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Tax alert: Supreme Court holds that input tax credit is not restricted if construction of premises satisfies functional utility test and is germane to business

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In a landmark ruling, the Supreme Court has held that input tax credit (ITC) is available on construction of immovable property when the same is essential for providing taxable services such as leasing, renting etc. However, the restrictions would apply when the immovable property is constructed for personal use, or it is used by the person constructing as a setting in which business is carried out.

In a nutshell

Upholding the Constitutional validity:

- Credit restrictions in S. 17(5)(c) and 17(5)(d) is valid
- The term "plant and machinery" used in section 17(5)(c) cannot be equated with the term "plant or machinery" used in section 17(5)(d) of the CGST Act

Functionality Test:

If the construction of a building was essential for carrying out the activity of renting or giving on lease, the building could be held to be a plant, and the restriction provided in 17(5)(d) will not be applicable

Significant Relief to the Industry:

This judgement paves the way for settling long pending disputes between the Assessee and Department

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Background

- The assessee was carrying on the business of constructing shopping malls for letting out to various tenants and lessees.
- Various goods and services required for construction of one shopping mall in Orissa (it is now spelt as Odisha) were procured by the assessee.
- The assessee approached Revenue authorities for availing input tax credit (ITC) on goods/services used for construction of shopping mall and utilise this credit against payment of outward GST on rentals received from the tenants.
- However, the assessee was advised to deposit GST without claiming ITC, in view of section 17(5)(d) of the Central Goods and Services Tax Act, 2017 (CGST Act), which restricts ITC on goods and/ or services for construction of an immovable property (other than plant and machinery) on its own account.
- Being aggrieved, the assessee challenged the action of tax authorities by way of a writ petition before the Orissa High Court.
- The Orissa High Court read down section 17(5)(d) as the very purpose of ITC, is to benefit the assessee and held that, since the assessee is required to pay GST on outward supplies, ITC should not be restricted on construction services procured by it.
- Against the said ruling of the Orissa High Court, the Department filed a Civil Appeal before the Supreme Court. There were similar writ petitions filed before the Supreme Court, which were disposed off in the instant case.

Contentions of the assessee

Submissions on constitutional validity

- The restriction provided in the GST law is violative of Article 14 of the Constitution of India as it treats the assessees engaged in construction of immovable property and then renting/ leasing/ letting out etc. premises, on the same footing as an assessee engaged in construction of immovable properties for sale, by denying ITC for business expenditure, i.e., the expenditure incurred in constructing the immovable properties.
- There is no intelligible differentia on the basis of which classification is done in section 17(5)(d). The differentia canvassed by the state, which is immovable characteristic of the deliverable i.e., building under a works contract is artificial and non-existent in the eyes of law.
- Break in chain is also not a differentia. There is no break in the chain at any of the levels of the business activity, starting from the subcontractor to the main contractor and the assessee, since all three entities are liable to output GST, and therefore, in such a case, denial of ITC cannot be justified.
- Even through the construction services are procured in relation to an immovable property, denial of ITC in such cases continues the cascading effect of tax, contrary to the objective of the GST law in eliminating the cascading effect of tax and achieving tax neutrality.
- Right to avail ITC is a statutory right under the GST law and blocking ITC on rentals collected by the assessee who has constructed the building, leads to unjust enrichment by the Revenue and violative of right to avail ITC flowing as per Section 300A of the Constitution of India (no one can be deprived of their property without the authority of law).

Submissions on reading down of section 17(5)(c) and 17(5)(d) of the CGST Act

- Clauses (c) and (d) of section 17(5) must be read down to the extent that ITC is blocked for suppliers who procure taxable works contract services, goods or services on the input side and then provide taxable supplies on the output side.
- GST law was introduced to prevent cascading effect of multiplicity of taxes. Since assessee is not permitted to avail ITC of the GST paid on construction services, it gets added to the price of outward services, i.e., renting/ leasing/ letting out. Further, GST is leviable on the outward supplies, services, resulting in tax on tax or the cascading effect of tax.
- The phrase "on his own account" should be interpreted in relation to construction done for personal use (towards an office/ building/ factory building). In such a case, GST is not applicable on sale of such a building and, therefore, a chain of taxability breaks. However, where construction is done for further renting of the immovable property, it should not be covered by the expression "on his own account".
- The restriction is not applicable in case of plant or machinery. The said phrase has not been defined in the GST law. Also, the Supreme Court, in earlier judgements, has held that "plant" means land, building, machinery, apparatus and fixtures employed in carrying on trade and other industrial business.
- Functionality or essentiality tests must be applied to decide what a plant is. The Supreme Court has previously held that a generating station building, hospital, pond, dry dock are "plants".
- In the instant case, malls, hotels, warehouses, etc., are "plants" A building or warehouse must be considered to be a "plant" since it serves as an essential tool of trade with which business is carried on and, therefore, ITC is not restricted on the construction of the same.
- The term "plant or machinery" provided for exemption from blocked credit in clause (d) is different from "plant and machinery" used in Clause (c). Accordingly, the explanation of 'plant and machinery' provided after section 17(6) is not applicable to Clause (d).
- While the term 'plant and machinery' has been used at least 10 times in Chapters V & VI, the term 'plant or machinery' has been used only once in section 17(5)(d) which clearly demonstrates the intention of the legislature. Reference was also made to the model GST law to substantiate the submission.

Contentions of the Department

Submissions on constitutional validity

- Classification of the assessee on the same footing as those engaged in construction of immovable properties and for further sale is justified on the ground that the classification has been done on a reasonable and logical basis as the transactions lead to the creation of immovable property.
- Further, such classification has a rational nexus with the object of GST since there is a break in the tax chain and therefore, the ITC is being denied.
- ITC is not a fundamental or constitutional right.
- In case of tax legislations, principle of equality does not preclude the classification of property, credit, profession and events for taxation. Also, a taxing statute is not open to challenge on the grounds that tax is harsh or excessive.

Submissions on interpretation of section 17(5)(c) and 17(5)(d) of the CGST Act

- It is not uncommon to read "and" as "or" or "or" as "and". Accordingly, the expression "plant or machinery" must be read as "plant and machinery",.

- For identification of plant and machinery/plant or machinery, it is not necessary to refer to decisions under the income tax law, as there is no concept of ITC under the income tax law.
- Main purpose of ITC is to extend, the ITC paid at the anterior stage to remove the cascading burden of taxation at a subsequent stage. Accordingly, if a shopping mall is sold as an immovable property immediately after the completion certificate is issued, no GST is payable at the time of sale of the immovable property. Also, if the mall is used to render renting service for five years and then is sold after five years, no GST will be payable on the sale.
- However, if ITC is allowed as contended during these five years, ITC will be exhausted against GST payable on rental income. Thereafter, the mall would be sold without paying any tax, which would cause a substantial monetary loss.

Observations and ruling of the Supreme Court

- Construction is said to be on a taxable person's "own account" when :
  - it is made for his personal use and not for service or
  - it is to be used by the person constructing as a setting in which business is carried out.
- However, construction cannot be said to be on a taxable person's "own account", if it is intended to be sold or given on lease or license.
- If there is a complex, building or civil structure constructed which is intended for sale to a buyer, wholly or partly, construction becomes a supply of service only, if consideration for sale is received before the issuance of a completion certificate or after its first occupation (whichever is earlier). On the contrary, the sale transaction will not amount to supply of service.
- However, no such distinction has been made in the case of lease, tenancy, or licence concerning land or letting of buildings. Thus, even if the entire consideration for lease, tenancy, or a licence to occupy land or a lease of a building is paid after the issuance of the completion certificate or its first occupation, it continues to be a supply of service.
- ITC has been granted by the legislature and the Court cannot add/ subtract from the provisions of the GST law. It cannot be disputed that the legislature can always carve out exceptions to the entitlement of ITC under Section 16 of the CGST Act.
- The cases covered by clauses (c) and (d) of section 17(5) are entirely distinct from the other cases. This appears to be done to ensure the object of not encroaching upon the State's legislative powers under Entry 49 of List II. Therefore, it is not possible to accept the submission that the difference is not intelligible and has no nexus to the object sought to be achieved. Therefore, 17(5)(c) and 17(5)(d) of the CGST Act are not *ultra-vires* and are valid.
- "Plant or machinery" in section 17(5)(d) cannot be read as "plant and machinery" used in section 17(5)(c), and that a building can also qualify as plant under section 17(5)(d) of the CGST Act.
- When the legislature has used the expression "plant and machinery," only a plant will not be covered by the definition. The expression includes such foundations and structural supports fixed to the earth. However, the definition excludes land, buildings, or any other civil structures.
- The expression "plant or machinery" has a different connotation; it can be either a plant or machinery. The very fact that the expression "immovable property other than "plants or machinery" is used shows that there could be a plant that is an immovable property.
- If it is found, based on the facts, that a building has been planned and constructed to serve an assessee's special technical requirements, it will qualify to be treated as a "plant". The word "plant" must be interpreted by applying the functionality test.

- If a building qualifies as a plant, ITC can be availed against the supply of services in the form of renting or leasing the building or premises, provided the other terms and conditions of the GST law are fulfilled.
- If the construction of a building by the recipient of service is for his own use, the ITC would not be available.
- In the present case, the High Court has read down the provision. The High Court has not decided whether the mall in question will satisfy the functionality test of being a plant. Each mall is different. Therefore, the case needs to be remanded back to the High Court to decide whether, on facts, the mall in question satisfies the functionality test so that it can be termed as a plant within the meaning of section 17(5)(d).
- While the amended section 16(4) has been held **not** to be arbitrary and discriminatory, the Court also observed that the provisions could have been drafted in a better manner or more articulately is not sufficient to attract arbitrariness.

Our comments

For determining what constitutes a plant, the Hon'ble Court has held that whether a building is a plant or not, is a question of fact. If it is found, based on the facts, that a building has been planned and constructed to serve an assessee's special technical requirements, it will qualify to be treated as a plant. The word "plant" must be interpreted by applying the functionality test. We need to see how the departmental authorities plan to adopt this principle and allow ITC or whether it would pave the way for a fresh round of litigation in determining whether a particular building is essential for rendering services.

Also, it is needed to examine whether the principle laid down in this judgement will be relevant for works contract service received for construction of immovable property.

Also, the Hon'ble Court observed that had it been a drafting mistake in using 'or' in 'and', the legislature could have stepped in to correct it. Now that the decision is held in favour of the Industry, will the government amend the law retrospectively to give effect to the original intention of denying the credit which has been the principle from the erstwhile regime?

While the DGGI and other authorities, who, in the past, forced assessees to reverse the construction credit along with interest and penalties, we need to examine how the assessee plans to re-avail the credit.

Also, another question that arises is that while the time limit for availment of credit has been upheld, what would be the fate of assessees who had not availed ITC at first place, assuming a pushback from the Department?

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