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Real estate funds may use share buyback route to escape tax net

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MUMBAI: Finance minister P Chidambaram may have plugged one gap to ensure offshore real estate funds that use share buyback as an option to exit their investments pay a withholding tax, but experts say another exit option is still available.

Experts say that with the government's new proposal to levy an additional tax of 20% on such buybacks by unlisted companies, a lesser-known and hardly-used Section 100 of Companies Act, 1956, that deals with reduction of capital can be used much like buybacks to help realty developers and private equity funds get an exit. But since the latter needs approval from courts and other investors it is fraught with legal implications, they caution.

"While share buyback is an automatic route, capital reduction under Section 100 is a relatively lengthier process involving legal approvals, but it can still enable tax-efficient exits," said Ruchir Sinha, head of debt and private equity in real estate at legal and tax firm Nishith Desai Associates.

Unlike other asset classes, real estate investments are typically self-liquidating in nature and dependant to a large extent on buybacks by the investee company for tax-efficient cash upstreaming. However, the new proposal will make it less efficient and also not make it possible to claim foreign tax credit or to set off capital losses against the capital gains made as a result of the buyback.

"Offshore real estate funds are left with not many options to get a tax-efficient exit from their investments. Most of the cash upstreaming and exits, typically in case of self-liquidating assets, were structured through buybacks, but now that route will significantly reduce returns by 20%," Sinha said.

The proposal to levy 20% additional tax seems to be an effort by the government to combat the practice of share buyback that developers and private equity players prefer over dividend distribution. Buybacks will turn out more expensive than dividends, which attract just 15% additional tax.

"The move may not impact domestic real estate funds as they can still draw out returns in the form of redemption, which is not possible for offshore funds as any instrument that is not fully and compulsorily convert ble into equity will be regarded as ECB, which is not permitted for real estate," said a senior partner at a tax consultancy firm who did not wish to be named.

In the first three years of realty sector opening to foreign investments in 2005, a large number of global financial giants allocated money from their books to be invested in the Indian real estate sector followed by multiple rounds of fund raising for their third party capital fund management business.

Flushed with liquidity and looking for an early start, funds that invested aggressively in projects across asset classes and cities in India are now looking to exit. In 2010 and 2011, India saw private equity firms' successful exits worth $3 billion from the domestic realty sector. In 2012 alone, such exits were expected to be worth close to that amount, but for the rupee depreciation during the year.

Most of these investments were routed through regions including Mauritius, Singapore and Cyprus that have a double taxation avoidance agreement in place with India.

Under Section 100 of the Companies Act, 1956, the company is allowed to reduce its capital to the extent of the shares held by the non-residents. For share capital reduction, the company is expected to get a special resolution passed by its members and prior approval of the court. However, this option may also have some limitations.

"It can be time consuming if one takes into account the time required for receiving lenders consent, which is a prerequisite for court approval," said V Hari Krishna, director at Kotak Realty Fund. Capital reduction can also be taken as dividend distribution if the developer has accounting profits and therefore limit the developers' preference for this route.

"For companies with accounting profits and accumulated cash, capital reduction for income tax purpose will be treated at par with dividend and liable to dividend distr bution tax at 15% excluding surcharge and education cess," said Bhairav Dalal, associate director at PwC India. However, in the current context, realty developers and their private equity partners may not have many options to consider if they are looking to minimise their tax obligations.

"Though this is a court driven route, courts have been usually comfortable in allowing for selective reduction of capital and to that extent this route can be used to give exits to the foreign funds. Unlike buybacks, there is no requirement for reduction of capital under Section 100 to be necessarily done out of profits or share premium," Sinha said.