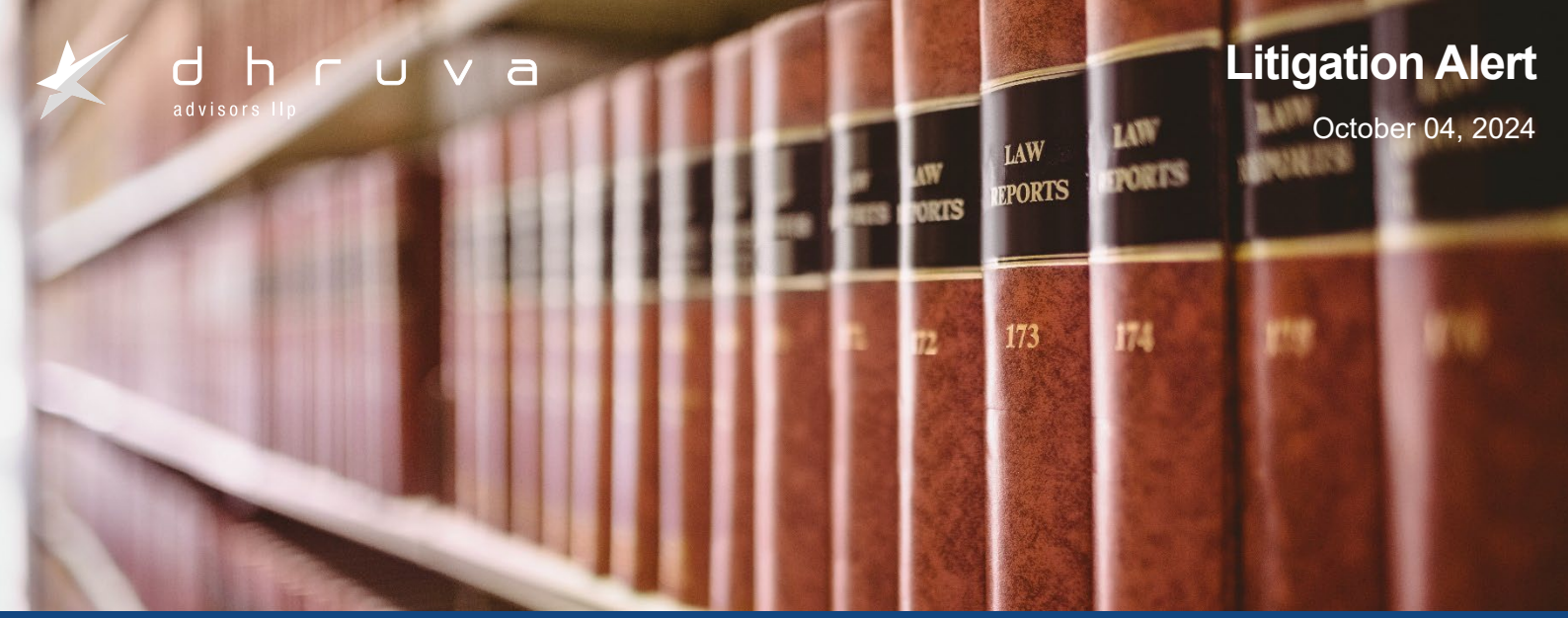

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Litigation Alert

October 04, 2024

Apex Court on blocked credit regarding 'Plant or Machinery'

Chief Commissioner of CGST & Ors. v. Safari Retreats Private Ltd. & Ors.[1]

The Supreme Court ('SC') upheld the constitutional validity of Section 17(5)(c) and (d) of Central Goods and Services Tax Act, 2017 ('CGST Act'). It also clarified that "Plant or Machinery" in Section 17(5)(d) cannot be equated with "Plant and Machinery" as defined in the Section 17. Finally, emphasizing the importance of the functionality test it remanded the underlying matter to the High Court ('HC'), to determine whether the shopping mall in the present case, can be considered as "Plant", and to thereby allow Input Tax Credit ('ITC').

Facts of the case:

- Safari Retreats Private Limited (the Respondents) engaged in the construction of a shopping mall (for letting out), accrued ITC of GST paid on costs incurred on various goods and services such as cement, steel, consultancy services and more, used in the construction of mall. It sought to utilize the same against the GST liability arsing on its rental income. However, the GST authorities denied this claim citing the bar of and restrictions under Section 17(5)(d) of the CGST Act

- Aggrieved by the said denial, the Respondent filed a writ petition before the HC[2], challenging the constitutional validity of Section 17(5)(d), arguing that it should not apply to the construction of immovable property that is meant for letting out on rent, as the objective of ITC is to eliminate cascading taxes and ensure the benefit flows to the assessee

- Referring to the Supreme Court's ruling in ***Eicher Motors Limited v. Union of India (1999)***[3]**,** which highlighted that ITC aims to prevent double taxation and reduce the taxpayer's burden, the HC ruled in favour of the Respondent and, read down Section 17(5)(d), to permit ITC on the construction of the mall, as the rental income was subject to GST, thereby avoiding an inequitable tax burden.

- Against which the Revenue Department presented a challenge before the SC.

Submissions by the Revenue Department

- Denial of ITC on construction-related activities is reasonable, as ITC is not a fundamental right but, a statutory one. Reliance was placed on the judgment of Supreme Court in the case of ***ALD Automotive***

[1] Civil Appeal No. 2948 of 2023, dated 03-10-2024
[2] 2019 (5) TMI 1278
[3] (1999) 2 SCC 361

Pvt. Ltd. v. Commercial Tax Officer*[4]*, to establish that the legislature has the discretion to restrict ITC and Courts cannot interfere unless a clear statutory right exists.

- Section 17(5)(d) is constitutionally valid as the principle of equality permits the legislature to create different categories for tax purposes as long as there is a rational basis. Reliance in this regard is placed on several cases, including ***Hari Krishna Bhargav v. Union of India***[5] and ***Joseph Shine v. Union of India***[6]**,** wherein it was stated that even if there is some level of discrimination, it is not necessarily unconstitutional unless it is "manifestly arbitrary."

- For the phrase “plant or machinery” used in Section 17(5)(d), “or” should be interpreted as “and”, to avoid potential discrimination between clauses (c) and (d) of Section 17(5), both of which deal with immovable property. Such an interpretation as well ensures that the two clauses are treated consistently.

- Shopping malls and other immovable properties, are excluded from GST as goods and thus there is justification for not allowing ITC on goods or services used in their construction. The rationale behind denying ITC is to prevent the exhaustion of credits on rental income, which would lead to a zero-tax scenario, if and when the mall is sold, without levy of GST. Thus, allowing ITC in these cases would result in a substantial revenue loss for the government.

Submissions of the Respondents (taxpayers)

- Unlike entities selling immovable properties (where there is a break in the credit chain), all parties involved in leasing/renting (sub-contractors, main contractors and the Respondents) are subject to output GST. Thus, denying ITC in such scenarios disrupts the credit flow, leading to a cascading tax effect, which contradicts the CGST Act's objective of eliminating cascading effects.

- Section 17(5)(d) unfairly equates entities constructing immovable properties for leasing/renting purposes with those constructing properties for sale, thereby treats un-equals as equals. Such classification is arbitrary and lacks a rational basis (‘intelligible differentia’).

- Alternatively, Section 17(5)(d) should be read down to restrict ITC only for cases where goods or services are used to construct immovable property “on their own account” for personal use, such as office or factory buildings. However, when the property is used for business purposes like leasing or renting (which are taxable supplies), ITC should be allowed.

- Use of “or” instead of “and” in Section 17(5)(d) when compared with Section 17(5)(c), is deliberate, indicating different legislative treatment that must be accorded. These terms should be construed strictly as separate categories.

- Absence of clear definitions for terms like “on its own account” and “plant or machinery” used in Section 17(5)(d), leads to lack of clarity and arbitrary interpretations, making the provisions ambiguous. This vagueness renders the provisions unconstitutional. Reliance in this regard was placed in the precedent set by ***Shreya Singhal v. Union of India***[7]**.**

Discussions and Findings

- Although Section 17(5)(c) and (d) both pertain to restricting ITC on the construction of immovable property, the two clauses differ significantly in various aspects. Clause (d) disallows ITC for goods or services used to construct immovable property on a taxable person’s own account, except in two cases: (i) if the construction is for a "Plant or Machinery," or (ii) if it’s for a property not built on the taxpayer’s own account, such as for sale or lease.

[4] (2019) 13 SCC 225
[5] (1966) 2 SCR 22
[6] (2019) 3 SCC 39
[7] (2015) 5 SCC 1

In contrast, clause (c) uses the term “Plant and Machinery,” which is specifically defined, while clause (d) uses “Plant or Machinery” without a definition. Besides, whereas clause (c) deals with works contract services, clause (d) is in respect of both goods and services.

- The term ‘’Plant and Machinery’’ defined in the explanation to Section 17(5)(c) has been used multiple times in the GST Act while the undefined term “Plant or Machinery” is used only in Section 17(5)(d), which indicates lawmakers’ intention to use different terms. Accordingly, the contention of the Revenue Department, that it’s a mistake in law and the word ‘or’ used in Section 17(5)(d) should be read as ‘and’, is not acceptable.
- The term "Plant or Machinery" can refer to either a plant or machinery and, plant can also be an immovable property. Since "plant" isn’t defined in the CGST Act, it should be understood in its common commercial meaning. Further, the expression "Plant or Machinery" cannot draw colour from the definition of “Plant and Machinery” in the Explanation to Section 17(5).
- The contention of Revenue Department about breaking the tax chain is not entirely valid, since Schedule II of the CGST Act recognizes renting or leasing buildings as a service. This means that if a building is treated as a plant, a taxpayer can claim ITC for renting or leasing it, as long as they meet the requirements of the CGST Act and its rules.
- The Apex Court ruled that the Functionality test is to be applied to determine whether a building can be considered a "Plant." If a building is designed and constructed to meet specific technical needs of a taxpayer, it can qualify as a plant for investment purposes. Thus, the term "Plant" in Section 17(5)(d) cannot be limited to the definition of "Plant and Machinery", which excludes land and buildings. However, the HC has not determined if the specific mall in question meets the functionality test to be classified as a plant.
- Section 17(5)(c) and (d) are constitutionally valid as the right to ITC is granted by law and it cannot be claimed unless explicitly provided. The legislature can create exceptions to ITC entitlements under Section 16 of the CGST Act. Reliance in this regard was placed on the judgement in the case of ***Union of India & Ors. v. VKC Footsteps India Pvt. Ltd.***[8].

Decision

- The SC upheld the constitutionally validity of Section 17(5)(c) and (d) of the CGST Act.
- The SC concluded that the term “Plant or Machinery” used in Section 17(5)(d) cannot be given the same meaning as that of the term “Plant and Machinery” defined by Explanation to Section 17(5).
- The Court ruled that the functional test will have to be applied in each case to determine whether a building constitutes “Plant” for a given business.
- The Court remanded the matter to HC for limited purposes of deciding whether, in facts of the case, the shopping mall is a “Plant” in terms of Section 17(5)(d).

Dhruva Comments

This important judgment was long-awaited and will positively impact businesses, especially, malls, warehouses, godowns. Project costs will stand altered due to availability of ITC.

The Apex Court laid down the principle that the functional test must be applied (to determine whether a building constitutes “Plant” in given circumstances) and consequently allow ITC. Taxpayers now have the onus to establish and prove how a building qualifies as “Plant”, so as to claim ITC. A new debate, as to what is a “Plant”, will flare up hereon.

For the past period transactions, taxpayers will separately, have to evaluate and conclude whether or not to avail ITC considering the time limits for availment of ITC and fulfilment of conditions prescribed for availment of ITC.

[8] (2022) 2 SCC 603

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