Point of Taxation Rules could spell 'real' time trouble for Realty Developers and Builders – Mar 21, 2010

A lot is being written on the Point of Taxation Rules, which is to be implemented with effect from April 1, 2011. Many are under the impression that this is an attempt to switch over from the cash basis to the accrual basis and an attempt is made to justify this proposed transition, especially for works contractors, on the basis that under the VAT law, tax is levied on a similar basis. I must caution the readers this is not so and that, under the proposals contained in the Point of Taxation Rules, a lot of confusion would arise and one class of service providers that would be affected most, would be the works contractors operating in the realty sector. The details of the new dispensation is contained in Notification No 3/2001, which seeks to amend Rule 6 of Service Tax Rules 1994 and substitute the words "payments are received, towards the value of taxable services ", with the words "service is deemed to be provided as per the rules framed in this regard " . The text of Rule 3 of the Point of Taxation Rules, as proposed, is reproduced below:

3. Determination of point of taxation – For the purposes of these rules, unless otherwise stated, "point of taxation" shall be determined in the following manner, namely:-

- a provision of service shall be treated as having taken place at the time when service is provided or to be provided; and
- if, before the time specified in clause (a), the person providing the service issues an invoice or receives a payment, the service shall, to the extent covered by the invoice or the payment made thereof, be deemed to have been provided at the time the invoice was issued or the payment was received, as the case may be, whichever is earlier.

Explanation 1.- For the purposes of this rule, wherever any advance, by whatever name known, is received by the service provider towards the provision of taxable service, the point of taxation shall be the date of receipt of each such advance.

Explanation 2.- For the purposes of this rule, in respect of services taxable under section 66A of the Act, the point of taxation under clause (b) shall be the date on which the invoice is received, or the payment is made, as the case may be, whichever is earlier.

As per Clause (a) stated above, the provision of service shall be treated as having taken place at the time when service is provided or to be provided. As per this provision, as we can see, a service provider can be asked to pay service tax, even when he has not actually rendered the services, on the basis that he has contracted to render services at a future date.

Under the Point of Taxation Rules, the service tax liability would be calculated on the basis of the earliest of the following four dates, viz.

- Date on which service is provided
- Date on which service is to be provided
- Date of the invoice raised by the works contractor
- Date of receipt of the money

Let's see some typical situations involving developers/works contractors and analyse how the Point of Taxation rules would operate….

Situation-1: A realty developer/builder enters into an agreement to construct, with his prospective buyer/customer and agrees, as follows, for a construction value of, let's say, Rs 60 lakhs

- 25% of the amount to be paid on signing of the agreement on April 2, 2011
- 25% of the amount to be paid on July 1, 2011, on completion of the laying of the slabs
- 25% to be amount to be paid on December 1, 2011, on completion of the basic structure

Final instalment of 25% to be paid on March 31, 2012, on possession Under the current service tax laws, the works contractor will have no issues in discharging his service tax liability, as he will pay service tax on the

receipt of the amounts from his customer, including, on the advance amount received. Assuming that, the developer/builder is not able to even start the construction activity, the developer/builder will pay service tax on the advance amount of Rs 15 lakhs received on April 1, 2011.

Let's see how things would work out post April 1, 2011, under the new dispensation, on the same assumption that the developer/builder has not carried out any activity. The said developer/builder would be liable to pay service tax on July 1, 2011, December 1, 2011 and March 31, 2012, on the amounts of Rs 15 lakhs each, despite that the developer has not even commenced the construction activity and has not received any amounts from the customer, except for the initial advance of Rs 15 lakhs on April 2, 2011, on which, the developer/builder would, of course, be liable to pay service tax.

Imagine the plight of a large developer/builder, constructing thousands of flats and the near impossibility of determining his service tax liability, under the new dispensation and the near impossibility of determining the service tax liability.

Situation-2: Let's discuss a slightly more complicated situation. Let's assume that, the developer/builder does some work on the project, which is nowhere near what has been committed to the customer. As what most typical builders do, let's also assume that invoices are raised on the customers promptly, on June 1, 2011, November 1, 2011 and March 1, 2012, in respect of the three instalments. Quite obviously, the customer would not pay the instalments, as the work that has been done falls short of the agreed milestones. What would happen to the service tax liability, Sir, under the new dispensation? The developer/builder would be liable to pay service tax on June 1, 2011, November 1, 2001 and March 1, 2012, on Rs 15 lakhs each, on the basis that he has raised invoices, not-withstanding the fact that he has neither done the work nor has got paid.

Situation-3: Take a typical situation, of a developer/builder who has let out a commercial property and raises invoices on a quarterly basis, on his tenants. Further assume that, the said lessor, raises invoices on his tenants on April 1, 2011 for the rent payable for the period April to June, 2011. Under the current dispensation, the lessor would have no issues, as he would pay service tax on receipt of the rentals. However, under the Point of Taxation rules, the lessor would be liable to pay service tax, in respect of the rentals for the quarter, despite the fact, that the tenants have not paid him, the rentals.

Situation-4: A realty developer constructs a residential complex consisting, let's say, of 200 flats and manages to get customers for, let's say, 120 flats. With the advance amounts that he has collects, he completes the construction for the entire project of 200 flats and obtains an Occupancy Certificate for the project. Post the date of the OC, let's assume that he starts selling the balance 80 flats as immovable property. Will the developer be required to pay service tax on the basis of the new Point of Taxation Rules, on the basis that he is rendering services? This is a very tricky question, which can throw up a possible answer only after a long deliberation. Per se, it would seem that, the Point of Taxation Rules would cover even the construction of flats to be ultimately sold as immovable property, under the deeming concept contained in these Rules, not- withstanding the fact that, in the absence of a construction agreement and consequently, a customer/service receiver, an invoice cannot be raised.

I heard a top Revenue official commenting that the service tax law is following the VAT law, after all. That the service tax law, in its proposed form, is far more draconian as compared to the VAT law, can be appreciated from the following comparison. Builders under the VAT law are liable to pay VAT,on the basis of the earliest of the following three dates, viz.

- Date of the actual transfer of property by accretion
- Date of the invoice raised by the works contractor
- Date of receipt of the money

However, as aforesaid, for a similar transaction under the the Point of Taxation Rules, the service tax liability would be calculated on the basis of the earliest of the following four dates, viz.

- Date on which service is provided
- Date on which service is to be provided
- Date of the invoice raised by the works contractor
- Date of receipt of the money

One can thus clearly see that, under the VAT law, there is no liability to pay service tax on a future transaction of transfer of property, while under the Point of Taxation Rules, a service provider would be liable to pay on the date he is to provide a service, despite that, he has not actually rendered the service nor has he got paid for the services rendered/to be rendered.

Before concluding …

Consider this example, which might look a bit 'fool'ish. Let TIOL readers please bear with me. Let's assume that, a realty developer, based in Bangalore, discusses on April 1, 2011, the project of constructing a residential complex consisting of 100 flats, with a landlord, and agrees, orally, to transfer 80 flats to the land lord, on March 31, 2013, in terms of a joint development agreement to be entered into. In terms of the fact that even oral agreements are recognized under the Indian Contract Act, 1872, in terms of the Point of Taxation Rules, as now proposed, the developer would be liable to pay service tax on the value of the 120 flats on April 1, 2011, as this would be the date on which, service 'is to be provided'. As we know, the residential realty sector has its own challenges and issues. Cancellation of construction agreements and re-allotment of flats, etc. is a very common feature. If the developers are made to pay tax on the basis of these Rules, a lot of issues in terms of refunds, etc. would emerge, in terms of cancellation of allotments, etc.

During a post Budget interaction in Bangalore, I did raise the complications arising out of these rules, with the CBEC Chairman, who was gracious enough to admit that, this issue has indeed been raised in other cities also. More than anybody else, the Realty Sector would be drastically affected by these Rules. Industry Associations like CREDAI would be well advised to take this issue up with the Government. One hopes that the Government does a complete rethink on these provisions. All that is has to do, is rathe0r simple… it has to delete the words 'to be provided' in Clause 3(a) of these Rules. Such a simple thing to do, Sir. I don't think, these Rules would stand judicial scrutiny, from a constitutional validity point of view. In a recent decision, the Karnataka High Court has struck down, a provision in the Karnataka VAT Act, which required he works contractors to pay VAT on advances received, even when no transfer of property had taken place.