SC, while affirming the validity of blocked ITC on immovable property, allows buildings to qualify as 'plant' for ITC availment, subject to functionality test

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Summary

The Supreme Court (SC) has upheld the constitutional validity of Section 17(5)(c) and (d) (impugned provisions) of the Central Goods and Services Tax Act, 2017 (CGST Act), which restricts the availability of the input tax credit (ITC) on goods and services used in the construction of immovable property, even if the property is intended for leasing or renting. Distinguishing between the terms 'plant *or* machinery' and 'plant and machinery,' the SC clarified that these expressions could not be given the same interpretation. It emphasised that whether a building or structure qualifies as a 'plant' depends on its functionality and role in business operations and must be evaluated on a case-by-case basis. The SC noted that structures actively involved in business activities, such as malls or warehouses, may be considered 'plant' if they serve as essential business tools rather than merely functioning as passive locations. Consequently, the case has been remanded to the Orissa High Court (HC) to determine whether a shopping mall is a 'plant' and falls under this exception, potentially allowing the ITC if it satisfies the functional test.

Facts of the case

- M/s Safari Retreats Private Limited ('the respondent') is engaged in the construction of a shopping mall primarily to let out the premises within the mall for commercial purposes. The respondent had incurred substantial costs in inputs (such as cement, sand, steel, aluminium, wires, plywood, paint, escalators, and electrical equipment) and input services (architect fees, etc.) for the mall's construction.
- Consequently, upon completion of the construction of the mall, the respondent intended to use the accumulated ITC against the outward tax payable on rental income from the properties.
- Section 17(5)(c) & (d) restricts the ITC on goods and services received by a taxable person for the construction of an immovable property on his ownaccount even though such immovable property is used in the course or furtherance of business. Because of the prescribed restriction, the petitioner was ineligible to avail the ITC for the aforesaid inputs and input services.
- The petitioner had assailed the constitutional validity of the provisions before the Orissa HC on the premise that it restricted the seamless flow of credit, and such denial of the ITC is unjust, arbitrary, oppressive, and contradictory to the basic rationale of GST.
- The HC had held that the purpose of the CGST Act is to provide a uniform law for the levy and collection of tax on intra-state supply of goods and services and to prevent multi-taxation[1]. The narrow interpretation of the impugned provisions was frustrating the CGST Act's objective, considering that the HC read down Section 17(5)(d).
- The decision was premised on the fact that if GST is required to be paid on rental income arising from the renting of mall premises, the entitlement to avail the ITC for the inputs and input services consumed in the construction of mall cannot be restricted. The department challenged the HC's judgement before the SC.

Issue raised before SC

- Whether the meaning of 'plant *and* machinery' as defined in the explanation to Section 17(5) can be applied to 'plant *or* machinery' used in Section 17(5)(d).

[1] The Constitutional (101st) amendment Act 2016 clearly states in the statement of objectives for ushering in GST that it is to remove the cascading effect of taxes (*tax-on-tax*) and allow the seamless flow of the tax credit across the supply chain.

- Whether the impugned provisions, along with Section 16(4) of the CGST Act, are constitutionally valid.

Respondent's contentions

Impugned provisions are violative of the Indian Constitution

- The impugned provisions treat dissimilar entities, i.e., those constructing immovable property for sale and those renting/ letting out, as equals by denying the ITC to both. This contradicts the GST principle of allowing the ITC on business expenditure, leading to arbitrariness.
- Denial of the ITC results in tax cascading, thereby defeating the objective of GST. Additionally, the lack of clear definitions for terms like 'on its own account' and 'plant or machinery' creates ambiguity, making the provisions vague and susceptible to challenge.
- The ITC is a statutory right, and blocking it for rentals collected post-construction results in the unjust enrichment of the State.

Impugned provisions to be read down to the extent it blocks ITC against taxable outward supplies

- The introduction of GST aimed to simplify the indirect tax regime and eliminate the cascading effect of taxes by allowing seamless ITC flow through the entire supply chain. However, denial of the ITC for construction costs leads to increased costs for services such as renting or leasing, resulting in a cascading effect of taxes and contradicting the core GST principle.
- The phrase 'on its own account' employed in the impugned provisions should be interpreted to mean construction for personal use and not for further provision of services like renting or hotel operations, where the immovable property itself is used for generating business. Accordingly, the impugned should be read down to align with GST objectives, ensuring that the ITC is available when there is no break in the taxable supply chain and avoiding the cascading effect of tax.

Functional test

- **'Plant and machinery' is different from 'Plant or machinery'**: The expressions are intentionally distinct, with 'plant or machinery' appearing only once, indicating the legislature's intent to treat them differently. Accordingly, the definition of 'plant and machinery' appended in the explanation to Section 17(5) cannot be applied to 'plant or machinery.'
- **Functionality and essentiality test**: Absent the explicit definition of the term 'plant,' its interpretation should follow commercial understanding. Accordingly, by applying the functional and essentiality tests, structures like malls or warehouses can be classified as 'plants' if they serve an essential business function, not just as settings for operations.

Revenue's arguments

- The classification based on the 'creation of immovable property' resulting in the denial of the ITC has an intelligible differentia and rational nexus with the objectives of GST due to a break in the tax chain.
- ITC is a statutory right, not a fundamental one, and cannot be claimed unless explicitly permitted in law.
- The term 'plant or machinery' should be read as 'plant and machinery' to maintain consistency and avoid contradictions between clauses (c) and (d) of Section 17(5). This avoids an unintended differentiation between similar scenarios under the GST Act.
- It is trite that a taxing statute is not open to challenge on the grounds that the tax is harsh or excessive.

SC's observations and judgement [CA No. 2948 of 2023]

Interpretation of the expression 'on own account'

- The SC observed that the blocked credit provisions restrict the ITC on goods or services used to construct an immovable property except where such immovable property is classified as 'plant or machinery' or such construction is on 'own account'.
- The SC held that construction is considered on 'own account' if it is either for personal use (*e.g., an office or factory for personal business*) or used as a setting for undertaking business activities.
- However, if the property is built for sale, lease, or license, it does not qualify as construction 'on own account,' making it eligible for the ITC. Thus, ITC eligibility under Clause (d) hinges on the purpose and usage of the constructed property.

Lease, tenancy, or license for land or letting of buildings are always 'supply of services'

- The SC observed that the sale of a building is considered a supply of service only if payment is received before the completion certificate (CC) or first occupation, whichever is earlier. However, there is no such requirement for lease or tenancy of land/buildings and it remains a supply of service regardless of when the payment is made.

Distinction between 'Plant and machinery' and 'Plant or machinery'

- The SC observed that the expression 'plant and machinery' has been defined in the explanation to Section 17(5), but the expression 'plant or machinery' remained undefined under the CGST Act. It emphasised that such a distinction is a conscious and intentional decision of the legislature because the expression 'plant and machinery' has been used multiple times in the GST provisions as against 'plant or machinery', which is only used once in Section 17(5)(d). A deliberate differentiation in the wording cannot be considered a drafting error.
- The SC explained that the expression 'plant and machinery' required the presence of both plant and machinery together. On the contrary, the phrase 'plant or machinery' can refer to either a 'plant' or 'machinery' individually which can be considered an immovable property. Considering the absence of an explicit definition of the term 'plant,' its ordinary meaning within a commercial context should be taken.

'Functionality test' a major determinant for establishing qualification as a 'Plant'

- The SC explained that a building that is constructed to serve as a shelter/space for conducting business activities would not qualify as a 'plant', as it does not serve a direct functional role in the operations themselves. However, if a building, such as a dry dock, plays an integral part in specific processes, e.g., holding ships in position during repairs, it would qualify as a plant.
- Applying the functionality and essentiality test established in various judgements[2], the SC held that a building might qualify as a plant if constructed to meet specific technical requirements. The term 'plant' cannot be restricted by the definition of 'plant and machinery,' which excludes buildings. Thus, a building could be considered a 'plant' under the functionality test and should be interpreted accordingly.
- The SC caveated that each mall is unique, and a fact-based inquiry is necessary to determine whether it would qualify as a plant. Similarly, warehouses and other buildings (except hotels and cinema theatres) must be assessed individually to determine if they meet the criteria for being classified as a 'plant.' Since the HC had not determined whether the mall would satisfy the functionality test to qualify as a 'plant,' the SC remanded the case to the HC.

Impugned provisions are constitutionally valid

- The SC highlighted that laws governing economic activities are more flexible than civil rights laws due to the complexity involved, allowing the legislature a wider scope in framing such regulations.
- The SC held that the differentiation between certain immovable properties and movable goods, resulting in a restriction on the ITC for such immovable properties, is based on a reasonable classification. Such legislative distinction serves a legitimate purpose of maintaining the State's legislative powers (concerning taxes on land and buildings) and, therefore, is not discriminatory, as equals are not treated unequally. Accordingly, the argument of discrimination fails due to the complex fiscal nature of the law.
- The court also emphasised that the ITC is not an inherent right of taxpayers but a benefit conferred by the statute. Therefore, unless a specific statutory provision grants the ITC, it cannot be claimed as a matter of right. The exclusions under clauses (c) and (d) are thus valid as long as the statute stipulates them. This classification serves a legitimate purpose and maintains a rational nexus with the objectives of the CGST Act.
- Considering the above, the challenge to the constitutional validity of the impugned provisions, along with Section 16(4), which prescribed the time limit for availing the ITC, was dismissed.

[2] Taj Mahal Hotel [(1971)3 SCC 550]; Victory Aqua Farm Limited ((2016) 16 SCC 553); Karnataka Power Corporation ((2002) 9 SCC 571)

Our comments

The highly anticipated judgment of the Supreme Court will have broad implications across sectors and has potentially opened the doors for ITC availment on construction-related expenses. This is contingent on businesses demonstrating that the immovable property serves a functional role akin to 'plant or machinery,' particularly when such property is constructed for the purpose of leasing or letting out. This links ITC eligibility to the property being used for generating taxable rental income, ensuring a clear connection between the ITC and taxable output. This ruling could ease the financial strain on tenants occupying leased commercial spaces, as lessors may now claim ITC on the construction of the leased property, potentially leading to lower rental costs.

Moreover, the effects of this judgement are not limited to commercial real estate. Other industries, like those with entities that own or construct buildings, such as factory premises, jetties, storage tanks, and large industrial facilities, may now re-evaluate their ITC eligibility under the new functionality test. This could prompt businesses to rethink their construction methodologies and justifications for usage to optimise tax savings through the ITC.

However, the ambiguity surrounding the terms 'plant and machinery' and 'plant or machinery' may necessitate further legislative or administrative clarification. The decision underscores the need for a more precise statutory definition or explanation of the term 'plant' to avoid differing interpretations, which would streamline compliance and reduce litigation. Given the potential impact, it will be interesting to see if the government introduces an amendment to change 'plant or machinery' to 'plant and machinery,' which could have significant ramifications.

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@Grantthornton_bharat
GTBharat@in.gt.com