Real Estate Update

March 26, 2012

BUDGET 2012 - TOP CONSIDERATIONS FOR OFFSHORE AND DOMESTIC REAL ESTATE FUNDS

Further to our analysis of Budget 2012 (India Budget Insights (2012 - 13) circulated last week, this Real Estate Alert discusses few of the changes introduced by Budget 2012 relevant to offshore and domestic realty funds and the sector in general.

While Budget 2012 has made some announcements on the policy front which may aid the sector in terms of boosting domestic demand, the key expectations such as removal of minimum alternate tax of 18.5% and dividend distribution tax of 15%[1] on Special Economic Zones (SEZ), granting of infrastructure status to SEZs, IT Parks and townships, introduction of an effective Real Estate Investment Trust (REIT) regime to facilitate exits, implementation of the Real Estate Regulatory Bill and the Land Titling Bill to ensure greater transparency were not addressed.

On the other hand, Budget 2012 has brought about several provisions that may have far reaching implications for offshore realty funds such as the ability to claim treaty benefits, expanding the definition of royalties (relevant particularly for the hospitality sector), withholding of tax on payments made by one non-resident to another non-resident where the income is subject to Indian tax, irrespective of their presence in India, and, importantly, introduction of the General Anti Avoidance Rules (GAAR) provisions. Particularly, the proposal to retroactively override the Supreme Court's decision in the Vodafone case with effect from 1962 raises a question as to whether foreign investments are protected in India at all and whether it will give rise to claims under bilateral investment protection treaties.

Budget 2012 also proposes to tax an Indian company at the rate of 30% on issue of shares to an Indian resident at a price above the fair market value of the Indian company shares, considering this difference as 'other income' for the Indian company. Transfer pricing, which was hitherto applicable only to international transactions, has been made applicable to certain domestic transactions as well making project management fees, development fees, marketing arrangements and similar arrangements expensive.

On the positive side, whilst affordable housing segment clearly emerges as the focus area on the policy front, Budget 2012 does little to address the liquidity crisis being faced the sector, and in many senses takes a lot more than it gives.

We now analyze few of these changes and their likely implications on the sector and investments therein. For a more detailed analysis of these provisions from a tax perspective, please see our hotline (India Budget Insights (2012 -13) circulated last week.

REAL ESTATE VCFS - PASS THROUGH STATUS

The Budget proposes to extend the tax 'pass-through' status to SEBI registered venture capital funds ("**VCF**") or a venture capital company ("**VCC**") for their income from investments in venture capital undertakings ("**VCU**") operating in all sectors (as against certain identified sectors such nanotechnology, information technology relating to hardware and software development, bio-technology, infrastructure, etc.), except the ones specified in the negative list by SEBI. Reflecting the true 'pass-through' position, not only the character of the income in the hands of the investor would be retained as that in the hands of a VCF / VCC, Budget 2012 also proposes that income shall be taxable in the hands of the investors the moment it accrues, arises or is received by the VCFs / VCCs. Currently, the income for the investors in the VCFs / VCCs was only taxable when actually received by them upon distribution irrespective of when such income having accrued or received by the VCF / VCC from the underlying VCUs. Following such proposal, the income of VCFs, from real estate companies will be taxed directly in the hands of their investors.

Analysis:

- This is a welcome proposal since the pass-through status granted to the SEBI registered VCFs put India at par with other countries, where the tax pass-through is automatically available in the form of choice of various entities or elections available such as LPs, etc.
- However, with the new the SEBI (Alternative Investment Funds) Regulations, 2011 ("**AIF Regulations**") regime set to replace the existing SEBI (Venture Capital Regulations), 1996 widening the asset classes substantially, it needs to be seen as to what extent these provisions would cover within its ambit all these asset classes. If the proposals rely on the spirit of pass-through for any pooling structure, then it should also cover all AIFs irrespective of their strategy, but if the idea is only to limit these benefits to certain priority sectors like a VCF, then the ambiguity for other classes of AIF shall remain. Although, the AIF Regulations do recognize a concept of 'Real Estate Funds' as a class of AIFs and are likely to permit direct ownership of the real estate asset, they pose additional challenges in form of minimum investment amount, minimum sponsor commitment etc. which may be practical hurdles in utilizing AIFs for funding real estate projects. For our paper on AIFs, please click here.

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DOMESTIC TRANSFER PRICING INTRODUCED

If the specified domestic transactions between two related persons or two units of the same entity exceed INR 50 million (USD 1 million), then in order to determine the correctness of (i) the income from domestic related party transactions and (ii) the domestic related party expenditure of the parties, the transfer pricing regulations (including procedural and penal provisions) would be extended to such domestic transactions as well.

Analysis:

- This may severely impact real estate transactions where the amended section 40A could be relied upon to disallow any payouts for, project management services, project development services, brokerage fee, marketing agreements etc. if they are considered to be excessive or unreasonable having regard to the fair market value.
- No advance pricing agreements are available in case of domestic transactions as has now been provided for international transactions. It would be a welcome change if advance pricing agreements are made available for domestic transactions also.

AFFORDABLE HOUSING

Affordable housing seemed to be the focus area for real estate in Budget 2012. External Commercial Borrowing ("**ECB**") for the affordable housing segment has been permitted. Interest withholding on ECB has been reduced from 20% to 5% for three years. Investment linked deduction of capital expenditure for hospitals and affordable housing at the enhanced rate of 150% as against the current rate of 100% has been permitted. On indirect taxes front, service tax exemption for construction services relating to specified infrastructure, residential dwelling, and low-cost mass housing up to an area of 60 square meters has been provided.

Analysis:

- This is clearly a welcome move and considering the demands for low income housing, one may see a lot more traction in this segment. It however remains to be seen how 'affordable housing' will be defined by the Reserve Bank of India ("RBI"), and whether ECB will be permitted under the automatic route or will be subjected to the discretion of the RBI under the approval route.
- Permissible coupon under the extant ECB regulations is fairly low, and a higher coupon rate may be permitted as external lenders may not find low income or affordable housing attractive, due to the low profit margins and high risk. On the policy front, if ECB is to be encouraged, leeway may be considered in terms of creation and enforcement of security interests. Creation of security interest (stamp duty costs) over an immoveable property can be expensive (in excess of 5% in some cases) and enforcing security interest created on immoveable property is fairly challenging in the Indian context, unless the enforcing party is a bank or notified financial institutions, which are entitled to certain statutory protections.

HOLDING COMPANY STRUCTURES: CASCADING DDT IMPACT REMOVED

Budget 2012 proposes to amend Section 115-0 to exempt dividends received from subsidiaries. Under Section 115-O of the Act, an Indian company is required to pay dividend distribution tax ("**DDT**") at the rate of 15% on dividends that are declared, distributed or paid by a domestic company. Hitherto, dividends received by a company from its subsidiary were tax exempt only if the holding company was not a subsidiary of another company. This restricted the dividend benefit to two tier structures only. Budget 2012 makes the dividend benefit applicable to multi-tier structures, thus providing a big fillip to large corporate groups which require multiple entities. For the purpose of this provision a company is regarded as a subsidiary of another company only where the parent holds more than half in nominal value of the equity share capital of the subsidiary.

Analysis:

- This will be particularly helpful for flagship real estate companies that have a multi-tier structure with an array project specific SPVs downstream.

QFIS ALLOWED TO ACCESS CORPORATE DEBT

Budget 2012 proposes to allow Qualified Foreign Investors ("QFIs") to access the corporate bond market. Currently, only SEBI registered foreign institutional investors ("FIIs") having debt allocation limits are permitted to purchase listed debt securities of Indian real estate companies. However, non-residents other than FIIs that were not permitted entry into this market.

Analysis:

- Whilst the detailed guidelines are yet to be notified, allowance for QFIs to access corporate debt will be significant considering the increased demand for debt funding in the sector, and in particular use of the listed non-convertible debentures to fund real estate projects. Please click here to see our paper on Debt Funding Real Estate in India for details on the NCD structure.
- In a move that seems to encourage disintermediation of the markets, the QFI route will now allow entities other than FIIs to debt fund the real estate sector, which seldom opts for equity listing. This may particularly be helpful for NRI's / HNIs that were interested in debt funding real estate in India, but could not do so due to the regulatory restrictions. [Please click here to see our paper on QFIs investment in equity].

COMPANY TO BE TAXED IF SHARES ISSUED AT PREMIUM

Budget 2012 proposes to tax any consideration for issue of shares that exceeds the face value of such shares, if the aggregate consideration received for such shares as exceeds the fair market value ("**FMV**")[2] of the shares. This applies in respect of issuance of shares to an Indian tax resident by a private limited company or unlisted public limited company (i.e. a company in which the public is not substantially interested). Such excess premium would be chargeable to tax as "income from other sources" at the maximum marginal rate of 30%. The provision is not applicable if the consideration is received from a non-resident or by a VCU from VCF or VCC.

Analysis:

- The above proposal is not applicable to cases where shares are issued to non-residents or VCFs/VCUs.
- It is possible to tax initial capitalization of a start-up company in excess of its fair market value thereby leading to immediate erosion of its capital base, and thus leading to an absurdity.
- A company may not be able to take any benefit of its losses or expenses for the purposes of the proposed tax.
- This may severely impact real estate transactions where the promoter may subscribe to the shares of an SPV at a price much above the FMV with the intent to fund the company to purchase immoveable property.
- This may also impair the ability of the promoters to seek private equity funding as private equity investors may value the company on the basis of discounted cash flows or any other methodology that may be higher than the NAV driven FMV (if the FMV is prescribed to be NAV driven in this case as well, as is the case currently for Section 56 (viia)).
- Though this provision shall not be applicable in case the issuance is made to a SEBI registered VCF, the domestic venture capital industry in India is also facing challenges of regulatory uncertainty with the SEBI having proposed a concept paper along with AIF Regulations that seeks to introduce a comprehensive regulatory framework for regulating AIFs, which proposes to override the present VCF Regulations.
- As a matter of regular business practice, Indian companies issue shares at a price over the market value of their shares, for various commercial reasons. Because share premium gets added to a company's free reserves, it is permissible for it to be used for certain specific purposes e.g. buy-back of securities etc. Similarly, a company may be inclined to issue shares at premium due to even conversion of its convertibles securities to maintain inter se shareholding percentage. Further, issuance of shares at premium may be done to avoid the requirement of increasing authorized share capital by altering the memorandum of association of a company, which has additional costs such as payment of stamp duty and fees of registrar of companies associated to it.

SERVICE TAX

With the intention of gradually transitioning towards the Goods and Service Tax ("GST") regime, Budget 2012 has proposed that the service tax law will henceforth follow the 'Negative List approach'. Under this approach, all services[3] , except those specified in the negative list and those specifically exempted, would be chargeable to service tax. The base rate of service tax too has been increased from 10% to 12% uniformly on all services.

Analysis:

- The Finance Bill, 2010 made renting of immovable property/related services liable to service tax with retrospective effect from June 1, 2007, if such services were used in the course of business or commerce. The Budget 2012 too specifically provides that services like renting of immovable property (except renting of residential dwelling used for residential purposes) will now be within the ambit of service tax.
- Additionally, certain other services associated with real estate projects like project management fees, supervisory fees etc. will get more expensive on account of increase of rate of service tax, and the application of service tax on a negative list basis could result in a levy upon previously unspecified services as well.

GAAR INTRODUCED

Budget 2012 proposes to introduce comprehensive GAAR provisions providing wide powers to the revenue authorities in taxing 'impermissible avoidance arrangements' including the power to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal sites of assets involved, treat debt as equity and vice versa, and the like. For a detailed analysis please see our hotline on Budget 2012 (India Budget Insights (2012 - 13)

Analysis:

- Given the 3 year lock-in for FDI in real estate; exits by foreign investors in some cases is structured by way of sale of the offshore company holding investments in the Indian real estate company. However, with the new GAAR provisions coming into force, it may be possible for tax department to take a view in such cases that the transfer at the holding company level is carried out to avoid tax in India and hence the treaty benefits for such transfer should not be granted.
- Presently, in case of transfer of shares of a company holding immovable property, long term capital gains benefit could be availed upon sale of shares of the Indian company provided the period of holding of such shares exceeded 12 months. However, applying GAAR, revenue may be able to re-characterize the nature of the transaction and declare that the real intent of the parties was to transfer immovable property and hence the period of holding to avail long term capital gains tax benefit should be a period of 36 months. As per existing section 2(47)(vi) of the Income Tax Act ("ITA"), any transfer of shares of company which have the effect of transferring any immovable property is captured within the purview of the term 'transfer'. Transactions involving transfer of an immovable property in India, irrespective of the transacting parties being non-resident may now become taxable as immovable property under GAAR coupled with existing section 2(47)(vi).
- Revenue authorities may deny tax benefits even if conferred under a tax treaty.
- Wide discretionary powers provided to the revenue authorities give much room for misuse and will increase litigation in the country.
- The GAAR provisions are likely to capture most of the structures for investments into India, especially since tax mitigation is always a key consideration.
- GAAR can give rise to double taxation in cases where taxpayers are denied treaty benefits on the basis of the

subjective interpretation of the facts under the GAAR provisions. Investors may also be denied the benefit of advance rulings on GAAR matters due to limitations in the current statutory provisions.

OBLIGATION TO WITHHOLD TAX

Budget 2012 seeks to include an explanation to extend the application of withholding tax on payments to non-residents, to all persons, resident or non-resident, whether or not the non-resident has a residence or place of business or business connection in India; or any other presence in any manner whatsoever in India. For analysis of withholding royalty (relevant for hospitality sector), please see our hotline on Budget 2012 (India Budget Insights (2012 -13).

Analysis:

- Exits by offshore realty funds were structured by way of transfer of shares of the offshore holding company as shares of real estate companies were locked-in for 3 years for investments. Such offshore transfers may now be taxable in India.

ELIGIBILITY TO CLAIM TREATY BENEFITS

The Budget proposals give rise to onerous compliance challenges for foreign investors. For claiming treaty benefits, non-resident taxpayers will be required to obtain a tax residency certificate containing specific particulars as may be prescribed by the Revenue.

Analysis:

- Not every country may issue a TRC and this may result in the denial of treaty benefits due to procedural issues.
- The impact of this along with the GAAR provisions may result in protracted litigation with the revenue authorities on any matter relating to treaty benefit.

WITHHOLDING ON IMMOVABLE PROPERTY

Further, withholding of tax on transfer of immovable property (other than agricultural land) is proposed to be imposed wherein every transferee, at the time of making payments or crediting the consideration for transfer of immovable property, shall deduct tax at the rate of 1% of such sum, subject to de-minims[4] principles.

Analysis:

- The proposal is bound to increase compliance and administrative obligations of buyers of immovable property. For instance buyers would now be required to obtain a tax deduction account number and deposit the tax deducted with the revenue. Since the obligation to withhold tax is casted on all persons, such obligations would extend to individuals as well.

REOPENING PAST CASES

Budget 2012 also increases the time period for taxing prior transactions from 6 years to 16 years, making it extremely difficult for taxpayers to maintain necessary documentation and manage litigation risks. Further, the provision contains a carve out which does not make the limitation period applicable to income which has escaped assessment including income in relation to any asset (including financial interest) in any entity located outside India.

Analysis:

- This could potentially result in such incomes not having a limitation period applicable at all.
- The proposal would prompt more players in the market to obtain tax insurance for their affairs, availability of which is already a challenge.

- Vivaik Sharma, Shreya Rao & Ruchir Sinha
You can direct your queries or comments to the authors

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[1] All rates mentioned are exclusive of surcharge and cess.

[2] FMV is the higher of (a) the amount, as may be substantiated by the company before the tax officer based on the value of its assets including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature; or (b) as may be determined as the method prescribed under the relevant rules for calculation of FMV. Though the rules for this new provision have not been prescribed, formula to determine FMV under current rules is essentially linked to the NAV.

[3] 'Service' has been widely defined as "any activity carried out by a person for another for consideration ..."

[4] No deduction of tax is required to be made where consideration paid or payable for immovable property is less than (i) Rupees fifty lakhs where the property is situated in specified area, (ii) Rupees twenty lakhs in other cases.
