Confederation of Indian Industry

Transactions in the real estate sector

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Contents

Foreword

India's real estate industry has rapidly evolved into an organised sector in the last 10 years, riding on the back of state-of-the-art residential and commercial projects, innovative concepts that maximise the value-add potential of industrial parks and residential complexes, and concepts that are tailored to suit the versatile needs of consumers and markets. It is estimated that the sector will have a compound annual growth rate (CAGR) of 11.2% (FY 2008-2020) and grow to 180 billion USD by 2020.[1]

In order to help ensure that the growth of this sector keeps pace with the country's economic growth, there is a need for an adequate and continuous flow of investments. The relaxation of foreign direct investment (FDI) rules for the real estate sector, opening up of the domestic fund industry to foreign investment, introduction of institutional frameworks like the real estate investment trust (REIT) and infrastructure investment trust (InvIT) are expected to help raise funds to support projects and accelerate growth. Another structural reform designed to bring about a paradigm shift in the way the real estate sector operates is the introduction of the Real Estate Regulatory Authority, which will help in improving transparency and efficiency, restore consumer confidence and revive demand.

Further, transactions in real estate have also started picking up pace in recent times given the increased demand for office and residential spaces in India. According to a Department of Industrial Policy & Promotion (DIPP) fact sheet on FDI from April 2000 to March 2017, cumulative equity inflows in the construction development sector were 24,293 million USD or 7% of total inflows[2]—the third highest among all sectors.

However, even with the government providing a much-needed boost to raise funds for the real estate sector, the ever-changing tax and regulatory landscape in India makes real estate transactions quite complex.

This report covers the typical transaction structures in the real estate sector and the key tax and regulatory implications that prove to be dealmakers or dealbreakers. In addition, it focuses on niche topics governing the real estate sector, such as funding options, internal restructuring, affordable housing and REITs. This publication will serve as a tax and regulatory guide for developers, financial institutions, consumers and investors entering into any real estate transactions.

We hope that it makes for insightful reading!

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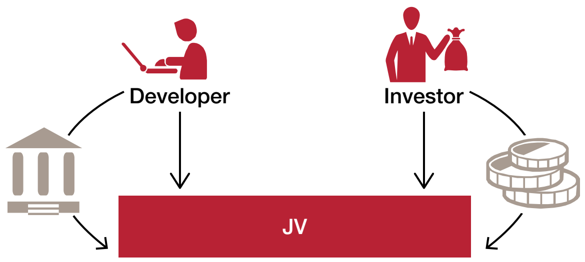
1. *India Brand Equity Foundation. (June 2017). Indian real estate industry. Retrieved from https://www.ibef.org/industry/real-estate-india.aspx (last accessed on 7 July 2017)*
2. *DIPP. (March 2017). Quarterly fact sheet. Retrieved from http://dipp.nic.in/sites/default/files/FDI_FactSheet_January_March2017.pdf (last accessed on 7 July 2017)*

Typical transaction structures

Joint ventures

A JV is a business arrangement wherein two or more parties agree to pool their resources to achieve a common business objective. Under this structure, all the parties retain some control over the entity with a defined set of activities to be executed by each of them. In the real estate sector, a JV is typically formed in one of the following ways:

I. Pooling of resources:



Pooling of resources, as shown above, involves the formation of a JV entity in which the real estate assets are contributed by the developer and funding is provided by the investor(s). The developer and investor(s) enter into a joint venture agreement to capture the rights and obligations of the parties in the project. There are various tax and regulatory implications to be kept in mind by both the parties while entering into such a structure. The key tax and regulatory implications are given below:

A. In the hands of the developer

1. Direct tax

1.1. On transfer of assets to the JV:

Property held as capital asset

On transfer of assets to the JV, the developer shall be liable to pay capital gains tax, depending on the period of holding of immovable property at the following rates:

Particulars	Tax rates
LTCG (property held for more than 24 months)	20%^
STCG (property held for less than 24 months)	30%^

^Plus applicable surcharge and cess

Further, indexation benefit shall be available while computing capital gains on transfer of a long-term capital asset.

Property held as stock in trade

In case, the land is held as stock in trade, transfer of immovable property shall be taxed as 'business income' in the hands of the developer.

Further, section 50C/43CA of the ITA provides that where an immovable property, held as a capital asset or stock in trade, is transferred at a value less than the stamp duty value (being the ready reckoner rate), then such stamp duty value shall be deemed to be consideration for such transfer and the developer shall be liable to pay tax based on such enhanced consideration.

In case the JV entity is incorporated as an LLP, transfer of land (being a capital asset) by the developer, by way of capital contribution, to the LLP would be subject to capital gains tax in the hands of the developer (depending on period of holding). Under section 45(3) of the ITA, the amount recorded by the LLP in its books of accounts shall be deemed to be the full value of consideration for computation of capital gains in the hands of the developer. However, in case the land is held as stock in trade, the provisions of section 45(3) would not apply and the income shall be charged to tax as 'business income' and the provisions of section 43CA should be applicable.

2. Indirect tax

As per the erstwhile indirect tax law, the transfer of assets (i.e. land or building) by the developer to the JV entity did not attract any VAT or service tax. This position remains the same under the GST regime.

B. In the hands of the investor

1. Direct tax

Section 56(2)(x) provides that where any person receives certain properties (including shares and securities, immovable property) for a consideration which is less than its FMV, then such deficit shall be taxed in the hands of the recipient of such property. Therefore, while issuing shares to investor(s), the company should ensure that the shares are issued at the FMV as per guidelines provided in this section.

Tax implications on exit by the investor are covered separately (refer to the chapter on 'Funding options').

2. Indirect tax

There should not be any indirect tax implications on infusion of funds by the investors in the JV entity.

3. FEMA regulations

3.1. Any inflow of funds from non-resident investors into India needs to be in compliance with the FDI policy issued by the DIPP. The Indian real estate market has huge potential to attract large foreign investments. However, being largely an unorganised sector, it creates hesitation in the minds of foreign investors.

Thus, in order to make investments in the Indian construction and development sector more lucrative, the government has allowed 100% FDI through the automatic route and eased the rules for investment in the construction development (townships, housing, built-up infrastructure) sector. The key conditions for FDI in this sector are given below:

Particulars	Conditions
Allowable FDI in construction/development of townships, housing, built-up Infrastructure	100% (under automatic route)
Minimum area	No minimum area requirement
Minimum FDI	No minimum FDI requirement
Exit under automatic route	• On completion of project or development of trunk infrastructure; or • Post 3 years, before completion of project, calculated from the date of receipt of each tranche of foreign investment[#]
Transfer from one non-resident to another non-resident before completion of project	Allowed under automatic route
Prohibition	Entities engaged in the business of real estate,[1] construction of farmhouses and trading in transferable development rights
FDI in LLP engaged in construction and development	Not allowed
FDI in LLP engaged in development of industrial parks/SEZ	Allowed

[#]Condition of lock-in not applicable to hotels and tourist resorts, hospitals, SEZs, educational institutions, old age homes and investment by NRIs

Further, 100% FDI under automatic route is permitted in completed projects for operation and management of townships, malls/shopping complexes and business centres. However, there would be a lock-in period of 3 years, calculated with reference to each tranche of FDI, and transfer of immovable property or part thereof is not permitted during this period.

3.2. The government has allowed 100% FDI under the automatic route for the development of industrial parks without applicability of any of the conditions of construction development (townships, housing, built-up infrastructure) sector as mentioned above, where the following two conditions are satisfied:

- Industrial park shall comprise a minimum of 10 units and no single unit shall occupy more than 50% of the allocable area; and
- The minimum percentage of the area to be allocated for industrial activity shall not be less than 66% of the total allocable area.

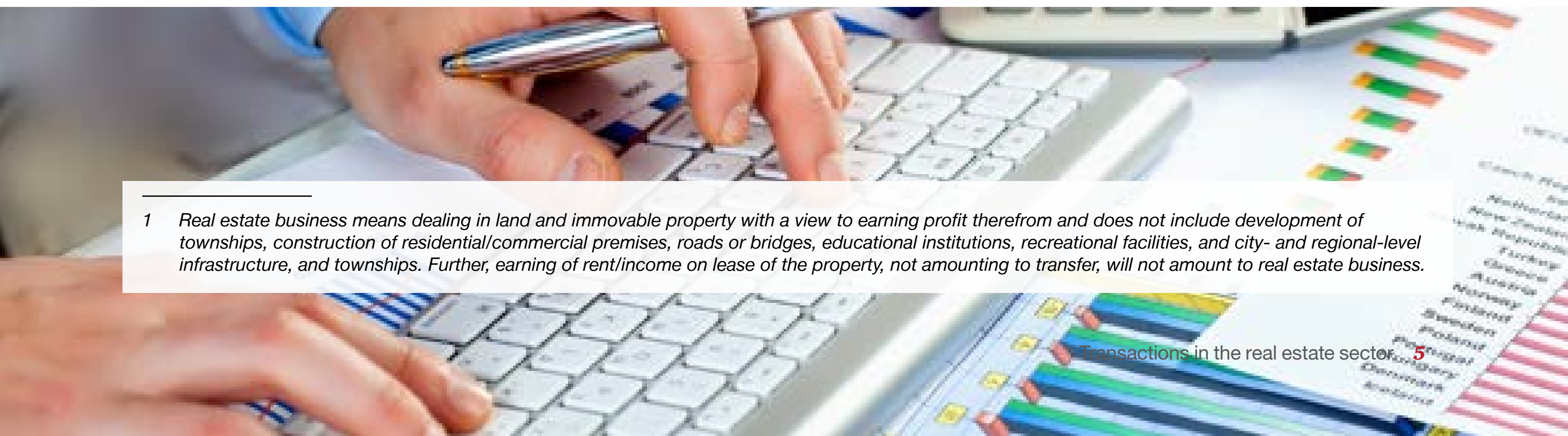
C. In the hands of the JV entity

1. Direct tax

1.1. Issue of shares to investor(s)

Where shares are issued, implications under section 56(2)(viib) of ITA should be analysed.
Section 56(2)(viib) of ITA provides that where a company issues shares at a value higher than its face value, then the amount received by the company in excess of the FMV determined by income tax provisions shall be taxed as income in the hands of the company. Therefore, while issuing the shares to the investor(s), the company should ensure that the shares are issued at the FMV as per the guidelines provided in this section.

In case the JV entity is incorporated as an LLP, no implications would arise under section 56(2)(viib), as stated above.



1 *Real estate business means dealing in land and immovable property with a view to earning profit therefrom and does not include development of townships, construction of residential/commercial premises, roads or bridges, educational institutions, recreational facilities, and city- and regional-level infrastructure, and townships. Further, earning of rent/income on lease of the property, not amounting to transfer, will not amount to real estate business.*

1.2. Receipt of property

Tax implications arising under section 56(2)(x) should be analysed on receipt of property by the JV entity from developers. In a situation where the JV entity receives property without consideration or for a consideration which is less than its FMV, the differential amount between the FMV of property and consideration paid should be taxed as 'income from other sources'.

2. Stamp duty implications

2.1. Transfer of assets (being land or building) shall attract a stamp duty cost at the rate prescribed in the respective stamp duty law of the state where the assets are located. An indicative stamp duty rate on transfer of assets in certain states is given below:

Sr. no.	State	Stamp duty rate	Surcharge and registration
1	Maharashtra	5% of the market value of the immovable property	**Registration fee** • 1% of the value of the property subject to a maximum cap of 30,000 INR
2	Gujarat	3.5% of the consideration or market value of the immovable property, whichever is higher	**Registration fee** • 1% on the consideration or market value of the immovable property, whichever is higher **Surcharge** • 1.4% on the consideration or market value of the immovable property, whichever is higher
3	Tamil Nadu	7% of the market value of the property	**Registration fee** • 1% of the market value of property
4	Delhi	Woman – 4% of consideration Others – 6% of consideration	**Registration fee** • 1% of consideration
5	Karnataka	5% of the market value of the property	**Registration fee** • 1% of the market value of the property **Surcharge** • 0.5% of the market value of the property

2.2. Issue of shares shall be subject to stamp duty at the rate prescribed in the stamp duty law of the state in which the registered office of the JV entity is situated. Generally, stamp duty @ 0.1% of fair value of shares is payable in most of the states.

D. Others

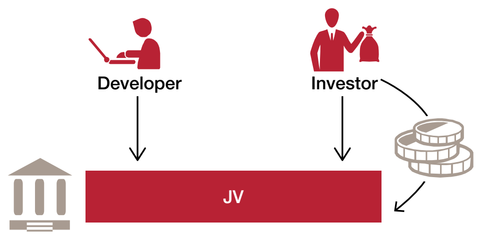
Another important aspect to be kept in mind while entering into a JV is the nature of the JV entity, i.e. whether to set up as a company or LLP. Both the company and LLP structure have pros and cons and a thorough analysis of the same needs to be done before taking a decision as it may have an impact on the entire arrangement. As far as the real estate sector is concerned, an LLP provides an effective structure from a tax and regulatory perspective since the structure provides flexibility for cash repatriation and each project can be easily set up in an LLP and wound up post completion of project.

The key characteristics of a company and LLP are given below:

Particulars	Company	LLP
Relevant legislation	The Companies Act, 2013 ('Companies Act')	The Limited Liability Partnership Act, 2008 ('LLP Act')
Legal entity and perpetual succession	It is a body corporate with a separate legal entity from its members and has perpetual succession.	It is a body corporate with a separate legal entity from its partners and has perpetual succession. An LLP agreement governs the mutual rights and duties of the partners of an LLP and a change in the partners of an LLP will not affect the existence of the rights or liabilities of the entity.
Tax rate	• The Corporate tax rate is 30%.^ • For companies having a turnover <50 crore INR for FY 2015–16, the tax rate would be 25%.^ It is pertinent to note that new companies incorporated after 31 March 2016 are not eligible for a lower rate of tax.	For all LLPs, the tax rate will be 30%.^
MAT/AMT	A company is required to pay MAT on book profits under section 115JB of the ITA @ 18.5%.^ MAT is payable only in case the tax payable under normal provisions is less than tax payable under section 115JB.	An LLP is required to pay AMT @ 18.5%^ in case it is claiming a tax holiday.
DDT	A company is required to pay DDT on profits distributed as dividend to the shareholders under section 115-O of the ITA @ 20.36%. The said dividend would not be taxable in the hands of the shareholders. However, if the dividend amount exceeds 10 lakh INR, then 10% additional tax is payable by the resident (non-company) shareholder on such dividend.	An LLP is not required to pay DDT on profits distributed to its members. The said distribution of profits would not be taxable in the hands of the members of the LLP. However, imposition of DDT in the future cannot be predicted.
Others	It is possible to convert a company into an LLP in a tax neutral manner assuming conditions under the ITA are satisfied. The key conditions are mentioned below: • Total sales, turnover or gross receipts of the company in any of the previous 3 years does not exceed 60 lakh INR; • Total value of assets of the company in any of the previous 3 years does not exceed 5 crore INR	It is possible to convert an LLP into a company in a tax neutral manner assuming the conditions under the ITA are satisfied. The key conditions are mentioned below: • Shareholders holding at least 50% of LLP interest to continue to be shareholders of the company for a period of 5 years post conversion

^Plus applicable surcharge and cess

II. JV in existing SPVs:



Under this structure, the investor(s) would infuse funds into an existing SPV of the developer containing the real estate project. Alternatively, the investor(s) may purchase shares from the developer or existing investor(s) by way of secondary sale. Similar to the 'pooling of resources' structure above, the developer and investor would enter into a JV agreement to record the rights and obligations of the parties.

There are various tax and regulatory implications to be kept in mind by both the parties while entering into such a structure. The key tax and regulatory implications are given below.

A. In the hands of the developer

1. Direct tax

1.1. In case the real estate project is already set up in a separate SPV and the investor is infusing the funds in the existing entity, there shall be no tax implications in the hands of the developer.

1.2. Transfer of shares by developers/existing investor(s) to new investors

Transfer of shares by developers/existing investors shall attract capital gains tax depending on the period of holding at the following rates:

Particulars	LTCG (held for more than 24 months)	STCG (held for less than 24 months)
Resident	20%^	30%^
Non resident	10%^#	40%^

^Plus applicable surcharge and cess
#without benefit of indexation

Indexation benefit shall be available in the hands of the resident developer/investor while computing capital gains on the transfer of a long-term capital asset.

Further, while executing transfer of shares, provisions of Section 50CA should be analysed. Section 50CA of ITA provides that where a person transfers shares of a company other than the quoted shares at a value lower than the FMV, then such FMV shall be deemed to be consideration for such transfer and the developer/existing investors shall be liable to pay tax based on the FMV on such transfer. The final rules to determine the FMV of shares is yet to be notified. As per the draft rules released, the computation of the FMV of the shares of a company would include the stamp duty value of immovable property in a company and not the book value as recorded in the books of accounts.

In case a JV entity is incorporated as an LLP, the developer/existing investor may transfer his LLP interest or withdraw part capital to arrive at a pre-determined ratio. While withdrawal of capital in the form of cash may not have any tax implications (depending on facts), transfer of LLP interest shall be taxed as capital gains at the following rates:

Particulars	LTCG (held for more than 36 months)	STCG (held for less than 36 months)
Resident	20%^	30%^
Non resident	20%^	40%^

^Plus applicable surcharge and cess

2. Stamp duty implications

2.1. In case the real estate project is already set up in a separate SPV and the investor is infusing funds in the existing entity, there shall be no stamp duty implications for the developer.

2.2. Transfer of shares by the developer/existing investor to the new investor(s) shall be subject to stamp duty at the rate of 0.25% on the market value of shares. However, where the shares are held in dematerialised form, there shall be no stamp duty on transfer of shares.

B. In the hands of the investor/JV entity

1. Direct tax

1.1. Issue of shares/transfer of shares to new investor(s)

As discussed earlier, the provisions of section 56(2)(viib) and 56(2)(x) should be analysed to determine the tax implications in the hands of the investor and JV entity on issue of shares. Further, section 56(2)(x) needs to be analysed on transfer of shares also.

In case the JV entity is incorporated as an LLP, no implications would arise under section 56(2)(viib) and 56(2)(x), as stated above.

Tax implications on exit by the investor are covered separately (refer to the chapter on 'Funding options').

2. Stamp duty implications

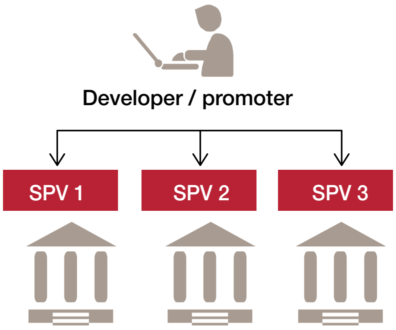
2.1. Issue of shares to the investor(s) shall be subject to stamp duty at the rate prescribed in the stamp duty law of the state in which the registered office of the JV entity is situated. Generally, stamp duty @ 0.1% of fair value of shares is payable in most of the states.

3. FEMA regulations

3.1. The implications under FEMA regulations will remain the same, as mentioned in the section on JVs

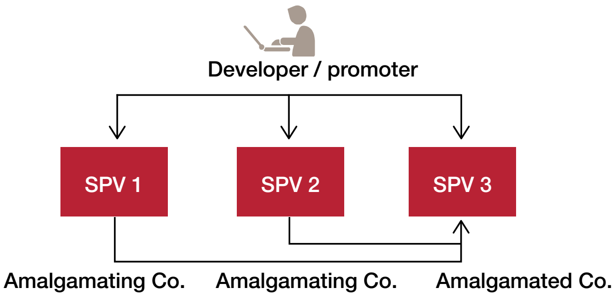
Case study

A. Investment for multiple projects



A developer has multiple projects in India in separate entities. The developer is looking for an investor to invest in all its projects. Typically, investors would not prefer to invest into separate SPVs and would want a single company holding all the projects. The developer may consider the following options for consolidating its projects into a single entity.

1. Option 1: Merger of all entities

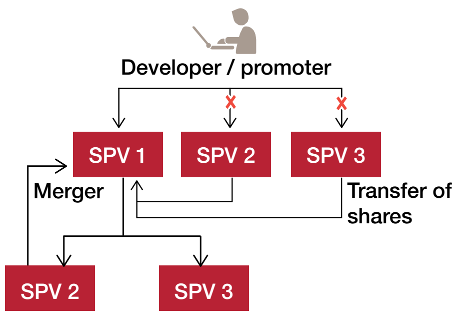


Key points for consideration:

- No adverse tax implications on merger assuming conditions mentioned in the ITA are satisfied
- The stamp duty would be payable on merger
- Approval required from the NCLT and other regulatory authorities

The detailed implications of merger are covered separately (refer to the chapter on 'Internal restructuring').

2. Option 2: Transfer of shares followed by merger



Key mechanics:

- Developer to transfer shares of SPV 2 and SPV 3 to SPV 1
- SPV 2 and SPV 3 to be merged with SPV 1 through an NCLT-approved scheme of amalgamation

Key points for consideration:

- Transfer of shares would be subject to capital gains in the hands of the developer/promoter (depending on period of holding).
- Transfer of shares should be undertaken at a value not lower than the FMV as per section 56(2)(x)/50CA of the ITA.
- No adverse tax implications on merger assuming conditions mentioned in the ITA are satisfied.
- No stamp duty would be payable on the merger of a wholly owned subsidiary with a holding company where the registered offices of the SPVs and immovable properties are located in the state of Maharashtra. (Stamp duty will be payable in other states)
- Approval required from the NCLT and other regulatory authorities.

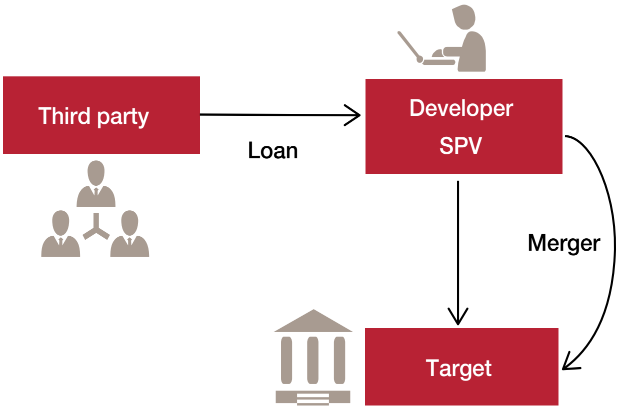
The detailed implications of merger are covered separately in the chapter titled 'Internal restructuring'.

Case study

B. Debt financing

A Developer is looking for debt financing to purchase an entity (having a real estate project) in India. It would be preferable for the developer to have the loan at the entity level so as to make it easier to service the interest on loan and repayment. It should be noted that a loan from a bank cannot be availed of for the acquisition of shares in India. However, it is possible to avail of a loan from an NBFC or other category of lenders for such acquisition.

Keeping the said objective in mind, the following structure may be considered by the developer:



Key mechanics:

- Developer SPV to obtain a loan from a third party
- Developer SPV to use the loan funds to purchase the shares of the target (having the real estate project)
- Developer SPV to be merged with the target through an NCLT-approved scheme of amalgamation

Key points for consideration:

- No adverse tax implications u/s 56(2)(x) in the hands of the developer SPV since typically the transaction value would be more than the FMV as defined under the said section.
- No adverse tax implications on merger assuming the conditions mentioned in the ITA are satisfied.
- Till the time the merger is not completed, there may be a risk of disallowance of interest under section 14A of the ITA.
- Post merger, the SPV may be able to claim interest expense on a third-party loan as a deduction while computing taxable income. (This may vary depending on the facts and circumstances of each case and has been subject matter of litigation in the past.)
- There should be nominal stamp duty payable on merger.
- Third-party loan will move to the target pursuant to merger.

Development agreement

A development agreement may be defined as an agreement between two or more developers or between a developer and a landowner to construct or develop a real estate project. The agreement, depending on the commercial circumstances, would typically include compensation in the form of revenue sharing or profit sharing, either in the form of cash or a share in built-up area or both. Generally, development agreements may be classified into two subheads:

1. JDA; and
2. Co-development agreement

I. JDA

Under a JDA, the landowner enters into an agreement (registered/unregistered) with a developer to develop a project along with a power of attorney providing the developer with rights such as development rights, rights to obtain necessary approvals and creating charge on land. In lieu of such development rights, the landowner is compensated in any of the following manner:

- Fixed consideration; or
- Fixed built-up area; or
- Percentage of total realisation

The role of the landowner is restricted to providing the developer with development rights and the landowner would generally not participate in the construction or development of property. The key tax and regulatory implications are discussed below.

1. Direct tax

There are certain typical tax challenges with respect to a JDA transaction, such as point of taxation of transfer and consideration for such transfer. The tax issues differ where the asset is held as a capital asset or as stock in trade. These differences are discussed in detail below.

1.1. Land held as capital asset

a) Point of taxation: What is the issue?

Section 2(47) of the ITA inter alia includes any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882. Under a JDA, the landowner parts with the possession of the land in lieu of certain built-up area or cash consideration or combination of both.

There have been various decisions of high courts and tribunals which concluded that capital gains may be chargeable in the year of execution of the JDA, where all the material rights and interest in the property coupled with possession were transferred to the developer. This caused unnecessary hardship to landowners as they were liable to pay taxes in the year of signing the JDA on notional gains when the actual consideration would be received in the year the project was completed.

Amendment by the Finance Act, 2017:

The Finance Act, 2017, has introduced sub-section (5A) to section 45, which states that where an individual or HUF transfers a capital asset, being land or building, to a developer under a JDA with consideration to be received as a share in built-up area with or without cash payment, then it shall be deemed that transfer of capital asset arises in the year in which the completion certificate is issued by the authority for the project.

However, where such individual or HUF transfers his share in the project before its completion, then the capital gains shall arise in the year of such transfer.

This amendment has provided relief to all landowners who were deeply aggrieved with this issue. However, this clarification has only been given for landowners who are individuals or HUFs and not for any other entity. Thus, it may be implied that where a company or partnership firm or LLP, being a landowner, enters into a JDA, the transfer may be taxable in the year of signing of the JDA. However, it should be noted that the point of taxation may be shifted to the year of completion where there is a separation of responsibilities between the developer and landowner with respect to the project. This shall, however, depend on the facts and circumstances in each case.

b) Value of consideration: What is the issue?

The other issue which arises concerns the total value of consideration for calculating the capital gains in the hands of the landowner where the landowner receives a share in the built-up area as consideration for the JDA.

Amendment by the Finance Act, 2017:

The Finance Act, 2017, has introduced sub-section (5A) to section 45, which states that where an individual or HUF transfers a capital asset, being land or building, to a developer under a JDA and the consideration is to be received as a share in built-up area with or without cash payment, then the total consideration shall be deemed to be the stamp duty value of a share in the project at the time of completion as increased by any additional cash received from the developer.

This clarification has only been given for landowners who are individuals or HUF and not for any other entity. However, even though there is no clarity in this matter, it may be implied that the value of consideration for the JDA for other assessees may also be calculated using the above-method mentioned.

With the above amendments to the Finance Act, 2017, the government has tried to resolve the long-pending tax issues relating to JDAs. However, why the benefit of these amendments is restricted to only individuals and HUF remains a mystery.

1.2. Land held as stock in trade

If the land is held as stock in trade by the owner, provisions of capital gains are not attracted. Accordingly, following various judicial pronouncements, subject to facts, it may be concluded that income arising from a JDA is taxable based on the accrual concept as 'business income'. It must be noted that amendments made to the Finance Act, 2017, shall not apply to land held as stock in trade.

2. Indirect tax

Applicability of indirect tax on construction-related activities has been a matter of dispute for a long time. Applicability of VAT or service tax and applicability of the law itself have been a regular topic of discussion before the courts.

VAT/service tax

Under the erstwhile law, ordinarily, on sale of units by the JV to end customers, VAT and service tax were payable. The taxes applied, so long as the units were under construction, i.e. prior to the issuance of the completion certificate. Under the service tax law, service tax applied @ 4.5% of the transaction value. While opting for the rate of 4.5%, the builder/developer could avail of input tax credit of the taxes paid on input services or capital goods.

Under the VAT laws, the rates varied from state to state. Further, there were numerous options for discharge of VAT in each state. In our experience, in the state of Maharashtra, mostly VAT @ 1% was levied on the transaction value. The rate of 1% VAT could be opted subject to the seller not availing of any input tax credit benefit.

Further, under a JDA, the service tax authorities had issued a few circulars clarifying that the coming together of two parties to construct a project brings into existence a UJV, which would be treated as a person different from the developer and investor. Accordingly, transactions between the UJV and developer/investor would also be taxable. This aspect had also been disputed (whether the UJV is rendering any service to the developer/Investor) and the matter is pending at various levels of litigation forums.

GST

Similarly, under the GST regime, supply of units by a builder, developer, etc., to the end customer shall be liable to GST. The applicable rate is 12% and the builder/developer can avail of input tax credit of the taxes paid on all procurements. As regards the taxability of JDA transactions under GST, the law is not clear; however, the same position as under service tax, could continue. Since GST is a new law, clarity is awaited on numerous aspects.

3. Stamp duty implications

Stamp duty shall be payable on entering into a JDA at the applicable rates, as mentioned in the stamp duty law of the respective state where the properties are located. An indicative stamp duty rate on JDAs in various states is given below:

State	Entry
Maharashtra	• 5% of the market value of property
Gujarat	• 3.5% of the market value of property
Delhi	No specific entry. There are two views possible: View 1 • No stamp duty on JDA View 2 • Stamp duty payable @ 6% of the market value of property under the article of 'Conveyance'
Karnataka	• 2% of the market value of undivided portion, consideration or money advanced (includes security deposit being refundable)

4. FEMA regulations:

As per FEMA regulations, a non-resident would not be able to become a party to a JDA. However, a non-resident may set up a company in India and such company may enter into a JDA, subject to the conditions (refer to the section on JVs).

II. *Co-development agreement*

Under a co-development agreement, one developer, who possesses land, enters into an agreement with another developer to jointly develop a property without creating a separate legal entity The agreement would distinguish the roles and responsibilities of the developers engaged in developing the project while further stipulating the duties of insurance, cash flow, books and accounts, etc. The revenues from such an agreement are jointly shared between both parties, though the manner of compensation shall differ from case to case. The various tax and regulatory implications are given below.

1. Direct tax

1.1. There is a risk of a co-development agreement being treated as an AOP. The definition of an AOP and the tax implications of the same are discussed below.

1.2. What is an AOP?

Under the provisions of income tax, when an unregistered entity or an unincorporated entity is engaged in business or profession, then the deeming fictions of law relating to AOP apply. An AOP is a deemed form of entity under the ITA where two or more persons join for a common purpose. An AOP, even though included as a separate taxable entity, has not been defined under the ITA. Therefore, in order to understand the meaning of an AOP, we must look at various judicial decisions in the past. A prominent Delhi High Court decision[2] states that an AOP must exhibit the following essential features:

a. It must be constituted by two or more persons;

b. The constituent members must have come together for a common purpose;

c. The association must move by common action and there must be some scheme of common management; and

d. The cooperation and association amongst the constituent members must not be perfunctory and/or merely in form. The association amongst members must be real and substantial enough for the association to be treated as a separate homogenous taxable entity.

Thus, since the definition of an AOP is quite subjective, it is important to analyse the facts and the transaction structure of each real estate project to analyse whether an AOP is created or not.

1.3. Tax implications of an AOP

Where an arrangement is considered as an AOP, the tax implications would be as under:

The taxable rates for an AOP differ under the two scenarios, as given below:

a) Shares of the members of the AOP are known

Particulars	Tax rates
Income of all members does not exceed the basic exemption limit	• Tax at normal slab rates in the hands of the AOP • Share of income from the AOP to be included in the total income of the member only for rate purposes – member entitled to rebate of tax on the entire share of income
Income of any member exceeds the basic exemption limit	• Tax at MMR in the hands of the AOP • Share of income from the AOP exempt in the hands of members
If a member is a foreign entity	• Share of foreign member taxed at 40%# and the rest of the income taxed at MMR* in the hands of the AOP • Share of income of the AOP to be exempt in the hands of members

**MMR: 30% plus applicable surcharge and education cess*
 # Plus applicable surcharge and education cess

2 *Linde A.G. vs DDIT*

b) Shares of the members of the AOP are unknown

Particulars	Tax rates
No member is a foreign entity	• Tax at MMR* in the hands of the AOP • Share of income of the AOP exempt in the hands of members
If a member is a foreign entity	• Total income taxed at 40%# in the hands of the AOP • Share of income of the AOP to be exempt in hands of members

**MMR: 30% plus applicable surcharge and education cess*
 # Plus applicable surcharge and education cess

The computation of the income of an AOP would be done as per the normal methodology under the ITA. However, certain expenses are not tax deductible under section 40(ba) of the ITA:-

- Interest[3] paid by the AOP to its members (as reduced by any interest paid by the member to the AOP); and
- Salary, bonus, commission, remuneration paid by the AOP to its members.

1.4. MAT/ AMT

Section 115JB of the ITA was amended vide the Finance Act, 2015, to provide that share of profit from the AOP is to be excluded for the purpose of calculation of MAT in the hands of its members (being a company). Further, even in a case where the member of the AOP is not a company, the share of profit from the AOP shall not be subject to AMT.

2. Indirect tax

The implications are similar to those mentioned above for JDAs.

3. FEMA regulations

As per FEMA regulations, a non-resident would not be able to become a party to a co- development agreement.

3 *Certain exemptions for interest provided in section 40(ba) of the ITA.*

Project management agreement

A project management agreement refers to an agreement entered into by a project manager with a developer to supervise and manage the development of a real estate project. Under this agreement, a project manager typically does not assume any risks and responsibilities of the real estate project and the compensation is not linked with the performance of the project. The key tax and regulatory implications under this arrangement are given below:

1. Direct tax

1.1 The amount received as compensation by the project manager shall be taxable as 'business income' in his hands. Further, the developer should be able to claim such project management fees as a tax deductible expense in its computation of income.

2. Indirect tax

2.1. Under the erstwhile law, the activities of a project management agreement were liable to service tax. The cumulative rate of service tax was 15%. Similarly under the GST regime, a project management agreement would be liable to GST and the applicable rate is 18%.

3. Stamp duty implications

3.1. Stamp duty shall be payable under the article of 'Agreement' in the state in which such agreement is executed.

4. FEMA regulations

4.1. A foreign entity may directly engage in project management activity with a developer in India so long as the foreign entity is not engaged in the construction or development of immovable property.

Bulk purchase of property

Under this arrangement, the developer monetises its investments in under construction/constructed properties by transferring the property to an SPV. Typically, the properties are transferred to an SPV by way of letter of allotment. An investor infuses funds by way of NCDs into such SPV with the redemption being linked to the ultimate sale of the properties by the SPV. The returns on NCD are structured in a manner such that the investor receives a predetermined return till a certain IRR. Post that, the overall returns are shared between the developer and investor. The key tax and regulatory implications under this arrangement are given below.

1. Direct tax

Gains arising on the sale of properties to the SPV shall be taxable as 'business income' in the hands of the developer. Further, there should not be any implications under section 56(2)(x) of the ITA in the hands of the SPV assuming the consideration paid for the transfer is more than or equal to the stamp duty value of the properties.

Typically, gains arising on the ultimate sale of properties by the SPV to the end customers would be taxable as business income in the hands of the SPV. Further, if the property (held as stock in trade) is vacant for a period exceeding one year from the date of completion, the implications of 'deemed let out' under the provisions of the ITA need to be evaluated.

2. Indirect tax

Constructed property

As per the erstwhile law, the transfer of constructed property by the developer to the SPV did not attract any VAT or service tax. This position remains the same under the GST regime.

Under-construction property

VAT/service tax

Under the erstwhile law, ordinarily, on the sale of units by the developer to the JV, VAT and service tax were payable. The taxes applied so long as the units were under construction, i.e. prior to the issuance of the completion certificate. Under the service tax law, service tax applied @ 4.5% of the transaction value. While opting for the rate of 4.5%, the builder/developer could avail of input tax credit of the taxes paid on input services or capital goods.

Under the VAT laws, the rates varied from state to state. Further, there were numerous options for discharge of VAT in each state. In our experience, in the state of Maharashtra, mostly VAT @ 1% was levied on the transaction value. The rate of 1% VAT could be opted subject to the seller not availing of any input tax credit benefit.

GST

Similarly, under GST, supply of units by a builder, developer, etc., to the JV shall be liable to GST. The applicable rate would be 12% and the builder/developer can avail of input tax credit of the taxes paid on all procurements.

3. Stamp duty implications

Stamp duty shall be payable at the time when conveyance is executed on the sale of property. The actual stamp duty cost would depend on the state in which the properties are situated.

4. FEMA regulations

Under FEMA regulations, foreign investors are not allowed to do 'real estate business' in India. However, foreign portfolio investors are allowed to invest funds as listed NCDs in Indian SPVs undertaking bulk purchase of properties through the arrangement mentioned in the case study above. However, a foreign investor cannot invest in unlisted NCDs as the RBI has notified certain end-use restrictions, such as investment in real estate business, capital markets and purchase of land.

Domestic investors are allowed to invest in either listed or unlisted NCDs in Indian SPVs undertaking bulk purchase of properties through the arrangement mentioned in the case study above.

Funding options

Background

Over the last couple of years, the economic landscape of India has been improving and its GDP is forecasted to grow between 6.75% and 7.5% in FY 2017–18. The government has been making a multifaceted effort to increase investments from foreign as well as domestic investors in the real estate sector. Due to the various tax and regulatory reforms, PE, which was at a nascent stage, has turned out to be one of the major sources of funding for the fund-deprived sector.

Typically, a PE investor funds a project or company for 4–5 years and seeks exit thereafter. In the past, equity/CCDs were the preferred mode of investment for PE investors to benefit from higher returns while also being exposed to higher risks. However, due to uncertain market conditions and exit prospects, PE investors suffered dearly in the past. This led to the emergence of structured debt deals which permit PE investors to have security (pledge, mortgage, etc.) over their investments and provide an agreed return depending on the performance of the company. Further, investors may also use ECBs as a mode of investment.

The key characteristics of the funding instruments are given below:

Particulars	Equity	CCD	NCD	ECB
FDI/FIPB approval	Not required			Required in certain cases
End-use restriction	No end-use restriction		• No end-use restriction for listed NCD • For unlisted NCD, certain end-use restrictions have been notified	End-use restrictions apply
Permitted lenders	Not applicable	Not applicable	Investor to be registered as FPI	Eligible lenders specified
Voting rights	Voting rights in proportion to stake held	No voting rights till conversion into equity shares	No voting rights	No voting rights
Return	Dividend	Interest	Interest	Interest
Regulatory ceiling on servicing the instrument	No ceiling on the amount of dividend distributed on equity capital subject to compliance with company law regulations	• SBI rate + 300 basis points • Deduction of interest allowed only up to 30% of EBITDA when paid to AE	• No regulatory cap on interest but subject to transfer pricing, if applicable, and provisions of section 194LD of the ITA • Deduction of interest allowed only up to 30% of EBITDA when paid to AE	• Capped at all in cost defined as per ECB regulations • Deduction of interest allowed only up to 30% of EBITDA when paid to AE
Listing of instrument	Optional	Not possible	Optional	Not possible
Call/put option	Permitted subject to lock in and exit to non-resident without any assured return as per pricing guidelines		Permitted	Not applicable
Exit option	Sale of shares/ buy-back of shares/ capital reduction	Pre-conversion: Sale of CCDs Post-conversion: Same as equity	Sale/redemption of NCDs	Repayment

With the slight revival of the Indian economy and various incentives by the government, it is important to analyse the merits and demerits of these instruments while making an investment. There are various tax and regulatory implications to be kept in mind while doing this analysis.

Equity instruments

Equity shares

1. FEMA regulations

There are no major regulatory hurdles for subscription to equity by domestic investors. The investors and the company should ensure compliance with the Companies Act, 2013, for issue of shares.

As per FEMA and regulations framed thereunder, FDI is not allowed in real estate business. Real estate business has been defined as 'dealing in land and immovable property with a view to earning profit'.

However, Real estate Business does not include the development of townships, construction of residential/ commercial premises, roads or bridges, educational institutions, recreational facilities, city- and regional-level infrastructure, and townships. Also, it also does not include holding a property with a view to earning rental income. Foreign investors have to comply with pricing guidelines and various conditions (refer to the section on JVs) for making an equity investment in India.

2. Direct tax

Repatriation options

Dividend

DDT payable @ 20.36% by the company

Tax @10% in the hands of the domestic investor (not being a company) if dividend exceeds 10 lakh INR

Buy-back

BBT @20% payable by unlisted company

Exempt in the hands of the investor on buy-back by unlisted company

Capital reduction

DDT payable to the extent of accumulated profits

Capital gains payable by investor over and above dividend

2.1. Dividend

Particulars	Implications
In the hands of the company	DDT payable @ 20.36%
In the hands of the investor	**Resident (other than a company)** • Taxable @ 10% plus surcharge and education cess in case the dividend amount exceeds 10 lakh INR u/s 115BBDA of the ITA **Non-resident** • No tax implications

2.2. Buy-back

Key company law conditions:

- Maximum buy-back in 1 year: 25% of net worth
- Debt- equity ratio should not exceed 2:1 post buy-back
- Buy-back subject to further conditions under section 68 of the Companies Act, 2013
- Board of directors' resolution (if up to 10%) and shareholders' resolution (if exceeding 10%) required to be passed

Tax implications shall be as under:

A. In the hands of the company

- Buy-back tax payable by company @ 20%^ under section 115QA of the ITA
- No DDT payable by company under section 115-O of the ITA

^ Plus applicable surcharge and cess

B. In the hands of the investor (resident/ non-resident)

Particulars	Tax rates
LTCG/STCG	Exempt

2.3. Capital reduction

Key company law conditions:

- Approval of the NCLT shall be required
- Approval required from the RD, ROC and creditors
- Capital reduction shall be subject to further conditions under section 66 of the Companies Act, 2013

Tax implications shall be as under:

A. Deemed dividend

Any distribution by a company to its shareholders (to the extent of accumulated profits) on capital reduction shall be treated as dividend. Such income should be exempt in the hands of the shareholder subject to the applicability of section 115BBDA. The tax implications shall be the same as discussed in point 2.1 above.

B. Capital gains

Further, any amount distributed on capital reduction as reduced by the amount assessed as dividend is chargeable as capital gains. Although there is no specific provision governing the same, the view is adopted from prominent judicial pronouncement.[4] Thus, the tax implications shall be as under:

Particulars	**LTCG** (held for more than 24 months)	**STCG** (held for less than 24 months)
Resident	20%^	30%^
Non-resident	10%^#	40%^

^ Plus applicable surcharge and cess

 # Without benefit of indexation

Indexation benefit shall be available to resident investors while computing capital gains on the transfer of a long-term capital asset.

4 *CIT vs G. Narasimhan [1999] 236 ITR 327 (SC)*

Exit

A PE investor(s) can exit from the company prominently by way of IPO or secondary sale. Implications in each case are given below:

<table>
<tr><th>Particulars</th><th>Implications</th></tr>
<tr><td>IPO (offer for sale by a PE investor to public)</td><td>On offer for sale, the shares offered by the promoters/investors shall be liable to securities transaction tax. Against this background, the tax rates would be as under:
• LTCG (shares held for more than 24 months) –
Capital gains shall be taxable at the following rates (subject to treaty benefits):
<table>
<tr><th>Particulars</th><th>Rates</th></tr>
<tr><td>Resident investor</td><td>Exempt*</td></tr>
<tr><td>Non-resident investor</td><td>Exempt *</td></tr>
</table>
• STCG (shares held for less than 24 months) –
Capital gains shall be taxable at the following rates (subject to treaty benefits):
<table>
<tr><th>Particulars</th><th>On the market</th></tr>
<tr><td>Resident investor</td><td>15%*</td></tr>
<tr><td>Non-resident investor</td><td>15%*</td></tr>
</table>
</td></tr>
<tr><td>Secondary sale (sale to another PE investor)</td><td>• Capital gains – unlisted company
<table>
<tr><th>Particulars</th><th>LTCG
(held for more than 24 months)</th><th>STCG
(held for less than 24 months)</th></tr>
<tr><td>Resident</td><td>20%^</td><td>30%^</td></tr>
<tr><td>Non-resident</td><td>10%^#</td><td>40%^</td></tr>
</table>
Indexation benefit shall be available to resident investors while computing capital gains on the transfer of a long-term capital asset.</td></tr>
</table>

** Exemption available if the conditions under section 10(38) of the ITA are satisfied*
^ Plus applicable surcharge and cess
 # Without benefit of indexation

Compulsorily convertible debentures

CCDs are instruments which are to be converted into equity shares after a definite period of time as agreed by the issuer and holders. CCDs carry a rate of interest till the time they are converted into equity shares, but cannot be redeemed.

1. FEMA regulations:

The regulatory implications for issue of CCDs remain the same as those for the issue of equity shares (refer to the section on equity shares) . However, the interest rate may be capped to SBI PLR + 300 basis points.

2. Direct tax:

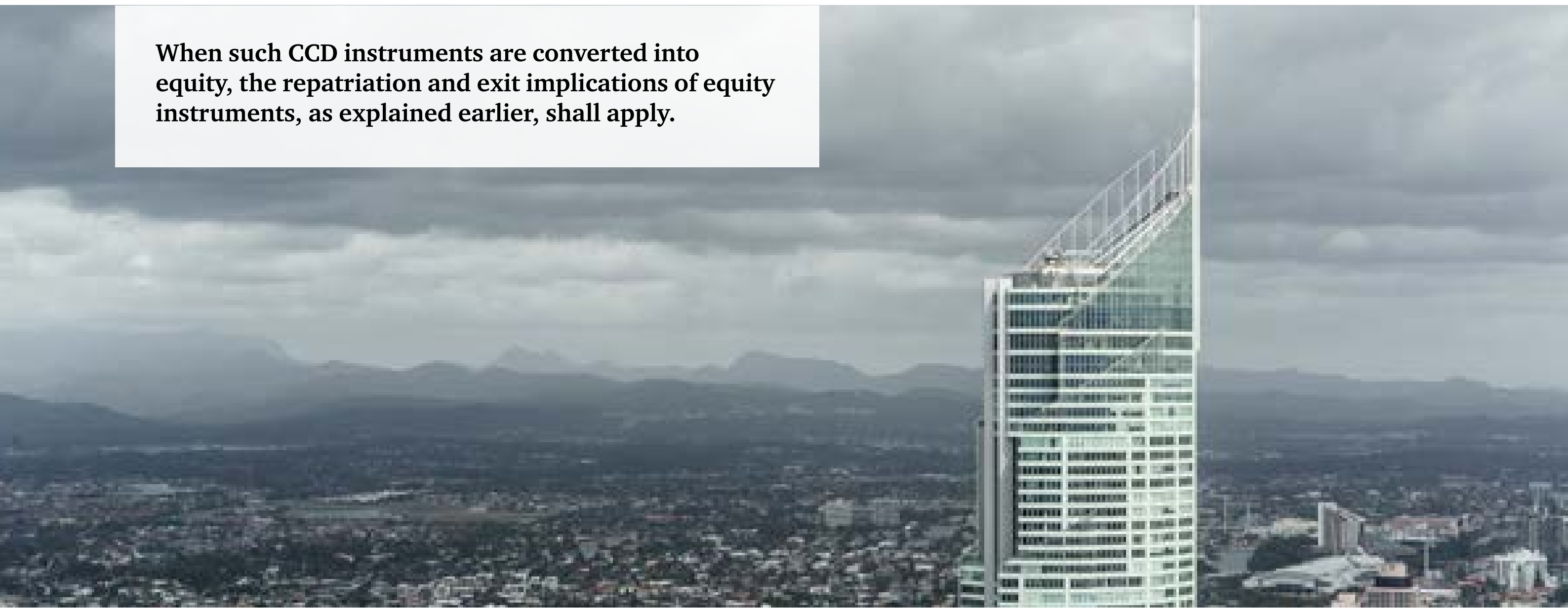
The tax implications of CCD instruments are mentioned below:

Particulars	Implications
Secondary sale (sale to another PE investor)	• **Capital gains – unlisted company** (see table below)
Interest	• Interest paid on CCDs to investors should be available as a tax deductible expense to the company • For interest paid to residents, withholding tax @ 10% by the company • For interest paid up to 30 June 2020 to non-residents, WHT @ 5% under section 194LD subject to fulfilment of conditions • Post 30 June 2020 or non-fulfilment of conditions u/s 194LD, WHT @ 40% for payment to a non-resident (subject to treaty benefits)
Conversion of CCDs into equity	• No capital gains implications on conversion of CCDs into equity shares • The period of holding and cost of acquisition of the CCDs shall become the period of holding and cost of acquisition of the equity shares post conversion

Particulars	LTCG (held for more than 36 months)	STCG (held for less than 36 months)
Resident	20%^	30%^
Non-resident	10%^	40%^

^Plus applicable surcharge and cess

When such CCD instruments are converted into equity, the repatriation and exit implications of equity instruments, as explained earlier, shall apply.



Debt instruments

Nonconvertible debentures

Debt structures are typically funded through listed/unlisted NCDs. Typically, NCDs have a fixed tenure of 3–5 years and carry a coupon payable at regular intervals with a redemption at premium, if any, as per commercial negotiations. Further, NCDs are secured through a pledge/mortgage/charge of assets. The key tax and regulatory implications on listed/unlisted NCDs are given below:

1. FEMA/SEBI regulations:

Non-resident investors need to comply with SEBI (Foreign Portfolio Investment) Regulations, 2014 (FPI Regulations), to invest in debt instruments like listed NCD/unlisted NCD. Accordingly, the non-resident entity must be registered as an FPI in order to subscribe to the listed/unlisted NCDs of an Indian company.

Further, the RBI has notified certain end-use restrictions for funds raised as unlisted NCDs, like investment in real estate business, capital markets and purchase of land.

2. Direct tax

2.1. Interest

Particulars	Implications
In the hands of the company	Interest paid on listed/unlisted NCDs to investors should be available as a tax deductible expense
In the hands of the investor	**Resident** • WHT @ 10% by the company **Non-resident (subject to treaty benefits)** • WHT @ 5% by the company* • WHT @ 20% by the company

*Assuming the conditions mentioned under section 194 LD of the ITA are satisfied

2.2. Exit

As discussed earlier, investor(s) can exit from the company prominently by way of redemption of NCDs and secondary sale. The implications in each case is given below:

<table>
<tr><th>Particulars</th><th>Implications</th></tr>
<tr><td>Redemption of NCDs</td><td>

Redemption of NCDs at par
No tax implications in the hands of resident/non-resident PE investors and company on redemption
Redemption of NCDs at premium:
The premium on redemption of NCDs shall be categorised as interest or capital gains in the hands of PE investors depending on the terms of NCDs and facts of the case.

</td></tr>
<tr><td>Secondary sale (sale to another PE investor)</td><td>

LTCG (debentures held for more than 36 months):
Capital gains shall be taxable at the following rates (subject to treaty benefits):
<table>
<tr><th>Particulars</th><th>Listed NCDs</th><th>Unlisted NCDs</th></tr>
<tr><td>Resident investor</td><td>10%^</td><td>20%^</td></tr>
<tr><td>Non-resident investor</td><td>10%^</td><td>10%^</td></tr>
</table>

STCG (debentures held for less than 36 months):
Capital gains shall be taxable at the following rates (subject to treaty benefits):
<table>
<tr><th>Particulars</th><th>Listed NCDs</th><th>Unlisted NCDs</th></tr>
<tr><td>Resident investor</td><td>30%^</td><td>30%^</td></tr>
<tr><td>Non-resident investor</td><td>40%^</td><td>40%^</td></tr>
</table>

</td></tr>
</table>

^ Plus applicable surcharge and cess

2.3. Thin capitalisation

The interest paid to investors on CCDs/NCDs/ECB should be available as a tax deductible expense to the company. However, the Finance Act, 2017, has introduced the concept of 'thin capitalisation', which limits the amount of tax deduction available on interest paid on any borrowings to specified persons.

As per the new provisions, where an Indian company or permanent establishment of a foreign company borrows from a non-resident who is an AE of such borrower or from a third party with an implicit or explicit guarantee provided by an AE, then the interest or payment of a similar nature (of more than 10 million INR) made on such borrowings shall be capped at 30% of EBITDA.

The definition of AE is provided in section 92 of the ITA. Some of the key parameters are mentioned below:

- One enterprise holds directly or indirectly not less than 26% of the voting power of the reporting entity
- The fellow subsidiary, if the parent enterprise holds not less than 26% of the voting power of such fellow subsidiary
- Loan advanced by one enterprise to the reporting entity constitutes not less than 51% of the book value of assets of such reporting entity
- More than half of the board of directors of the reporting entity or one or more than one executive director is appointed by another enterprise

Where any interest is disallowed owing to the aforementioned provision, such disallowed interest can be carried forward till 8 assessment years and allowed to the extent of 30% of the EBITDA of the year of claim.

An illustration of the thin capitalisation rule is given below:

Particulars	Scenario A	Scenario B	Scenario C
EBITDA (A)	100	100	100
Interest paid to AE (B)	40	40	40
Interest paid to third party (C)	20	50	0
Maximum interest deduction allowable (D = A*30%)	30	30	30
Disallowed interest carried forward [(B + C - D) or B whichever is lower]	**30**	**40**	**10**

The carry forward interest may be set off within the next 8 assessment years subject to the conditions above. An illustration of set-off of interest under Scenario A is given below:

Particulars	Scenario A (Year 5)
EBITDA (A)	200
Interest paid to AE (B)	30
Interest paid to third party (C)	20
Maximum interest deduction allowable (D = A*30%)	60
Disallowed interest carried forward [(B + C - D) or B whichever is lower]	**Nil**
Carry forward interest to set off	**10**
Balance carry forward	**20**

External commercial borrowings

ECBs are commercial loans raised by eligible resident entities from recognised non-resident entities and should conform to the parameters mentioned in the FEMA regulations. The key tax and regulatory implications on ECBs are given below:

1. FEMA regulations

A brief overview of the FEMA regulations relating to ECBs is given below:

Particulars	Regulations
ECB framework	**Framework comprises 3 tracks:** Track I: Medium-term foreign currency denominated ECB with a minimum average maturity of 3/5 years Track II: Long-term foreign currency denominated ECB with a minimum average maturity of 10 years Track III: INR denominated ECB with a minimum average maturity of 3/5 years
Commonly used forms of ECB	i. Loans ii. Securitised instruments (e.g. floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares/debentures); iii. Buyers' credit iv. Suppliers' credit v. Foreign currency convertible bonds vi. Financial lease and vii. Foreign currency exchangeable bonds
Available routes	The first six forms of borrowing mentioned above are allowed under the automatic route or approval route. Foreign currency exchangeable bonds are allowable only under the approval route.
Minimum maturity period	i. Track I: 3 years (ECB up to 50 million USD)/5 years (ECB beyond 50 million USD) ii. Track II: 10 years iii. Track III: Same as Track I
Eligible borrowers (related to real estate)	i. Track I: Companies engaged in the infrastructure sector ii. Track II: REIT iii. Track III: Same as Track I and II
All in cost	i. Track me: Minimum average maturity period 3–5 years – 300 basis points over 6-month LIBOR. Minimum average maturity period beyond 5 years – 450 basis points over 6-month LIBOR ii. Track II: Maximum spread over benchmark 500 basis points. Remaining conditions same as Track I iii. Track III: All in cost to be in line with market conditions
End-use restrictions (related to real estate)	For Tracks I, II and III: ECB cannot be used for real estate activities, investing in capital markets or for purchase of land. However, ECB can be used for the purpose of development of integrated township or affordable housing projects.

NCDs that are subscribed to by FPIs are not subject to the ECB regulations mentioned above.

2. Direct tax

The tax implications on ECBs are mentioned below:

2.1. Interest

Particulars	Implications
In the hands of the company	Interest paid on ECB (loan/debenture) to investors should be available as a tax deductible expense.
In the hands of the investor	**Resident** • WHT @ 10% by the companyy **Non-resident (subject to treaty benefits)** • WHT @ 5% by the company* • WHT @ 20%/40% by the company

**Assuming the conditions mentioned under section 194LC or 194LD of the ITA are satisfied*

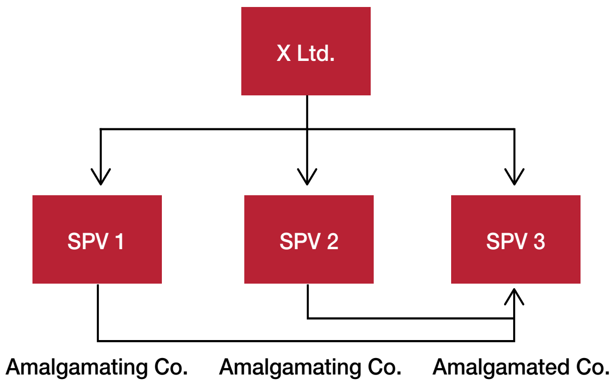
Exit under ECB (being loan/debenture) generally does not invite any tax implications.

Internal restructuring

The corporate structures of real estate developers are highly complex and often consist of various SPVs that hold land parcels. Over a period of time, it becomes increasingly tough to manage such structures owing to administrative and regulatory hassles. Thus, in order to simplify their corporate structures, real estate developers can consider various options to consolidate the entities. The ensuing paragraphs discuss the various tax and regulatory implications on two consolidation options, namely (a) merger and (b) demerger

I. Merger of group entities

A vanilla merger, wherein two or more entities are combined into one, is one of the simplest options for consolidating group companies. In India, a merger requires the approval of the NCLT and certain other regulatory authorities such as the RD and ROC. It is a tax-neutral transaction if certain conditions mentioned in the ITA are complied with. A pictorial representation of the transaction is given below.



The conditions for a merger to be tax neutral are given below:

- All the properties of amalgamating companies become the property of the amalgamated company.
- All the liabilities of amalgamating companies become the liabilities of the amalgamated company.
- Shareholders who hold not less than three-fourths in value of shares in amalgamating companies become shareholders in the amalgamated company (except where shares are held by the amalgamated company itself or through its nominee or its subsidiaries).

1. Direct tax

1.1. The key tax implications on mergers are given below:

Particulars	Implications
Capital gains	Tax impact in the hands of: • Amalgamating company As per section 47(vi) of the ITA, the transfer of capital assets by an amalgamating company is exempt from capital gains. • Shareholders As per section 47(vii) of the ITA, the exchange of shares of an amalgamating company for an amalgamated company by shareholders is also exempt.
Section 56	Implications under section 56(2)(viib) should be considered while issuing shares on mergers.
Cost of assets in the hands of an amalgamated company	Tax written down value is in the hands of an amalgamating company.
Brought forward losses/ unabsorbed depreciation of amalgamating companies	Brought forward losses shall not be available in the hands of an amalgamated company as 'real estate' would not be considered as an 'industrial undertaking' under section 72A of the ITA.

2. Indirect tax

Under the erstwhile indirect tax law, there were no implications under VAT/service tax on mergers. Similarly, under the GST regime, no GST shall be payable on mergers, assuming that the business is transferred as a 'going concern'.

3. Regulatory approvals

The scheme of amalgamation shall be filed under section 230–232 of the Companies Act, 2013, and requires the approval of the NCLT. Further, there are certain other regulatory approvals required which are mentioned below.

Approvals from other regulators:

- Approvals shall also be sought from the ROC, RD, OL and income tax authorities.
- In case of listed companies or NBFCs, the approval of SEBI and the RBI (as may be applicable) shall be sought.

Time frame:

- Listed companies: 7–9 months
- Unlisted companies: 5–6 months

4. Stamp duty implications

A merger will be subject to stamp duty in India. Stamp duty is payable on the NCLT order approving the merger in the state where the registered offices of the companies are situated. A majority of state stamp duty laws have specific entries[5] for mergers.

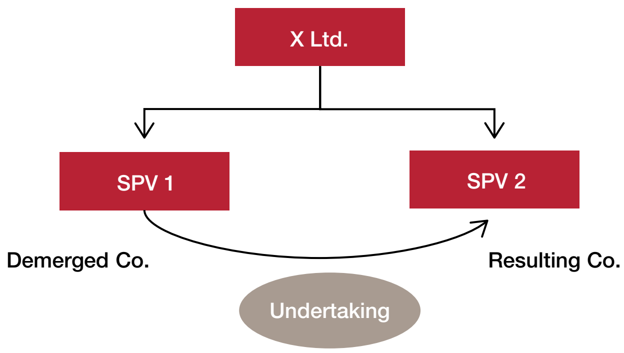
Further, stamp duty shall also be payable on any immovable properties that are transferred pursuant to the merger.

The stamp duty entries on mergers in a few states are given below.

State	Entry
Maharashtra	Subject to a maximum of 10% of the market value of shares allotted as consideration, the stamp duty shall be the higher of: • 5% of market value of the immovable property located within the state of Maharashtra of the transferor company; or • 0.7% of the market value of shares allotted as consideration, subject to a maximum of 25 crore INR The following points are to be noted: • Mergers of wholly owned subsidiaries with a holding company may not attract stamp duty as no consideration is paid in Maharashtra. • Where the net asset value of the company is nominal but the fair value of immovable property is significant, for internal restructuring purpose, stamp duty costs may be capped at 10% of the value of shares issued based on nominal NAV in Maharashtra.
Gujarat	The stamp duty shall be the higher of: • 1% of market value of the immovable property located within the state of Gujarat of the transferor company; or • 1% of the fair value of shares allotted as consideration, subject to a maximum of 25 crore INR
Delhi	7% of consideration issued
Karnataka	The stamp duty shall be the higher of: • 3% of the market value of the property; or • 1% of the consideration issued (including shares cancelled)
Tamil Nadu	The entry for merger/demerger has been included in the amendment to the Tamil Nadu Stamp Act, 2013. However, such a notification has not yet been made effective. The notification has the following entry: • 2% of the market value of immovable property; or • 0.6% of the consideration, whichever is higher Accordingly, the following two views on stamp duty on merger/demerger may be taken: View 1: Stamp duty payable @ 6% of the market value of the immovable property under the 'conveyance' article. View 2: No stamp duty would be payable on merger/demerger.

II. Demerger of undertakings from group entities

Demerger refers to the segregating of business/divisions of a company. Typically, where there are two or more than two divisions/undertakings, the company segregates one or more divisions by way of a demerger to another company. This helps in the segregation of a businesses in a tax-efficient manner. The demerger process in India requires the approval of the NCLT and certain other regulatory authorities such as the RD and ROC. A pictorial representation of the transaction is given below:



5 *Where the specific entry for levying stamp duty on merger is not provided, stamp duty may be paid under the entry of conveyance as per judicial pronouncements.*

The conditions for a demerger to be tax neutral are given below:

- All the properties of the undertaking of a demerged company are transferred to the resulting company.
- All the liabilities of the undertaking of a demerged company become the liabilities of the resulting company.
- Assets and liabilities forming a part of the undertaking are transferred at book value.
- The transfer is on a going-concern basis.
- Shareholders who hold not less than three-fourths in value of shares in a demerged company become shareholders in the resulting company (except for the situation where shares are held by the amalgamated company itself or through its nominee or subsidiaries).

1. Direct tax

1.1. The key tax implications on demergers are given below:

Particulars	Implications
Capital gains	Tax impact in the hands of: **Demerged company** • As per section 47(vib), the transfer of capital assets by a demerged company is exempt from capital gains. **Resulting company** • As per section 47(vid) of the ITA, the transfer or issue of shares by the resulting company to the shareholders is also exempt.
Section 56	Implications under section 56(2)(viib) should be considered while issuing shares on demergers.
Cost of assets in the hands of the resulting company	Tax written down value is in the hands of the demerged company.
Brought forward losses/unabsorbed depreciation of the demerged company	Can be carried forward by the resulting company in relation to transferred business undertakings.

2. Indirect tax

Under the erstwhile indirect tax law, there were no implications under VAT/service tax on demerger. Similarly, under the GST regime, no GST shall be payable on demergers, assuming the business is transferred as a 'going concern'.

3. Regulatory approvals

The regulatory approvals required for a demerger are similar to the approvals required for a merger, as mentioned above. However, no approval is required from the OL for demerger.

4. Stamp duty implications

A demerger will be subject to stamp duty in India. Stamp duty is payable on the NCLT order approving the demerger in the state where the registered offices of the companies are situated. A majority of state stamp duty laws have specific entries[6] for demergers.

Further, stamp duty shall also be payable on any immovable properties that are transferred pursuant to a demerger.

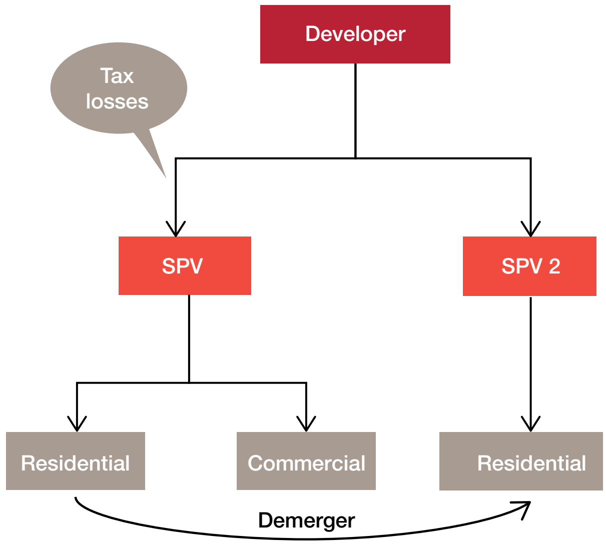
The stamp duty entries on a demerger are similar to the entries on a merger, as mentioned above.

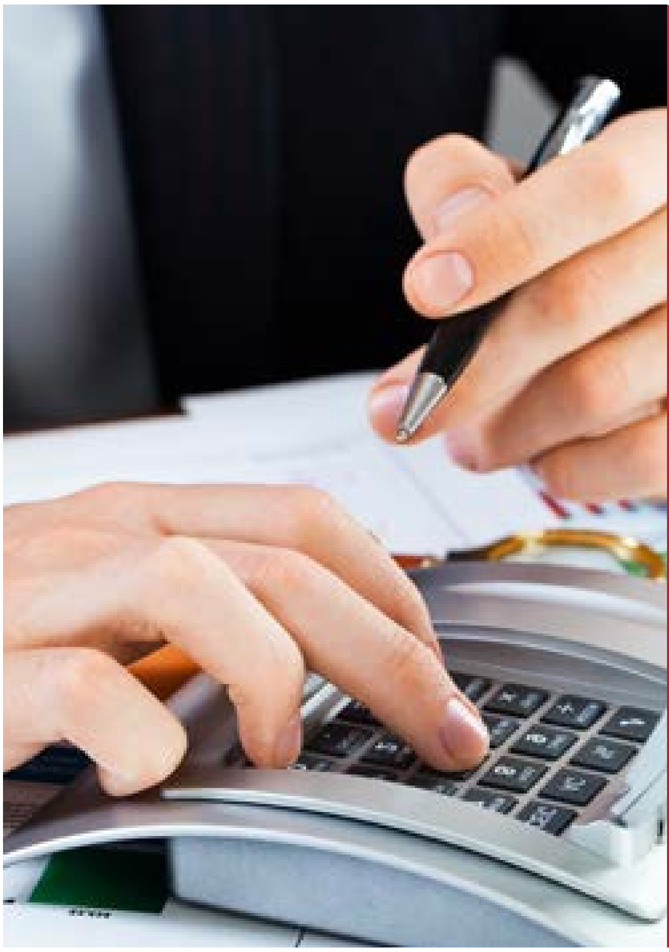
6 *Where the specific entry for levying stamp duty on demerger is not provided, stamp duty may be paid under the entry of conveyance as per judicial pronouncements.*

Case study

A developer has a commercial and a residential real estate project in an existing SPV. However, the said SPV has substantial tax losses pertaining to its residential projects. The developer is looking for an investor in its residential projects portfolio.

Keeping in mind the said objective, the following structure can be considered by the developer:





Key mechanics:

- *SPV to demerge its 'residential business' into SPV 2 through an NCLT-approved scheme of arrangement*

Key points for consideration:

- *There are no adverse tax implications on the demerger, assuming that the conditions mentioned in the ITA are satisfied.*
- *Stamp duty is payable on the demerger.*
- *Approvals are required from the NCLT and other regulatory authorities.*
- *Tax losses pertaining to the residential project are to be transferred to SPV 2 on demerger (as per section 72A of the ITA). The benefit of the same can be availed of by SPV 2 and the same needs to be commercially discussed with the investor while finalising the valuation of SPV 2.*

Affordable housing

'Affordable housing' refers to the development of household units to address the housing needs of low- and middle-income households. The government has devised various policy initiatives and tax exemptions in this regard, which are in line with its vision of 'Housing for All by 2022'. Further, in a major relief to the housing sector, Finance Minister Arun Jaitley accorded 'infrastructure' status to affordable housing, providing a much-needed thrust to the sector. This section discusses the benefits of the government's policy and tax incentives.

Key highlights

I. Lower interest rates and multiple funding options

Conferring 'infrastructure' status on the affordable housing segment will make borrowing for projects easier as it will now permit longer tenure of loans, lower interest rates and better terms. This will help in reducing developers' costs of borrowing, which in turn will help in bringing down the cost of housing. This new status will also open up many funding options by potentially allowing insurance companies, pension funds and other sovereign funds to invest in the sector. Moreover, ECBs will be available. Further, the 'infrastructure' status will simplify the approval process for affordable projects, create clear guidelines and increase transparency in the affordable housing segment.

II. Tax incentives

In a bid to provide impetus to affordable housing, the Finance Minister introduced section 80-IBA in the Finance Act, 2016, which provides a profit-linked tax exemption. The section provides 100% tax exemption on the profits earned on an affordable housing project, subject to certain conditions. The regulations or conditions governing the exemption were further relaxed through the Finance Act, 2017.

The key regulations for claiming tax exemption under section 80-IBA of the ITA are as under:

Sr. no.	Particulars	Conditions
1	Project approval by a competent authority	After 1 June 2016 and before 31 March 2019
2	Project completion	Within 5 years from the date of approval
3	Size of a plot of land	• Not less than 1,000 sq. m in cities such as Delhi, Mumbai, Chennai and Kolkata or a place located within 25 km (measured aerially) from the municipal limits of the above cities • Not less than 2,000 sq. m in any other place
4	Carpet area of a residential unit	• Does not exceed 30 sq. m in cities such as Delhi, Mumbai, Chennai and Kolkata or a place located within 25 km (measured aerially) from the municipal limits of the above cities • Does not exceed 60 sq. m in any other place
5	Utilisation of the floor area ratio	• Not less than 90% in cities such as Delhi, Mumbai, Chennai and Kolkata or a place located within 25 km (measured aerially) from the municipal limits of the above cities • Not less than 80% in any other place

While a tax incentive has been provided by means of a tax holiday, a company will still have to pay MAT @ 18.5% (plus applicable surcharges and cess).

Further, when an LLP undertakes an affordable housing project, they will also be liable to pay AMT @ 18.5% (plus applicable surcharges and cess). AMT is payable by an LLP if:

- Profit-linked deduction is claimed under section 80-IA–80-RRB or 10AA; or
- Deduction is claimed under section 35AD

In this scenario, entities may consider combining the affordable housing project with other non-tax holiday projects to minimise the impact of MAT/AMT.

Case study

A developer is looking to start an affordable housing project in India. The developer is already carrying out real estate construction activities through an existing SPV, but wants to decide whether to start the affordable housing project in a new SPV or in the existing SPV.

As discussed above, the income from an affordable housing project will be exempt under normal income tax provisions on account of the specific exemption provided in the ITA (subject to compliance of certain conditions). However, a new SPV shall be liable to pay MAT @ 18.5% (plus applicable surcharges and cess) on the book profits.

Thus, an affordable housing project started through an existing SPV (having taxable profits) will be liable to lower tax outflows on account of MAT on the income of the affordable housing project. This is further explained with an example.

Particulars	Scenario 1: Affordable housing project through a new SPV and existing SPV continued for other projects	Scenario 2: Affordable housing project through an existing SPV
Taxable profits (assumed)		
• Affordable housing (exempt from normal tax)	20	20
• Other projects	100	100
Taxable profits		
• New SPV (MAT @ 20%^) **(A)**	4	NA
• Existing SPV (normal tax @ 30%^ or MAT @ 20%^, whichever is higher) **(B)**	30 (normal tax)	30 (normal tax)
Total tax	34	30

^ Plus applicable surcharges and cess

Real estate investment trust

A REIT is an investment platform for small investors and a breather to entities engaged in the sector. Against this backdrop, SEBI had introduced REIT as a platform for trading.

A. What is a REIT?

In common parlance, a REIT is a SEBI-registered investment vehicle that owns and operates infrastructure/real estate assets and allows institutional/retail investors to earn stable, low-risk income generated through ownership of commercial/retail real estate.

B. What's in it for developers/sponsors?

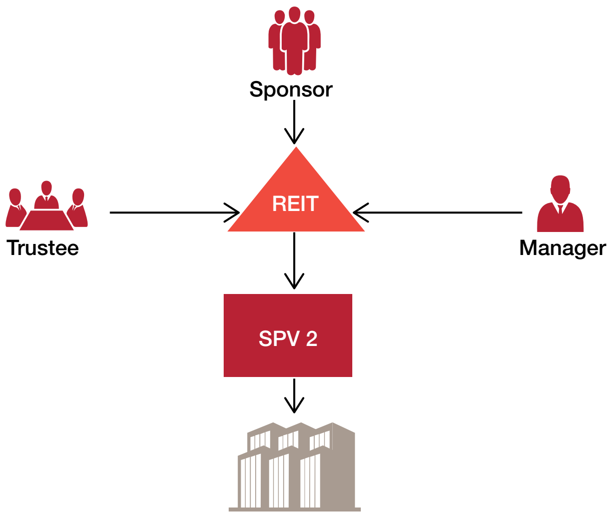
A sponsor/developer is required to swap his properties/assets or holdings in SPVs, holding the assets to a REIT in consideration of the units of the REIT. These units are to be offered to the public, generating liquidity for the sponsors/developers. The REIT model provides an opportunity to monetise existing assets and reduce debt.

C. What's in it for investors?

Globally, REITs have been key drivers for development in real estate as they provide an investment platform to retail and institutional investors.

Since the platform is regulated, it reduces the inherent risks and gives investors opportunities to invest in stable return-generating instruments with low risk to capital. A REIT, being a listed platform, provides an easy entry and exit to new as well as existing investors.

D. Typical REIT structure:



A brief description of the parties involved in a REIT structure is given below:

- **Sponsor:** A sponsor is akin to a promoter in an IPO. Typically, a sponsor is a developer who owns real estate and the one who sets up a REIT.
- **Trustee:** A trustee is an independent person who manages a REIT on behalf of a unitholder, in accordance with SEBI regulations.
- **Manager:** A manager is an entity who manages the assets and investments of a REIT and undertakes operational activities for them.

E. Regulatory implications

REITs are governed by SEBI regulations. The SEBI regulations governing REITs are given below.

Particulars	Regulations
Key investment conditions	**Asset-related conditions** • At least 80% of the value of a REIT is to be in completed and rent-generating real estate, with a lock-in period of 3 years from the purchase date. • A maximum of 20% of the total value of REITs can be from: – Under construction properties with a lock-in period of 3 years after completion (sub-cap of 10%) – Listed or unlisted debt of real estate companies – Mortgage-backed securities – Equity of listed companies in India, generating at least 75% of their income from real estate activities – Government securities – Unutilised FSI and TDR with respect to existing investments – Cash or money market instruments **Additional conditions** • A minimum of two projects to be held by a REIT with an investment cap of 60% for a single project • Direct holding of real estate assets in India or through an SPV • Investment not permitted in vacant land, mortgages or agricultural land (with certain exceptions) • At least 75% of the revenue to be from rental or leasing of assets, or incidental revenue • Investment in another REIT or lending not permitted • Unitholders' approval required for disposal of a REIT's assets or interest in an SPV if it exceeds 10% of the value of the assets in a financial year
Distribution policy	• A minimum of 90% of the net distributable cash flow of a REIT • Distribution to be undertaken at least once every six months • At least 90% of sale proceeds to be distributed unless reinvestment is proposed
Public offer	• Minimum value of REIT assets: 500 crore INR • Minimum public float: 25% • Minimum offer size: 250 crore INR • Minimum subscription amount: 2 lakh INR per applicant • Trading lot: 1 lakh INR • Minimum number of subscribers: 200
Sponsor holdings	• Minimum post-IPO holding of at least 25% – Three-year lock-in period of 25% for a post-IPO holding – One-year lock-in period for the balance for a post-IPO holding • Sponsors' consolidated holding of at least 15% • Divestment of 15% continued holding subject to the following: – Completion of a three-year lock-in period from the listing date; and – Another sponsor acquiring the minimum holding with the prior approval of unitholders

F. Tax implications

With the advent of REITs in Indian stock markets, the government recently introduced various income tax measures to ensure that REIT regulations are at par with world standards and that there are effective REIT listings in India. A brief overview of the tax incidence in the hands of various parties involved is as follows:

1. In the hands of the sponsor/developer (on the set-up of a REIT)

Particulars	Regulations
Swap of shares of companies (holding assets) to a REIT	Capital gains shall be exempt. Also, MAT is not applicable during the year of the swap.
Swap of assets to a REIT	Taxable

2. In the hands of the REIT

Income stream	From an SPV	Direct ownership
Rent	Taxable at SPV	Pass-through for REITs (tax incidence on unitholders)
Dividend	Pass-through: Possible to take a view that section 115BBDA of the ITA may not apply	NA
Interest	Pass-through	NA
Capital gains	Taxable	Taxable

3. In the hands of unitholders (including sponsors)

Income stream	Resident	Non-resident
Rent from REITs	Taxable at applicable rates	Taxable at applicable rates (subject to treaty)
Dividend	Exempt: Possible to take a view that section 115BBDA of the ITA may not apply	Exempt
Interest	Taxable at applicable rates (WHT @ 10%)	WHT @ 5% (final tax under domestic law)
Capital gains on the sale of units on the floor of stock exchange (subject to securities transaction tax)	LTCG[7]: Exempt STCG: Taxable @ 15% plus surcharge + education cess MAT[8] applicable for companies	LTCG: Exempt STCG: Taxable @15% plus surcharge + education cess (subject to tax treaty)

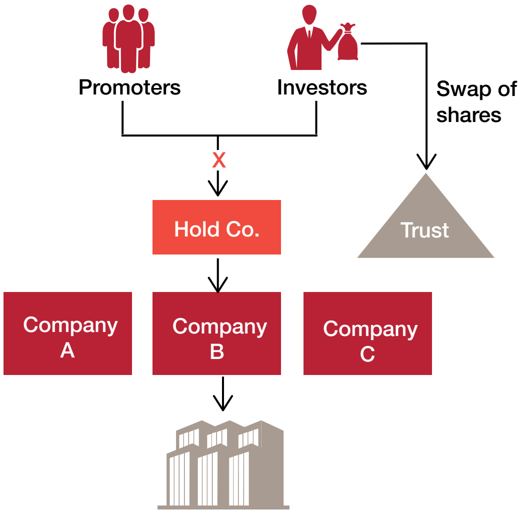
G. Conclusion

REITs could be a game changer for the realty and infrastructure sector. They could redefine funding strategies and provide a lucrative platform for retail and institutional investors to reap benefits. With the government giving REITs a much-needed boost in the regulatory and tax field, the market for these investment vehicles is expected to grow at a rapid pace in the future, thus helping to accelerate growth in the Indian economy.

7 *Units held for more than 36 months will be considered as long term.*
8 *MAT will be chargeable @ 18.5% (plus applicable surcharge and cess).*

Case study

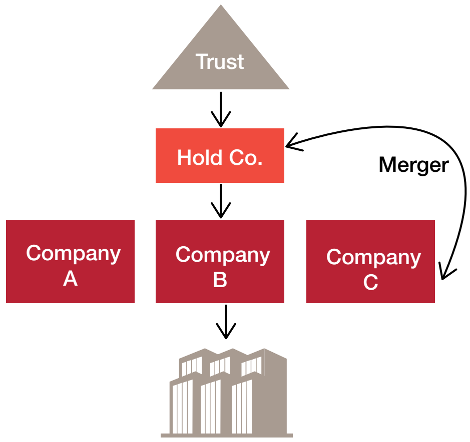
A real estate developer with a multi-tier structure is looking to list a REIT in India. In order to do so, the promoters and investors will swap their shares in the holding company for units in the REIT. A pictorial representation is given below.



While such a swap is permitted under SEBI's guidelines, there are a few tax implications which may need to be kept in mind:

- No DDT exemption is available for dividend declared by Company A/B/C to Hold Co.
- In case the REIT gives a loan directly to Company A/B/C, it may not be eligible for pass-through status for interest income received from Company A/B/C. In case the loan is routed through Hold Co., the REIT may be entitled to take the benefit of an interest pass-through. It must be kept in mind that there will be WHT implications on the interest paid by Company A/B/C to Hold Co.

In view of the above, the following structure may be considered by a developer/promoter



Key mechanics:

- *Company A/B/C to be merged with Hold Co. through an NCLT-approved scheme of amalgamation (post listing or prior to listing)*

Key points for consideration:

- *No adverse tax implications on merger, assuming conditions mentioned in the ITA are satisfied.*
- *Stamp duty would be payable on merger.*
- *Approval is required from the NCLT and other regulatory authorities.*
- *Post-merger, DDT exemption on dividend from Company A/B/C to the REIT is available assuming the REIT holds the entire equity share capital of Company A/B/C.*
- *Post-merger, interest income received by the REIT from Company A/B/C should be eligible for interest pass-through.*

Glossary

Abbreviation	Full form
AMT	Alternate minimum tax
AOP	Association of persons
AE	Associated enterprise
CCD	Compulsorily convertible debenture
DDT	Dividend distribution tax
DIPP	Department of Industrial Policy and Promotion
EBITDA	Earnings before interest, tax, depreciation and amortisation
ECB	External commercial borrowing
FDI	Foreign direct investment
FEMA	Foreign Exchange Management Act, 1999
FMV	Fair market value
FPI	Foreign portfolio investor
FSI	Floor space index
GST	Goods and Services Tax
HUF	Hindu undivided family
INR	Indian rupee
IPO	Initial public offering
ITA	Income-tax Act, 1961
JDA	Joint development agreement
JV	Joint venture
LIBOR	London Interbank Offered Rate
LLP	Limited liability partnership
LTCG	Long-term capital gains
MAT	Minimum alternate tax
MMR	Maximum marginal rate
NAV	Net asset value
NBFC	Non-banking finance company
NCD	Nonconvertible debentures
NCLT	National Company Law Tribunal
OL	Official Liquidator
PE	Private equity
RD	Regional Director
REIT	Real estate investment trust
RERA	Real Estate (Regulation and Development) Act, 2016
ROC	Registrar of Companies
SEBI	Securities Exchange Board of India
SEZ	Special economic zone
SPV	Special purpose vehicle
STCG	Short-term capital gains
TDR	Transferable development rights
VAT	Value-added tax
WHT	Withholding tax

Notes

1. We have not assessed the effect of the provision of GAAR on the case studies described in the foregoing paragraphs, either as a whole or with regard to each step in the overall process.
2. Stamp duty is a state-specific subject and is subject to frequent changes. Thus, the stamp duty implications mentioned in this report are based on desktop research and should be verified with the local consultant.

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