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Indirect Tax

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Supreme Court upholds constitutional validity of section 17(5)(d) of CGST Act, 2017, 'Building' to be treated as 'Plant' for availing ITC applying Functionality Test

Snapshot

The Supreme Court affirmed the constitutional validity of clauses (c) and (d) of Section 17(5) as well as Section 16(4), finding these provisions consistent with constitutional requirements. Furthermore, the Court clarified that ITC entitlement is not an inherent right but a statutory privilege subject to the specific stipulations of the legislation.

The Court observed that ITC is generally restricted under Section 17(5)(d) of the statute concerning the construction of immovable property. However, an exception exists if the immovable property qualifies as "plant or machinery." This classification requires the application of a functionality test, as extensively discussed in the judgment. Accordingly, the Supreme Court emphasized the necessity of applying this functionality test to determine whether a building can be regarded as a "plant" within the statutory framework. Consequently, the matter was remanded to the High Court of Orissa for a comprehensive factual examination to ascertain whether the shopping mall in question meets the criteria for classification as a "plant" for ITC eligibility.

Factual Background

The taxpayer¹ (*Respondent in this case and with other parties in this case is collectively referred to as "Taxpayer"*) had accumulated Input tax credit (ITC) totalling over Rs. 34 crores through the procurement of goods and services used in the construction of the mall. Specifically, this amount comprised ITC on raw materials like cement and steel, professional services like architectural and engineering consultancy, and other input services necessary for the construction process. The taxpayer claimed that these inputs were procured solely for the purpose of constructing commercial property intended for leasing, which is a taxable activity under the GST framework. The department, however, denied this ITC claim, invoking the provisions of Section 17(5)(d) of the Central Goods and Service Tax Act, 2017 (The CGST Act) which disallows ITC on the construction of immovable property "on own account," thereby classifying the expenditure as non-creditable.

Consequently, the taxpayers approached the High Court of Orissa, seeking a declaration that the relevant provision was unconstitutional, specifically arguing that it violated Articles 14 and 19(1)(g) of the Constitution of India, which guarantee equality before the law and the right to carry on any occupation, trade, or business, respectively. Alternatively, they argued that the provision should not apply to immovable properties intended for leasing. The taxpayers contended that the denial of ITC not only imposed a significant financial burden by effectively increasing the cost of construction but also frustrated the core objectives of the GST regime.

¹ Chief Commissioner of Central Goods and Service Tax & Ors V/s. M/s Safari Retreats Private Ltd. & Ors. CIVIL APPEAL NO. 2948 OF 2023 with WP (CIVIL) NOS. 804 of 2022 & 1030 of 2022 CIVIL APPEAL NO. 2949 OF 2023 WP (CIVIL) NOS. 1036 of 2022 & 90 of 2023 WP (CIVIL) NO. 846 of 2023 and WP (CIVIL) NO. 847 of 2023

Arguments by Taxpayer (Respondents)

Constitutional Violation: The taxpayers argued that Section 17(5)(d) contravened Articles 14 and 19(1)(g) of the Constitution of India. Specifically, the denial of ITC results in treating entities leasing immovable properties on par with those engaged in the sale of immovable properties, thus treating "unequals as equals." Such treatment, they argued, is inherently discriminatory and fails the test of reasonable classification. Article 14 guarantees equality before the law and any differentiation under tax legislation must rest on an intelligible differentia that bears a rational nexus to the objective sought to be achieved by the legislation.

Arbitrary Classification: The taxpayers further contended that the classification created by Section 17(5)(d) lacked a rational nexus with the objectives of the CGST Act. GST is intended to be a comprehensive tax on the supply of goods and services, with ITC provided at every stage to prevent the cascading burden of taxes. By disallowing ITC on the construction of immovable property intended for leasing, the provision discriminates among assessees based on the ultimate use of immovable property, irrespective of whether the property generates taxable income. This arbitrary distinction imposes an undue burden on businesses in the leasing sector.

Lack of Nexus with Objectives: The taxpayers emphasized that denying ITC contradicts the core principles of the GST framework, particularly the elimination of cascading taxation and the assurance of seamless ITC availability. They asserted that GST is fundamentally a destination-based consumption tax and denying ITC on construction inputs results in increased costs for lessors, ultimately inflating the cost for end consumers. The cascading effect is antithetical to the spirit of GST as envisioned under the Constitution (122nd Amendment) Act, 2017,

which sought to introduce GST as a comprehensive, unified, and simplified system of indirect taxation.

Reading Down the Provisions: The taxpayers proposed that section 17(5)(d) should be read down to limit the blockage of ITC only in cases where goods and services are procured for personal consumption rather than for business purposes. Specifically, they contended that the phrase "on its own account" should apply exclusively to properties used for personal use rather than commercial leasing activities. Where immovable property is used to generate taxable revenue such as leasing, renting, or letting out ITC should be available to ensure continuity in the credit chain. The taxpayers supported their argument with judicial precedents that advocated for purposive interpretation of tax statutes to uphold legislative intent and facilitate economic activity.

Interpretation by Taxpayers of "Plant and Machinery" and "Plant or Machinery": The taxpayers argued that Section 17(5)(d) of the CGST Act can be interpreted to make ITC available for the construction of immovable property used for further output supply. This argument is based on the following points:

- a) **Distinction Between Plant and Machinery vs. Plant or Machinery:** The taxpayers argued that Clause (d) exempts "plant or machinery" from blocked credit, which is distinct from the expression "plant and machinery" used in Clause (c). They contended that the explanation to subsection (6) of Section 17, which defines "plant and machinery," does not apply to Clause (d). The Revenue, however, opposed this by submitting that the word 'or' must be read as 'and,' suggesting that the different phrasing was a legislative mistake. The taxpayers countered that the different phrasing was intentional, as the model GST law originally used "plant and

machinery" in both clauses (c) and (d), but the enacted law made a deliberate change to "plant or machinery" in Clause (d). The taxpayers argued that the legislature's intention to treat the expression "plant or machinery" differently from "plant and machinery" is evident from the language used and must be respected.

- b) **Definition of Plant:** The taxpayers submitted that buildings like malls, hotels, and warehouses should be treated as "plants" and therefore exempted from blocked credit under Clause (d). They argued that the word "plant" is not defined under the CGST Act, the General Clauses Act, or State GST laws, and thus must be interpreted in its ordinary commercial sense. Reliance was placed on several judicial precedents that defined "plant" broadly to include buildings that serve as integral tools of trade, provided they play an essential role in business operations rather than merely serving as a setting. The taxpayers highlighted that this interpretation is consistent with commercial realities, where such buildings are not mere settings but critical to the conduct of business, thereby qualifying as "plants."
- c) **Application of Functionality Test:** The taxpayers emphasized that a functionality or essentiality test should be applied to determine whether an asset qualifies as a "plant." They argued that any building or structure that functions as an essential tool for carrying on business, such as a shopping mall designed to attract customers, should be treated as a plant. This interpretation aligns with precedents that consider functionality as the primary determinant for defining an asset as a plant. They submitted that if a building or infrastructure serves as a necessary component for generating taxable

output, it should not be subject to blocked credit under Section 17(5)(d).

- d) **Legislative Intent and Consistency:** The taxpayers also argued that Section 17, being an exception to the general rule under Section 16, must be construed strictly. They noted that the expression "plant and machinery" has been used multiple times throughout the CGST Act, whereas "plant or machinery" appears only in Section 17(5)(d). The deliberate use of different language suggests a distinct legislative intent that should not be ignored. The taxpayers further pointed out that in the model GST law, the expression "plant and machinery" was used in both clauses (c) and (d) of Section 17(5), but the final law adopted different expressions, indicating an intentional differentiation by the legislature.
- e) **Exemption for Malls, Hotels, Warehouses as Plants:** The taxpayers asserted that certain commercial buildings, such as malls, hotels, and warehouses, should qualify as "plants" under Section 17(5)(d) based on their functionality in business operations. They argued that these properties are integral to carrying out taxable activities and therefore should be exempted from blocked credit. They cited various precedents, to support their contention that the word "plant" must be interpreted broadly in accordance with trade understanding and commercial practice.

The taxpayers emphasized that excluding such assets from ITC would create inconsistencies and economic inefficiencies within the GST framework. They argued for a purposive interpretation of the term "plant and machinery" to maintain coherence in the GST system and promote fairness in tax

treatment. Additionally, they stressed that the essentiality and functionality tests are crucial in determining whether an asset should be treated as a "plant" for the purpose of availing ITC, advocating for an approach that aligns with the economic objectives of the GST regime and supports the growth of business activities.

Arguments by Revenue (Appellants)

Justification for Classification: The revenue argued that the classification in Section 17(5)(d) was based on intelligible differentia. The denial of ITC for immovable property was justified as immovable property inherently leads to a break in the tax chain. The Revenue emphasized that immovable properties are distinguishable from other types of assets that qualify for ITC, as immovable properties are designed for long-term use and do not undergo transformation or consumption in the course of providing taxable supplies. As such, the denial of ITC falls within the permissible discretion of legislative policy.

ITC as a Statutory Right: The Revenue underscored that ITC is a statutory right rather than a fundamental or constitutional right. Its availability is subject to the specific conditions prescribed under the statute, and the legislature possesses the authority to impose reasonable restrictions on such statutory rights. The Court, therefore, cannot extend ITC beyond the clear terms of the statute without encroaching on legislative authority. The Revenue relied on case law that emphasized judicial deference to legislative policy in matters of economic regulation, particularly regarding tax classifications.

Interpretation of "Plant or Machinery": The Revenue contended that the term "plant or machinery" should be interpreted as "plant and machinery" to reflect the legislative intent. The differentiation between the terms in Section 17(5)(d) and other parts of the CGST Act was characterized as a drafting

inconsistency rather than a deliberate distinction. Furthermore, the Revenue argued that shopping malls, as immovable property, could not be considered "plant or machinery" for ITC purposes, as they do not meet the functional attributes that characterize plant or machinery in the tax context.

Challenge to Constitutional Validity: In response to the principles for examining the constitutional validity of taxation statutes, the Revenue submitted that the test for determining the vice of discrimination in a taxing statute is less rigorous. The Revenue argued that the Parliament is entitled to make policy choices and adopt appropriate classifications, especially given the latitude that the Constitutional jurisprudence allows in matters involving tax legislation. They asserted that the principle of equality under Article 14 of the Constitution does not preclude the classification of property, credit, profession, or events for taxation purposes. The Revenue further argued that a taxing statute cannot be challenged on the grounds that the tax is harsh or excessive. The Revenue refuted the contention that clauses (c) and (d) of Section 17(5) are a fraud on the Constitution or manifestly arbitrary.

The Revenue relied on judicial case law, emphasizing that even if clauses (c) and (d) exhibited discriminatory tendencies, they did not rise to the level of being manifestly arbitrary under established legal principles. Furthermore, the Revenue argued that English legal precedents were not applicable in this matter, as the constitutional and statutory distinction between movable and immovable goods in India is unique and not mirrored in English law. Therefore, the differentiation under Section 17(5) must be analyzed within the context of Indian constitutional and statutory norms.

Judgment of the High Court

The High Court of Orissa ruled in favour of the assessee, holding that Section 17(5)(d) should be read down to better align with the objectives of the CGST Act. The Court observed that denying ITC, while GST was being charged on the rental income from the constructed property, would frustrate the fundamental objectives of the ITC provisions. ITC is designed to ensure tax neutrality and prevent cascading taxes. Denying ITC to entities engaged in leasing immovable properties would lead to higher costs for lessees, thereby impeding economic efficiency.

Supreme Court Analysis

Exception to clause (d) of section 17(5): The Hon'ble Supreme Court observed that there are two exceptions in clause (d) to the exclusion from ITC. The first exception is where goods or services or both are received by a taxable person to construct an immovable property consisting of a "plant or machinery". The second exception is where goods and services or both are received by a taxable person for the construction of an immovable property made **not on his own account**. Construction is said to be on a taxable person's "own account" when (i) it is made for his personal use and not for service or (ii) it is to be used by the person constructing as a setting in which business is carried out. **However, construction cannot be said to be on a taxable person's "own account" if it is intended to be sold or given on lease or license.**

Interpretation of "Plant or Machinery": The Supreme Court made an in-depth analysis to determine whether the explanation under Section 17(5)(d) encompassed the term "plant or machinery." The Court noted that the CGST Act distinguishes between "plant and machinery" and "plant or machinery," and that the latter terminology was used only in Section 17(5)(d). The Court concluded that the distinction was intentional and that the provision should not be interpreted to deny ITC where immovable property constitutes a 'plant' for the purpose of section 17(5)(d) of the Act. The court further held that if the construction of a

building was essential for carrying out the activity of supplying services, such as renting or giving on lease or other transactions in respect of the building which are covered by clauses (2) and (5) of Schedule II of the CGST Act, the building could be held to be a plant.

Constitutional Challenge: The Supreme Court assessed whether the classification made under Section 17(5)(d) was arbitrary or discriminatory. The Court emphasized that the provisions must satisfy the test of reasonable classification, which necessitates an intelligible differentia as the foundation of the classification, and that this differentia must have a rational connection to the legislative objective. The Court recognized that immovable property and immovable goods form a distinct class within the GST framework, and clauses (c) and (d) of Section 17(5) are intended to apply specifically to this category. The right to claim ITC is statutory rather than inherent, subject to the terms explicitly prescribed in the legislation.

The Court further reasoned that the differentiation established by clauses (c) and (d) has a rational basis, specifically aimed at safeguarding the legislative powers of the States and avoiding encroachment into domains outside the scope of GST. Although these provisions could be seen as less inclusive, the Court held that they meet the constitutional test for reasonable classification. The classification is not about creating inequalities among similar entities but rather addressing distinct economic concerns requiring specific treatment. Consequently, clauses (c) and (d) of Section 17(5) were determined to be neither discriminatory nor unconstitutional.

The Court concluded that, despite any perceived imperfections in the legislation, the provisions remain constitutionally valid. The Court underscored that it cannot impose its policy preferences over legislative decisions, especially in complex matters involving fiscal adjustments and economic policy. A purposive interpretation of tax provisions, the Court emphasized, is essential to mitigate economic inefficiencies and uphold the integrity of the GST system.

Conclusion

The Supreme Court affirmed the constitutional validity of clauses (c) and (d) of Section 17(5) and Section 16(4) of the CGST Act, determining that these provisions do not contravene constitutional standards. The Court reasoned that the expression “plant or machinery” in Section 17(5)(d) cannot be directly equated with “plant and machinery” as defined in the explanation to Section 17, emphasizing a deliberate distinction in legislative language. The classification of a building, such as a mall or warehouse, as a “plant” under Section 17(5)(d) depends on the building's role within the business operations of the registered person and whether it is integral to the supply of services, including leasing or renting.

The Court highlighted that a functionality test must be employed to determine if a building qualifies as a “plant.” Accordingly, the matter was remanded to the High Court of Orissa to undertake a detailed factual determination of whether the shopping mall constructed by the petitioner meets the criteria of a “plant” for ITC purposes. The Court underscored that the ultimate adjudication of whether the construction of immovable property constitutes a plant must be context-specific, relying on the particularities of each case and guided by the principles articulated in the judgement.

KCM Comments

This judgment carries considerable implications for businesses engaged in the construction and leasing of commercial properties. It provides essential clarity on the treatment of ITC for construction activities under the GST, affirming the legislative intent to preserve an uninterrupted ITC chain. By distinguishing between “plant or machinery” from “plant and machinery,” the Court articulated a framework consistent with GST's broader economic objectives. The emphasis on applying the functionality test — assessing whether a building qualifies as a “plant” based on its essentiality in business operations — advances a deeper understanding of ITC applicability for immovable properties used commercially. The Supreme Court also addressed the conditions under which immovable property can be considered as constructed on one's 'own account.' It determined that construction can be regarded as on one's own account when it is intended for personal use or to serve as the business's operational setting. One perspective is that any utilization of immovable property other than for personal use or consumption, such as leasing, or licensing, might not qualify as construction on one's 'own account.' Although this point wasn't extensively discussed, it implies that constructing immovable property for lease or license could be eligible for ITC, even if the building does not meet the definition of a 'plant.' However, without explicit guidance, this interpretation remains open to potential litigation.

The ruling is likely to benefit the commercial real estate sector by reducing leasing costs and fostering investment in infrastructure. By advocating a purposive interpretation of tax provisions, the Court underscored the importance of aligning tax laws with economic principles, particularly to avoid cascading tax effects and ensure seamless credit flow.

This decision also establishes a precedent for comparable cases where ITC claims were previously disallowed under rigid statutory interpretations. The functionality test, alongside the differentiation between “plant or machinery” and “plant and machinery,” facilitates a more nuanced approach to ITC eligibility, considering the specific role of the property in business operations.

The Supreme Court, relying on precedents in income tax law, held that a building may qualify as a 'plant' if it is specifically designed and constructed to fulfil the technical requirements of a business. However, the Court remanded the case to the High Court to determine, based on the functionality test, whether the mall in question satisfies the criteria to be deemed a 'plant.' The High Court is now tasked with defining the conditions under which immovable

property can be classified as a 'plant' for the purpose of claiming ITC. Accordingly, it is necessary to await the High Court's clarification of the functionality test parameters to determine when immovable property may qualify as a 'plant' for ITC eligibility.

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