Service Tax implications on Land Development Agreements between landlord and developers

Ravi Kumar Somani
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In case of a Real estate and construction industry, where due to various political and economical reasons we have seen that there is a sharp downturn being noted in the sale of residential and commercial construction projects irrespective of fact that the prices of land are still reaching sky high. Therefore, in a current business and economic conditions where uncertainty prevails over everything it becomes financially not so viable for a developer to acquire and

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purchase the land from the land owners and then perform the construction activity. However, as we know that every problem comes with a solution. Therefore, in order to ensure financial and commercial viability of the construction projects, one of the solution is a concept of tri-partite construction business model, wherein 3 parties involved in the construction activity as under:

i. The land owner;
ii. The builder/developer; &
iii. The contractor (who undertakes the construction).

Typically, in such a model, the land owner enters into an agreement with the builder, whereby, the land owner gives either land or development rights to construct or develop a residential complex to the builder and whereas the capital, construction and legal work will be carried out by the. The builder/developer, in turn, agrees to assign a portion of the constructed area, in the form of flats in favour of the land owner (Generally, in the ratio of 60:40). The remaining flats are sold by the builder/developer to various buyers. The builder/developer receives consideration for the construction service provided by him, from two categories of service receivers as under:

i. From landowner, in the form of land /development rights; and
ii. From other buyers, normally in the form of money.

In order to understand a practical functioning of Land Development Agreement (also known as joint development agreements), let us take an illustration. For instance assume, ABC developers limited enters into a Joint Development Agreement with land owner Mr. XYZ whereas in lieu of this agreement a total of 1000 residential units will be constructed by ABC ltd on the land provided by Mr.

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XYZ whereas 40% of the units i.e. 400 units shall be given to Mr. XYZ and rest 600 units shall be taken by ABC ltd. Both can commercially sell the units in the open market. Land owner gets 400 units of flats in lieu of the land given and Developer gets 600 units of flats in lieu of the construction work done.

As we have learnt that with every problem comes a solution but it will also not be incorrect to say that with every solution comes the new problem. Of course, that's the life cycle. As far as service tax law is concerned the moot problem that persists in this are the following:

Whether the agreement between developer and land owners is in the nature of joint venture?

If it is not a joint venture then whether the transaction of giving 400 units of flats in return of a land (i.e. a non - monetary consideration) amounts to service and whether the same is liable for service tax?

If it is liable for service tax, then what shall be the value adopted for levying service tax as the consideration given in land is in non-monetary form?

If the value is computed, then when shall the liability to pay service tax arises? i.e. what shall be the point of taxation? Is it at the time of transfer of development rights? Or at the time of entering into agreement or at the time of possession of flats?

Let us answer each question one by one:

Whether the agreement between developer and land owners is in the nature of joint venture?

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CBEC vide circular No. 151/2/2012-ST dated 10th February, 2012, it has been clarified that applicability of service tax under these joint development models, shall be decided based on the principles enumerated in the transaction of revenue sharing between distributors/sub-distributors and film exhibitors where one supplies film and other exhibits the same in their theatre.

In the said circular, it is held that a joint venture is recognized as legal & juristic entity in the nature of partnership of constituent business entities. Further relied on Supreme Court judgment as to the meaning of joint venture wherein it was held that "*the expression 'joint venture' connotes a legal entity in the nature of a partnership engaged in the joint undertaking of a particular transaction for mutual profit or an association of persons or companies jointly undertaking some commercial enterprise wherein all contribute assets and share risks. It requires a community of interest in the performance of the subject-matter, a right to direct and govern the policy in connection therewith, and duty, which may be altered by agreement, to share both in profit and losses".*

It is further clarified that two or more entities undertaking a particular activity for mutual benefit will be treated as joint venture only when they are sharing risks and rewards. In other words, where no risks and rewards are shared, they cannot be called as joint venture. In such case, the transactions between them constitute as took place between two separate persons.

In the instant case, land is contributed by Mr. XYZ and the same is developed by ABC ltd. Each of them are sharing built up area and no risks and rewards are being shared. So their association to construct residential complex cannot be called as joint venture. Therefore, in view of the principles laid down in the said circular, both developer and land owners are treated as different persons and

not as joint venture. Since, the transaction is between 2 different persons, it shall be interesting to look if the transaction shall be liable for service tax.

If it is not a joint venture then whether the transaction of giving 400 units of flats in return of a land (i.e. a non - monetary consideration) amounts to service and whether the same is liable for service tax?

The term 'Service' has been defined under section 65(B)(44) of the finance act, 1994. The relevant extract is as follows:

"service" means

- any activity carried out **by** a person **for** another
- for **consideration**.

In the given case, activity of 'construction' is being carried out. Further, as the agreement is not in the nature of joint venture, therefore it can also be said that the parties to the transaction are two different persons and therefore the activity is carried out **by** one person **for** another person.

Consideration is involved in the transaction in a non-monetary form i.e. instead of giving 'cash' land lord is giving a piece of land in lieu of 400 flats received by it. Therefore, it can be said that developer is providing a service to the land lord by giving 400 units of flats and in return land lord is giving consideration for service in the non-monetary form of land.

Further, in the case of **LCS City Makers Pvt Ltd vs CST, 2013(030)STR0033(Tri-Mad)** wherein it was held that services by way of construction of residential complex to land owners who are transferring their rights in land and getting constructed flats are liable for service tax.

If it is liable for service tax, then what shall be the value adopted for levying service tax as the consideration given in land is in non-monetary form?

As per Circular 151/2/2012-ST dt.10.02.2012, it has been stated that ***value must be determined in terms of section 67(1) read with rule 3(a) of Service Tax (Determination of Value) Rules, 2006***.

However, according to the Para 6.2.1 of the Education Guide 2012 issued by CBEC, it is stated that ***value shall be the value of the land when the same is transferred***.

Although, the circular and the education guide both have been issued by the CBEC but still there exists a divergence of view between the both as highlighted above on how flats handed over to land owners are to be valued for the purpose of levy of service tax.

Therefore, in order to put rest to this issue, High level committee set-up by the ministry of finance has looked upon the matter and has recently vide its instruction issued dated 20.01.2016 has stated as under:

"Education Guide is merely an educational aid based on a broad understanding of a team of officers on the issues. It is neither a "Departmental Circular" nor a manual of instructions issued by the Central Board of Excise and Customs. To that extent it does not command the required legal backing to be binding on either side in any manner. The guide was released purely as a measure of facilitation so that all stakeholders could obtain some preliminary understanding of the new issues for smooth transition to the new regime. Hence, Circulars would prevail over the Education Guide, 2012.

In view of the above, it is directed that in valuing the service of construction provided by a builder/developer to a landowner, who transfers his land/development rights to builder, for getting, in return, constructed flats/dwellings from builder/developer, ***the Service Tax assessing authorities should be guided by the said Board Circular dated 10.2.2012 and not the Education Guide****".*

Therefore, by applying the principle laid down in Circular No. 151/2/2012-ST, value of such flats shall be determined in terms of Rule 3 of the Service Tax (Determination of Value) Rules, 2006 as under:

a. the value of such taxable service shall be equivalent to the gross amount charged by the service provider **to provide similar service to any other person in the ordinary course of trade** and the gross amount charged is the sole consideration;

b. where the value cannot be determined in accordance with clause (a), the service provider shall determine the **equivalent money value of such consideration which shall, in no case be less than the cost of provision of such taxable service**.

In the instant case, the value of taxable service provided shall be the proportionate market value of the land on the date of allotment. However, if the same is not ascertainable then the value shall be the price at which similar flats are sold in the ordinary course of trade to other buyers. In case the price of flat undergoes a change over the period of sale then the value of similar flat as sold nearer to the date on which the land is made available for construction should be used for arriving at the value for the purpose of tax. The same view has also been taken by board in its Circular 151/2/2012-ST dt.10.02.2012.

Overall, the value in any case shall not be less than the cost of construction of the land owners share.

If the value is computed, then when shall the liability to pay service tax arises? i.e. what shall be the point of taxation? Is it at the time of transfer of land? Or at the time of completion of flats?

According to Rule 3 of these Rules, the point of taxation shall be earlier of the following events.

a. Date of receipt of consideration

b. Date of completion of service with respect to each event in case where invoice is not issued within 30 days

c. Date of issue of invoice.

Generally with respect to construction services especially between landlords and developer, there would not be any system of issue of invoices. Therefore only two of the above events would be relevant i.e. date of receipt of consideration or completion.

In case of Joint development agreements, the consideration received by developer is the **date on which development rights are received by him**. This is generally before the project commencement date. Accordingly service tax is required to be paid by 5th/6th of the month following the quarter in which such development rights are transferred.

A similar view has been taken in Circular 151/2/2012-ST dt.10.02.2012. Para 2.1 of circular clarifies that "*Service tax is liable to be paid by the builder/developer on the 'construction service' involved in the flats to be given to the land owner,*

at the time when the possession or right in the property *of the said flats are* ***transferred*** *to the land owner by entering into a conveyance deed or similar instrument (eg. allotment letter).*

However, generally developmental rights are transferred before the commencement of construction and it very is harsh to levy service tax at such a point which leads to huge cash outflows for the developers at the start of project itself. Further, it is also difficult to arrive at value at that point as the construction cost and value of sale of similar flats is unknown. Therefore, the point of taxation has been a matter of issue in this regard. To conclude, many construction companies are taking divergent views based on their risk appetite to arrive at which point they prefer to pay service tax. An aggressive view would be to pay on completion of the commercial construction and on transfer of the possession of the flats and a safe view would be to pay at the time of transfer of developmental rights. However, there also exists a moderate view which is to pay proportionate amounts on completion of each event leading to total payment being made by the completion of whole construction.

(By CA Ravi Kumar Somani)
For feedback or queries write to ravi.somani03@gmail.com)

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