

SERVICE TAX ON COMMERCIAL RENTING

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INTRODUCTION

Service tax was introduced in our country in 1994 with a famous quote that “*when goods are taxable in our country why not services*”. Only three services were covered under the net of service tax at that time at the rate of 5 %, but now more than 100 services are covered under this tax at the rate of 12.36 % and our law makers have chosen a selective approach to tax services instead of taxing the whole service sector. Lately, they have started taxing transactions in the garb of services, which are not related to with the rendering of any service. There has been an increasing tendency to indiscriminately levy tax on contracts rather than tax the services. Renting of immovable property for commercial purposes is one of them.

With onset of liberalization, there has been a sharp rise in the prices of immovable properties over the last five years. The rents of properties too have shot up simultaneously. Arrival of multinational companies and change in work culture in wake of computerization has increased the demand for well furnished properties. This phenomenon has drawn attention of the Finance Ministry, which through the Finance Act, 2007, has brought seven new services under the taxable net, including, amongst others, renting of immovable property for business or business purposes, w.e.f. 1st June 2007. This has given rise to the basic question, as to whether all taxable events brought under the service tax net are really services or something else and “*how renting of immovable property is a service*”.

THE FINANCE ACT, 2007

Service tax is payable @ 12.36 % of the rent received, as reduced by the property tax paid by the assessee, for the period for which service tax is paid and includes 2 % education cess and 1 % secondary and higher education cess payable on service tax. As

per Section 65 (90a) of the Finance Act, 2007, “*renting of immovable property*” includes “*renting, letting, leasing, licensing or other similar arrangements of immovable property for use in the course or furtherance of business or commerce*” but does not include:

- Renting of immovable property by a religious body or to a religious body; or
- Renting of immovable property to an educational body, imparting skill or knowledge or lessons on any subject or field, other than a commercial training or coaching centre.

This service has been made taxable as per provisions of Section 65 (105) (zzzz) of the Finance Act, 2007 and renting of the following properties have been included in ambit of service tax, if the rented property is used by the tenant for the commercial purpose:-

1. Building and part of a building, and the land appurtenant thereto.
2. Land incidental to the use of such building or a part of the building.
3. The common or shared areas and facilities relating thereto.
4. In case of a building located in a complex or an industrial estate, all common areas and facilities relating thereto, within such complex or estate.

The following properties have been specifically excluded from the purview of service tax:

1. Properties used for residential purpose or used for residential accommodation, such as hotels, boarding houses, holiday accommodations, tents, camping facilities.
2. Vacant land solely used for agricultural, aquaculture, farming, forestry, animal husbandry and mining purposes.
3. Vacant land, whether or not having facilities clearly incidental to use of such vacant land.
4. Land used for educational, sports, circus, entertainment and parking purposes.
5. Properties owned by a religious body or given on rent to a religious body.
6. Renting of immovable property to an educational body, other than, commercial training or coaching centre.

If the agreement for renting of a property is a composite agreement, though the property is used partly for residential purpose and partly for commercial purpose, then service tax would be levied on the whole value of rent. The statutory explanation in this respect reads:-

“For the purposes of this sub-clause, an immovable property partly for use in the course or furtherance of business or commerce and partly for residential or any other purpose shall be deemed to be immovable property for use in the course or furtherance of business or commerce.”

Since the exemption available to small service providers, as provided by Notification No. 6/2005-S.T., dated March 1, 2005, has been increased from Rs. 4 lakhs to Rs. 8 lakhs w.e.f. April 1, 2005, by amending the Service Tax Rules, 1994, the small property holders receiving rent up to Rs. 8 lakhs fall outside of the purview of levy of service tax.

TESTING THE VALIDITY OF THE LEVY

VIREES

Article 265 of the Constitution mandates that, “no tax shall be levied or collected except by authority of law”. In other words, tax cannot be levied or collected by a mere executive fiat. It can be done only by authority of law, which implies a valid law. In order for the law to be valid, the tax proposed to be levied must fall within the legislative competence and domain of the legislature imposing the tax and authorizing the collection thereof.¹ Entry 49 of List II of the Seventh Schedule refers to tax on land and building on which State Government alone has the legislative competence. Accordingly, laws relating to imposition of tax on land and building fall within the exclusive legislative domain of State Legislature / Government and the Parliament and / or the Central Government (the Union) has no legislative authority to deal with the same. A tax on land and building would also include a tax on the rent pertaining to such land and building. As such, a tax on rentals would come within the scope of Entry 49 of List II and further, if there is no “service” provided by the landlord, there would be no scope for levy of service tax on rentals and such a tax on rentals would not even come within the scope of Entry 49 of List II of the Seventh Schedule.

¹ *H.M.M. Ltd. v. The Administrator, Bangalore City Corporation, Bangalore*, AIR 1990 SC 47 : (1989) 4 SCC 640.

Recently, the retailers, real estate developers and multiplex owners, among others, have moved the Bombay High Court challenging the constitutional validity of levy of service tax on commercial renting of immovable property. The petitioners have sought relief contending that lease or license (including renting or letting out) is not a service and further tax relating to land and buildings is covered under List II of Seventh Schedule and the state legislature / government alone has the exclusive power to levy or impose tax on the subject. The Division Bench of the Bombay High Court comprising of Justice F I Rebello and Justice J.P. Devadhar have admitted the writ petition filed by the Retailers Association of India, the Confederation of Real Estate Developers' Association of India and the Multiplex Association of India, which was last heard on October 29, 2007 and is pending for arguments.

Similarly, the Madras High Court vide its Order date October 9, 2007 has granted an interim injunction restraining the Union Finance Ministry from collecting service tax on rent of commercial buildings following a petition filed by General Star Kitchen Pvt. Ltd., which operates a restaurant in Chennai Citi Centre. The petitioners have challenged levy of service tax on the grounds that the Union Government has no power to levy any tax on rentals accruing from building in the form of service tax or otherwise. Such a levy is a tax on rent, which in turn is a tax on property. Under the Constitution, only the State as opposed to Union has the exclusive domain and legislative competence to levy tax on land and building. The petitioners have also submitted that there is no service involved in letting out of the immovable properties. The Union Government is attempting to levy a tax on service, which it is not entitled to under the federal framework of the Constitution. The Petitioner has also argued that the Government has drawn a distinction between letting properties to business or commerce, on which the service tax is levied, and other leases. There is no distinction between the landlord who lets out property for a commercial purpose or otherwise. So, the distinction created by the Union to assume legislative authority to impose the said levy is hostile and discriminatory and violates the principles enshrined in Article 14 of the Constitution of India.

Having drawn the attention of the judiciary at such a nascent stage, the levy of service tax on rent payable for lease of commercial immovable property is highly debatable and it is difficult for such a levy to successfully sustain the test of its constitutional validity.

In *Tamil Nadu Kalyana Mandapam Association v. Union of India*², service tax levied on *kalyana mandapams / mandap-keepers* (marriage halls) was challenged on the premises that only state government had the legislative competence to levy tax and such tax amounted to “*tax on land and building*”. The Supreme Court rejected this contention and observed that, in case of a *mandapam*, it is not just renting of premises for a few hours. A mandap-keeper provides lighting arrangements, furniture, fixtures, floor coverings, and so on. A *mandap keeper* also provides services relating to decoration and organizing the *mandap*. The nature of the contract is not a mere transfer of immovable or moveable property or rights therein.

In commercial renting of immovable property the situation is different. Mere renting of office space does not involve rendering of any service, apart from handing over the vacant possession of the property and it is incomprehensible as to how a return in from rentals from such leasing per se could be construed as a taxable ‘service’. If a lease deed also requires landlords to provide services, such as, maintenance and upkeep of the property, etc., certainly this component can be subject to levy of service tax. There is a deduction of 60% on the amount paid for use of a *kalyana mandapam* or hotel. However, under the Finance Act, 2007 in renting of immovable property, the only deduction is the property tax paid to the local authority.³ Unfortunately, there is no deduction for the amount paid purely for use and occupation of commercial space

TRANSFER OF PROPERTY ACT, 1882

The taxable event for the service tax is rendition of services and the question the needs to be answered at the first place is whether renting, leasing or licensing of immovable property is rendition of service or a ‘transfer’ under the Transfer of Property Act, 1882. The term “*immovable property*” has not been defined in the Transfer of Property Act, 1882, except that, Section 3 states that “*immovable property*” does not include standing timber, growing crops or grass. Unless there is anything in the subject or the context to suggest to the contrary, the term “immovable property” can be given the same meaning as contained in the General Clauses Act, 1897. Section 3(26) of the General Clauses Act,

² (2004) 5 SCC 632.

³ Notification No. 24/2007 (Service Tax) dated May 22, 2007, issued by the Under Secretary to the Government of India, Ministry of Finance, Department of Revenue, Published in the Gazette of India, Extraordinary, Part II, Section 3(i). (It points out that, if the rent is Rs 1 lakh and the property tax is Rs 2, 000/-, service tax will have to be paid on Rs 98, 000/-).

1897 defines “*immovable property*” to include “*land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth*”. “*Immovable property*” as defined in Section 2(6) of the Registration Act, 1908, also includes land and buildings. These definitions though illustrative and not exhaustive, do cover buildings and benefits arising out of or appertaining to buildings. Building is a thing attached to the earth and is by itself an immovable property. In the case of land, benefits arising out of land are also “*immovable property*”, unless specifically excluded. Similarly, in case of buildings, benefits arising out of buildings can be deemed to be “*immovable property*”.

Benefits arising out of building can be of various kinds, depending upon the rights which can be enjoyed by the person. In case of lease, the lessee enjoys benefits arising out of the building. Lease has reference to any transfer of possession or control of tangible or intangible personal property for a fixed or indeterminate period for consideration. A *lease of immovable property* is defined as “*a transfer of right to enjoy such property, in consideration of a price paid or promised...*”⁴ A lease involves two agreements, one by the landlord agreeing to let his accommodation to be used by the tenant in consideration of the latter paying him money, called rent, and the other by the tenant agreeing to pay the landlord money, called rent, in consideration of the latter allowing him to use his accommodation.⁵ Each party agrees to do a certain act and each agreement is a consideration for the other.⁶ A lease is something more than a mere contract. When executed, it passes from the domain of contract into that of conveyance, a lease being a species of conveyance too.⁷ The right of enjoyment contemplated is an interest in the immovable property conferred on the lessee by the agreement of lease which is also the subject-matter of the lease.⁸ When the lessee (tenant) enjoys certain rights in the buildings, he is a person who is in enjoyment of benefits arising out of the building and the tenancy right shall by itself be an “*immovable property*”. Lease is the transfer of a right to enjoy the immovable property and what has been transferred is the right of

⁴ Section 105 of the Transfer of Property Act, 1882.

⁵ Dr. Sir Hari Singh Gour, COMMENTARY ON THE TRANSFER OF PROPERTY ACT, Vol. 2, 11th edn. (2005), Delhi Law House, Delhi, at p. 1766.

⁶ *Udhoo Dass v. Prem Prakash*, AIR 1964 All 1, at p. 3.

⁷ *Jitendra Nath Mukherjee v. Commissioner of Madurai University*, AIR 1967 Cal 423, at p. 427.

⁸ *Kenneth Solomon v. Dan Singh Bawa*, AIR 1986 Del 1, at p. 2.

enjoyment.⁹ Hence, there is a transfer of possession though not a transfer of title to the immovable property. Such a transfer of possession of immovable property cannot be equated with that of a 'service' so as to make it liable to service tax under the provisions of Finance Act, 1994, as amended by the Finance Act, 2007.

'Rent' means "a return made by a tenant or occupant of land to the owner for the possession and use thereof" or "a pecuniary sum agreed upon between a tenant and his landlord and paid at fixed intervals by the tenant to the landlord for the use of land".¹⁰

Section 105 of the Transfer of Property Act, 1882, also defines the term "rent". According to this section, "rent" is the periodical payment in money or kind to the landlord for the enjoyment of a property held by the tenant from the landlord. 'Rental' may be defined as "a sum total of rents".¹¹ On the other hand, 'service' means "an act of assistance or benefit".¹² If renting of immovable property is without providing any service like maintenance, infrastructure services and other support service then it is merely a "renting of a property", and it cannot be said that the landlord provides any service to a tenant. Hence one can say that "renting of immovable property for commercial purpose" is not a service though it has been made chargeable to service tax as per the provisions of the Finance Act, 1994 (the law governing the service tax in our country) as amended by the Finance Act, 2007. Rental paid cannot be said to be in lieu of help or assistance, so cannot be brought within the purview of service tax.

IMPLICATIONS

With this fresh imposition, the landlord, who is already under the burden of paying property tax to the local or municipal authorities and income tax on the rental income, apart from interest on borrowed capital, if any, will now have to pay service tax on the rent received from property leased for commercial purposes. The lessor / owner would surely be inclined to pass on the burden of service tax to the lessee / occupier. However, many long term leases do not have a provision for passing on the burden of the new tax and, despite being an indirect tax, landlords who do not have a covenant in the existing contracts about passing on the tax, may have difficulty transferring the burden and are

⁹ Dr. Sir Hari Singh Gour, COMMENTARY ON THE TRANSFER OF PROPERTY ACT, Vol. 2, 11th edn. (2005), Delhi Law House, Delhi, p. 60.

¹⁰ Section 105 of the Transfer of Property Act, 1882 and Section 167 (explanation) of Indian Succession Act, 1925.

¹¹ P. Ramanatha Iyer, ADVANCED LAW LEXICON, Vol. 4, Wadhwa and Company (Nagpur), 2005, p. 4063.

¹² *Ibid.* at p. 4304.

likely to be challenged by the tenants. This deadlock may perhaps end up in a flood of litigations between the landlords and the tenants. The dispute may get worse where a '*no escalation*' in rent clause has been signed between the parties.

The plight of landlords who do not have a clause in the existing contracts about passing on the tax, is worse off since he has to pay service tax while also being liable to pay income tax on the commercial rental income without being entitled to claim any deduction for the service tax payable on the amount. The annual value of the property of the owner is chargeable to income tax under the head "Income from House Property" under Section 22 of Income Tax Act, 1961. In determining annual value of the property, taxes levied by any local authority is deducted which would include the House tax / Property tax paid by the owner. Further, the following deductions are permitted:

- a. a sum equal to thirty percent of the annual value;
- b. where the property has been acquired, constructed, repaired, renewed or reconstructed with borrowed capital, the amount of any interest payable on such capital.

Except these two specific deductions, no other deductions are permissible. Service tax which is charged by the Central Act is not allowed as deduction. Thus the owners, with the long term leases already in place and where the tenant refuses to bear the liability, would be hit hard.

In addition, such a levy is bound to encourage rampant tax evasion. Rentals may now be paid upto Rs 8 lakh which is the exemption limit for levy of service tax and the remaining rental may be simply collected in cash. It is also possible that in the case of multi-storied buildings, rentals may be paid by different companies, each within the ceiling limit of Rs 8 lakh. The provision also fails to address as to whether the exemption of Rs 8 lakh will be available to each co-owner if the building is owned by more than one person.

This move shall also affect those developing commercial properties with the intention of renting or leasing them out, especially to IT/BPO outfits. Investment in commercial space to earn rental incomes, especially by venture capital funds and private funds, is just taking off in the country and their plans could suffer from this impost. Consequently, investment in developing commercial space by those other than the users themselves is likely to slow down, especially if there is resistance from the tenants/lessees to pay the service tax. This new imposition of service tax on rental income would worsen the

already existing grim situation as far as the availability of rental commercial stock is concerned. Rentals will go up significantly due to the proposed levy and with developers and owners unlikely to absorb this tax burden, many of the occupants would be required to re-work their cost and expenditure strategy who have already seen rental go up in the recent years due to increase in land prices and construction costs and are worried over the eroding margins.

This imposition would also lead to shift of focus by realty investors from Domestic Tariff Area (DTA) towards Special Economic Zones (SEZ) where the Centre, through several special fiscal provisions, have provided various tax exemptions to service provided to a developer or units of SEZ by any service provider, for the purpose of setting up SEZ units or for development, operation and maintenance of SEZ or for manufacture of goods by the SEZ unit, from the whole of the service tax levied thereon. This would result in heavy rush of commercial sectors entities looking for space in SEZs for availing the fiscal benefits, which would further appreciate the rentals and indirectly sanctifying the practice of premium paid over and above the prevailing market rates. Such a shift would further disturb the balance that needs to be maintained between the DTA and SEZ and lead to loss of revenue for the exchequer.

With introduction of service tax on commercial rent, the service tax burden of big bank branches / regional offices / zonal offices, insurance companies / multinational companies/ retailers etc. has increased significantly, especially on those who are situated in metros and the state capitals. Tax burden of the manufacturers has also increased because most of them are having warehouses in various cities on rental basis. Besides, some of the manufacturers not having their own factory but working from a factory taken on lease will also be affected. The consumers would be the ultimate sufferers in the process as the manufacturers, the retailers and service providers would surely shift the additional service tax burden by increasing the prices of the basic commodities or services.

Commercial property rents are significantly high and the real-estate boom, coupled with the non-availability of commercial space, has resulted in the rentals reaching dizzy heights. Service tax on commercial rentals is certainly an additional burden. The growth of economy would be substantially hampered by this new levy of service tax on rentals and the Government will also not benefit much because of enhanced revenue collection.

The stronger players of the service sector would be able to adjust the service tax paid by them on their rentals against the service tax collected by them from their customers so that there would be no additional service tax collection from them. However, the new entrants will not be able to sustain this additional burden during their initial years while they are still struggling to make profits. While other countries around the world are reducing the entry barriers for the new-comers by encouraging them to set up business for generating employment, economic activity and revenue, in our country the entire industry / business community is faced with the predicament of having to bear additional tax burden and squeezing of their profit margins further. In the long term, this would reduce the revenue collection of the Government, including collection of service tax.

The appropriateness of a tax should be evaluated by the authorities keeping in view the Indian context and there is certainly a need to ensure the existence of the component of service for the imposition of service tax. Levy of such a tax is bound to slow down the construction industry which not only provides employment to the largest segment of India's population after agriculture but has proved to be the engine for the growth of the entire economy. Particularly, when we are marching ahead with the quintessence of liberalization, an unreasonable tax burden like the imposition of service tax on commercial renting will impede the development and progress of the Nation. The Government has been unimaginative and non-innovative in its approach while imposing such an inequitable levy which has been a major disappointment.

It has been rightly said by F. J. Raymond that *"The best things in life are free, but sooner or later the Government will find a way to Tax them"*.