EY Tax Alert

Supreme Court upholds the levy of VAT on sale of flats under construction, affirming the decision in the K. Raheja case

Executive summary

This Tax Alert gives an update on the latest Supreme Court decision in the case of Larsen & Toubro & Anr. vs. State of Karnataka & Anr. [TS-156-SC-2013-NT], in which the Apex Court has upheld the levy of VAT by the states on the sale of flats which are under construction, as it amounts to works contract.

The three judge bench of the Supreme Court has affirmed the division bench decision in the case of K. Raheja Development Corporation vs. State of Karnataka [(2005) 5 SCC 162].

It has also upheld the Bombay High Court’s verdict in the case of Maharashtra Chamber of Housing Industry (MCHI) vs. State of Maharashtra [2012-(ST1)-Gj X-0075-BOM], wherein it was held that the state has the power to levy VAT on sale of under-construction flats.
Background and facts

► Larsen & Toubro (L&T) was engaged in the property development along with the owners of vacant sites. It entered into agreements of sale with intended purchasers, which provided that on the completion of construction; the apartments would be handed over to the purchasers who will also get an undivided interest in the land.

► In the light of the Supreme Court decision in the case of K. Raheja Development Corporation vs. State of Karnataka [(2005) 5 SCC 162], the revenue authorities contended that L&T is engaged in construction activity on behalf of the prospective buyers, which amounts to works contract and hence, would be liable to pay turnover tax on the transfer of goods involved in such works contracts.

► The Supreme Court decision in the case of K. Raheja case was based upon the provisions of the Karnataka Sales Tax Act, 1957, clarifying the scope of the definition of “works contract”. It was held in this case, that so long as there was no breach of agreement, the construction would be for and on behalf of the purchaser and would remain a works contract.

► The matter in the L&T case was referred to a Larger Bench of the Supreme Court for re-consideration of the decision of the Division Bench in the case of Raheja Development.

► Out of the 26 appeals under consideration on this issue before the Supreme Court, 14 were from Karnataka and 12 from Maharashtra.

► The appeals from Maharashtra are from the decision of the Bombay High Court in the case of MCHI v State of Maharashtra, in which it was held that the State would have the power to levy VAT on sale of under-construction property as it would amount to works contract.

The view taken in the K. Raheja case was referred for consideration of the following issues:

► Whether the tripartite agreement could be considered as works contract?
► If the ratio of the decision in the K. Raheja case was accepted, there would be no difference between a works contract and a sale of chattel as a chattel.
► Can the developer be said to be a contractor for the prospective flat purchaser?

► The revenue contended that for the purposes of Article 366 (29A) (b) of the Constitution, in a construction contract, if the developer has received or is entitled to receive valuable consideration, then it would be a works contract.

► It was the further contention of the revenue that the dominant nature test would have no application and the traditional decisions which have held that the substance of the contract must be considered, have lost their significance where transactions are of the nature contemplated in Article 366 (29A).

Supreme Court ruling

► The Supreme Court (Larger Bench) in the case of M/s Larsen & Toubro Ltd. vs. State of Karnataka has upheld the levy of VAT on sale of under-construction flats on the grounds that it involves an element of works-contract.

► The aforesaid judgment upholds the Division bench judgment in the case of K. Raheja Development Corporation v. State of Karnataka and the Bombay High Court judgment in the case of MCHI vs. State of Maharashtra. In both these cases, it was held that the State has the power/ right to impose VAT on sale of under-construction property, as the same are ‘works contracts’.
The argument on behalf of the developers was that, since the purchaser was entitled for the transfer of flat only on the full payment of the instalments, it goes to show that the agreement between the developer and the purchaser was for the sale of flat and not for the appointment of the developer as a contractor of the purchaser.

However this argument was not accepted by the Court based on an analysis of Form V of the Maharashtra Ownership Flat Rules (MOFA) and the relevant clauses of the agreements under the Karnataka Ownership Flat Rules (KOFA) and MOFA, wherein it was observed that the work was undertaken by the developer for and on behalf of the purchaser, and not for himself and the owner of the land.

Where it is a composite contract comprising of both, a works contract and a transfer of immovable property, such contract does denude it of its character as a works contract.

Article 366 (29A) (b) covers all genre of works contract and is not limited to one specie of the contract. If the developer has undertaken to build for the flat purchaser, so long as there is no termination of the contract, the construction is for and on behalf of the purchaser and it remains a works contract.

Merely because the developer has the right of lien in the event of non-payment of the instalments by the purchaser, would not alter the character of the contract being works contract.

The Court further clarified that the activity of construction undertaken by the developer would be works contract only from the stage the developer enters into a contract with the flat purchaser, and that only the value addition made pursuant to the agreement with the flat purchaser can be made chargeable to VAT.

The Court also had to consider the constitutional validity of the explanation b(ii) to Section 2(24) in the Maharashtra Value Added Tax (MVAT) Act and Rule 58(1A) of the MVAT Rules, arising out of the judgment of the Bombay High Court in the MCHI case.

The Supreme Court upheld the constitutional validity of the explanation b(ii) to Section 2(24) which was amended with effect from 20 June 2006, in pursuance of the decision in the Raheja case, which brings transactions in the nature of works contract, within the ambit of the expression ‘sale’.

Rule 58(1A) of the MVAT Rules, inserted by notification dated 1 June 2009, having effect from 20 June 2009, which provides for the measure of tax, has also been held to be constitutionally valid.

The value of the goods on which tax can be levied is the value of the goods at the time of incorporation of goods in the works even though property in goods passes later.

The Court has also accepted the contention of the Advocate General of Maharashtra that the implementation of Rule 58(1A) will not result in double taxation and all claims of alleged double taxation would be determined in the assessment of individual cases.

The Larger Bench has sent the matter back to the Regular Bench for final disposal.
Comments

This judgment is an important development for the real estate sector as it concludes that pre-construction/pre-completion agreements for sale of property would qualify as a 'works contract' and hence, attract VAT.

The judgment has been delivered pursuant to the appeals filed by builders from the States of Karnataka and Maharashtra. It provides a technical view on the concept of works contract taxation and the resultant applicability of VAT on transactions for property under construction. Therefore, its impact is likely to extend to states other than Karnataka and Maharashtra.

Post this judgment, it is expected that the State Governments would aggressively purport to tax all such arrangements, if not already done in the last few years post the Supreme Court ruling in K Raheja case referred above. This is particularly so when in recent times many State governments have brought in specific provisions to tax such transactions under State VAT laws.

Some of the possible issues which may arise in this regard are as follows:

► Valuation for the purpose of levy of VAT: The mechanism for determining the value of on which VAT should be payable in case of sale of pre-constructed flats.

Per the judgment, VAT should apply on value addition done post execution of agreement with the buyer. This could result in issues regarding determination of the value on which VAT should be payable in various scenarios such as:

► If the developer sells any flat which has been partially developed; or

► Where the flat being bought has been constructed but the whole project has still not been developed/completed; or

► Valuation of land (for the purposes of deduction as VAT would not apply on land).

► Taxability of transactions where the actual construction is complete but the completion certification is pending to be obtained from the local authority.

► Determination of the appropriate method under which tax should be paid would also be important. Most States have optional schemes for paying VAT on works contract arrangements; each with its own set of conditions (including limitations on input credits). Developers will have to evaluate the options available to determine the optimum tax outcome for their transactions. Moreover, such outcomes may be different for agreements for flats sold at different stages of construction. Therefore, ascertaining the best-fit method for a project, period or year would be critical.

► Past assessments could be re-opened to recover VAT with interest on such transactions executed within the limitation period of the relevant State regulations. The ability of the developer to pass on the burden of additional taxes to the ultimate buyer (specifically where the title and possession of the flat have been passed on to the buyer) would be critical to assess the impact on bottom-line. Furthermore, if interest and penalties are levied in addition to tax, developers may have a bottom-line impact if they are not able to entirely pass on the burden of such interest and penalty.

► In case of resale of flats under-construction, it would be important to evaluate whether the reseller be also liable to VAT or is it a mere assignment of right/sale of immovable not liable to VAT.

► Whether the buyers would be liable to deduct Works-Contract TDS on payments made to builders under these contracts, as there is no exclusion for individuals in many States.
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