

Decoding the draft GST law

Impact on Real Estate sector

June 2016

India on the brink of GST

The current Indirect tax regime in India provides for a complex tax environment due to multiplicity of taxes, elaborate compliance obligations and tax cascading. In addition, the Real Estate industry has been embroiled in disputes due to ambiguity in provisions as well as multiple taxation. The proposed GST regime is expected to simplify the Indirect tax regime as it would subsume most of the Indirect tax laws (except Stamp duty) and hence is touted as a major tax reform.

There has been significant progress on the GST front recently. With the release of the draft Model GST Law on 14 June 2016, a major milestone has been achieved, and India has certainly moved a step closer to GST. It is expected that the Government would push for passage of the GST Constitution Amendment Bill during the upcoming Monsoon session. India finally seems to be on the cusp of implementing this much awaited tax regime.

In the ensuing paragraphs, we have sought to identify the key aspects of the Model GST Law as may be relevant for the Real Estate Industry.

1. Possible increase in Real Estate price? – Interplay between tax rate and credit eligibility

Scheme of taxation under proposed GST law for works contract is as under:

- Works contract as well as sale of under-construction property deemed as ‘service’
 - No specific valuation provision (deduction of land or abatement or composition) prescribed for construction contract or sale of under-construction property
 - Free of cost supplies by recipient to contractor would be liable to GST. Thereafter, the contractor may need to include value of such free supplies in the value of his services.
 - Following specific restrictions are proposed under credit rules with regard to goods and services acquired for the purpose of construction of immovable property as per section 16(9):

‘(c) goods and/ or services acquired by the principal in the execution of works contract when such contract results in construction of immovable property, other than plant and machinery

‘(d) goods acquired by a principal, the property in which is not transferred (whether as goods or in some other form) to any other person, which are used in the construction of immovable property, other than plant and machinery’

Per the above, key implications are discussed below.

Currently, both VAT and Service tax is applicable on construction as well as sale of under-construction property (referred to as ‘works contract’) at abated/ concessional rate¹. This has not only resulted in higher tax burden but also in numerous litigations for real estate developers.

The Model GST Law specifies that works contract would be taxed as a service. This is a welcome move and should provide certainty on taxability of the construction sector.

However, there is no specific valuation provision for works contract services. The Model GST law provides that the value of a supply would typically be the transaction value. In case no deduction is provided under GST for value of land, or no abatement/ composition is provided, it may lead to significant increase in tax burden, especially if such services are taxed at Standard GST rate (which is expected to be 18%). Even if such services are subjected to lower tax rate (expected to be around 12%) considering that there is additional tax incidence in the form of Stamp duty on value of land/ immovable property, it would need to be evaluated whether the tax incidence would be higher than the current regime (in absence of any deduction).

The above-mentioned restrictions under credit rules could have significant adverse impact on Real Estate industry. The industry was expecting a much more liberal credit regime where it could get the credit of the construction services acquired in relation to commercial property which would be subsequently leased.

¹ For construction contract - Service tax to be paid at 40% of value in case of works contract and VAT to be paid depending on relevant valuation scheme (post abatement value is 70%-75%)
For sale of property – Service tax to be paid on 30% of value and VAT to be paid depending on relevant valuation scheme (Post abatement value is 70%-75% or, alternatively, composition scheme is available)

However, the draft law could be interpreted to mean that there may not be any credit available either to a contractor or the developer involved in construction of immovable property (whether sold as under-construction property or leased). This does not seem to be the intent of the lawmaker and hence would need significant revision.

Considering the absence of valuation rules and the restrictions under Credit Rules, the proposed law as it stands today could have a negative impact on the Real Estate Industry.

Key Action points

- Assess possible impact if no deduction is provided under GST – Possible impact on vendor agreements as well as prices of the property
- Representation for lower rate of tax for Real Estate sector
- Representation for specific valuation rule under GST which provides for deduction of value of land from transaction value. Such representation may include that no tax to be levied on FOC supplies in hand of contractee as the same would be revenue neutral
- Representation for simpler and liberal credit regime allowing credit of goods and services acquired either by contractor or developer and the provisions should not be subject to multiple interpretations which would result in future litigations
- Review of existing contracts with customers as well as contractors/ vendors to analyze impact of change in taxability of works contract – Tax clause and Change in law clause to be analyzed
- Future contracts to be framed in light of proposed GST provisions for tax optimization
- In case of increased eligibility of credit, IT systems would need to be revamped to record input tax credit (currently various credits may not be recorded if developer opts for composition/ abatement scheme).

2. Ambiguity on taxability of TDR may continue

It is a common practice for the landowner to transfer development rights in the land to the developer. In lieu of such rights, the developer may provide a fixed quantity of flats to the landowner or share in the revenue from sale of the flats. Ambiguity remains regarding taxability of such TDR as to whether the same are liable to Service tax, and at what value.

The Model GST Law defines ‘supply’ in very wide terms, which also includes barter/ exchange of goods or services. Hence, ambiguity on taxability of TDR may continue under GST.

If TDR is taxable, time of supply, the valuation of transfer of the development rights by the landowner to the developer, as well as credit eligibility of the developer needs to be clearly provided for in the GST law. If the current credit provisions remain, the developer may not be entitled to avail credit of GST paid on TDR, hence resulting in huge incremental cost.

Key Action points

- Represent to Government for clarity on treatment of TDR to avoid any future litigation under GST law
- Advocacy for removal of restriction on credit of goods/ services used in works contract services

3. Possible requirement of contract restructuring

Place of provision for services in relation to immovable property would be location of the immovable property.

There may be possible issues where a single contract is entered into for provision of services related to immovable properties across two or more States. For example, in case of facility management services outsourced to vendors, typically, a single contract may be entered into with the vendor, for which consolidated invoices may be raised at one location.

Under GST, since immovable property may be located in more than one State, the place of supply would be each such State where the immovable property is located, and hence, there may be a requirement for the vendor to raise separate invoices (for which separate contracts may also be required).

Key Action points

- Identify vendor contracts which need to be split State-wise to comply with GST requirement
- Revamp IT system to be in line with place of supply for various transactions

4. Input Service Distributor concept ('ISD')

ISD concept has been proposed for transfer of credit of input services between two or more locations. ISD can transfer credit of all types of GST (CSGT, SGST or IGST). Further, ISD can be any supplier of goods or services. Considering the possibility of multiple registration state-wise, ISD could be used as a tool to ensure optimal utilisation of head office related credit, and hence resulting in actual reduction in cost.

Key Action points

- Locations to be identified where there may be accumulated credit, and there may not be sufficient output liability – ISD registration may be taken in such State to distribute credit to other locations

5. Compliance requirements

Registration may be required in each State where there is a premises from where supplies are being made. Hence, registration may need to be obtained in each State where there is a premises (including site office) from which services are being provided.

One aspect which may be analysed is, if place of business is located in one State and services relating to immovable property are provided in various States (where there is no place of business), would registration be required in all States, or would it suffice if registration is obtained in only one State.

Key Action points

- Identification of States where registration may be required
- Appropriate changes required in IT systems to be GST compliance ready

6. Impact on ongoing contracts

Specific transition provision has been stipulated vide Section 159 and 160 for works contract/ periodic supplies as under:

'159. The goods and/or services supplied on or after the appointed day in pursuance of a contract entered into prior to the appointed day shall be liable to tax under the provisions of this Act.

160. Notwithstanding anything contained in section 12 and 13, no tax shall be payable on the supply of goods and/or services made on or after the appointed day if the consideration for the said supply has been received prior to the appointed day and the duty or tax payable thereon has already been paid under the earlier law'

Per the above, it appears that in case of periodic supply of goods/ services, GST Act would not apply on advances received prior to the GST law for goods/ services to be provided during the GST regime, provided tax has been paid on the same. This provision does not cater to the scenario where tax has not been paid, but is payable under earlier law post enactment of GST regime.

Also, there is no provision for treatment of supplies prior to GST law where either the invoice has not been raised for the same, or payment has not been received, or tax has not been paid prior to enactment of GST law. This could result in dual taxation both, under the previous regime as well as under the GST regime.

Coverage of the transition provision to be analysed as to whether implications for all its possible transactions during the transition period are clear. Accordingly, necessary representation would need to be filed for clear transition provisions

Key Action points

- To analyse tax liability for all ongoing projects in line with transition provision
- Transaction structuring may be undertaken depending on impact of GST. If GST has negative impact, consideration may be made earlier even for supplies to be undertaken post GST
- Transition planning for timing of supplies, advances and payment of tax
- Representation to be filed to provide more clarity on transition provision for ongoing contracts

7. Eligibility to avail credit of goods held as service provider

- Currently, a service provider is not eligible to avail credit of the tax paid on goods (specially VAT)
- Under GST, since all supplies would be liable to GST, there needs to be a provision to allow a service provider to avail credit of the inputs held on the date of enactment of GST. There should be a mechanism to make this possible.
- In the Model GST law, there is no specific transition provision to this effect.

Key Action points

- Representation to be filed to include specific provision to allow credit of stock in hand for service provider as well as for traders

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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