This commentary proceeds by laying out the factual premise of the case, identifying the key issues therein and stating the judgment passed by the Court. It then undertakes a critical analysis of the verdict, expostulating the hits and misses of the Court in the process. To conclude with, the authors have pointed out the profound impact this decision will have on the building sector in the backdrop of the burgeoning real estate market.

1. INTRODUCTION

On April 22, 2015, the two-judge bench of the Punjab and Haryana High Court, in a landmark decision, held that the immovable property's value that is involved in the execution of a building contract needs to be subtracted when tax is levied under the Haryana Value Added Tax Act,

* Student, National Law University, Odisha.

2003 (hereinafter referred to as **'Act'**) pertaining to building contracts[1] - that has been held to be a works contract by the Apex Courts verdict in the matter of *Larsen and Toubro Ltd. v. State of Karnataka*[2] (**'Larsen case'**).

2. LEGAL HISTORY AND EVOLUTION OF WORKS CONTRACT

Taxability of works contract has been a subject matter of excessive litigation in India for several decades. Before delving further, it is important to understand the concept of 'works contract' and the confusion associated with taxability of the same. Works contract is a composite contract which is a contract for work, service or labour and not for sale of goods; however, goods are used in executing such contracts. For example, generally in a construction contract, buyers enter only into a contract to buy flats/buildings, and the contractor *inter-alia* has to purchase the material and use them for constructing the building. When the buyer makes payment for the cost of building upon its completion, such payment also includes cost of building material, labour and other services offered by the contractor. Broadly speaking, the property in building is passed on to the buyer and there is no separate contract for supply/sale of building materials in a works contract.

The bone of contention was regarding the taxability on such supply/sale of building materials. Entry 54 of the State List (List II) in the Constitution of India empowers the State to levy tax on the sale or purchase of goods. The moot question was whether by virtue of this Entry, the State is authorized to levy and collect tax on the materials supplied/transferred in execution of works contract. The State government was levying sales tax on such material supplied for execution of works contract by arguing that they can bifurcate the works contract and tax on the supply/sale portions of it. Finally, the Supreme Court intervened in the case of *State of Madras v Gannon Dunkerly& Co.*[3], and held that a building contract is indivisible work contract and it is not permissible for the State governments to levy sales tax on the transfer of property in the goods involved in execution of such contract. As an implication of this case, States were not able to levy and collect any tax

[1]CHD Developers Limited, Karnal v. State of Haryana and others, Civil Writ Petition No. 5730 of 2014 (Punjab and Haryana High Court, 22/04/2015).

[2]Larsen and Toubro Ltd. v. State of Karnataka, (2013) 46 PHT 269 (SC); (2014) 1 SCC 708.

[3]State of Madras v Gannon Dunkerly& Co, AIR 1958 SC 560.

on goods involved in the execution of works contract. The Tax payers were avoiding sales tax under the guise of 'works contract'. This peculiar problem was referred to the Law Commission of India. Accordingly, the Commission in its sixty-first report[4] recommended that the law must be amended to confer power on the State Government to tax the 'goods' involved in the execution of works contracts. By way of 46th Constitutional Amendment, 1983, Clause 29A was inserted to Article 366 (Article 366 defines 'tax on the sale or purchase of goods') to include within its ambit transfer of property in goods involved in the execution of works contracts. This constitutional amendment permitted the States to levy tax on the sale of goods involved in execution of works contract. The validity of such provision was affirmed by five judge bench of Supreme Court in *Builders Association of India v. Union of India*[5], wherein it was held that after the constitutional amendment it was permissible for the State government to levy sales tax upon the goods portion involved in the execution of a works contract. After several judicial pronouncements and legislative amendments, the law was finally settled and States were levying and collecting sales tax on the material used in execution of a works contract. However, what constituted works contract and the manner of taxing such contract continued to be litigated.

3. BACKGROUND OF THE CASE

The Hon'ble Supreme Court in the *Larsen case*[6] has enlarged the definition of 'works contract' to include within its ambit the activities of the builders, contractors, etc. in construction of flats, buildings and commercial properties. Accordingly, the state was empowered to levy VAT on the said activities which fall under the definition of 'works contract'. This authoritative decision left no room for doubt in the minds of the taxing authorities and also the builders as regard to the levy of VAT on the activities of the builders. However, most of the builders in the State of Haryana and Punjab did not start paying VAT voluntarily due to certain grievances. Accordingly, the Hon'ble Punjab and Haryana High Court witnessed plethora of writ petitions filed by these builders

---

[4] 61st Law Commission of India Report, *Certain Powers Connected with the Powers of the State to levy a Tax on the Sale of Goods and with the Cenral Sales Tax Act, 1956*, 21 (1974), available at http://lawcommissionofindia.nic.in/51-100/report61.pdf (last accessed on 12 October 2015).

[5] Builders Association of India v. Union of India, (1989) 2 SCC 645.

[6] *supra*, at p. 2.

against the assessment orders[7] issued to them as regard to the levy of VAT on their activities of constructing flats and buildings. Among the writ petitions, the present case was the lead one. The major grievances of the builders were that the value of land involved in execution of works contract was subjected to the levy of VAT under the guise of 'works contract'. The builders challenged the assessment notices, circulars and prayed for issuance of writ declaring Explanation (i) to Section 2(1)(zg) of the Act and Rule 25(2) of the Haryana Value Added Tax Rules (hereinafter referred to as **'Rules'**) *ultra vires* to the Constitution of India to the extent that they include the value of land while charging VAT.

4. FACTS OF THE CASE

The petitioner, who was a developer, was engaged in the business of development and sale of apartments/flats/units. The petitioner entered into a flat buyers' agreement with prospective and interested buyers. The sale deed was executed on payment of stamp duty on total consideration to sell the property. The Excise and Taxation Commissioner issued a Circular dated May 7, 2013 stating therein that VAT will be charged for all those builders, who are entering into agreements for sale of constructed apartments prior to or during construction. On June 4, 2013, the Excise and Taxation Commissioner issued a circular about the making of assessments on developers and builders. Consequently, the Circular dated May 7, 2013 was varied *vide* Circular dated February 10, 2014 and value of land was sought to be included for imposition of VAT.

[7]B. L. Gupta, *Liability of the Builders/Developers under the VAT Laws - Impact of Punjab & Haryana High Court order in CHD Developers, Karnal Case*, GST Simplified, available at http://www.gstsimplified.in/news-publications/liability-of-the-builders-developers-under-vat-laws-impact-of-punjab-haryana-high-court-order-in-chd-developers-case (last accessed on 27 September 2015).

5. CONTENTION OF THE PARTIES

5.1. Key Arguments placed by the Petitioner

The petitioner contended that the imposition of tax as demanded by the taxation authorities was unconstitutional and beyond the provisions of the Act and under the Rules framed therein. The counsel for the petitioners contended that since builders were engaged in sale of immovable property, their activities should not be construed as 'works contracts' as contained in Section 2(1)(zt)[8] of the Act. Most importantly, they argued that Explanation (i) to Section 2(1)(zg)[9] of the Act and Rule 25(2)[10] of the Rules were ultra viresto the Constitution of India. To substantiate this argument, they contended that Entry 54 of the State List empowers the State to charge tax on transfer of property in goods in execution of works contract[11]; however, contrary to the powers provided by the Entry, the State is trying to charge tax on a value which was far in excess of the value of goods transferred in the course of execution of works contract. Key Argument placed by the Respondent

The Respondent by relying on the judicial pronouncement by the Hon'ble Supreme Court in the *Larsen case*[12] contended that the activities of constructing of buildings, flats and commercial properties by the developers and builders were liable to sales tax laws of the State. The reason being that such activities are covered in the definition of 'works contract' as provided in Section 2(1)(zt) of the Act.[13]Most importantly, they contended that there is a transfer of property in the execution of the contract and such transfer of property in goods was covered under Section 2(1)(zt) of the Act.[14] Based on all the above submissions, it was argued that the petitioner was contractor and the prospective buyer a contractee.

6. KEY ISSUES BEFORE THE COURT

The key points for adjudication before the Court were as follows:-

---

[8]The *Haryana Value Added Tax Act*, 2003, s. 2(1) (zt).
[9]*id.*, at s. 2(1) (zg).
[10] The *Haryana Value Added Tax Rules*, 2003, Rule 25(2).
[11]Entry 54, List II, the Constitution of India.
[12]*supra* 2.
[13]*supra* 8, at s. 2(1) (zt).
[14]*ibid.*

a) Whether the developers and builders can be treated as works contractor?
b) Whether the State can impose VAT on the developers/builders, who *vide* an agreement with the prospective buyer has agreed to construct a flat and thereafter sell the same with some portion of land?
c) If the answers to the above issues are in affirmation, whether the method of valuation of VAT on such agreements, can directly or indirectly, include the value of land by following the method of calculation of the taxable turnover as provided by Commissioner *vide* Circulars dated May 7, 2013,June 4, 2013 and February 10, 2014?
d) Whether Section 42 of the Act[15] is legally valid or not?

7. JUDGMENT

The writ petition was partly allowed by the Court. Based on the below mentioned reasoning, the Court struck down the assessment order and revisional order passed by the concerned authorities and ordered for fresh assessment. For clarity, the authors have sub-divided the issues and reasoning given by the Court.

7.1. Legislative History of the Taxability of 'works contract': Implication of the Forty Sixth Constitutional Amendment

The Court, while adjudicating the first two issues, delved into the legislative history of the taxability of 'works contract', various definitions and other provisions under the Act. The Court noted that prior to the Forty Sixth Constitutional Amendment (hereinafter referred to as '**Amendment**'); composite work contracts were not exigible to States sales tax under Entry 54 of the State List,[16] which pertains to '*tax on the sale or purchase of goods.'* The Court discussed the implications of the Amendment which inserted a new clause (29A) to Article 366 to expand the meaning of the expression '*taxes on sale and purchase of goods*'.[17]Sub-clause (b) of clause (29A) states that tax on the sale or purchase of goods includes '*tax on the transfer of property in goods (whether as goods or in*

[15]*supra*8, at s. 42.
[16]*supra* 11.
[17]*id*, at Art.366 (29A).

some other form) involved in the execution of a works contract.'[18]The latter part of clause (29-A) states that transfer of any goods shall be deemed to be a sale of those goods by the person making the transfer and a purchase of those goods by the person to whom such transfer is made.[19] By virtue of clause (29-A), any transfer of property in goods under sub-clause (b) of clause (29A) will be deemed to be a sale of the goods involved in the execution of the works contract. The expression '*tax on sale or purchase of goods*' carries the same meaning (as discussed above) wherever it appears in the Constitution of India. Therefore, the said expression as contained in Entry 54 of the State List includes a tax on the *transfer of property in goods (whether as goods or in some other form)* involved in the execution of a works contract.[20]The Court cited the observation of the Apex Court in *Builders' Association of India and others v. Union of India*[21], which affirmed the validity of the Amendment and accordingly held that after the Amendment it became permissible for the States to levy sales tax on the works contract involving supply/transfer of goods.

7.2 Pre-Conditions and Subject for Levy of VAT on Works Contract

The Court after referring to the decision of the Hon'ble Supreme Court in the *Larsen case*[22] reiterated the pre-conditions for taxing authorities to levy VAT on works contracts. The said pre-conditions are as follows:-

a) A works contract should exist.
b) While executing such works contract, goods should be involved.
c) The property in those goods must be transferred to a third party either as goods or in some other form.

[18]*ibid.*
[19]*supra* 11.
[20]*ibid.*
[21]*supra* 5.
[22]*supra* 2.

7.3 Building contracts are species of works contract

The Court after analyzing landmark decisions rendered by the Hon'ble Supreme Court concluded that builders are work contractors and agreement between the developer and the flat buyers to build a flat and thereafter sell the flat with some portion of land would be covered under '*works contract*'. The Court, in particular, relied in the case of *K. Raheja Development Corporation v. State of Karnataka*,[23] which had similar facts and was pertaining to issue of taxability of developers/builders under VAT.The Court held that though the activity of constructing/ building a flat is essentially a transaction of sale of flat, however, it has all the attributes of works contract. Since there will always be an element of sale of goods in a contract to build a flat, the Court came to a conclusion that building contracts will be species of the works contract.

7.4 Determining of taxable turnover relating to transfer of goods involved in the execution of works contract

Once it was settled that building contracts are works contracts, the Court went out to ascertain the principles for determination of taxable turnover pertaining to goods involved in the execution of works contract. In this regard, the Court apprehended two scenarios: a) where proper books of account are maintained by the developer, and b) when the developer does not maintain books of accounts. The Court held that in the first scenario, the charges towards service, labour and cost of land would be deducted as per the books of account. And, with regards to the second scenario the charges towards service labour and cost of land will be deducted as per the formula prescribed by the State legislature.

Further, the Court clarified that works contract will not be there when the agreement between the flat purchaser and developer is entered into after the completion of the flat. However, the element of works contract will be there when an agreement is entered into before construction has been completed and States would be empowered to impose tax on such transactions.

7.5 No Taxability on transfer of immovable property in a works contract

The Court held that while the state can tax the sale of goods element in a works contract under Article 366 (29A) (b) read with Entry 54 of State

[23]K. Raheja Development Corporation v. State of Karnataka, (2005) 5 SCC 162.

list, it cannot purport to tax the transfer of immovable property in such works contract.

7.6 Constitutional validity of Explanation (i) to Section 2(1) (zg) of the Act and Rule 25(2) of the Rules

The petitioner had challenged the constitutionality of Explanation (i) to Section 2(1)(zg) of the Act and Rule 25(2) of the Rules, since the said provisions provide for deductive method in the event of labour and services but does not provide any mechanism for exclusion of the value of land.

To examine the validity of the (i) to Section 2(1)(zg), the Court analyzed cases providing for principles of interpretation which results in sustaining the statute. The Court citing the judgment of the Constitution Bench of the Hon'ble Supreme Court in the *State of Madhya and others v. M/s ChhotabhaiJethabhai Patel and Co. and another*[24] held that, '*It is settled law that where two constructions of a legislative provision are possible one consistent with the constitutionality of the measure impugned and the other offending the same, the Court will lean towards the first if it be compatible with the object and purpose of the impugned Act.*' After relying to other cases, the Court held that rule of interpretation mandates that such meaning should be assigned to the provision which would make the provision of the Act valid and effective. Accordingly, the Court, keeping in view that said provision does not embrace within its ambit something which is prohibited by law, upheld its constitutionality.

Analyzing Rule 25(2) of the Rules, the Court stated that the 'deductive method' under the said rule provides a mechanism for deduction of charges towards labour, services and other like charges, however there is no mechanism for deduction which relates to the value of immovable property. The Court referred to the *Larsen case*, [25] wherein while considering the legality of Rule 58 of the Maharashtra Value Added Tax Rules, 2005 under similar circumstances, the Court had applied the principle of reading down a provision for upholding its constitutional validity. In light of the above case, the Court directed the State that the value of immovable property and any other thing done prior to the date of entering of the agreement of sale is to be excluded from the agreement value. Further the Court held that VAT is to be directed on

[24]State of Madhya Pradesh and Ors. v. M/s.ChhotabhaiJethabhai Patel and Co. and Anr., AIR 1972 SC 971.

[25]*supra* 2.

the value of the goods at the time of incorporation of goods in works contract and it should not purport to tax the transfer of immovable property. Consequently, the said rule was held to be valid. However, the State government was directed to amend the rule as per the above directions.

7.7 Joint and Several Liability of developer and sub-contractor: Constitutionality of Section 42 of the Act

The petitioner had challenged the constitutionality of Section 42 of the Act, [26] wherein the works contractor/developer appoints a sub-contractor to execute the works contract. The said Section provides for joint and several liability of the contractor/developer and the sub-contractor to pay tax in respect of transfer of property in goods involved in the execution of the works contract by the sub-contractor.

While interpreting the provisions of Section 42, the Court held that tax cannot be levied on the developer in respect of the value of goods involved in the execution of the works contract on which tax has already been paid by the sub-contractor. However, it was stated that this Section will protect the interest of revenue in the event of default on the part of the subcontractor to discharge his tax liability. Accordingly, the Court upheld the constitutionality of Section 42 of the Act.

8. CRITICAL ANALYSIS OF THE JUDGMENT – MORE PITFALLS THAN PROMISE?

The present deliberation has undertaken a critical analysis of the High Court's judgment under five sub-headings. To begin with, we have addressed the issue of 'postponed agreements', i.e., agreements entered into by a builder long after accepting the payment. Then we have moved on to the 'issues in land valuation' that the judgment has failed to cover and discussed the inefficacy of not referring the disputed 'matter to a competent appellate authority'. The final heading contains a critique of the highly 'complex accounting system' that the Court has prescribed for such cases of VAT assessment.

8.1 Postponed Agreements

It is known to us that the property in goods is taxed during its incorporation into the works and not thereafter. In the present case, the

[26] *supra* 8, at S. 42.

Court has stated that a tax cannot be levied on any work before the conclusion of the agreement between a buyer and seller.[27] But a dilemma may arise if the builder books an unit in advance by accepting a certain booking amount from a buyer, with an agreement being entered into later – maybe even after one or two years. The method of valuation in such cases, pertaining to taxable turnovers, necessitates further clarification. Also, the builders do not mention the unit that has been provided to a buyer during the booking, thus making it impossible to determine if the work done has been on the booked unit. This particular issue needs elaborate addressing by the concerned authorities.[28]

8.2 Issues in Land Valuation

Further, the Court also ordered to bring in the Rules that specify the deductions of land values from the total taxable turnover. Now, an issue will rise herein when the developer does not provide the value of land categorically, as an unit is booked per square feet and no information may be procured of the per head amount that has been taken from the buyers. The practice followed by the Housing Boards is that they specify the value of land and building individually while preparing the conveyance deed, although each unit is booked according to its value per square feet. Thus the concerned authority needs to obtain beforehand the land value upon which the stamp duty has to be paid and prescribed in a conveyance deed, and in instances wherein no valuation has been mentioned would require the authority to directly assess the entire value after giving the builders a reasonable opportunity, with the matter subsequently being possibly decided by the higher Courts.

8.3 Matter to Competent Appellate Authority

It needs to be noted that the Hon'ble Court decided to set aside all revision and assessment orders without giving them a hearing on merit, after which it remanded it to the appropriate authorities to freshly adjudicate on further hearing in view of the present judgment. But, since there was not any instance with the Court to adjudicate these matters as per merit, with all provisions of the Act/Rules/instructions upheld, the cases could have been put forward before a competent appellate

---

[27] *supra* 1, at 45.

[28] MaliniMallikarjun and Bhupender Singh, *Includibility of land value in works contract: A Pandora's Box! – Part II*, Taxsutra, available at http://www.idt.taxsutra.com/expertprint?sid=159, (last seen on 12 October 2015).

authority – in place of setting them aside and sending them to the authorities that passed the order, thus saving time and bringing about clarity to the issue in hand.[29]

8.4 Complex Accounting System

The keeping of accounts in accordance with the Court's guidelines is difficult since it is highly complex; the lack of accurate data with the authorities preventing them from making correct VAT assessments. Such issues can only be adequately addressed when GST debuts in India. With the system we have, the best option for builders is to take the lump sum composition scheme as per Rule 49A[30] and award the work contracts to only those sub-contractors who chose such lump sum payment scheme under Rule 49.[31] Such an approach will be both cost and time effective, bringing simplicity to the structure for buyers.

9. CONCLUSION – THE WAY FORWARD

This case has settled the dispute regarding the liability of builders who are engaged in the business of constructing and selling constructed flats, to pay VAT. The Haryana Government has failed to realize VAT from builders since April 1, 2003 - the date from which the Haryana VAT Act was made operational. One of the major reasons attributed was the willful default of the concerned officers responsible for the implementation of the Act. The builders and developers rescued themselves from meeting the statutory requirement of paying VAT on their businesses of constructing and selling buildings, by arguing that they were engaged in selling of constructed immovable property and there was no liability of any VAT on such sales. All of this created a situation where the authorities were uncertain about the taxability on sale of constructed buildings under the VAT laws, with no clarity on the liability of the builders to pay VAT. Amidst this chaos, there was a growing need to bring clarity on this issue for the consumers who as end users are ultimately charged VAT by the builders. The aforementioned case has gone a long way in firmly establishing the basis of VAT liability for builders engaged in the business of constructing and selling flats.

---

[29] *supra* 7.
[30] *supra* 10, at Rule 49A.
[31] *id*, at Rule 49.

The importance of this case lies in the fact that after the *Larsen case*,[32] this happens to be the only verdict that has explicitly mentioned building contracts to be works contracts. Further, it has improved the said decision by stating the principle that land transfer cannot be taxed under VAT or works contract. The onus thus now falls on the Haryana legislature to amend the definition of 'sale' in a manner that includes the transfer of property for goods related to immovable property while excluding the value of land for levying VAT or works contract. It is pertinent to note in this regard that the Legislatures of Uttar Pradesh, Karnataka, Delhi and Maharashtra have already amended their respective VAT Acts to exclude the value of land when valuing building contracts while levying VAT.[33]

.

[32] *Supra* 2.

[33] ShammiKapoor, Hitender Mehta &Shilpa Sharma, *Punjab & Haryana High Court Holds Non-Taxability of Land Transfer in Building Contracts (Works Contract)*, Mondaq, available at http://www.mondaq.com/india/x/395246/sales+taxes+VAT+GST/PUNJAB+HARYANA+HIGH+COURT+HOLDS+NONTAXABILITY+OF (last accessed on 02 October 2015).