

**GST Alert 02/2021-22**

**Date 18.06.2021**

### **Taxability of Annuity in HAM Projects**

Initially public road works were executed under the traditional EPC (Engineering Procurement and Construction) model whereby governments used to give contracts and 100% payments were released during the construction period itself. Due to increase in demand for infrastructure and paucity of funds, Government turned towards BOT (Build, Operation Transfer) model where the contractor used to construct the roads and he was given a right to collect toll for 15 to 30 years period and recover his cost. Some projects were issued under BOT Annuity system as well. Due to many reasons, these longterm projects didn't prove to be financially sound and banks started showing disinterest in funding them and contractors also found it financially unviable. In 2016 government came up with the new HAM mode (Hybrid Annuity Model)

It was widely understood and as also affirmed by a AAAR ruling that Annuity portion in these HAM projects was exempt from levy of GST, council had in its 43<sup>rd</sup> meeting held on 28.05.2021 has recommended clarifying this crucial issue and based on this recommendation Board has issued Circular 150/06/2021-GST dated 17.06.2021, this alert analyses this circular.

#### **1. Brief understanding of HAM projects:**

In Hybrid Annuity Model, private player construct the roads in which certain portion say 40% of the project costs is paid by National Highway Authority of India (NHAI)/State Government during construction period and remaining 60% of the cost is paid as Annuity during the concession period which runs in 15 or more years along with the agreed interest. This model is a combination of both EPC and BOT annuity. In terms of an example, in a contract worth Rs. 1000 crores, NHAI releases 400 crores during the construction phase in 5 milestones of 8% each. After construction is over and after due process of verification, NHAI issues COD (Commercial Operations Date) which means that the construction phase is over and the contractor becomes eligible to receive Annuity payments (60%) as per terms of the Concession Agreement.



### 2. New Special Purpose Vehicle (Company) Creation:

Flow of the entire agreement process is as under:

- HAM Tender is issued by NHAI / Govt organisation
- Bid to this Tender is submitted by a Holding Company
- NHAI announces the winning bid
- Bidder who wins the bid must form a New SPV company to be formed as it is a Pre-condition in such contracts
- NHAI awards work to New SPV and enters into a concession agreement with this SPV
- SPV awards turnkey EPC contract for construction of road to its sister concern / holding Company

### 3. Consideration and Payment thereof under HAM:

Consideration under HAM projects is agreed upon through a well laid out tendering process and is chartered by a Concession Agreement.

- Payment Under HAM project by NHAI to SPV
  - i. On achieving predefined milestone, NHAI releases 8% payment on each such milestone. As per standard agreement, there are in total 5 milestones till the completion of the construction, which means 40% payment is released during construction period
  - ii. After Construction Period: 60% payment will be paid in form of annual/bi-annual equated annuity along with interest
- **Payment by SPV to Holding Company for EPC contract:** SPV will make 100% payment of EPC work to Holding Company during the construction phase itself

### 4. Sample Facts of one HAM contract:

- A. **Tender filed** by the ABC Projects Limited.
- B. **Letter of Award (LOA)** Received on 01.04.2016 in Name of ABC
- C. **New SPV** incorporated: ABC Highway Ltd, a 100% subsidiary of the ABC Projects
- D. **Concession agreement** between ABCHL and NHAI dt 1.05.2016.



- i. BID Project Cost: 1000 Crore
- ii. Payment of Bid Project Cost: Article 23.3 of the Concession agreement Vol I
  - a) 40% of the Bid Project Cost, adjusted for the price Index Multiple, shall be due and payable to the concessionaire in 5 equal instalments of 8% each during the Construction Period in accordance with the provision of Clause 23.4.
  - b) The Remaining Bid Project Cost, adjusted for the Price index Multiple, shall be due and payable in 30 biannual instalments commencing from the 180<sup>th</sup> day of COD in accordance with the provision of clause 23.6.

#### E. EPC agreement between ABCHL and ABCPL

- i. Contract Price is 850 Crore
- ii. As per Clauses of the EPC agreement, the Contract Price shall be paid to the contractor in accordance with the agreement

#### 5. Some Important Clauses from the Concession agreement with NHAI

As per the Concession Agreement Concessionaire has to construct the road but also have to operate and maintain the same for the entire concession period.

- A. As per Article 15 of the agreement the Project shall enter into commercial service on receipt of Commercial Operation COD whereupon the Concessionaire shall be entitled to demand and collect Annuity Payments in accordance with the provisions of this Agreement.
- B. Further as per Article 23 of the agreement, concessionaire is to receive payment in 5 milestones being an installment equal to 8% (eight per cent) of price index adjusted Bid Project Cost as under:
  - a) First Payment Milestone - On achievement of 20% Physical Progress
  - b) Second Payment Milestone - On achievement of 40% % Physical Progress



- c) Third Payment Milestone - On achievement of 60% Physical Progress
- d) Fourth Payment Milestone - On achievement of 75% Physical Progress
- e) Fifth Payment Milestone- On achievement of 90% Physical Progress

### C. Annuity Payments during Operation Period

As per article 23 of the agreement, The balance Completion Cost remaining shall be due and payable during the Operation Period in accordance with the provisions of Clause 23 .6.2.

As per Article 23.6.2 The Completion Cost remaining to be paid in pursuance of the provisions of Clause 23.6.1 shall be due and payable in biannual instalments over a period of 15 years commencing from COD to be termed as "Annuity Payments". The 1st installment of Annuity Payments shall be due and payable within 15 days of the 180<sup>th</sup> day of COD and the remaining instalments shall be due and payable within 15 days of completion of each of the successive six months.

### D. Key takeaways from above clauses from the agreement are as under:

- i. Scope of work is not just for construction of road, it also involves maintaining and operating the road for a predefined period of 10 to 20 years and also performance and fulfilment of all other obligations as mandated by NHAI in the contract
- ii. Contract defines an important event known as the "Commercial operation date" (COD). Receipt of COD means that construction of the road project is complete in all respects and that it can be opened for public. **As per this clause, the SPV becomes eligible to charge and collect annuity payments only AFTER the project receives COD.**
- iii. As per the contract Payment milestones are bifurcated in 2 broad brackets, first is the Construction Phase and the other is the Annuity Phase. Phase wise milestones are as under:

#### **Construction Phase**

SPV will be eligible to receive 8% of the project cost on achievement of each milestone which are based on construction, these being 20%, 40%, 60%, 75%, 90% and 100%. Accordingly, in these 5 parts SPV will receive payments worth 40% (8% x 5) of the project cost within the construction phase. Once the project receives COD, SPV becomes eligible to start claiming annuity payments



### **Annuity Phase**

As per the contract remaining 60% of the project cost is due and payable in a graded manner within 15 years starting from the COD date. SPV is slated to receive annuity payments on biannual basis which means that SPV will receive 30 payments (15 years x 2 payments every year). These 15 years are known as operation period and the SPV is required to provide Operation and Maintenance Services in these 15 years for the entire road project constructed by it. Consideration towards maintenance is paid alongwith the Annuity payments.

## **6. Legal issues involved under GST**

### **A. Exemption for Annuity payments:**

22<sup>nd</sup> GST Council meeting deliberated on the issue of granting exemption to Annuity being given to contractors in place of Toll charges. This issue was put in the agenda for the meeting at point no. 13 (iv) as under:

*iv. Issue of Annuity being given in Place of Toll Charges to Developers of Public Infrastructure- exemption thereon*

After due deliberations in the meeting, following was noted in the Minutes released:

### ***Agenda item 13(iv): Issue of Annuity being given in Place of Toll Charges to Developers of Public Infrastructure - exemption thereon***

*61. Introducing this Agenda item, the Joint Secretary (TRU-II), CBEC stated that while toll is a payment made by the users of road to concessionaires for usage of roads, annuity is an amount paid by the National Highways Authority of India (NHAI) to concessionaires for construction of roads in order that the concessionaire did not charge toll for access to a road or a bridge. In other words, annuity is a consideration for the service provided by*

*concessionaires to NHAI. He stated that construction of roads was now subject to tax at the rate of 12% and due to this, there was free flow of input tax credit from EPC (Engineering, Procurement and Construction) contractor to the concessionaires and thereafter to NHAI. He stated that as a result, tax at the rate of 12% leviable on the service of road construction provided by concessionaire to NHA1 would be paid partly from the input tax credit available with them. He stated that the Council may take a view for grant of exemption to annuity paid*



by NHAI/State Highways Construction Authority to concessionaires during construction of roads. He added that access to a road or bridge on payment of toll was already exempt from tax. The Hon'ble Minister from Haryana suggested to also cover under this provision annuity paid by State-owned Corporations. **After discussion, the Council decided to treat annuity at par with toll and to exempt from tax, service by way of access to a road or bridge on payment of annuity.**

Based on above decision of the Council, entry 23A was introduced in notification 12/2017-CTR dated 28.06.2017 which read as under:

Sr. No.	Chapter, Section, Heading, Group, or Service Code (Tariff)	Description of Service	Rate (Percentage)	Condition
23A	Heading 9967	Service by way of access to a road or a bridge on payment of annuity.	Nil	Nil

**Effective from 13.10.2017 it was widely interpreted and understood that annuity portion of HAM projects was exempted from levy of GST.**

### **B. Recent Clarification as recommended by Council has been issued by Board**

GST Council in its 43<sup>rd</sup> meeting held on 28.05.2021 has recommended to issue a clarification saying as under:

*“vi. To clarify that GST is payable on annuity payments received as deferred payment for construction of road. Benefit of the exemption is for such annuities which are paid for the service by way of access to a road or a bridge.”*

Based on this recommendation, Board has issued Circular 150/06/2021-GST dated 17.06.2021 which reads as under:

*2.1 GST is exempt on service, falling under heading 9967 (service code), by way of access to a road or a bridge on payment of annuity [entry 23A of notification No. 12/2017-Central Tax]. Heading 9967 covers “supporting services in transport” under which code 996742 covers “operation services of National Highways, State Highways, Expressways, Roads & streets; bridges and tunnel operation services”. Entry 23 of said notification exempts “service by way*



*of access to a road or a bridge on payment of toll". Together the entries 23 and 23A exempt access to road or bridge, whether the consideration are in the form of toll or annuity [heading 9967].*

*2.2 Services by way of construction of road fall under heading 9954. This heading inter alia covers general construction services of highways, streets, roads railways, airfield runways, bridges and tunnels. Consideration for construction of road service may be paid partially upfront and partially in deferred annual payments (and may be called annuities). Said entry 23A does not apply to services falling under heading 9954 (it specifically covers heading 9967 only). Therefore, plain reading of entry 23A makes it clear that it does not cover construction of road services (falling under heading 9954), even if deferred payment is made by way of instalments (annuities).*

*3. Accordingly, as recommended by the GST Council, it is hereby clarified that Entry 23A of notification No. 12/2017-CT(R) does not exempt GST on the annuity (deferred payments) paid for construction of roads.*

**In a nutshell, council has said that this exemption is for those annuities only which are paid for providing access to road and not for construction of roads. Second legal point that they have taken is that Service of Construction of Road is classifiable under heading 9954 whereas the exemption entry 23A is for heading 9967 only. Accordingly, annuities received under HAM projects stand taxable since the beginning, i.e. 1<sup>st</sup> July 2017 onwards they are taxable.**

### **C. Time of Supply provisions – When is Invoice to be issued?**

We need to look at Time of supply provisions to see whether the SPV has supplied any Annuity related service during the construction phase. For this we need to look at the provisions of section 13 (2) read with section 31 of the CGST Act.

Section 13 (2) prescribes that the time of supply of services shall be the earliest of the following dates:

- Date of Invoice (if the invoice is issued within time prescribed in section 31)
- Date of payment
- Date of provision of service if the invoice is not issued within time prescribed in section 31

*13 (2) The time of supply of services shall be the earliest of the following dates, namely:—*



***(a) the date of issue of invoice by the supplier, if the invoice is issued within the period prescribed under section 31 or the date of receipt of payment, whichever is earlier; or***

***(b) the date of provision of service, if the invoice is not issued within the period prescribed under section 31 or the date of receipt of payment, whichever is earlier; or***

Further, explanation to section 13 (2) provides that Supply covered by an invoice raised will be deemed to have been provided. In view of this explanation we can deduce that supply equivalent to the value reflected in Invoice raised by SPV to NHAI during construction phase is deemed rendered and not more.

*Explanation.—For the purposes of clauses (a) and (b)—*

***(i) the supply shall be deemed to have been made to the extent it is covered by the invoice or, as the case may be, the payment;***

Section 31 (5) prescribes timeline as to when to issue an invoice in case of continuous supply of services, as per section 31(5)(a) invoice must be issued on or before the due date of payment as is ascertainable from the contract. In case due date of payment is not ascertainable then the invoice is to be issued as and when the supplier receives the payment. Further, as per section 31(5)(c), in a case where the payment is linked to the completion of an event, the invoice shall be issued on or before the date of completion of that event.

In case of HAM projects due dates of Annuity payments are clearly ascertainable from the concession agreement, which as explained above is on biannual basis for 15-20 years starting from COD date, hence invoices to principal are to be issued on or before these due dates.

***31 (5) Subject to the provisions of clause (d) of sub-section (3), in case of continuous supply of services,—***

***(a) where the due date of payment is ascertainable from the contract, the invoice shall be issued on or before the due date of payment;***

***(b) where the due date of payment is not ascertainable from the contract, the invoice shall be issued before or at the time when the supplier of service receives the payment;***

***(c) where the payment is linked to the completion of an event, the invoice shall be issued on or before the date of completion of that event.***



Term Continuous Supply of Services is defined in section 2 (33) of the Act as under:

*(33) "continuous supply of services" means a supply of services which is provided, or agreed to be provided, continuously or on recurrent basis, under a contract, for a period exceeding three months with periodic payment obligations and includes supply of such services as the Government may, subject to such conditions, as it may, by notification, specify;*

It is evident that the HAM project qualifies to be a continuous supply of services as per the definition reproduced above.

**On conjoined reading of the provisions of section 2(33), 13 and 31 of the CGST Act it is clear that the SPV is legally bound to issue invoices for 8% of the price index adjusted bid cost at every construction milestone irrespective of the fact that physical construction level are much higher. Further, in case of annuity payments invoices are required to be issued only when the payment thereof is due as per the agreement which is after the construction phase ends, hence it can be safely deduced that during the construction phase only that portion of Income is taxable for which invoices are raised because no annuity payments were due or payable during that time and accordingly SPV has not rendered any supply of Annuity related services during the construction phase.**

**C. Whether the SPV is eligible to avail 100% Input Tax Credit (ITC) during the construction phase**

After the recent clarification issued by the board, as the entire HAM project is taxable there can be no question on eligibility of 100% ITC.

**7. Notional Income and its impact under GST**

Ind AS (Accounting Standard) are applicable to some SPVs due to which they account for certain income in their balance sheet as 'Notional Income'. This Notional income is merely an accounting provision and cannot be termed as Supply under section 7 and can neither be included in valuation of construction phase vide section 15. As per Appendix C of the Ind AS 115, Service Concession Agreement are governed by Ind AS 115 and therefore accounting norms prescribed in this Ind AS are



to be followed. As per this Ind AS a company is required to recognize notional revenue in its books and create a Financial Asset in terms of Receivable from the Principal during the construction phase because the entire expenditure for construction is expended in this period itself, in other words the company has to recognize expense matching revenue in its books. This is purely an accounting treatment and has no bearing whatsoever on the liability to pay GST. Mere accounting entry cannot be deemed to become a supply, one has to satisfy requirements of Section 7, 13, 15 and 31 of the CGST Act to establish the fact that a Supply took place whose time of supply has occurred and Invoice is due to be issued. If any one of the above 4 limbs is missing, the said transaction even if accounted for cannot be considered as taxable under GST.

### 8. Discussion on Advance Ruling given by Appellate Authority of Rajasthan in case of Nagaur Mukundgarh Highways Pvt. Ltd

Rulings given by Advance Ruling Authority (AAR) are binding only on the Applicant and it cannot be used for or against any other taxpayer. Having said so would like to discuss this particular AAAR because the transactional facts of this case are similar to issue being deliberated in this paper.

AAAR has ruled on 3 points as under:

- Annuity payments are exempted by virtue of Entry No. 23A of the **notification No. 12/2017-Central Tax (Rate) dated 28.06.2017.**
- ITC of the GST paid on the Input and Input service used in the construction phase is available to the Appellant subject to the provisions of Section 17(5) of the Central GST Act, 2017.
- Full ITC of the GST paid on the inputs and input services used in the O&M phase is available to the Appellant subject to the provisions of Section 17(5) of the Central GST Act, 2017.

We understand that this ruling has been challenged in the Rajasthan High Court and its verdict is pending, having said so, it would be interesting to see what stand the government takes against the taxpayer because the AAAR has ruled that the Annuity Payments are exempt whereas council has said that they are taxable.



### 9. Conclusion

As can be witnessed from above discussion on facts of HAM projects it is clear that these are peculiar projects in terms of execution, structuring, payment schedules and exemption granted. The fact that the exemption entry 23A was widely interpreted by all including NHA as applicable to the HAM projects and companies executing these long term contracts were led to believe the same by all, now after 3.5 years to issue a clarification saying that the exemption was never there is a financial travesty for these companies. They will be forced to pay interest and penalties with no recourse of recovering it from anyone.

Further, the GST investigating agencies are taking a stand that entire project will be taxable within the construction phase itself as per time of supply provisions will also mean that the shit is going to hit the fan very soon unless the council in its wisdom issues another circular clarifying this crucial issue.

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