Real Estate Update

February 08, 2017

IMPACT OF BUDGET 2017 ON PRIVATE EQUITY IN REAL ASSETS: NOT MUCH TO CHEER!

In line with the expectations, and as an aftermath to the hugely controversial demonetization exercise, Budget 2017 announced on February 1 has clearly toed the populist line. Whilst significant incentives were announced for affordable housing, other amendments, such as the introduction of thin capitalization norms, are likely to severely impact the interests of private equity investors in the real estate sector.

Summarized below are a few key amendments introduced by Budget 2017 and their impact on private equity in real assets.

THE BIG DAMPENERS

1. Thin Capitalization Norms Introduced

More than 70% of the foreign funding in real assets is received in the form of structured debt. Most particularly, non-convertible redeemable bonds were the most popular source of receiving foreign funds hitherto. Legitimate tax optimization of cash up-streaming in cash accretive assets (such as real estate, roads, hospitals, and infrastructure) is the cornerstone of any investment in these sectors globally.

Budget 2017 has now borrowed from BEPS Plan Action 4 and introduced thin capitalization norms for 'associated enterprises' in an attempt to prevent excessive interest deductions being claimed by Indian companies. The explanatory memorandum to the Finance Bill, 2017 provides as under:

"In view of the above, it is proposed to insert a new section 94B, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest expenses claimed by an entity to its associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less."

Implications

- An Indian company may not be eligible to claim deductions for interest payments to associated enterprises that exceed 30% of Earnings Before Interest, Taxes, Depreciation and Amortization ("**EBITDA**") of the borrowing company in the year of the payment of the interest. Interest payments of amounts lower than INR 10,000,000 (ten million) per annum are exempt from the above requirement.
- The ambit of 'associated enterprises' under the Income Tax Act, 1961 ("**ITA**") is extremely wide, and includes any person who lends an amount in excess of 50% of the book value of the assets of the borrowing company. For instance, a special purpose vehicle is setup will be funded by offshore PE funds largely in the form of nominal equity and large debt, and typically a 6:1 debt-equity ratio is quite common. In such a situation, the private equity investor / offshore lender will also qualify as an 'associated enterprise'.
- This interest deduction cap has been made applicable to 'associated enterprises' as defined under the ITA without application of mind, since it goes much beyond the group or parent subsidiary relationship.
- Even though interest paid in excess of this 30%, is permitted to be carried forward for a period of 8 years, the carry forward may not be of much practical use since interest costs are likely to remain constant in light of long term borrowings which run into more than 10 years.
- The thin capitalization norms, as proposed, shall be applicable to interest payments made from FY 17 – 18, and, hence, will cover even interest payments on loans taken prior to such period. [For instance, a company has borrowed INR 100 at an interest of 15% per annum. If there is an EBITDA of INR 30, the borrower can claim deductions up to INR 9 instead of its requirement to pay INR 15 to the lender. Thus, while an amount higher than INR 9 may be payable, the interest expense over and above INR 9 is not a deductible expense for the borrowing company, making the entire purpose of debt investment futile.

2. Income from house property

Earlier, any loss arising under the head 'house property' could have been set off against income from any other head.

Since housing was also considered as an investment asset, a large population was acquiring multiple housing assets backed with the support of tax incentives on purchase of second house and thereafter.

Budget 2017 provides that a loss under the head 'house property', in excess of INR 200,000 may not be set off against income from any other head.

Implications

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- Any difference between the rental yield and interest paid on the housing loan will no longer be deductible beyond INR 200,000.
- This would be a substantial blow to real estate as an 'investment asset'. In a market where capital appreciation of real estate has been a severe disappointment, withdrawal of tax incentives will be major dampener on sales of housing assets. Investors investing in real estate assets will now look for alternative asset classes.
- For instance – If an individual has availed a loan wherein the annual interest payout is INR 500,000. In the event that the individual does not have any income from house property, an amount of INR 300,000 cannot be set off. Further, the amount of INR 300,000 cannot be set off against any other head of income which such individual may have.

MILD BOOSTERS

3. Promotion of affordable housing projects

- Budget 2017 has provided further impetus to affordable housing projects being undertaken by developers. The Government has proposed expanded size of the units required to be eligible for 'affordable housing' units: (i) by increasing the limit of 30 square meters in the non-metropolitan cities to 60 square meters for each residential unit; and (ii) by increasing the size of units in a non-metropolitan region and in a metropolitan region from a '*built-up*' area of 30 square metres, and 60 square metres, respectively to a *'carpet area'* of 30 square metres and 60 square metres respectively. The change from 30 to 60 square meter itself increases the unit size by approximately 30%.
- The Finance Minister in his budget speech for the financial year 2016-17 had provide 100% deduction benefits to real estate developers for any profits arising out from affordable housing projects, subject to the satisfaction of certain conditions mentioned in the ITA[1], including the project being completed within 3 years from the date of the receipt of the by the competent authority. The approval from the competent authority is defined to mean building plan and layout plan approvals. However, a building would require a large number of other approvals, including fire NOC, approvals for height, environmental clearance, etc., which would be time consuming. Accordingly, it was seen that it was extremely difficult for developers to complete projects within 3 years from receiving the building/ layout plan approvals. Further, if the income in any year was not completed within the 3 year timeline, the deduction claimed earlier would be added as an income for the financial year in which the 3 year period expires. The Finance Bill, 2017 now proposes to increase this time limit to 5 (five) years, effective from April 1, 2018, which should be major positive for developers.
- The Finance Minister has proposed to offer affordable housing 'infrastructure' status. This could be another major boost for developers, since SEBI registered foreign venture capital investors ("**FVCI**") may now be permitted to invest in companies engaged in affordable housing. However, it is to be seen how the Central Government intends implement this, considering that most of developers who would be engaged in affordable housing would be engaged in development of non-affordable housing projects as well.

4. Long term capital gains concessions

With the view to furthering investments in real estate, effective April 1, 2018, the holding period for capital gains arising from immovable property has been reduced from 36 months to 24 months. Further, the base year for indexation benefits has also been prescribed to be April 1, 2001 from April 1, 1981 earlier. These measures should allow for greater mobility of assets in the real estate sector and enhance liquidity for investments in the sector.

5. Notional rental income: Delaying the taxation

Currently, unsold inventory in a project which is completed is deemed to provide developers notional rental income, and as such, is taxed in the hands of the developers. This prompted developers to offload units at the earliest possible, at times, even at prices below market prices. The industry has been requiring the roll back of this provision. The Delhi High Court, in the case of *Ansal Developers*, had earlier upheld the clause in relation to the taxation of the notional income of the developer. While the Budget was expected to bring cheer, the cheer was limited, since the Finance Bill provides that this deeming fiction of notional income shall apply only 1 year post the completion of the project. Having said that, the 1 year extension provides developers a breathing space of 1 year post the completion of projects to offload the units.

6. Interest expenditure: A step forward

Substantial foreign funding in Indian real estate is structured debt, being infused as non-convertible debentures ("**NCD**"), since this benefits the company to obtain interest expense benefit and the investor to have security over the asset. Interest on NCDs payable to foreign portfolio investors ("**FPI**") is taxable at the rate of 20%, which has now been reduced to 5%, under the provisions of the ITA till July 1, 2017. This was a major boost for the real estate sector, where back-ending the coupon rate is quite common due to the liquidating nature of real estate.

The Bill now extends the benefit of reduced withholding of 5% on interest payable to non-residents on non-convertible debentures for all interest payments till July 1, 2020. The extension of the reduced withholding benefits would greatly encourage further foreign investment into the real estate sector.

CONCLUSION

Budget 2017 appeared to offer a lot of goodies to the real estate sector in the speech of the Finance Minister. However, the fine print of the provisions presents a different picture. The combined effect of the measures could result in the growth of the real assets sector as a whole, but with introduction of thin capitalization norms and withdrawal of deductions on housing loans, this government has made its priorities very clear. Incentivize only where needed, and tax where possible.

As regards the demand side, in the short run, it is quite possible that the perspective of individual flat buyers, towards real estate (due to withdrawal of tax deductions on loss from housing property) changes from that of an investment asset to being limited to merely a consumption story.

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[1] Section 80-IBA of the ITA

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