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Decision to blacklist Cyprus for not providing tax data will hit developers and realty funds

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India's recent decision to blacklist Cyprus for not providing tax data will hit developers and realty funds. Investors who have routed their funds through Cyprus are likely to face a big decline in returns as developers will now be expected to withhold higher tax amounts. So far, these investments were structured around 10% withholding tax, which is likely to jump to 30%.

Cyprus, which ranks seventh on the list of FDI destinations for India, has so far been used extensively for raising debt and quasi-debt. But given the possibility of higher tax incidence and lack of clarity on policy, PE firms are now routing their offshore funds through destinations such as Singapore, giving Cyprus the short shrift.

"The move could significantly impact current structures that have made investments through Cyprus. With the arm's length pricing requirements between unrelated entities, withholding rate being increased and the possibility of expense disallowance, there could potentially be serious cash flow issues," said Ruchir Sinha, Head, Private Debt and Private Equity at legal firm Nishith Desai Associates.

Given the possible impact of this decision on private equity funds' returns, they are considering other destinations. Around 85% of the private equity funds inflow into Indian real estate came through Cyprus and Mauritius together as these destinations are considered as tax havens. But the scenario is going to change now.

"People have started looking at Singapore as a possible route due to a new guideline that says we need to have substance. Singapore can attract talent and has defined substance. It is an attractive destination as attracting manpower will not be difficult. Mauritius as a country will be difficult to attract substance," said Vishakha Mulye, Managing Director and CEO of ICICI Venture Funds.

ASK Group, a diversified financial services group, has recently taken the Singapore route and has routed its $200 million offshore real estate-focused fund through that jurisdiction. This was managed by ASK Capital Pte, the Singapore-based subsidiary. "Cyprus and Mauritius have been the most preferred and efficient routes that fund houses have been using to raise capital. Today global investors s like India, but do not want the policy regime to come in their way," says Sunil Rohokale, MD & CEO, ASK Group.

According to Rohokale, Singapore is much transparent and regulated; substance is an important aspect in Singapore and funds with long-term plan will go to a geography that's regulated. Substance compliance for attracting lower taxes in Singapore mandates the company to spend at least Singapore $250,000 annually on company related expenditures and also have a minimum three employees with two local directors.

Navin Kumar, Executive Director, Fund Raising at Milestone Capital Advisors, also echoed Rohokale's view that Singapore is now emerging as a destination for these fund houses.

"Singapore is emerging as the next destination due to brand Singapore that is associated with credibility and transparency and therefore has larger acceptance from the investor community. Netherlands is another emerging destination that is replacing Cyprus," Navin Kumar said.

Typically, funds use the Mauritius route to take advantage of the treaty between India and Mauritius on long-term capital gains that's linked to equity holding. Cyprus was used mainly as a route to protect intermittent payout on debt, he said. India, apart from blacklisting Cyprus for not sharing information on tax evaders, is also looking to take away the favorable tax treatment available to investors from Cyprus. While the issue continues to pan out, new funds prefer to move to other destinations to avoid any complexities later. Existing fund houses that have used the Cyprus route are waiting for clarity to emerge.

"It needs to be clarified as to what happens to funds that have been deployed through Cyprus. If it is with retrospective effect, then it may lead to more disputes between developers and funds about who would bear the brunt to additional withholding tax," Rajeev Bairathi, executive director of capital transactions group at property consultancy firm Knight Frank.

Existing fund houses that have deployed their funds through Cyprus are stuck with their investments that are anyway under stress due to rupee's depreciation against the dollar. "Until further clarity emerges on the negotiations, fund managers may either suspend payouts on debentures. In cases where the Cypriot entity or its affiliates also hold equity, consider taking returns on equity by way of dividends," Sinha added.