

DESAI SAKSENA & ASSOCIATES

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Friday Tax Alert

From:

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Supreme court landmark ruling on GST: A game changer for ITC on construction expenses for leased buildings

In a development that may encourage increased investment in commercial real estate, the Supreme Court granted the industry relief on Thursday by permitting the application of input tax credits (ITC) on construction expenses for commercial buildings meant for leasing.

The Supreme Court of India recently issued a landmark judgment in the case of Chief Commissioner of Central Goods and Service Tax & Ors. Vs Safari Retreats Private Ltd. & Ors. (Supreme Court of India) interpreting Section 17(5) of the Central Goods and Services Tax (CGST) Act, which could significantly alter how businesses claim Input Tax Credit (ITC) on immovable properties like shopping malls, commercial complexes, and office buildings. This decision holds the potential to shift the compliance landscape for entities involved in constructing properties for leasing, renting, or commercial purposes.

Background of the case

In the case of Safari Retreats, a mall owner approached the Orissa High Court, arguing that when a mall is being built to provide commercial rental services for the shop spaces therein, there should be no restriction on availing input credit/set-off for the GST cost incurred on the said construction.

The Orissa High Court upheld this argument, and the GST authorities subsequently appealed to the Supreme Court. Several similar matters eventually reached the Supreme Court, leading to the formation of a large batch of matters on this legal point. Some of these newer matters also challenged the constitutional validity of such a restriction on input GST credit. The Supreme Court has pronounced its judgment—while it has rejected the constitutional validity of the restriction, it upheld the conclusions of the Orissa High Court and, among other things, held that input credit will be allowed if the construction activity is for ‘plant’ or ‘machinery’.

Understanding the issue

Section 17(5) of the CGST Act restricts the availment of ITC on goods and services used for the construction of immovable properties, with a key exception for “plant and machinery.” The intent behind this provision is to ensure that ITC is not misused for personal construction or for purposes that do not contribute to taxable supplies.

However, in scenarios where a business constructs a property for commercial use—such as renting out a shopping mall or leasing office spaces—the question arises: should the ITC on construction expenses be allowed?

This question took center stage in the Safari Retreats Pvt. Ltd. v. Chief Commissioner of Central Goods and Service Tax & Ors. case, where the first respondent, M/s Safari Retreats Pvt. Ltd., faced restrictions on claiming ITC for constructing a shopping mall that would be leased out for commercial purposes.

The Key Takeaway – The Functionality Test

The Supreme Court’s decision revolves around a critical interpretative element—the functionality test. The Court has effectively broadened the scope of what could be considered a “plant,” thus potentially allowing certain immovable properties to qualify for ITC based on their business usage.

What is the Functionality Test?

The functionality test is a principle that examines how integral a property is to the business's operations:

Integral to Taxable Supply: If the property plays an essential role in generating taxable supplies (e.g., a shopping mall constructed for renting), then it may be classified as a "plant."

Determining ITC Eligibility: This test helps determine whether a property is more than just a passive asset and is, in fact, functionally necessary for the business, thus qualifying for ITC under Section 17(5).

Safari Retreats Case: A Turning Point

The case of M/s Safari Retreats Pvt. Ltd. is pivotal to this ruling. The company had constructed a shopping mall and accumulated ITC on the goods and services used during the construction phase. They aimed to offset this credit against GST payable on the rental income received from tenants. However, tax authorities rejected the claim based on Section 17(5)(d) of the CGST Act, which blocks ITC on the construction of immovable properties "on one's own account."

The Supreme Court's ruling has now sent the case back to the Orissa High Court for reconsideration based on the functionality test. This will require the High Court to ascertain whether the shopping mall can be classified as a "plant" under the functionality test.

The Impact of the Ruling on Businesses

The Supreme Court's ruling opens the door for a more nuanced interpretation of ITC on immovable properties. The key points of impact include:

Potential ITC on Construction Expenses: Businesses constructing immovable properties like malls, hotels, office complexes, and warehouses could claim ITC on construction costs if they can demonstrate that the property is an essential part of their business operations. This could significantly reduce their tax burden.

Aligns with the Objective of Seamless Credit:

The ruling supports the larger GST objective of allowing seamless credit flow and avoiding the cascading effect of taxes. By allowing ITC on construction costs for properties used to generate taxable supplies, the judgment aligns with the goal of tax neutrality.

Importance of Business Purpose: The functionality test implies that entities must assess the role of their property within their business model. If the property is directly linked to taxable activities like renting or leasing, it stands a better chance of being classified as a "plant" for ITC purposes.

Encourages Re-evaluation of Tax Positions: Businesses involved in commercial real estate, hospitality, retail, or any sector where properties are constructed for business activities should reevaluate their tax positions. If their immovable property is critical to their supply of services, they might now be able to claim ITC on its construction.

The Court's Balanced Approach to Tax Policy

While this ruling offers clarity on the interpretation of Section 17(5), the Supreme Court emphasized that it is not the role of the judiciary to modify tax policies or laws. Such changes are under the purview

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of the GST Council, which is responsible for addressing policy inconsistencies or practical challenges in implementation.

The Court's ruling encourages the GST Council to take a fresh look at Section 17(5) and consider the practical implications of denying ITC on construction costs for commercial properties used in generating taxable supplies. The expectation is that this judgment will prompt policy adjustments to create a more equitable and business-friendly tax framework.

Steps for Businesses to Maximize ITC Benefits

For businesses, the ruling provides an opportunity to optimize their tax strategy and take proactive steps to leverage ITC on construction costs:

Assess the Role of Property in Your Business: If you own properties like shopping malls, office complexes, or warehouses that are integral to your taxable supplies, evaluate how they function in your business model.

Review Section 17(5) Restrictions: Carefully analyze the provisions under Section 17(5) of the CGST Act and assess if your property can qualify as a "plant" under the functionality test. The goal is to establish that the property is not merely a passive asset but a critical component of your taxable activities.

Document and Justify ITC Claims: Ensure that all documentation related to the construction and usage of your property is in order. Be prepared to justify the property's role in your business operations to support your ITC claims.

Conclusion:

The Supreme Court's interpretation of Section 17(5) of the CGST Act brings much-needed clarity and could serve as a catalyst for more equitable ITC provisions for businesses. By introducing the functionality test, the Court has signaled that commercial properties used actively for generating taxable supplies should not be treated as passive assets and deserve fair ITC treatment.

This ruling could lead to substantial tax savings for businesses with construction costs, provided they meet the criteria established by the functionality test. It underscores the importance of aligning tax positions with business models and staying informed about policy changes that could affect tax planning and compliance.

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Major TDS Rates Changes, w.e.f 01st October 2024

TDS Sections	Current TDS Rate	Proposed TDS Rate	Effective from
Section 194D - Payment of insurance commission in case of other than company	5%	2%	1st April 2025
Section 194DA - Payment in respect of life insurance policy	5%	2%	1st Oct 2024
Section 194G -Commission on sale of lottery tickets	5%	2%	1st Oct 2024
Section 194H - Payment of commission or brokerage	5%	2%	1st Oct 2024
Section 194-IB - Payment of Rent by certain individuals or HUF	5%	2%	1st Oct 2024
Section 194M - Payment of certain sums by certain individuals or HUFs	5%	2%	1st Oct 2024
Section 194-O - Payment of certain sum by e-commerce operator to e-commerce participants	1%	0.1%	1st Oct 2024
Section 194T - Payments to partners of firms	-	10%	1st April 2025
Section 194F - Payment on account of repurchase of units by mutual funds or UTI	Proposed to be Omitted		1st Oct 2024