

Know about the taxes on under-construction flats

VAT and service tax will push up the final cost of property. So, make your investment with care

If you are looking to buy a flat, you must also budget for service tax and Value Added Tax (VAT) in addition to the purchase price and stamp duty. With a recent Supreme Court ruling on sale of under-construction flats, there is possibility of demand of VAT (where it was earlier not collected) for flats sold years back. Let us understand how these taxes are applied.

Under-construction flats are popular as investment options. For one, they are cheaper than ready-to-occupy flats. Another attraction for buyers is that the payments can be staggered as they are linked to the progress of construction. So, there is no compulsion to pay the entire amount in one go.

Service tax is applicable on under-construction flats. Since the flats are under construction, there is an element of 'construction service' in the agreement between builder/developer and purchaser. Hence, it attracts service tax. While service tax is charged at 12.36 per cent, in case of under construction flats, the effective rate works out to 3.09 per cent of the value of property. This is because service tax is not applicable on the entire purchase price. Since there is sale of goods elements, in addition to service, the tax is applicable on 25 per cent of the gross consideration.

For agreements entered towards construction of flats after March 2013, service tax is payable at 3.71 per cent per cent where the flats are above 2,000 sq ft or cost more than Rs 1 crore. Any charges towards additional facilities such as maintenance, car parking etc, would also attract service tax. A single residential unit is, however, exempt from service tax. This means that a single villa or a bungalow is exempt.

When is VAT applicable?

In the case of ready-to-occupy flats, service tax is not payable as the construction is carried out by the builder/developer on his own account and later sold to independent buyer. As sale of ready-to-occupy flat amounts to sale of immovable property, VAT is also not applicable on such transactions. However, the sale agreement should not have been entered or payment made before the completion certificate is issued.

Further to the decision, in May 2005, in the case of Raheja Development Corporation v/s State of Karnataka; (2005) 5 SCC 162 being referred to larger bench, the industry was of the view that no VAT should be payable on an under-construction flat as there is no transfer of property in goods. In the meanwhile, developers from Maharashtra and Karnataka started filing writ petitions. Their argument was that the construction undertaken cannot be construed as a works contract liable to VAT.

However, this was completely nullified by the Supreme Court's larger bench in the case of Larsen and Toubro v/s State of Karnataka & Another (Civil Appeal No. 8672 of 2013), in September 2013 affirming the decision in the case of Raheja, that is, any agreement entered into by the builder/developer before completion of construction amounts to works contract and is, hence, liable to VAT.

It was held that for execution of a works contract, the important ingredients are (1) there must be a works contract (2) the goods should have been involved in the execution of a works contract and (3) the property in such goods should be transferred to a third party either as goods or in some other form.

A works contract is one which involves supply of goods plus services, together. In other words there is transfer of property in goods and service. For instance, a painting contract would fall under this category, since there is an element of service of painting.

The expression "in some other form" has greater significance as goods, which have ceased to be chattels or movables and get embedded to earth, also constitute supply of goods. Even if the dominant intention of the contract is not to transfer the property in goods, but rendering of service, still States are allowed to levy VAT on the materials used in such works contract. This view gets further affirmed by Supreme Court five Judges Bench in the case of Kone Elevators India Private Limited v/s State of Tamil Nadu WP (c) 232/2005. in May 2014.

The effect of the L&T judgement is far reaching as every state government could start pursuing builders/developers to pay VAT on under-construction flats as the judgement will be taken to have a retrospective effect, in cases which are yet to be reported. The procedure of assessment of VAT will take time and these cases are yet to be reported. Therefore, the real estate industry may witness number of demand notices from VAT authorities for past periods. Demand will not be restricted to VAT amount alone, but also loaded with interest and penalty.

The liability can be recovered from flat owners if the contract provides for the same. Disputes could start between developers and purchasers if there are no clear contractual terms for claim of VAT. Further, what happens if the flat owner has sold the flat to another person? How will the builder/developer recover VAT? In such case, it becomes burdensome for them.

How is VAT calculated?

It has been held that VAT is payable on value of goods at the time of incorporation of goods in the works and not the purchase value of goods by the builder/developer. Further, VAT is not payable on value towards immovable property, that is, land.

As every instalment comprises value of land and building, the land value has to be apportioned over various instalments, that is, exemption has to be claimed proportionately.

The ultimate victim is the flat purchaser who has to bear the cost of service tax and VAT at not less than 9 per cent on the total value of the flat, apart from stamp duty. After paying so much tax, one can only hope that the appreciation in the property value would at least match the interest on loan and the tax cost.

(Business Standard)