ITC on construction expenses -
A macro outlook on bones of contention!!!
Every Indirect Taxation system contains a credit / set-off mechanism to avoid cascading effect of taxes incurred at previous stage. The credit mechanism which should be smoothest for the taxpayers, has been the most debated topic in Indian Indirect Tax laws. The credit framework should be wide in ambit with least exceptions. Yet the law makers choose to keep long list of goods and services outside the basket. With the advent of Goods and Services Tax (‘GST’) regime, the taxpayers expected a sigh of relief on this front, but the reality is far distant.

One of the important credit restrictions in earlier as well as today’s times is on goods and services used for ‘construction and works contract for construction’.

Rightly the famous lawyer Clarence Darrow once said, ‘History repeats itself. That’s one of the things wrong with history.’ The Cenvat Credit Rules, 2004 (‘CCR 2004’) underwent a major change in 2011 wherein goods and services used for construction, were specifically made ineligible for credit. This journey has continued in GST regime as well. In this article, the Authors will touch upon various disputes emanating from this restriction in GST regime.

Constitutionality of credit restriction

Taxpayers always endeavor to avail credit on all expenses incurred by them on the pretext of credit being a vested right. On the contrary, it is settled legal position that power to grant or deny credit is wholly a legislature’s perspective and their domain. Thus, denial of credit in a statute cannot be held to be unconstitutional merely due to blockage of credit chain.

Though the taxpayers have challenged the validity of this restriction under GST regime, it will be interesting to see whether the Courts will uphold legislature’s power to restrict credit. In authors’ view, this restriction is valid, and its constitutionality should prevail considering the earlier judicial precedents.

Nuts and bolts of credit restriction on construction expenses

Section 17(5) of the Central Goods and Services Tax Act, 2017 (‘CGST Act’) restricts Input Tax Credit (‘ITC’) on inward supplies of ‘construction and works contract for construction’. Clause (c) and (d) of Section 17(5) restrict ITC on:

(c) works contract services when supplied for construction of an immovable property (other than plant and machinery) except where it is an input service for further supply of works contract service;

(d) goods or services or both received by a taxable person for construction of an immovable property (other than plant or machinery) on his own account including where such goods or services or both are used in the course or furtherance of business;’

This restriction has potential of immense litigation in GST regime. The normal understanding of the term ‘construction’ is to ‘make or build’ something. For the purpose of Section 17(5), the term.

‘construction’ has an inclusive definition to include ‘re-construction, renovation, additions or alterations or repairs, to the extent of capitalization, to the said immovable property.’ The foremost test to be applied for triggering this restriction is whether an activity qualifies as ‘construction’ at first place or not. If it does not, then the restriction does not apply, and ITC will be available.

Further, the term ‘for’ employed in Section 17(5)(c) and (d) would encompass only such goods and services inextricably linked with construction. Had the legislature intended to deny ITC on all goods and services directly or indirectly linked with construction activity, it would have been explicitly provided in the law.

Another important issue is that the restriction is confined to ‘immovable property’ and ITC will be available on goods and services used for ‘construction’ of a movable property. Consequently, the judicial precedents laying down the test of ‘immovable property’ under the erstwhile laws, will continue to hold relevance in the GST regime.

Further, this restriction is not confined to every immovable property and ‘Plant and Machinery’ is an exception to this. Resultantly, ITC will be available on immovable property qualifying as ‘Plant and Machinery’. Section 17(5) of the CGST Act defines ‘Plant and Machinery’ to mean:

‘…..apparatus, equipment, and machinery fixed to earth by foundation or structural support that are used for making outward supply of goods or services or both and includes such foundation and structural support but excludes.

- Land, building or any other civil structures;
- Telecommunication towers; and
- Pipelines laid outside the factory premises’

Thus, it becomes important to identify ‘Plant and Machinery’ in an immovable property. In an endeavor to maximize ITC, taxpayers should consider proper structuring of contracts. For example, expenses on electrical fittings, wirings, plumbing, lighting system etc. in a building may not hit by this restriction. The series of GST Advance Rulings on this issue, have given contradictory verdict. The Maharashtra Authority of Advance Ruling (‘AAR’) allowed ITC on overhead crane, sewage system, sanitary ware, air, water and oil supply systems and electrical works being plant and machinery. On the contrary, the Karnataka AAR disallowed ITC on electrical works, pumps, pumping systems and tanks, lighting system, physical security system and fire system being part and parcel of a building. Similarly, the Karnataka AAR observed that lifts, air handling units, chillers, sewage treatment plant and other facilities in a building cannot be separated from building and hence, disallowed ITC on the same.

The accounting treatment of expenses on such goods and services in books of accounts, will also play a pivotal role in creating eligibility or ineligibility of ITC. If expenses are not capitalized, ITC will be available.

The last controversy revolves around ITC on construction expenses incurred for constructing a building which is further let out or meant for self-use. Clause (d) of Section 17(5) restricts ITC on goods and services received for construction on own account. To the taxpayer’s respite, the Orissa High Court[5]

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1 Hinganghat Integrated Textile Park Private Limited v. UOI, 2019 (10) TMI 1008 - BOM
2 RR Kabel Limited v. UOI, 2019 (10) TMI 207 - GUJ
3 DLF Cyber City Developers Limited v. UOI, 2019 (12) TMI 413 – P&H
4 Safari Retreats Private Limited v. CCGST, 2019 (5) TMI 1278 - ORI
5 Safari Retreats Private Limited v. CCGST, 2019 (5) TMI 1278 - ORI
allowed ITC on expenses incurred for construction of a building which is further let out by reading down Clause (d) of Section 17(5). In authors’ view, the term ‘own account’ employed in Clause (d) of Section 17(5) should be read as ‘construction activity done on own account’ for own use. The statutory provision does not distinguish between immovable property used for self or given on rent. Also, it is a settled judicial principle that restriction clause in a statute should be read strictly unless there is an absurdity or ambiguity in the law.

Given various facets of ‘ITC on construction expenses’, the Authors expect this issue to open pandora box of disputes in times to come. It will be interesting to watch as to how the Courts will do a balancing act wherein the taxpayers will endeavor to maximize their credits and the tax officers will seek to deny the same. Taxpayers must carefully analyze restriction areas as well as avail optimization opportunities in the midst of prevailing controversies on this issue.

*The views are strictly authors’ personal and do not in any manner represent any advice.*