DIVISIBILITY OF COMPOSITE CONTRACTS IN INDIA IN REGARD TO TAX LAWS

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ABSTRACT

The question of the divisibility of contracts entered into between various parties holds significant importance for revenue authorities, particularly given that contract clauses are often drafted to minimize tax liabilities. Nevertheless, the legal interpretation of taxing statutes has remained strictly textual, as tax laws require clear language regarding both the charging category and the machinery for subject-matter valuation. The scope of this article is restricted to Central tax laws and the subsequent Goods and Services Tax (GST) framework unifying indirect taxes of Central and State governments. The legal landscape in this field is actively shaped by two competing forces: revenue authorities seeking to safeguard tax collections and assessees offering statutory defenses, each presenting distinct interpretations of facts and law.

INTRODUCTION

Indivisible composite contracts are contracts whereby one party agrees to supply goods and render services to another party for a consolidated consideration, with no segregation between the goods or service components, thereby reflecting its composite nature. Consequently, such a contract cannot be treated solely as a pure contract for goods or a pure contract for services under indirect tax regimes such as Value Added Tax (VAT) or Service Tax. The bundling of multiple obligations into a single consolidated contract involving a unified gross consideration historically presented a major obstacle in the levy and collection of tax. However, taxing statutes must be specific in nature to impose any charge and are strictly interpreted by judicial authorities due to their non-quid pro quo character.

COMPOSITE CONTRACTS PRIOR TO 2007

Prior to 2007, composite contracts were governed by Chapter V of the Finance Act, 1994. Under this framework, the Act contemplated service contracts *simpliciter* and contained neither a charging provision nor the machinery necessary to levy and assess service tax on indivisible composite works contracts[1]. This statutory legal position assumed great importance, as parties to indivisible composite contracts could draft agreements consolidating goods and service components under a single transaction, thereby shielding the service component from tax exposure due to the lack of a statutory mechanism to divide the contract or evaluate the service component supplied.

In comparison to goods, determining the valuation of services supplied is particularly complex when masked under a consolidated contract for goods and services. The determination of the divisibility of composite contracts came squarely before the Supreme Court of India in *Commissioner of Service Tax, Chennai v. M/s Diebold Systems (P) Ltd.*[2]. In that case, the respondent-assessee was engaged in the business of supplying Automated Teller Machines (ATMs) and providing support services to various banks. The Directorate General of Central Excise Intelligence (Zonal Unit, Chennai) issued a Show Cause Notice alleging service tax liability on 33% of the gross consideration received by the assessee for the period from July 2003 to April 2006.

The Supreme Court held that during this period, an indivisible contract could not be separated into constituent elements of supply so as to bring a portion under a distinct taxable category not apparent from the face of the contract. Although the assessee discharged VAT/Sales Tax on the entire consideration of the contract, the demand for service tax on 33% of the gross consideration lacked a statutory basis under the Finance Act, 1994.

This ruling aligned with the statutory scheme recognized earlier by the Supreme Court in *Daelim Industrial Co. Ltd. v. Commissioner of Central Excise, Vadodara*, wherein it was established that in the absence of an express charging mechanism authorizing the vivisection of indivisible composite contracts, no part of a composite consideration could be artificially segregated and taxed under specific categories such as "commissioning or installation."

LEGISLATIVE REFORMS POST-2007

The post-2007 period saw the curing of this statutory defect under the Finance Act, 1994, empowering revenue authorities to properly classify the nature of a contract into its goods and service components. As a result, artful drafting of contract terms alone could no longer alter the applicable tax incidence.

The underlying canon of tax construction applied during this era, as recognized by the Supreme Court in *Shiv Steels v. State of Assam and Others*[3], established that:

"A taxing statute admits of neither intendment nor equity. The existence, extent and incidence of a tax must be discernible from the language employed by the legislature, and no tax can be imposed by implication or by an expansive construction of the charging provision. Equally well settled is the principle that machinery or valuation provisions facilitate the computation of a tax validly imposed and they do not create or enlarge the charge itself. The charging provision and the machinery provisions must therefore be construed harmoniously, but the latter cannot be employed to supply what the former does not enact."

To implement this principle, Section 65(105)(zzzza) was inserted into the Finance Act, 1994, defining "taxable service" as any service provided or to be provided to any person, by any other person, in relation to the execution of a works contract, excluding works contracts in respect of roads, airports, railways, transport terminals, bridges, tunnels, and dams.

The statutory definition categorized a "works contract" as an agreement wherein:

1. transfer of property in goods involved in the execution of such contract is leviable to tax

as sale of goods; and

2. such contract is for the purpose of carrying out:

1. erection, commissioning, or installation of plant, machinery, equipment, or structures (prefabricated or otherwise), electrical and electronic devices, plumbing, drain laying, or other installations for transport of fluids, heating, ventilation, or air-conditioning; or

2. construction of a new building, civil structure, pipeline, or conduit primarily for commerce or industry; or

3. construction of a new residential complex or part thereof; or

4. completion, finishing, repair, alteration, renovation, or restoration services related to (b) and (c); or

5. turnkey projects, including engineering, procurement, and construction (EPC) or commissioning projects.

Under this mechanism, works contracts were taxed only on the service portion calculated via specific valuation rules, separating out the material transfer component subject to state VAT/sales tax. To simplify this further, the Works Contract (Composition Scheme for Payment of Service Tax) Rules, 2007 was introduced. Under Rule 3(1), assessees were granted the option to discharge service tax liability by paying an amount equivalent to 4% of the gross amount charged for the works contract, rather than paying tax on the calculated service portion under Section 66 read with Rule 2A of the Service Tax (Determination of Value) Rules, 2006.

As ascertainable from the statutory wording, the works contract definition was introduced to address composite contracts, both sharing the essential characteristic of involving supplies of both goods and services. Therefore, this period witnessed legislative recognition of judicial precedents requiring explicit statutory intent regarding tax incidence while simultaneously providing the necessary machinery for valuation.

This principle aligns with Article 265 of the Constitution of India, which mandates that *"No tax shall be levied or collected except by authority of law."*

THE GST REGIME POST-2017

The enactment of the Goods and Services Tax (GST) framework under the Constitution (One Hundred and First Amendment) Act, 2016 unified state VAT, service tax, and central excise duties into a single tax regime[4]. Under Section 2(30) of the Central Goods and Services Tax (CGST) Act, 2017, a "composite supply" is defined as:

“...a supply made by a taxable person to a recipient consisting of two or more taxable supplies of goods or services or both, or any combination thereof, which are naturally bundled and supplied in conjunction with each other in the ordinary course of business, one of which is a principal supply;”

Illustration.—Where goods are packed and transported with insurance, the supply of goods, packing materials, transport and insurance is a composite supply and supply of goods is a principal supply.

This section is read in conjunction with Section 2(90) of the CGST Act, which defines "principal supply" as the supply of goods or services that constitutes the predominant element of a composite supply, to which any other constituent supply is ancillary. Under Section 8(a) of the CGST Act, the tax treatment of a composite supply is governed entirely by its principal supply, subjecting the entire transaction to the rate applicable to that predominant element.

However, disputes between taxpayers and revenue authorities frequently arise regarding what constitutes a "principal supply." When the dominant element remains elusive, revenue authorities rely on the contract consideration, correlating the largest proportion of consideration to the principal supply.

For example, in a contract involving the purchase and installation of industrial water pumps, where the installation service is ancillary to the sale of the pumps, the water pumps constitute the principal supply. The entire contract consideration is thus taxed at the GST rate applicable to water pumps.

A separate statutory classification exists for "works contracts" under Section 2(119) of the CGST Act:

“...a contract for building, construction, fabrication, completion, erection, installation, fitting out, improvement, modification, repair, maintenance, renovation, alteration or commissioning of any immovable property wherein transfer of property in goods (whether as goods or in some other form) is involved in the execution of such contract."

Pursuant to Paragraph 6(a) of Schedule II to the CGST Act, 2017, a works contract is legally deemed to be a supply of service. The key distinguishing feature of a GST works contract is its exclusive attachment to *immovable property*. To summarize current GST classifications:

1. **Composite Supply:** A transaction comprising naturally bundled goods and services where tax treatment is determined by identifying the "principal supply." Even though the contract consideration is not divided, the statutory scheme taxes the dominant component while absorbing ancillary elements.

2. **Works Contract:** Composite transactions involving immovable property, which are statutory deeming provisions categorized strictly as a supply of service.

To illustrate, in a composite supply comprising mobile phones (principal supply) and ancillary items for a gross consideration of ₹60,000 (where standalone phone value is ₹40,000), the total value of ₹60,000 is taxed at the 18% GST rate applicable to phones, resulting in a total tax liability of ₹10,800.

Under GST, the historical question of contract divisibility has been largely laid to rest by adopting the "Principal Supply Doctrine." Instead of vivisecting the contract, the statutory scheme identifies the predominant ingredient and subjects the entire contract value to that tax category.

VALUATION CHALLENGES AND REVENUE LEAKAGE

In spite of these statutory advancements, fundamental valuation challenges remain. Theoretically, a correct valuation method should mirror the market value of the underlying goods or services. However, market value can be elusive, as an ideal market assumes an environment where forces of supply and demand are not artificially altered and numerous independent buyers and sellers exist.

Instances of undervaluation by suppliers aiming to make bids competitive present serious risks of revenue leakage. Tax authorities face delays in tax collection as such artificially valued transactions must be identified quickly before fair market value can be determined under GST valuation rules, demonstrating that valuation mechanisms remain an active area of tax litigation.

CONCLUSION

The principles of tax law dictate that every action of a revenue authority—whether in direct or indirect taxation—must find express backing in charging statutes. Furthermore, the legal framework must be complete, providing not only the authority to charge tax but also all incidental machinery including valuation methods and subject-matter identification, without relying on arbitrary assumptions to expand statutory scope. Taxation is essential for state functioning, acting as both a revenue source and a policy tool to influence behavior through differential tax slabs and progressive wealth redistribution. While nuances like the divisibility of composite contracts may seem subtle to a layman, they represent the critical difference between fiscal deficit and surplus for the government.

Endnotes:

[1] *Commissioner, Central Excise and Customs, Kerala v. Larsen and Toubro Limited*, (2016) 1 SCC 170.

[2] *Commissioner of Service Tax, Chennai v. M/s Diebold Systems (P) Ltd.*, 2026 INSC 808.

[3] *Shiv Steels v. State of Assam and Others*, 2025 SCC OnLine SC 2006, ¶ 14.

[4] The Constitution (One Hundred and First Amendment) Act, 2016.