

**B S R and Associates**

# **Tax and Regulatory Challenges in the Real Estate Sector**

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**WIRC of ICAI**



# Snapshot

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- 3 Taxation Challenges
- 4 Budget Proposals – Impact on Real Estate Sector
- 5 Specified Domestic Transactions – Impact on Real Estate
- 6 Structuring options
- 7 Forthcoming Challenges

# **Indian Real Estate Sector – Overview**

# Contribution of the Sector to the Indian Economy

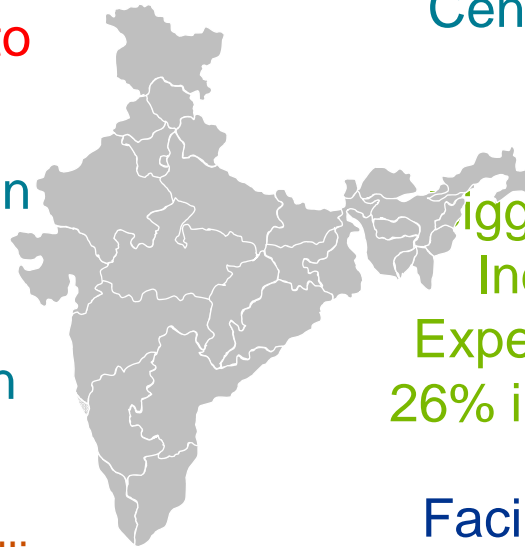
Second Largest contributor to the Indian economy after  
Agriculture

2nd largest contributor to  
India's GDP – from 5 to  
10.6%

2<sup>nd</sup> largest employer in  
the Country

Supports more than  
350 industries

Attracted USD 21.38 billion  
from FY 2000 to FY 2012.  
Expected to attract FDI of USD  
180 billion by 2020



largest contributor to  
Central Exchequer – 37 to  
40%

largest contributor to the  
Indian Urbanization -  
Expected to increase from  
26% in 2006 to 34% in 2026

Facilitates development in  
sectors like tourism,  
healthcare, education,  
retail, entertainment, and  
IT/ITES

# Industry Overview

2011 E

Real Estate  
Market Size

USD **67** bn

2015 P

Real Estate  
Market Size

USD **126** bn



**Strong  
economic  
growth**

Avg. GDP  
growth  
7-8%

**Rapid  
urbanization**

By 2030,  
India would  
be 40%  
urban

**Young  
demographics**

Avg. Indian  
age: 29  
years

**Progressive  
investment  
climate**

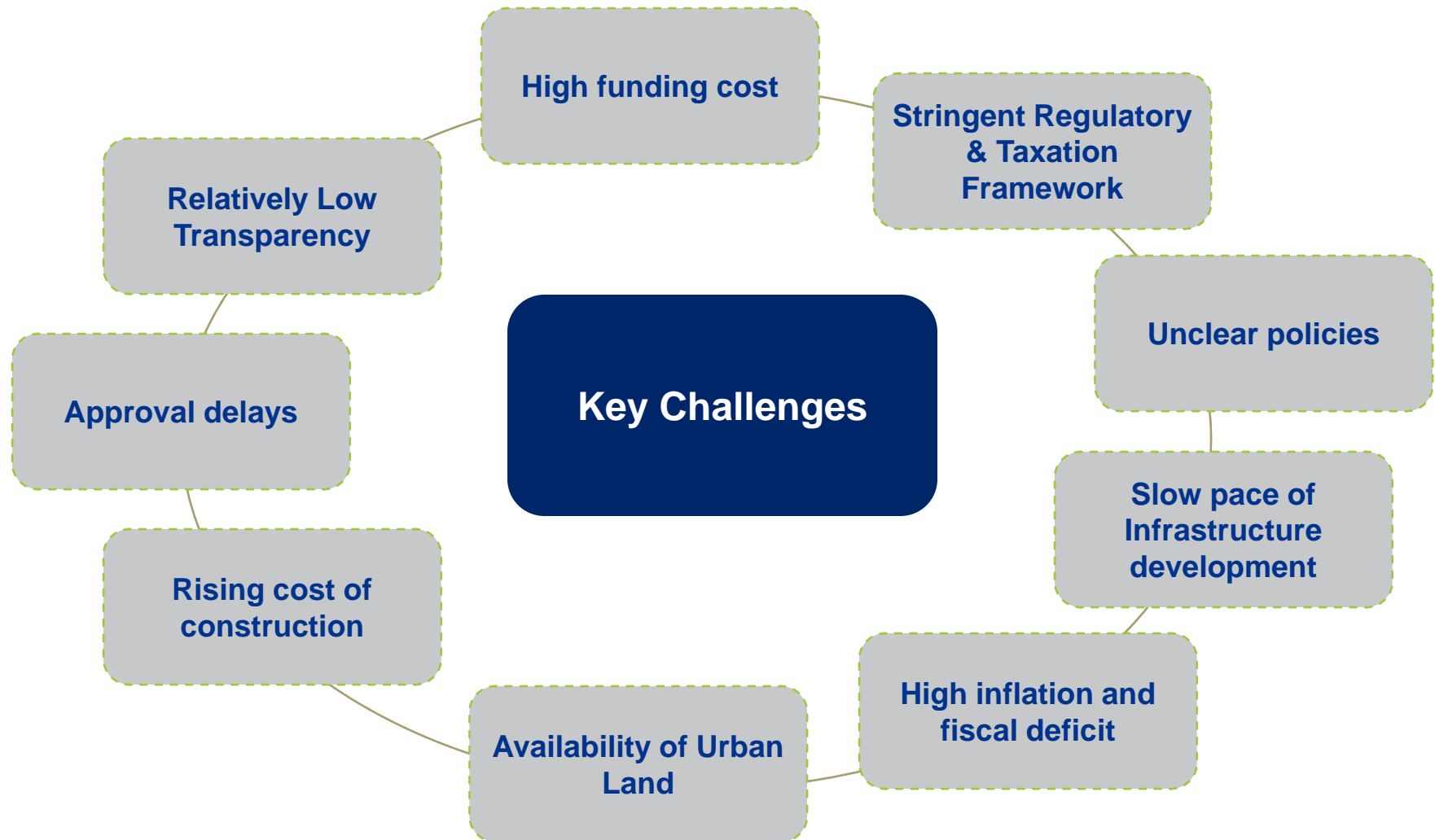
**Huge housing  
requirement**

XIth Plan  
(E): 24.7  
million  
shortage

**Infra spend  
XIIIth Plan**

USD 1  
trillion

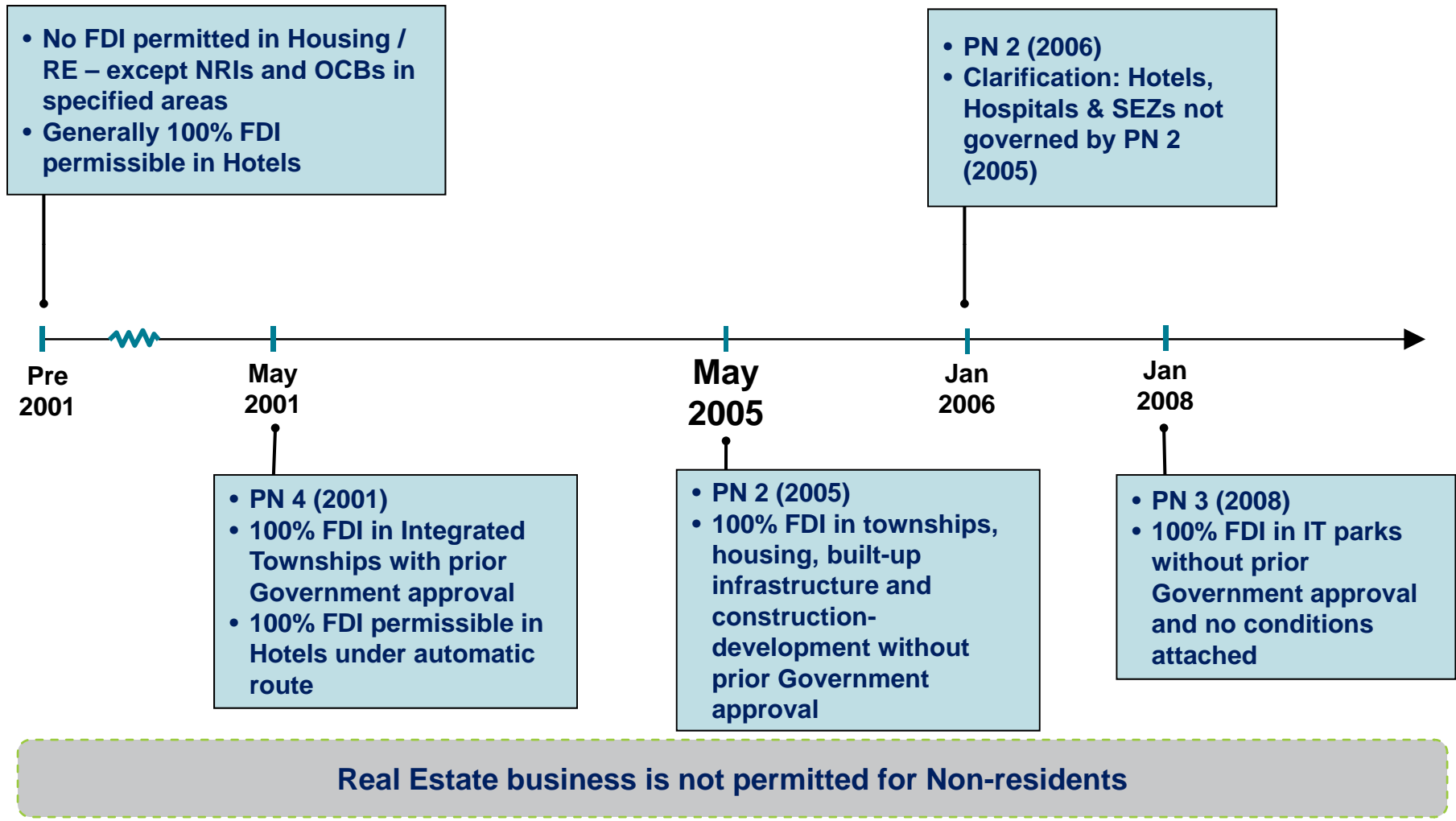
# Operational Challenges faced by Real Estate Sector



# Regulatory Framework and Challenges

# FDI in the Real Estate Sector – Roll out of Enabling Policies

## FDI governed by “Press Notes” issued by Government of India





# FEMA Regulations

FDI is not allowed for Real Estate Business

*Press Note 2 (2005) does not apply to Industrial Parks (including Information Technology parks), Hospitals, Hotels, Special Economic Zones, Education sector and Old age homes*

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1<sup>st</sup>

## Investment-related guidelines

**Minimum foreign investment-** USD 10 million for Wholly Owned Subsidiary/ USD 5 million for JV

Funds to be brought into India **within 6 months**

**Issue of shares** within 180 days of receipt of inward remittance

**Lock in period of 3 years** from completion of minimum capitalization. Early exit possible with prior government approval

2<sup>nd</sup>

## Project-related guidelines

Minimum area requirements: 10 hectares for serviced housing plots and 50,000 sq. meters for construction development projects

50 percent of project to be developed within 5 years from date of obtaining all statutory clearances

Investor cannot sell undeveloped plots or TDRs

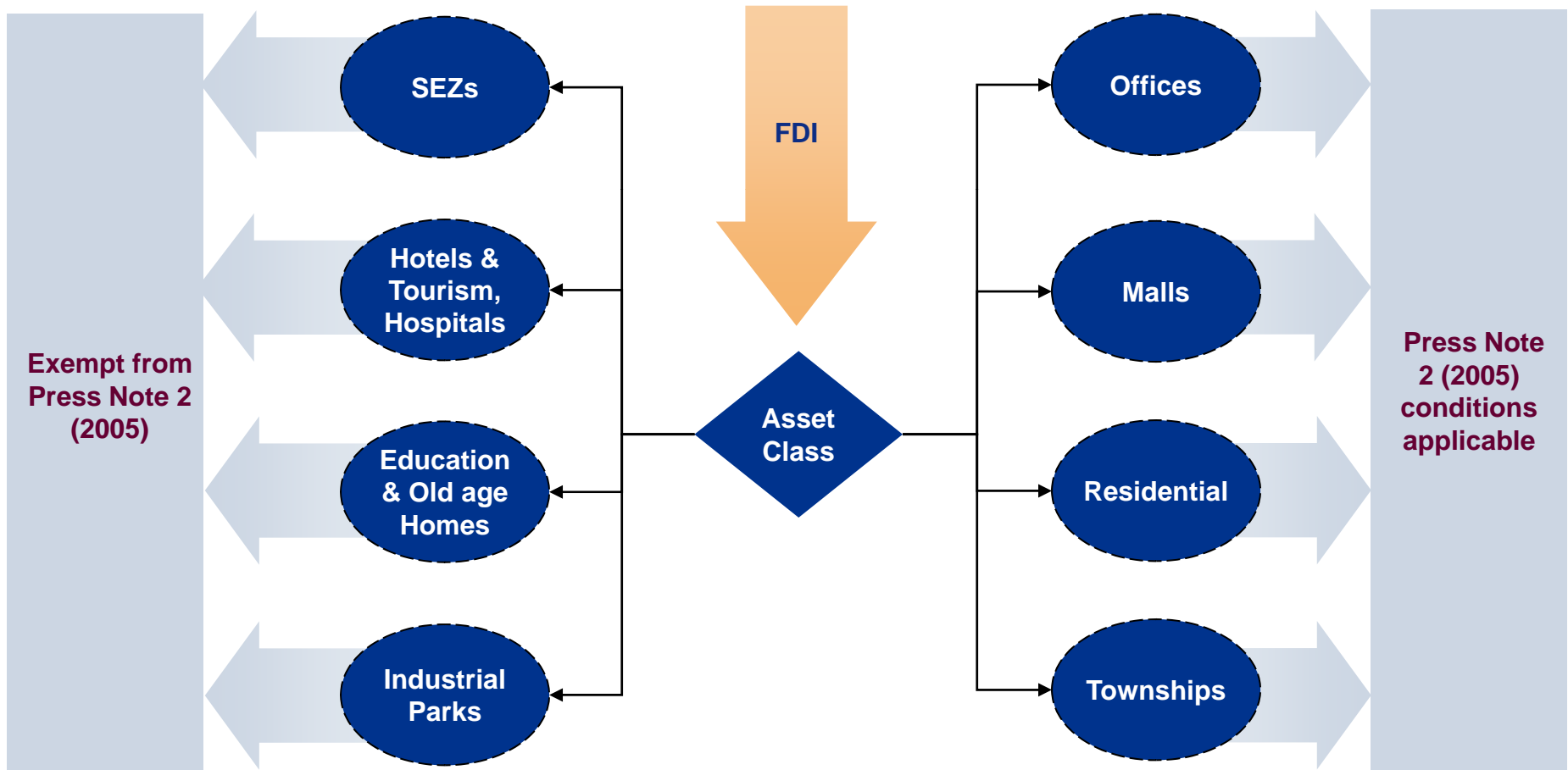
Project to conform to norms and standards laid down by respective state authorities

# FDI in Real Estate Sector

“Direct ownership of Real Estate not permitted. Investment possible only in shares and compulsorily convertible instruments of the Company owning / developing Real Estate”

Investment in Greenfield projects and existing assets

Investment in Greenfield projects



# Clarifications Issued



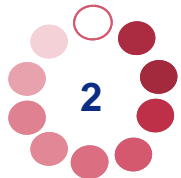
## Clarifications – FDI Policy – October 2010



Term 'Original Investment'



*Means entire amount brought in as FDI*



Lock-in Period of three years



*Three years to be applied from the date of receipt of each installment/tranche of FDI or from the date of completion of minimum capitalization, whichever is later.*



Minimum Capitalization



*It would include the share premium account*

# Issues under Press Note 2 of 2005

## Issues under Press Note 2 of 2005

1

Whether FDI is permissible in an under construction projects/partly developed projects (percentage of completion not known)

2

Whether minimum capitalization would be required to be satisfied at 'project level' or 'SPV level'

3

In case of transfer of shares - amount paid by the transferee beyond the issue price of the share should be taken into account while calculating minimum capitalization?

4

FDI in company having agricultural land pending conversion permissible?

5

Whether FDI in a Company having FDI and Non-FDI compliant projects permissible?

6

Whether FDI company having land can enter into Development Agreement or JDA?

# Issues under Press Note 2 of 2005

## Issues under Press Note 2 of 2005

7

Whether minimum built up area means carpet area? Whether car parking area, basement area etc. is included for the purpose of computing built up area?

8

Commencement of Business – Not defined – whether acquisition of land constitutes the commencement of business

9

Whether transfer of shares between non-resident to other non-resident allowed within lock in period?

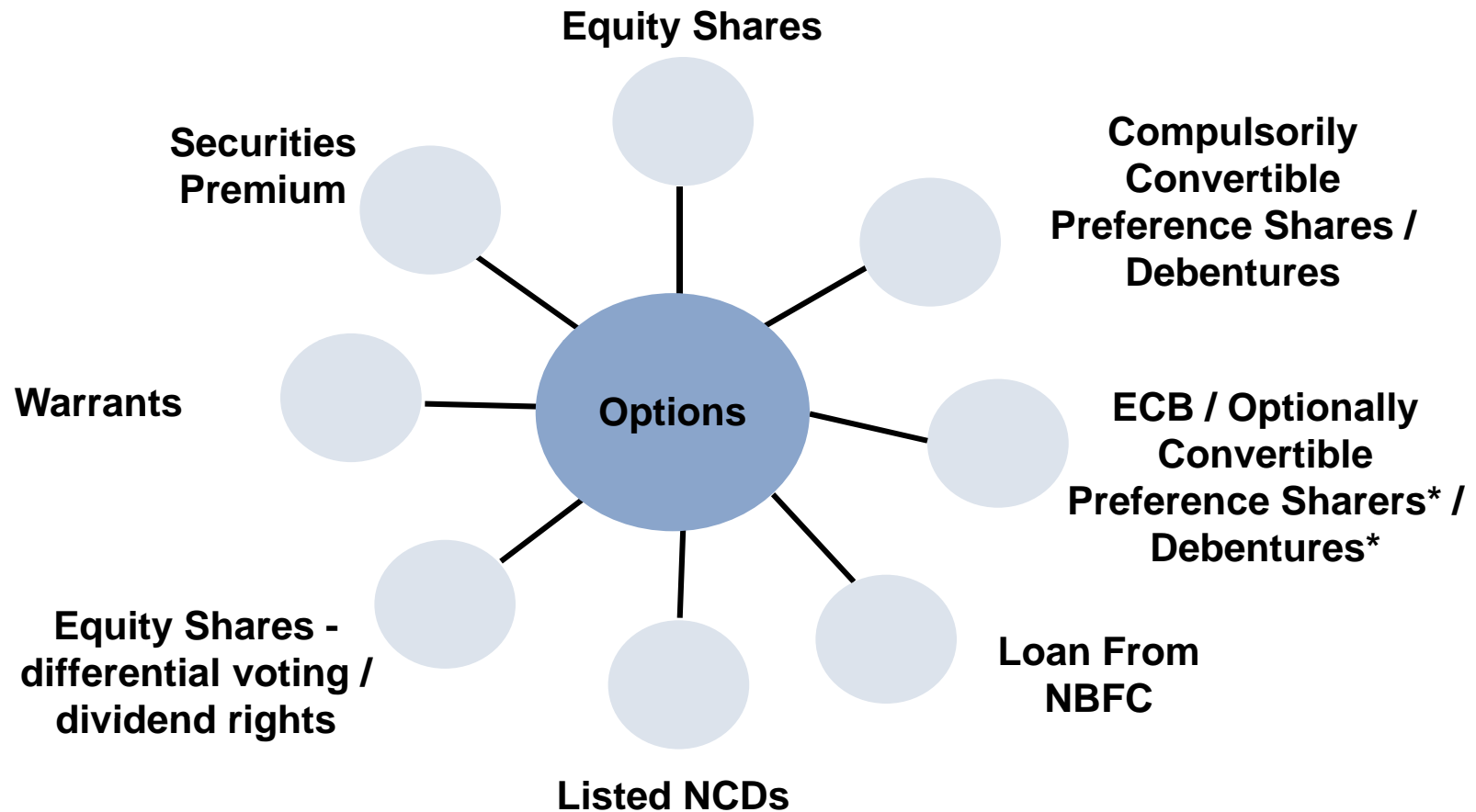
10

Whether exit post lock-in period but before completion of 50% of the Project is permissible?

11

Whether conditions of PN 2 to be satisfied by NRI Investors?

# Investment Instruments – Offshore / Domestic



**Combination of the above can be explored**

\* Optionally convertible / Non-convertible Preference Shares / Debentures are considered as ECB, requiring compliance with ECB guidelines

# Taxation Challenges

# Taxation issues

## General

- **Build to Sell Model - Point of taxability**
  - **Project Completion Method**
  - **Percentage of Completion Method**
    - ✓ **Provision for anticipated losses or adjustment for actual losses**
- **Build to Lease Model - Characterization of income ~ Business Income or Income from House property**
- **Applicability of Accounting Standards and TAS – AS-2, AS-7 and AS-9 and Guidance Notes**
- **Date of Setting up of Business Vs. Commencement of Business**
- **Conversion of capital asset (say land) into stock-in trade and vice-a-versa**
- **Valuation of Work-in-Progress and stock-in-trade – varied methods adopted**
- **Impact of Section 50C, Section 50D and Section 43CA**
- **Acquisition of land on long term lease – Deductibility of lease premium**
- **Development Rights Transfer Arrangement and Joint Development Arrangements – Taxability for the Land Owner and the Developers**



# Taxation Issues

## Tax Treatment of various payments and expenses

- **Issue of CCDs/OCDs/NCDs**
  - **Allowability of instrument issue expenditure**
  - **Allowability of redemption premium amount**
- **Financing cost including interest cost**
  - **Build to Sell Model**
  - **Build to Lease Model**
- **Construction and development cost – escalations and damages**
- **General Administration and Marketing Cost**
  - **Allocation of costs among various projects**
- **Expenditure incurred for “Temporary Structures” and “Show Flats”**
- **Protection money payments**
- **Franchise fees or marketing fees or technical know-how fees**
- **Payment for removing lien or unauthorised occupants or legal tenants**

# Taxation of Lease Rental / Service Income – House Property Income vs. Business Income

Landscape of disputes.....

## Revenue Authorities - IHP

- Specific provisions should prevail over general provisions
- The taxability of income is not on rentals but on the inherent capacity of the asset to yield profit
- Letting out of property & provision of amenities (which are inseparable to property) is not adventure in nature

## Characterisation of Income

**Lease Rental**

## Tax Payers – Business Income

- The entity is engaged in the business of developing specific properties for renting or sale
- Primary object - to exploit the immovable property by way of commercial activities
- Bifurcation of rent income between HP income and BI in respect of building and services – to be done in accordance with agreement

**Income from leasing and provision of services – debatable with diverse precedents**

**Rental income taxable as HP Income under DTC – necessitating appropriate structuring**

# Vacancy Allowance – Tax Issue

Landscape of disputes.....

## Revenue Authorities

- Property should be let out and vacant for part of the year
- The words 'property is let' cannot be read as 'property is intended to let'

Scope of applicability  
of section 23(1)(c) of  
the Act

**Lease  
Rental**

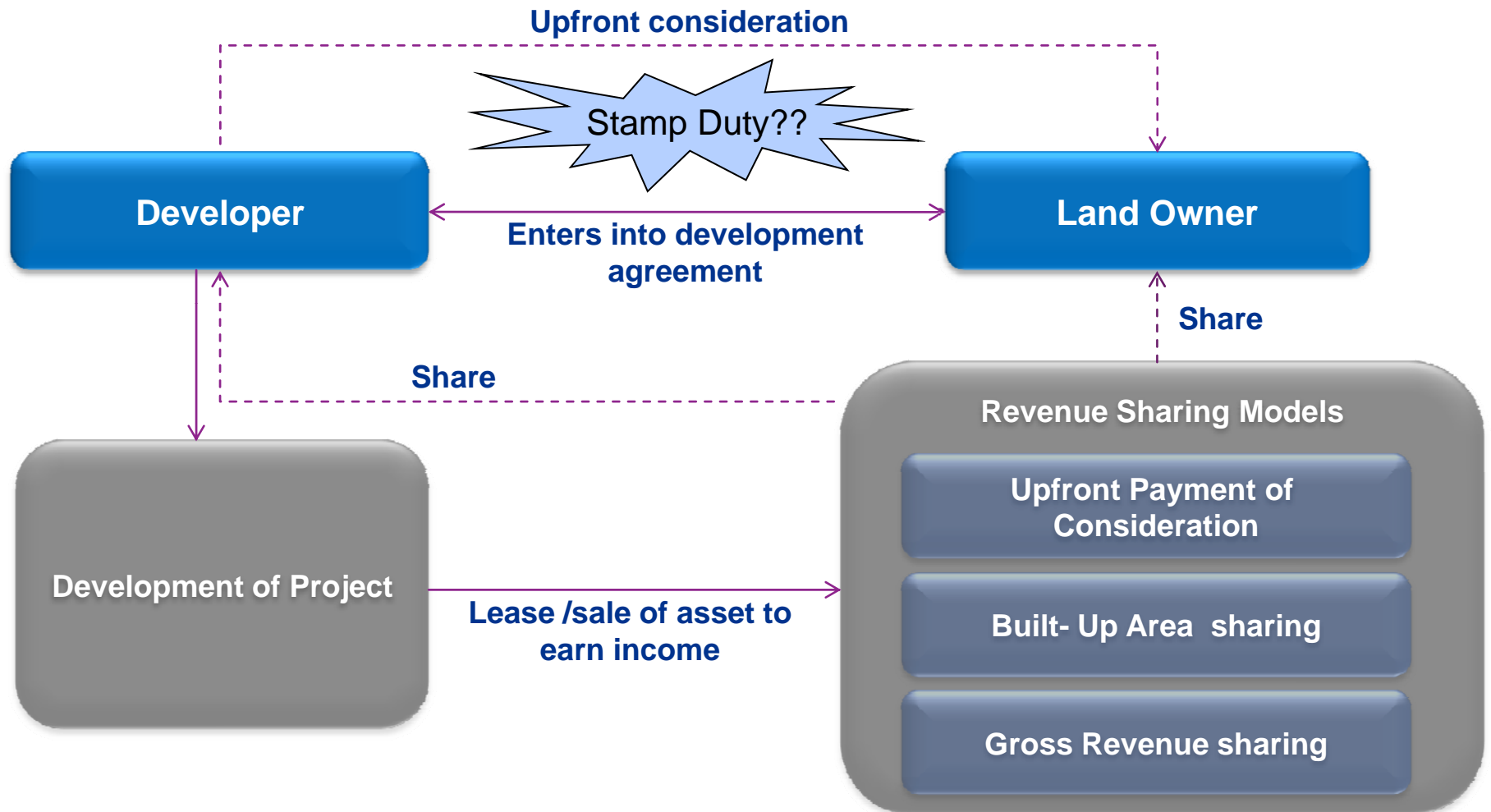
## Tax Payers

- Property let out does not mean actual let out of property
- Intention to let out coupled with efforts is sufficient to say property is let out
- The words 'property is let' has to read as 'property is intended to let'

Recently the Delhi High Court in the case of Ansal Housing Finance and Leasing Co. Ltd held that deemed rent is taxable on the immovable property held as a stock in trade by a developer

Rent received or receivable taxed under Direct Tax Code

# Joint Development Arrangements – Tax Issues



# Joint Development Arrangement – Tax Issues

## Key Tax Issues – Land Owner Perspective

1

**Point of Accrual of Capital Gain/ Business Income – Transfer u/s 2(47)(v) read with section 53A of Transfer of Property Act**

2

**Revenue or Area Sharing Models – Value for Taxation Purpose and characterization of income**

3

**Revenue Sharing Arrangements - Association of Person (AOP) Exposure**

4

**Capital asset vis-à-vis Stock in trade and conversions – tax treatment**

5

**Applicability of Section 50C/43CA**

6

**Eligibility to claim deduction u/s. 80 IB (10)**

7

**Payment of Stamp Duty on execution of JDA/DA**

# Joint Development Arrangement – Tax Issues

## Key Tax Issues – Developer Perspective

### Developer Perspective



- Income characterization based on business models:
  - Business Income
  - Income from House property
- Deductibility of share payable

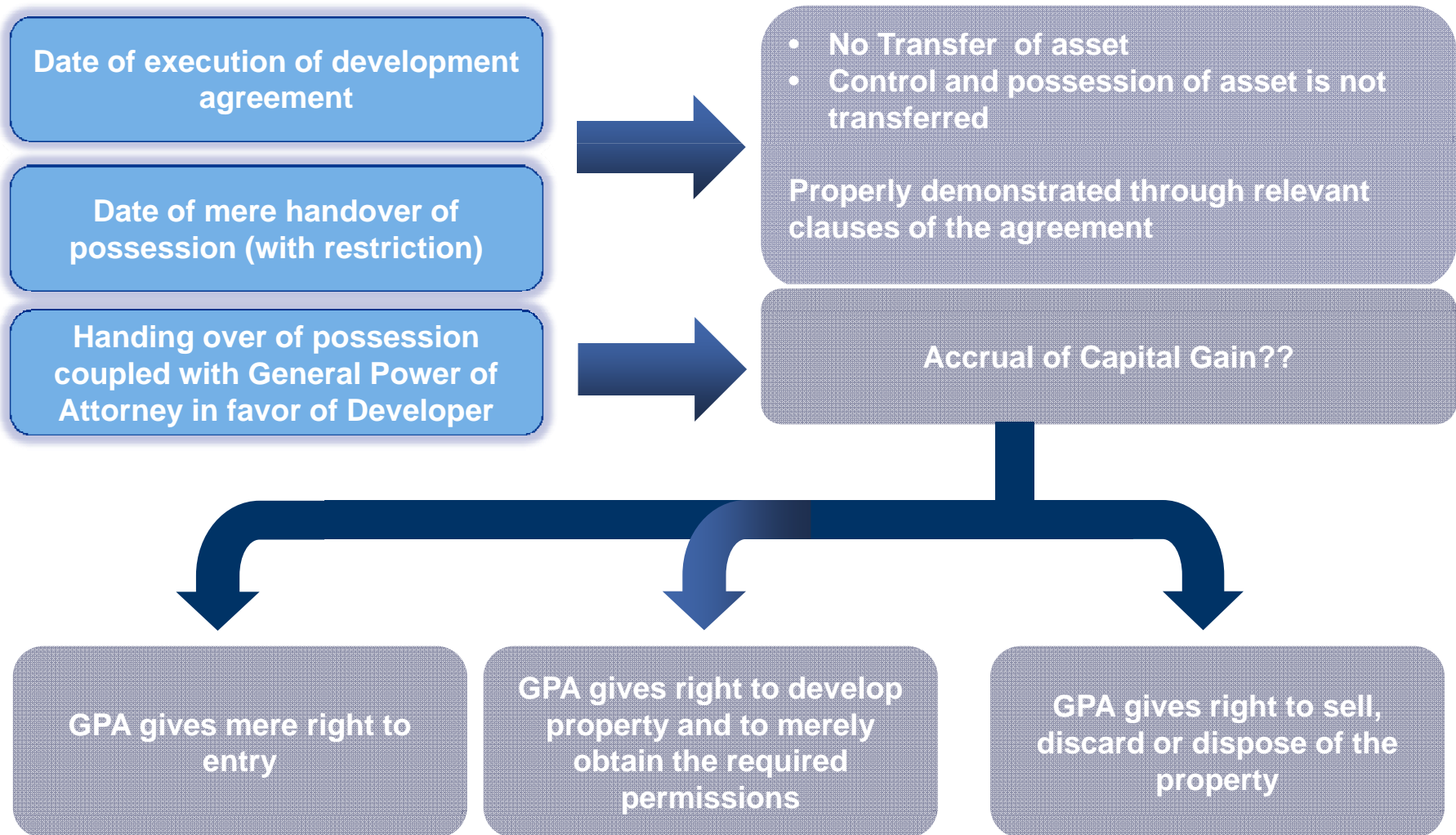
AOP Exposure and consequential adverse implications

### Tax and Regulatory Issues

- Stamp duty on JDA or on ultimate sale
- Service Tax on JDA

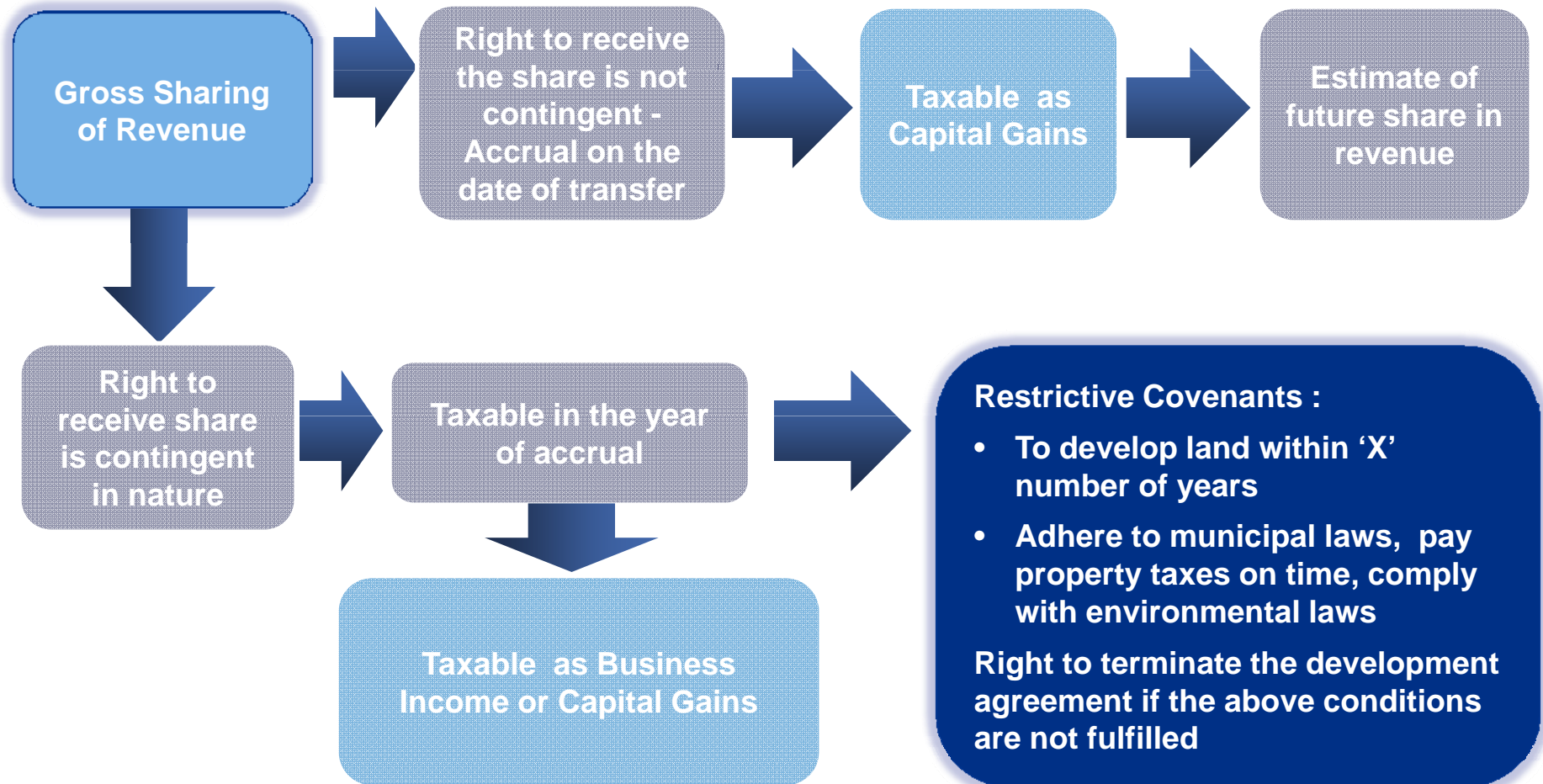
Eligibility to claim weighted Deduction – Section 35AD or Deduction under section 80IB(10)

# Income-tax issues from Land Owner Perspective Summary



# Income Tax Issues from Land Owner Perspective

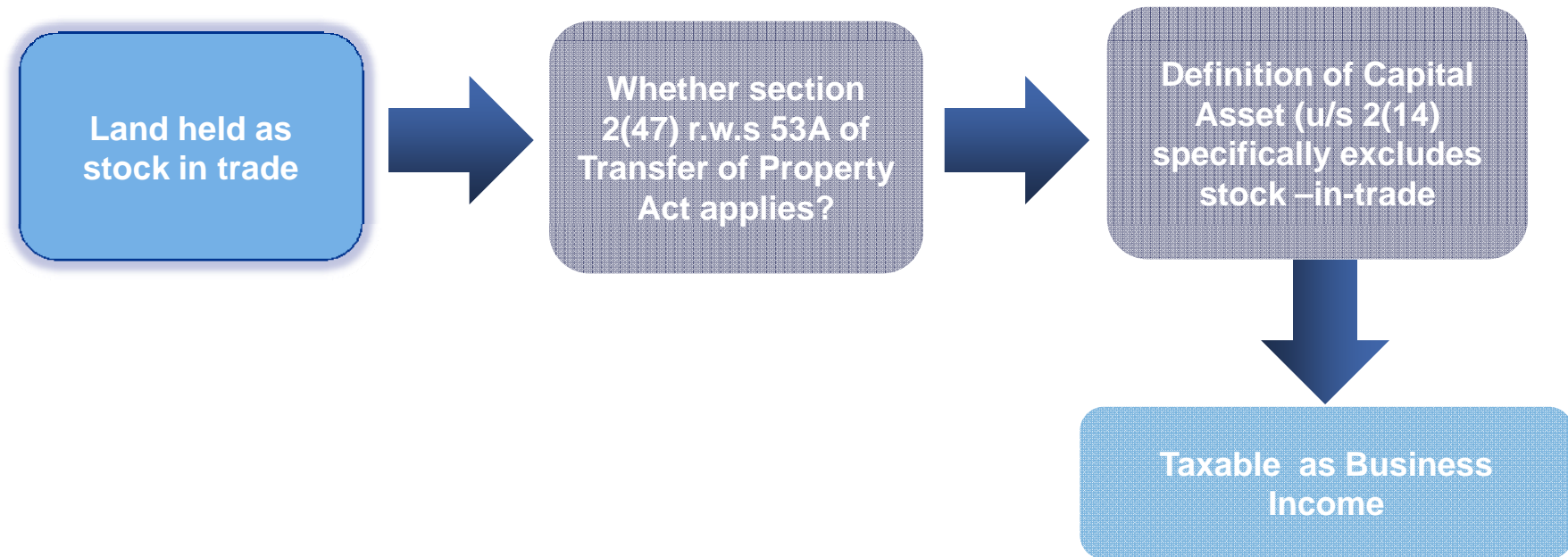
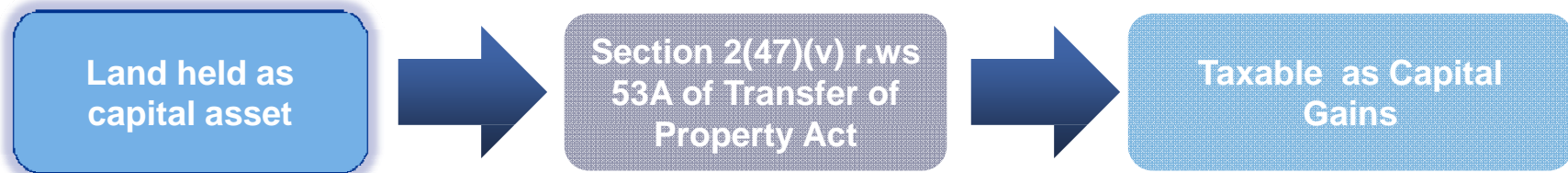
## Modes of Consideration – Taxation Aspects





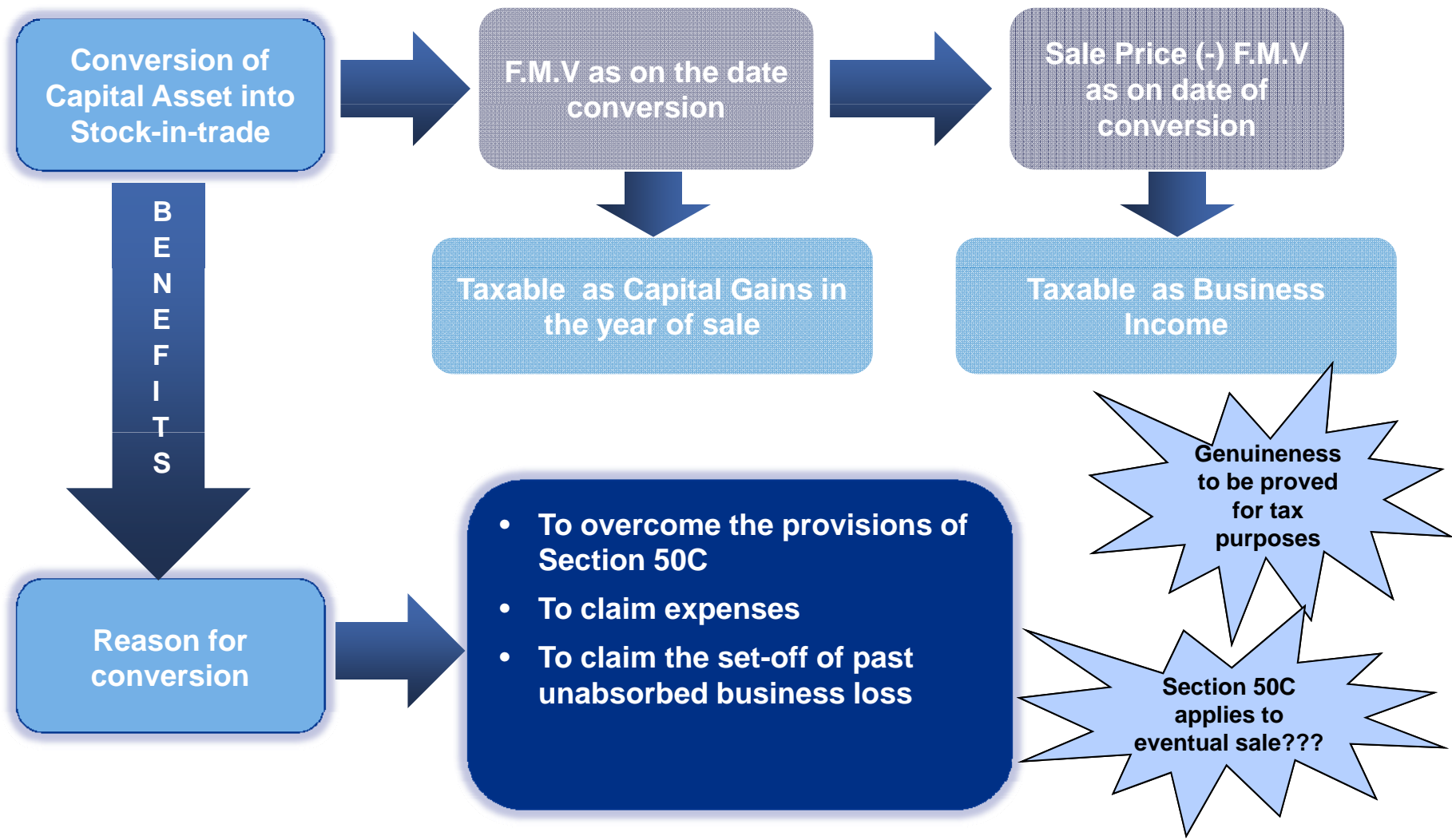
# Income-tax issues from Land Owner Perspective

## Capital Asset vis-à-vis Stock in trade



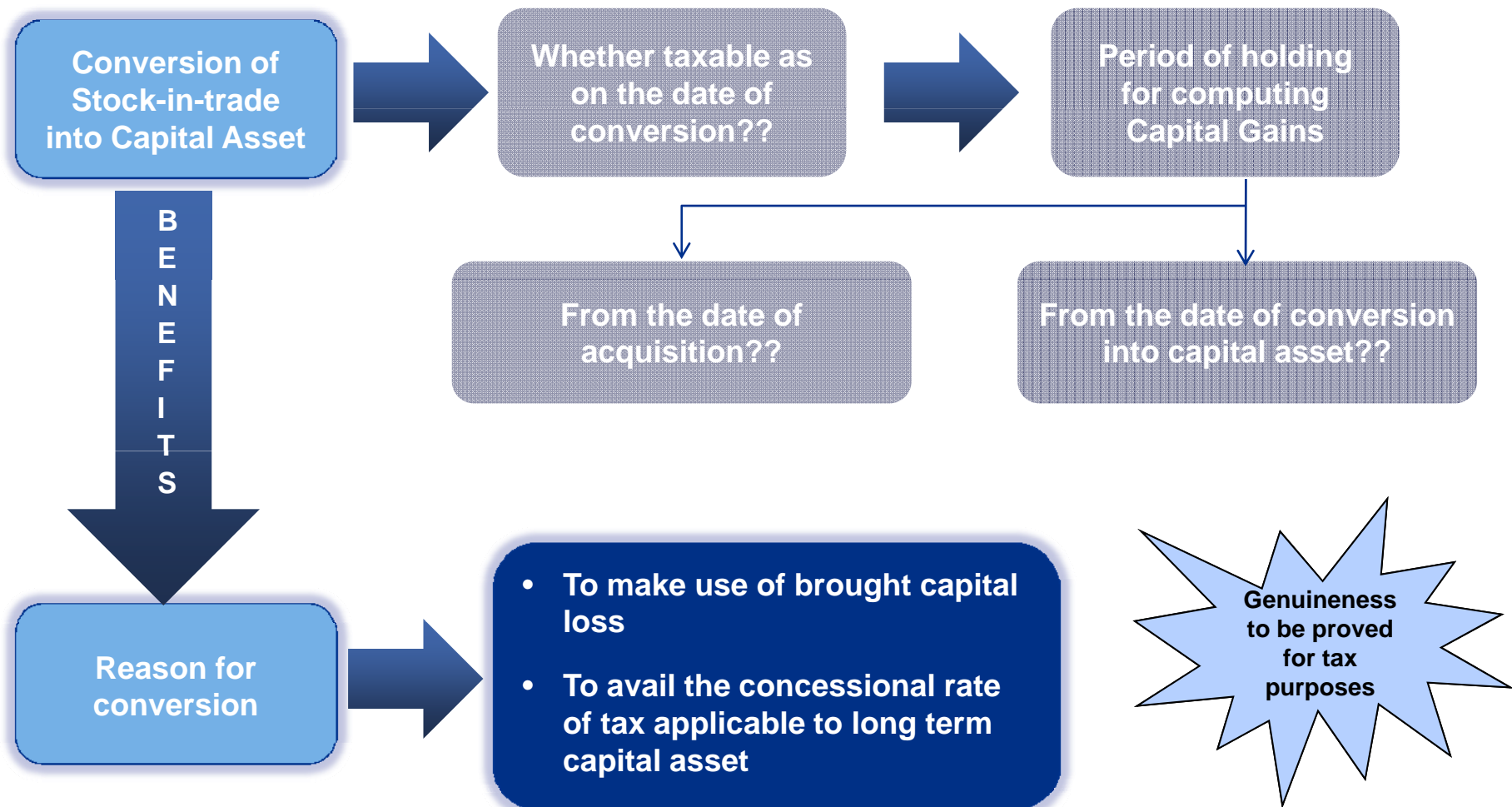
# Income-tax issues from Land Owner Perspective

## Capital Asset vis-à-vis Stock in trade



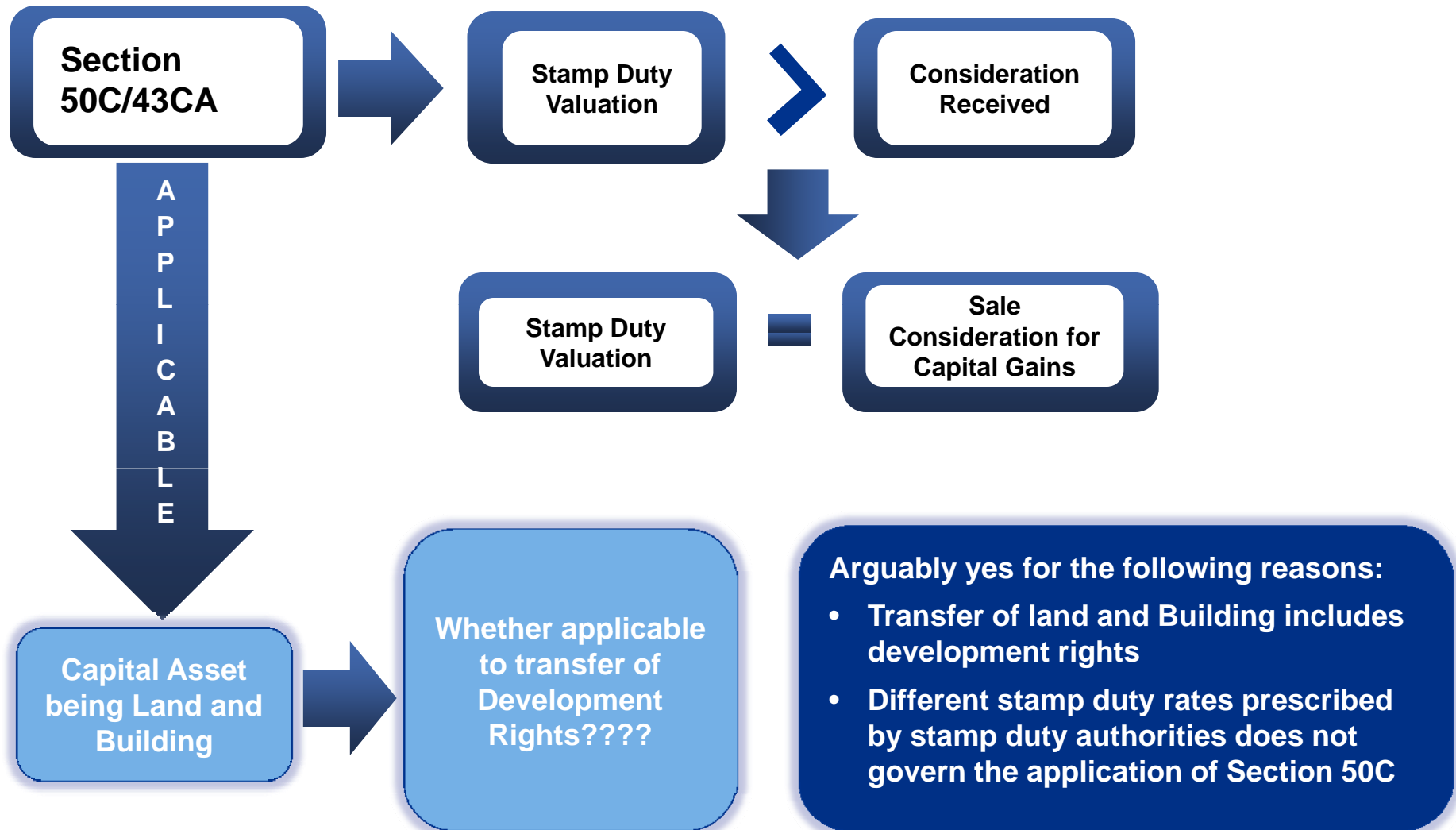
# Income-tax issues from Land Owner Perspective

## Capital Asset vis-à-vis Stock in trade



# Income-tax issues from Land Owner Perspective

## Applicability of Section 50C/43CA



A large blue trapezoidal graphic on the left side of the slide, tapering towards the right. The text is centered within this graphic.

# **Budget Proposals - Impact on Real Estate Sector**

# Relevant Direct Tax Proposals

Stamp duty valuation for transfer of Immovable Property held as stock-in-trade



## Deeming provision to tax sale of immovable property held as Stock in trade at “circle rate”

### Proposed Provision:

- **Condition to attract the deeming provision for determination of sale consideration**
  - Transfer of asset, being, land or building or both held as stock in trade
  - Transfer consideration is less than stamp duty value
- **Other Points**
  - Where date of agreement for transfer and date of registration is different and any consideration or a part thereof is received by any mode other than cash on or before the date of agreement for transfer, then the stamp duty value as on date of agreement for transfer is to be adopted
  - Provision of sub –section 2 and 3 to section 50C applicable

### Points to Ponder:

- Is such deemed taxation violative of fundamental principles of taxation of business income?
- Meaning of the term ‘transfer’ – general meaning or reference to section 2(47) or Transfer of Property Act ?
- Whether transaction exempted under section 47 are covered?
  - Gift / Will / Succession (example - conversion of business legal status)
  - Slump sale, demerger, amalgamation?
  - Contribution of assets to Partnership Firm or AOP
  - Withdrawal of asset on retirement of Partner or dissolution of Partnership Firm or liquidation of a Company?
  - Conversion of stock in trade in to Capital Asset
  - Compulsory acquisition of land or building?
- Whether applied to sale of development rights / TDR, JDAs, etc.
- Impact of date of accrual or receipt being different from the date of agreement or date of registration

# Relevant Direct Tax Proposals

## Withholding Tax on Transfer of Immovable Property

### Proposed Provision

- Transfer of land (other than agricultural land) or building or part of building by Resident
- Transferee to withhold tax at the rate of 1 percent on gross consideration at the time of credit or making payment, whichever is earlier
- Applicable where total consideration is INR 5 million or more
- Applicable from 1 June 2013

### Issues and Concerns

- Negative impact on the overall cash flows of the Developers
- Definition of “transfer” – general meaning or section 2(47)?
- Whether transaction exempted under section 47 excluded?
- Whether applicable to transfer made before 1 June 2013 though the payment made post 1 June 2013
- Whether Stamp duty value (i.e. section 50C or 43CA) to be regarded as the deemed consideration, if higher than consideration agreed upon?
- Applicability when section 50D is applicable to the transfer
- Whether consideration to include service tax / VAT component / interest for late payment/ development fees/membership fees / other fees
- Threshold qua property or qua owner?
- Applicability to lease premium – Section 194I vs Section 194IA
- Whether transferee required to obtain TAN and file TDS Return

**Similar but stringent provisions were introduced in Finance Bill 2012, but dropped**

# Relevant Direct Tax Proposals

Taxation as gift for receipt of immovable property for inadequate consideration

## Proposed Provision

An individual or HUF who receives immovable property from any person (other than relatives)

Consideration for which is less than the stamp duty value and the difference exceeds fifty thousand rupees

Such difference to be taxable as “Income from Other Sources” in hands of such recipient

**Whether amount proposed to be taxed u/s 56 in the hands of recipient – could constitute cost of acquisition for subsequent sale?**

**Leads to Double Taxation i.e. taxed in the hands of seller u/s 50C (if capital asset) or proposed section 43CA (if stock-in-trade) and also in the hands of buyer u/s 56**

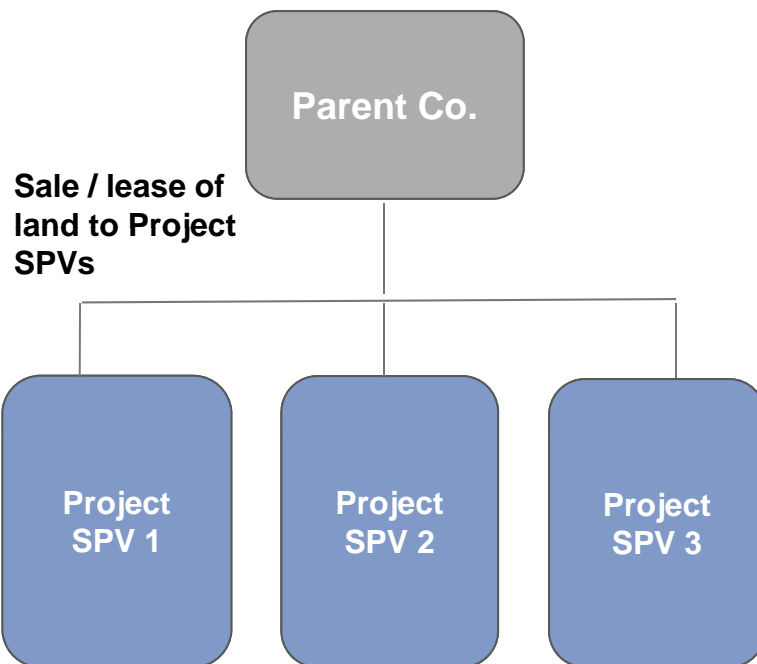


**Specified Domestic  
Transactions - Impact on  
Real Estate Sector**

# SDT – Common transactions between related parties

- **Purchase/lease of land**
  - **Joint Development Arrangement or Acquisition of Development Rights**
  - **Purchase of Goods / Provision of services - Overseas or Domestic Procumbent Company**
  - **Centralised Corporate Services - Strategy, Marketing, Design & Engineering, HR, accounting, finance, etc.**
  - **Common management personnel like common MD, CEO.**
  - **Use of common facilities and Infrastructure - space, equipment, etc.**
  - **Payment to Managing Director / Directors**
  - **Use of brand name or trademarks**
  - **Group Restructuring**
  - **Reimbursement of expenses**
-

# Land Transactions – Purchase / Lease of land



## Key Challenges:

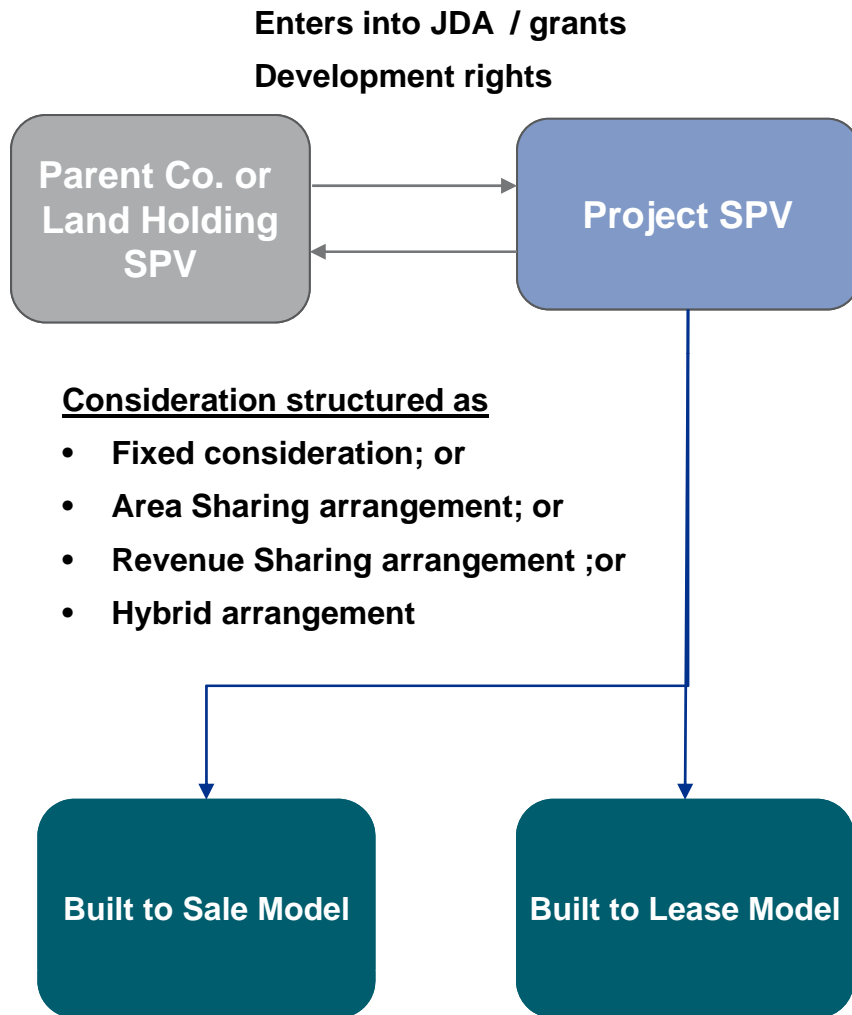
### ➤ Land sold to Project SPV

- Arms length price justification: Most Appropriate Method – TNMM, CUP, Market Price, Stamp Duty valuation, Cost plus mark-up?
- Availability of comparable data?
- Year of reporting and use of benchmarking data:
  - Project SPV, developing on a build to sell model and following POC method:
    - Land to be recognized as expense on a POC method
  - Project SPV, developing on a build to lease model
    - Land to be recognized as capital asset
    - Land is non-depreciable asset / Income offered under House Property

### ➤ Land leased (long term) to Project SPV for a upfront lease premium or recurring lease

- Arms length price justification: Most Appropriate Method – TNMM, Market Price, Finance cost plus mark-up, Present value of future rent?
- Year of reporting and use of benchmarking data: same as above

# Land Transactions – JDA / Development rights

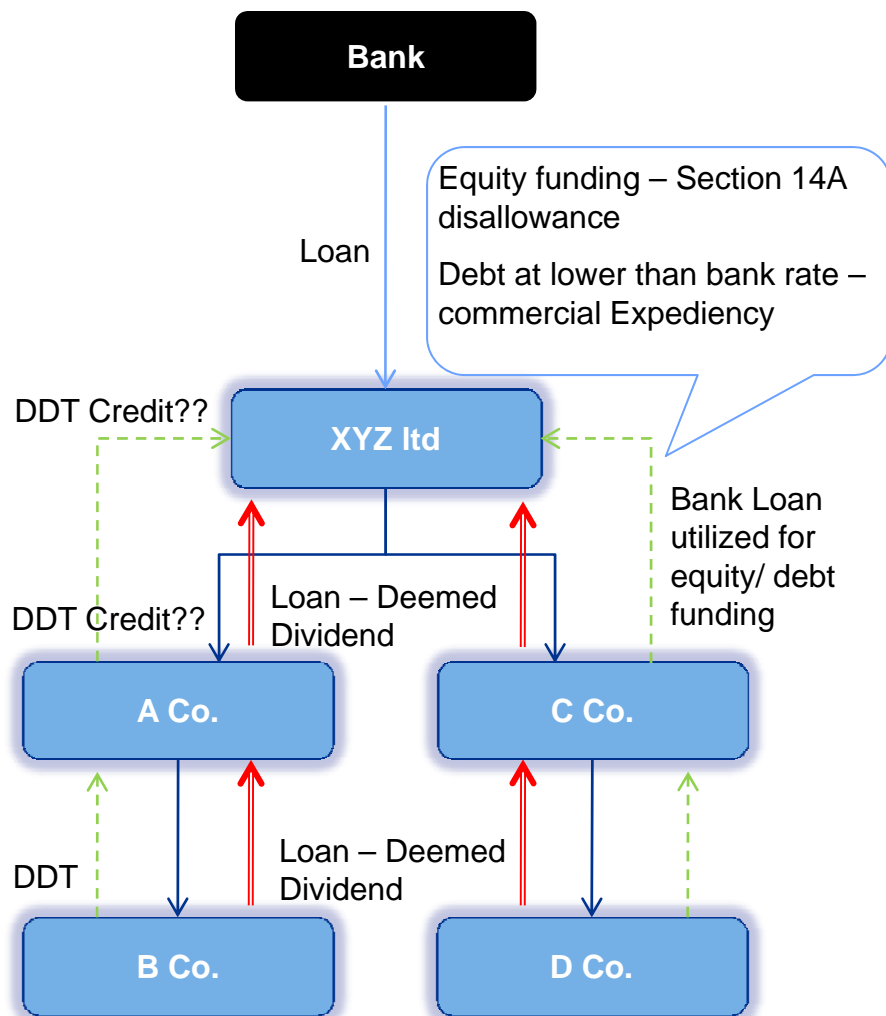


## Key Challenges:

- Whether Transfer Pricing applies – Gross Basis Vs. Net Basis of accounting?
- Arms length price justification: Most Appropriate Method
  - Fixed consideration: as discussed in earlier slide
  - Area sharing arrangement: - CUP, TNMM?
  - Revenue sharing arrangement:
    - Whether a SDT?
    - If yes, CUP, TNMM?
  - Availability of comparable data?
- Applicability of Section 50C or 50D or TP provisions?
- Year of reporting and use of benchmarking data: same as discussed in earlier slide
- Where JDA treated as AOP
  - Whether consideration (i.e. Area shared or Revenue shared) disallowable under section 40(ba)
  - If yes, whether section 40A(2)(b) applicable
- Different approach or interpretation by different revenue authorities – Income-tax Vs. Service tax authorities

# Structuring Options

# Holding Structure & Funding Options – Key Considerations



## Legend

- Shareholding/ Investment/ Funding
- Income Upstreaming
- Loan to Hold Co,

## Taxation Aspects

- Availability of DDT Credit
- Deemed Dividend Issues - Use of Business Advance model
- Effective utilization of tax losses of loss making entities
- Tax advantages to a LLP - No DDT leakages on dividend distribution by LLP
- Mitigation of disallowance under section 14A of the Act
- Allowability of Interest Expenditure - Test of Commercial Expediency to be satisfied

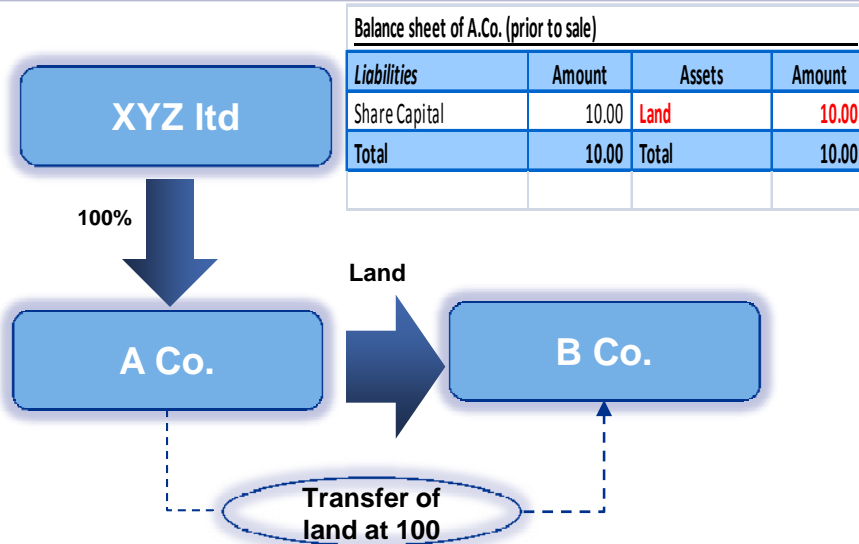
## Other Aspects

- Funding Options to be tax efficient in relation to income up streaming (i.e., Effective use of Convertible/ Optionally convertible debt instruments)
- Minimum capitalization to be met in case of competitive bidding and as per the commercial terms of the bid
- Use of LLP structure in real estate not permitted under FDI Regulations
- Applicability of Core Investment Company ('CIC') Guidelines
- Applicability of NBFC norms
- Adherence to SEBI guidelines for listed entities
- Adherence to Inter-Corporate loans & Advances - Section 372A of Companies Act, 1956
- RoC objections on use of LLP as investment holding vehicle

# Tax Optimisation vis-à-vis Land Cost

## Situations in which this can be triggered

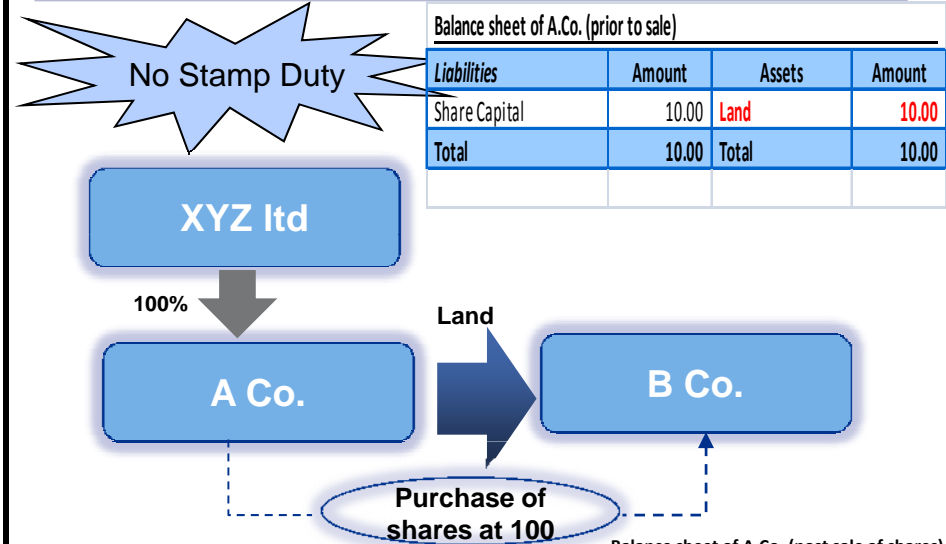
### 1. Direct sale of Land



#### Implications:

- If Land is held as SIT gain on sale of land 90 (100-10) is taxable as business income at 32.45% in hands of A.Co.
- If Land is held as capital asset gain on sale of land 90 (100-10) is taxable as capital gains at 21.63% in hands of A.Co.
- Stamp Duty implications on transfer of land in the hands of BCo

### 2. Sale of Shares



#### Implications

- Long term Capital gains tax liability on gain on sale of shares 90 (100-10) at 21.63% in the hands of the seller
- No step up in land cost as land remain to appear at 10 in books of A Co.

Balance sheet of A.Co. (post sale of shares)

Liabilities	Amount	Assets	Amount
Share Capital	10.00	Land	10.00
Total	10.00	Total	10.00

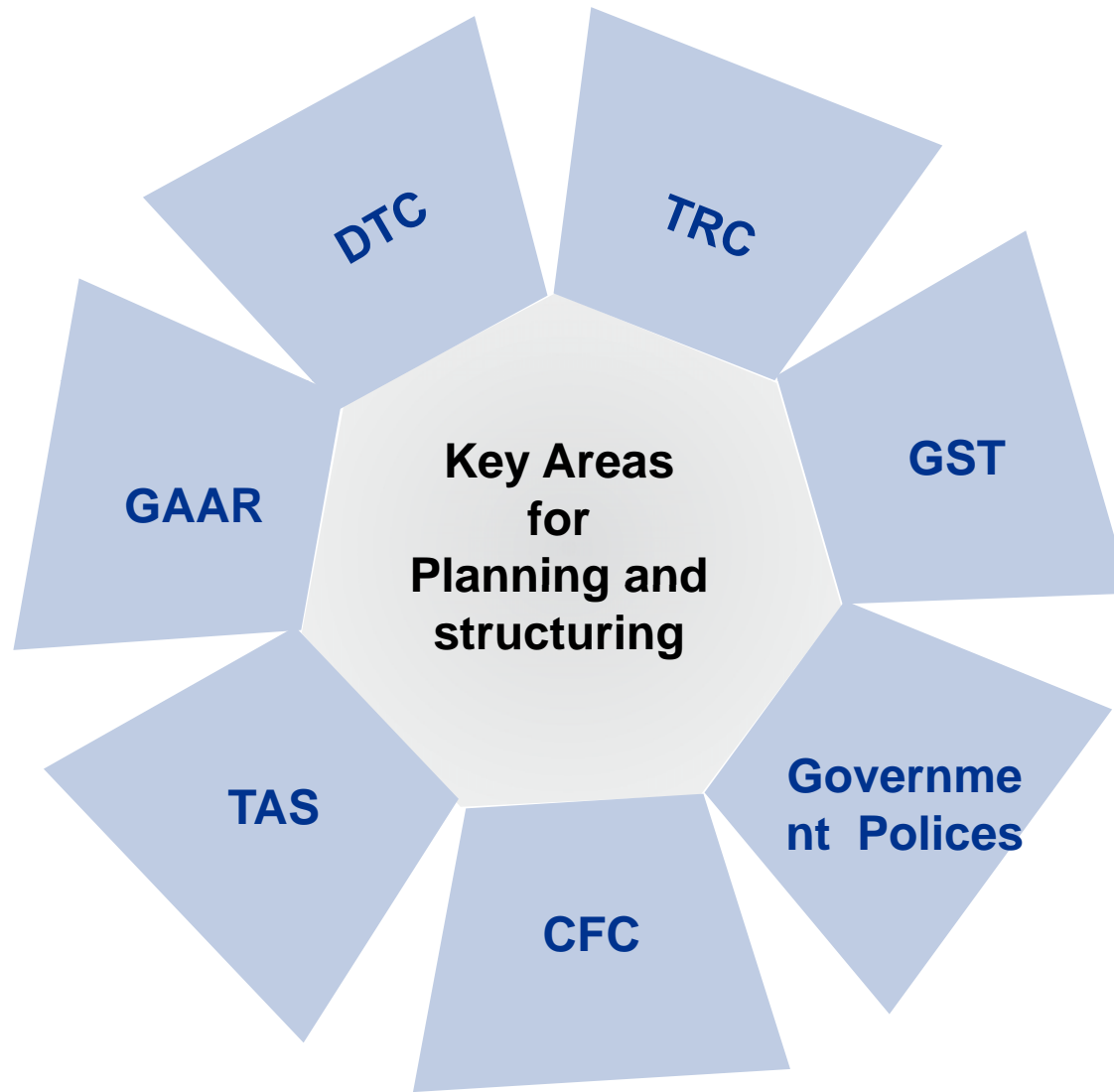
Balance sheet (extract) of B.Co. (post sale)

Liabilities	Amount	Assets	Amount
		Investment in A.Co.	100.00
Total	-	Total	100.00

# Forthcoming challenges



# Forthcoming challenges



## Companies and Professionals should prepare for the future...

- 1 There could be significant impact on the business and cost structures due to these changes
  - 2 There may be a need to assess impact of these changes on the business
  - 3 Offers planning opportunities to reorganize your house
  - 4 There may be a need to reorganize holding or transaction structures considering impact of GAAR and DTC provisions
  - 5 Tight rope balancing while reorganizing the affairs – income-tax Vs. indirect taxes
  - 6 Consider long term view in light of the forthcoming regimes – GAAR, DTC, GAAR
  - 7 Revising contracts and documentation to “ring fence” from potential uncertainties
-



**Questions**

**&**



**Answers**

# Thank You

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