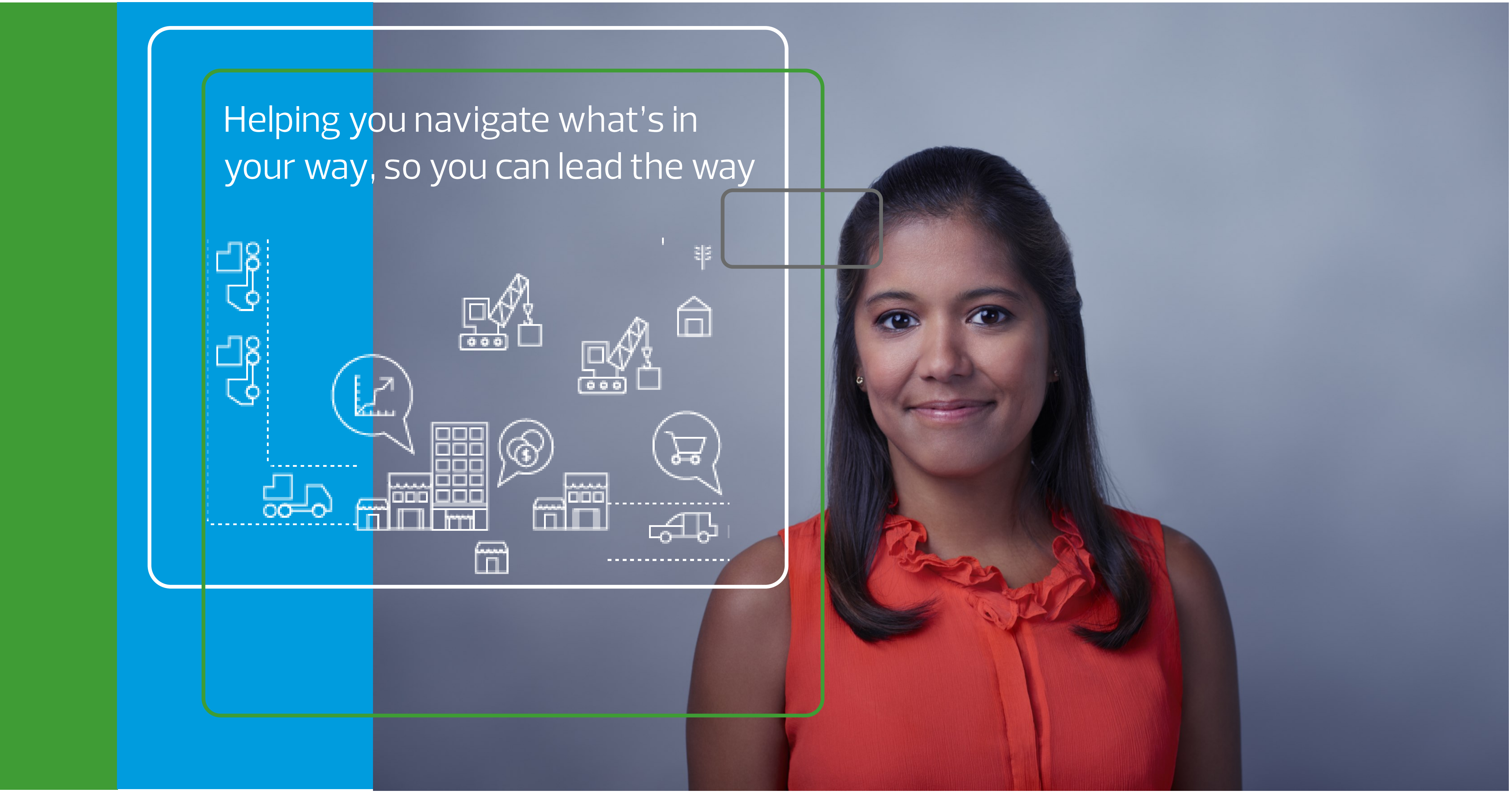

White Paper - Analysis of GST on Construction of Roads and Highways

THE POWER OF BEING UNDERSTOOD

RSM

1.0 Introduction

The government allocates a substantial part of its disbursements towards development of roadways and has given a lot of thrust to highway-building initiatives in collaboration with the National Highways Authority of India (NHAI) especially in recent times. Being a booming sector, the introduction of Goods & Services Tax (GST) has certainly had an impact on this sector. In this whitepaper, we attempt to explore the major issues arising in this sector as a result of implementation of Goods and Services Tax (GST). Our issues in this whitepaper are confined to the activity of road construction and do not consider the effect of toll payments, which are notified to be exempted.

Let us first explore the typical manner in which road and highway construction projects are carried out.

2.0 Contract Structure

Typically, there is a pattern to the manner in which road projects are carried out. The Government or the NHAI floats a tender or request for proposal for road construction activity and based on the outcome of the tender process, awards the contract for road construction to the bidders. These bidders may be individual contractors either incorporated as a company or may be a consortium of contractors who are bidding collectively for the road construction project. After award of the contract, the consortium or the individual contractor will have to incorporate a specific company, commonly known as "Special Purpose Vehicle" (SPV) which will sign the contract with NHAI. SPV is created for obtaining project financing and for effecting a greater degree of operational control over project implementation. The SPV then allocates the work for road construction to a contractor or a group of contractors who may in turn subcontract the work to others.

3.0 Taxability of Road Construction Projects

In GST, the taxable event is supply, which may be a supply of goods or a supply of services. Schedule II entry no. 6(a) read with Section 7 of the CGST Act, 2017 states that a composite supply of goods and services in the form of a works contract as defined in clause (119) of section 2 of CGST Act, 2017 shall be deemed to be a supply of service and the tax rate to be applied on such works contract is specified in Notification No. 20/2017- Integrated Tax (Rate) dated 22nd August 2017 wherein "Composite supply of works contracts as defined in clause (119) of section 2 of the Central Goods and Services Tax Act, 2017, supplied by way of construction, erection, commissioning, installation, completion, fitting out, repair, maintenance, renovation, or alteration of a road, bridge, tunnel, or terminal for road transportation for use by the general public" is taxable at the rate of 12%.

4.0 Input Tax Credit

Availability of input tax credit is one of the more litigative areas in this sector. Section 17(5) of the CGST Act specifies situations wherein **the taxpayer is not eligible to claim input tax credit. Certain relevant sections are reproduced below for ease of understanding.**

Section 17(5)(c) of the Central Goods and Services Tax (CGST) Act, 2017 states – "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" shall not be available for input tax credit to the recipient.

Section 17(5)(d) of the CGST Act, 2017 – "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 when such goods or services or both are used in the course or furtherance of business."

As per the Explanation to clause (c) and (d) – "For the purposes of clauses (c), the expression "construction" includes reconstruction, renovation, additions or alterations or repairs, to the extent of capitalization, to the said immovable property"

The statement above makes it clear that Input Tax Credit **cannot be claimed** by the recipient of works contract services when supplied for construction of an immovable property (other than plant and machinery) **except** where it is an **input service for the further supply of works contract service**. Proper attention needs to be paid to the terms “works contract” and the word “construction” as defined in the relevant portions of the GST laws and the manner in which the GST authorities give meaning to these terms.

Further, in typical road construction projects, income is generated from both, taxable supplies (i.e. road construction) and exempt supply (i.e. toll charges collected). In such cases, the amount of input tax credit available to the recipient shall be restricted to so much of the input tax as is attributable to the taxable supplies. Companies engaged in road construction and toll collection need to pay attention to this pertinent aspect.

5.0 Exemptions

As the infrastructure initiatives have been receiving a lot of thrust from the Government, exemptions are inevitable. In this section, we explore certain exemptions given to the road construction projects, which are as follows:

- Service by way of access to a road or a bridge on payment of toll charges - S. No. 23 of Exemption Notification No. 12/2017-Central Tax (Rate). Therefore, no GST is payable on payment of toll charges.

- Service by way of access to a road or a bridge on payment of annuity - S. No. 23A of Exemption Notification No. 12/2017-Central Tax (Rate), amended by Notification No. 32/2017-Central Tax (Rate) dated 13.10.2017. Therefore, annuity amounts received from NHAI for construction of highways is exempt.

- Services provided by the Central Government, State Government, Union territory or local authority by way of tolerating non-performance of a contract for which consideration in the form of fines or liquidated damages is payable to the Central Government, State Government, Union territory or local authority under such contract - S. No. 62 of Exemption Notification No. 12/2017-Central Tax (Rate). The exemption pertains to contracts entered into by the Central Government, State Government, Union territory or local authority, and is limited to the payments received as fines, penalty etc. for tolerating non-performance of the contract.

6.0

Burning issues faced by the industry under the GST regime

The new tax reform will pose several challenges for the infrastructure sector such as treatment of works contracts as service contracts, the imposition of new tax rates on ongoing projects, change in the costs of construction materials, etc. In this section, we have elaborated some of the burning issues faced by this segment.

6.1 Issues related to transitional credits for goods lying in stock on appointed date

Under transitional provisions enacted, the credit of goods lying in stock, whether in the form of stock in trade or in the form of work in progress, as on the appointed date is available only for those stocks which are not older than one year. Construction companies tend to accumulate stock and keep the same over several years. Thus, reversing input tax pertaining to stock older than twelve months preceding the appointed date of GST would be extremely difficult. The transition provisions as enacted by the GST laws do not consider the long gestation period of the roadways and highways construction projects and thus, representations have been made to the GST Council for preparation of transition rules specific to builders and contractors. Further, mixing of materials is very common and at times it is difficult to specifically identify which raw material was used for which project. There has been no progress on these aspects till date based on the information available in the public domain and thus, it is expected that there would be much litigation arising out of transitional credits relatable to stocks on appointed date.

6.2 Accumulation of Input Tax Credit in the case of Special Purpose Vehicles (SPVs)

We have already discussed in the previous part of this whitepaper, the typical structure of road construction projects and the creation of SPVs. SPVs which typically render nil rated or exempted supplies will, under the GST regime have an **accumulation of ITC** because there is no mechanism under the GST law to provide refund of accumulated input tax credit to companies having nil rated outward supplies**. Refund of the accumulated ITC** can be claimed only in the following two cases;

- **Where the supplier effects zero-rated supplies** without payment of tax.
- Where the credit has accumulated on account of the rate of tax on inputs being higher than the rate of tax on output supplies (i.e. **Inverted Duty Structure**)

Both the refund mechanisms are not available to the road and highway construction companies as such entities have a business that is largely domestic and inbound. The provisions related to refund arising out of an inverted duty structure cannot be invoked in those situations where the outward supplies are nil rated. Thus, input tax credit accumulating in the books of accounts of the SPVs shall be a cost and add to the cost of construction of projects.

6.3 Issues faced by industry in relation to refunds under the inverted duty structure

In Infrastructure sector, construction of roads & highways is charged at the rate of 12% while input tax credit is usually works contract service taken from contractors, which is liable to be taxed at the rate of 18%. This creates an inverted duty structure and may create blockage of working capital if there are restrictions and delays in obtaining the GST refunds.

It needs to be highlighted that there is no refund of any **input tax credit arising in relation to capital goods as well as input services (due to recent amendments made to rule 89(5) of the CGST Rules, 2017)** as the same does not fall within the definition of ‘net input tax credit’ for purpose of computation of refund arising out of inverted duty structure.

Thus, refund under inverted duty structure is available only to the ‘net input tax credit’ which is attributable to inputs. Such net input tax credit shall not include any ineligible credits and may further be subject to further reversal on account of proportionate reversal to be done in respect of exempted income. As a result, the refund amount available may not be substantial and a large part of the input tax credit may get blocked in industries having an inverted duty structure, such as road construction.

6.4 Issues in respect of place of supply

Given that roadway and highway projects are typically site-based services, analysing the place of supply aspects becomes even more important for such services. There are specific rules enacted in the IGST Act, 2017 for the place of supply in respect of services related to construction. In case of construction of roads or bridges, the place of supply shall be the location where the roads or bridges are constructed or are intended to be constructed. Place of Supply of services directly in relation to an **immovable property**, *inter alia*, any services provided by way of grant of rights to use immovable property or for carrying out or coordination of **construction work** shall be the **location at which the immovable property is located** or **intended to be located** [Section 12(3) of the IGST Act, 2017]. Place of supply related aspects for **interstate projects where activities are carried out in more than one state would** require a careful and detailed analysis and may require taxpayers to obtain multiple registrations for the same projects.

6.5 Invoicing

Construction contracts typically have a long gestation period, and as a result, construction of roads, bridges and, highways may be regarded as a **continuous supply of service**. Invoicing for such continuous supplies needs to be done as per the provisions of section 31(5) of the CGST Act, 2017. The time of supply in such cases depend on the clauses enacted in the contract with respect to the due date of payment. The following table shall determine when the invoicing is to be done.

Due Date of payment	Date of Invoice
Ascertainable from the contract	On or before the due date of payment (as per the contract terms)
Not ascertainable from the contract	Before or at the time of receipt of the payment
Linked to completion of an event	On or before the date of completion of that event

Further, as per section 31(6) of the CGST Act, 2017, in case where the supply of services ceases under a contract before the completion of the supply, the invoice shall be issued at the time when the supply ceases and such invoice shall be issued to the extent of the supply made before such cessation.

6.6 Taxability on Advance Receipts/ Mobilization Advance

GST is required to be paid in respect of advances received for supply of services. Under service tax era, services of construction of roads were exempt and thus, advances received in the erstwhile service tax era were not liable to tax. This creates issues under the GST regime and one needs to carefully interpret the transitional provisions and specific rules enacted in this regard. An important aspect that needs to be analysed is where a certain part of the construction work is done in the GST regime, whether GST would be levied on the entire Invoice Value including income pertinent to erstwhile indirect tax era or whether GST should be levied on the value determined after reducing the advance amount received during the pre – GST regime. According to transition provisions [Section 142(11) (b)], no GST on services shall be payable to the extent tax was leviable on the said services under Chapter V of the Finance Act, 1994. As per point of taxation rules framed under the service tax regime, Explanation to Rule 3 of the Point of Taxation Rules, 2011 provides that where any advance was received by service provider towards any service, the point of taxation shall be the date of receipt of such advance. Therefore, advance received prior to GST coming to force shall be leviable to Service Tax. However, no tax would have to be paid on the service of road Construction because of a specific exemption provided through a notification. **Adjusting the advance** received prior to GST from the Gross Value of Invoices raised during the GST regime for determining the value of supply in GST may **evoke litigation and it may be prudent to examine this issue carefully.**

6.7 Liquidated Damages

The GST law considers the activity of 'agreeing to the obligation to refrain from an act, or to tolerate an act or a situation, or to do an act' as a supply of service in accordance with Schedule II to the CGST Act, 2017. Therefore, payment of Liquidated Damages because of cancellation/ modifications in terms of the contract/ deficiency of performance (e.g. delay) may trigger GST unless the act of tolerating non-performance is by the Government. According to Advance Ruling No. GST-ARA-15/2017-18/B-30 dated 8th May 2018, liquidated damages fall within the heading 9997 and are liable to be taxed @ 18% IGST. This is, however, a matter of litigation and great debate. Careful attention needs to be paid to the intention of the legislators.

6.8 Cross Charge and Input Service Distributor Mechanism Under GST

Under GST Law supply of goods or services or both between related persons and between distinct persons when made in the course or furtherance of business is deemed to be a supply even if the supply is made without consideration. Thus, any supplies between different registered presences under the GST law of the same entity shall be deemed to be a supply and shall be liable to GST. In line with the said provision, a supply between distinct persons results in a cross-charge between such entities. Therefore, common services taken up by the Head Office for the entire organization may be required to be cross charged or distributed across the various projects.

Since the presence of roads and highways may span across more than one state it may be challenging to segregate the common expenses that are provided to one or more registered presences. For e.g., site audits carried out for a highway project having two toll plazas in two states each. The challenge faced here is related to segregation of the value of supply provided to each of these locations individually. The same would have a bearing on invoicing by the supplier and utilization of Input Tax Credit thereon by the recipient.

7.0 Conclusion

Overall, GST shall have a **positive impact** on the Construction of Roads sector (Works Contract Services). The current tax rates on the aforesaid services attract **12% IGST** as compared to the **initially notified rate of 18%**. It is reasonably lower in comparison to the VAT and Service Tax charged in the previous Indirect Tax Regime. With **entire ITC available** to the contractors and sub-contractors, it will encourage **competitive pricing** in the industry and lower the burden of costs in the form of taxes. Litigation is expected on account of transitional provisions being enacted.

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