New GST regime for Realty - need to relook at existing business models

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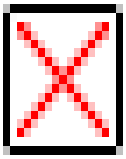

THE new GST regime that has come into effect from April 1,2019 would seem to upset certain existing methods by which the Realty Sector operates, one of which, is the highly popular model involving joint development agreements. As is known, in a typical JDA model, the Developer enters into an agreement with the Land owner, in terms of which, the Developer conveys the agreed portion of the constructed area, mostly in the form of completed apartments to the Land owner in exchange of the transfer of development rights by the Land owner. There has indeed been a big confusion regarding the levy of service tax on JDAs, in terms of Circular No. **151/2/2012-ST** dated February 10, 2012. Come GST, we have had Notification No. **4/2018-CTR** dated January 25, 2018 in terms of which, the Developer is liable to pay GST on the transfer of the constructed area to the Land owner, while the latter is liable to GST on the transfer of development rights to the Developer. Now, the latest is Notification No. **4/2019-CTR** dated March 29, 2019, in terms of which, the Developer is being made liable to pay GST even on the transfer of development rights to himself by the Land owner, under the Reverse Charge Mechanism, subject of course, to an exemption to the extent of the quantum of flats sold prior to the date of the completion certificate (â€˜OC').

Be that as it mayâ€¦

The shifting of the liability to pay GST to the Developer under the RCM, in respect of unregistered Land owners, would seem to have pushed the Developer from the frying pan to the fire itself. In most cases, the Land owners are not registered taxable persons under the GST law and in the light of the fact that Section 9(4) of the CGST Act had not been implemented till March 31, 2019, the Developer was not required to bother about the payment of GST by the Land owner, on the transfer of development rights. The Developer is now waking up to the possibility of huge GST payments on JDAs, as, Notification No. **4/2019-CTR** seems to cover all transfer of development rights on or after 1-4-2019 and thus could cover JDAs entered into prior to 1-4-2019 as well, especially considering the fact that, in terms of the said notification, the date of transfer of the development rights is the date of completion or first occupation of the project, as the case may be, whichever is earlier. Thus, the Developer could become liable to pay GST on all projects under the JDA model including projects that were commenced years ago, that get completed on or after 1-4-2019. This development is quite obnoxious and the said Notification imposing a tax liability for the period prior to 1-4-2019 can be held to be unsustainable and illegal. Though the Developer is liable to pay GST only on the value of development rights that is attributable to the value of unsold flats lying as on the date of the OC, considering the fact that with the advent of RERA, the quantum of flats sold post OC could be significant, this development is bound to adversely affect the Developers even in respect of projects launched years ago.

Another popular model that is widely followed in the Realty sector is that of revenue sharing, in terms of which, the Developer and the Land owner share the revenues arising out of the residential project, after payment of indirect taxes, in an agreed percentage. Thus, in a typical revenue sharing model, the Developer and the Land owner could agree to share the revenues arising out of the project, after payment of indirect taxes, in the ratio of 70 : 30. Developers who had entered into revenue sharing agreements with the Land owners prior to 1-4-2019 are finding out, to their horror that, post 1-4-2019, the quantum of cash outflows to be shared with the Land owners would substantially go up, as is indicated in the table below.

Â	Pre 1-4-2019	Post 1-4-2019
Gross revenues/billings on customers	112	112
GST collected	12	5
Net Revenue	100	107
Post GST Revenue shared with LO (%)	30	30
Post GST Revenue shared with LO - cash outflows	30	32.1

Needless to sayâ€¦ Developers would need to amend their existing agreements to take care of these very unfortunate developments concerning revenue sharing arrangements.

Another development that would affect existing JDAs and revenue sharing agreements is the stipulation that, the Developer would need to pay GST under RCM, in cash and all the accumulated credit cannot be used even for payment of GST on the Developer's share of flats.

It seems quite strange that, under the erstwhile service tax law, the Government, it would seem, had not tried to levy service tax on Land owners, presumably, by following the legal principle that, development rights are nothing but rights arising out of land and are consequently, to be treated as land itself. The first attempt to levy GST on Land owners came with Notification No. **4/2018-CTR** dated 25-1-2018 and instead of simply dropping its view of taxing Land owners on transfer of development rights, the Government has made matters much worse, by shifting the responsibility to pay GST, on the Developers.

The point of taxation, vis-Ã -vis payment of GST by Developers under the RCM, is the date of the OC, which is welcome. The new dispensation also provides for valuation of the development rights, on the basis of the value of similar flats sold, nearest to the date of the OC. In the absence of a valuation methodology prescribed earlier, valuation of development rights had been assumed on a cost plus 10% basis and with the new valuation rule, the overall GST liability on the Developer, in respect of JDAs, is bound to increase. Thus, this could be a case wherein, the GST liability on the Developer under RCM could work out to be much more than the GST liability that could have arisen on the Land owner under the forward charge mechanism, which is clearly impermissible in law. Section 9(4) can only shift liability to pay GST on the recipient but, cannot increase the liability on the recipient through a valuation mechanism.

Another major concern for Developers is the GST rate of 18% that is applicable on JDAs, which is very high, compared to the effective rate of 7.5% GST on the construction value of the flats sold by the Developer, for new residential projects. Assuming an average of about 30% of the flats remaining unsold as on the date of the OC, the GST liability on the Developer, in respect of JDAs, could work out to an effective GST rate of about 6.4% on the construction value, which is a very huge risk that the Developer carries on his head. In my view, wherever possible, Developers would be better off signing revenue sharing agreements rather than JDAs, with their going forward, as under revenue sharing agreements, there can be no GST levy vis-Ã -vis development rights attributable to unsold flats. As regards existing JDAs, Developers would need to re-negotiate these agreements, in the light of the GST liability that is fastened on them under RCM, in respect of transfer of development rights, with effect from 1-4-2019. These developments are far too harsh on the Developer and carry a huge amount of risk, which the Developer would want to avoid, by looking at alternate arrangements like revenue sharing, etc. Developers can also look at the option of converting their existing JDAs into revenue sharing agreements.

In so far as levy of GST on transferable development rights (â€˜TDRs') by non-land owners is concerned, there are cases where the sellers of these rights have already paid GST based on the consideration received on the transfer of these rights and in these cases, these transferors/sellers of TDRs might have to ask for a refund of the GST paid by them, as the responsibility to pay GST on TDRs has now been shifted to the Developers.

Before partingâ€¦

One would hope that the Developers challenge Notification No. **4/2019-CTR** dated March 29, 2019 as being violative of the basic concept that, development rights being rights that arise or accrue out of land, cannot be subjected to the levy of GST, at all. As contrasted to the Land owners, the Developers, whether working in their individual capacity or as an Association, are far better placed to challenge this obnoxious Notification.

The methodology prescribed for arriving at the quantum of GST to be paid by the Developer, vis-Ã -vis the unsold flats as on the OC date, is very complex, to say the least. Being a CA with over 34 years of experience, I myself find it very difficult to make sense of this method.

The only class of persons who would happy with these developments would be the Land owners, who are not registered under the GST law and their happiness could be at the cost of the hapless and helpless Developers.

(The views expressed are strictly personal.)