

Real Estate Update

February 26, 2014

RESEARCH PAPER ON PRIVATE DEBT AND PRIVATE EQUITY IN REAL ESTATE

Year 2013 and start of 2014 witnessed interesting changes from a regulatory, legal and tax perspective. Herein below are some of those changes in brief, which are detailed later in this paper:

LEGAL AND REGULATORY CHANGES

I. Put options permitted under the Foreign Direct Investment Regime

RBI has now permitted optionality clauses in agreements for foreign direct investment eligible instruments issued to non-residents, provided the valuation norms prescribed for such optionality clauses are adhered to. The valuation norms prohibit any assured returns to the non-resident.

II. Real Estate Investment Trusts (REITs) re-introduced and shelved once again

With the intention of re-introducing REITs in India after a failed attempt in 2008, SEBI introduced the draft SEBI (REIT) Regulations, 2013. While investors braced themselves for the REIT regime to be implemented, REIT regime seems to have been deferred once again for the time being by the SEBI.

III. Foreign Portfolio Investor (FPI) introduced, replaces existent portfolio investment regimes

SEBI notified the SEBI (FPI) Regulations, 2014, harmonizing the portfolio investment routes of Foreign Institutional Investors (FIIs) and Qualified Foreign Investor (QFIs) into a new class- the FPI. FPI will be a dis-intermediated platform for trading in securities without SEBI approval. Pending RBI and CBDT notifications, the FPI regime is still to be implemented.

IV. Offshore listing allowed for unlisted Indian companies

Hitherto unlisted companies in India were prohibited from issuing American Global Depository Receipts (ADR/ GDR) and Foreign Currency Convertible Bonds (FCCB) without a simultaneous or prior listing on a domestic exchange in India. However, RBI and the Central Government have now removed this requirement of prior or simultaneous listing on a domestic exchange, revising back to the position pre-2005, when the requirement was introduced. SEBI norms in this regard are still awaited. Private companies can now list their ADRs/ GDRs/ FCCB in an overseas stock exchange.

V. Investment advisors have been regulated

SEBI notified the SEBI (Investment Advisers) Regulations, 2013. The regulations seek to regulate the working of investment advisers. Advisers will have to register themselves with SEBI and subject to the obligations such as Chinese walls, KYC norms, Code of Conduct. While the Investment Advisers Regulations include all sorts of advice given by any person, engaged in the business of providing investment advice for consideration, the Regulations specifically excludes investment advice provided exclusively to clients (not being NRIs or PIOs) outside India.

Once regulated such investment advisor companies may qualify as financial services and attendant conditions may apply.

VI. Research Analysts proposed to be regulated

SEBI has indicated its intention to regulate research analysts by introducing the draft SEBI (Research Analyst) Regulations, 2013. By way of the regulations, SEBI seeks to regulate independent research analysts, intermediaries employing research analysts and also the research analysts providing recommendations in the public media.

Once regulated such research analyst companies may qualify as financial services and attendant conditions may apply.

VII. Companies Act 2013

The Companies Act, 2013 finally received the assent of the President of India. The Ministry of Corporate Affairs has decided to implement the new Companies Act 2013 in a phased manner. Some of the important provisions of Companies Act 2013 include restrictions on issue of shares with differential rights, restrictions on loans and guarantees to subsidiaries and entities where a director is interested, valuation norms for issuance of capital, provisions for minority squeeze outs, outbound mergers of Indian companies, insider trading norms for unlisted securities and increased liabilities and obligations on directors.

VIII. Control

Definition of control under the FDI Policy has been amended to bring it in line with the definition of 'control' as provided under Companies Act 2013 and SEBI (Substantial Acquisition of Shares and Takeovers) Regulations,

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2011. The amendment has enlarged the scope of control. Existing downstream investments by domestic companies with foreign investment will have to be examined more closely to ascertain if it is affected by the new definition of 'control', and to what extent will such structures be grandfathered.

IX. Non-Banking Financial Companies (NBFC)

The transfer of shares of a company in the financial sector, including NBFCs, from a resident to a non-resident required a no-objection certificate from the RBI, thereby causing delay in the transfer. The requirement of a no-objection certificate has been dispensed with, thereby facilitating such transfers.

While NBFCs were permitted to issue unsecured debentures earlier, they have now been restricted to issue only fully secured debentures. In addition, the exemption of an issuance to only 49 members by way of private placement has also been withdrawn for NBFCs. Also NBFCs have been given status of financial institution under Companies Act 2013.

TAX CHANGES

I. Cyprus – no longer cooperative

Due to the lack of information exchange, CBDT notified Cyprus, which has traditionally been a favorable jurisdiction for investors to invest in India, as a non-cooperative jurisdiction. Consequently, withholding tax at the rate of 30%, or such higher tax rates under the (Indian) Income Tax Act, 1961 shall apply to all transactions with Cyprus entities and all such transaction shall be now subject to transfer pricing. India and Cyprus have been negotiating a new double taxation avoidance agreement to replace the existing agreement in place, which shall include a 'Limitation of Benefit' clause.

II. Share subscription subject to transfer pricing adjustment

Tax authorities subjected subscription of shares of the subsidiary company by the parent company to transfer pricing norms. In doing so the tax authorities ascertained a fair market value for the shares of the subsidiary as per their own calculation. Difference in subscription price and fair market value was subject to transfer pricing adjustment and, subject to tax at the rate of 30%. Further, since the amount was not received, such amount was considered to be in nature of loan deemed to have been given by the Indian company to its offshore company, and arm's length interest income tax levied on the same.

III. 'Safe harbour rules' introduced

With a view to provide certainty with respect to transfer pricing issues, CBDT introduced the '*Safe harbour rules*'. According to the rules, the tax authorities will accept the transfer price set by the taxpayer if the taxpayer and transaction meet eligibility criteria specified in the rules.

IV. General Anti-Avoidance Rules (GAAR): Finally here

GAAR has been postponed to FY 2015-16 as per the Finance Act, 2013. GAAR is to be applicable where the main purpose of the transaction is to obtain a tax benefit. CBDT notified GAAR rules in 2013, which shall be applicable from April 1, 2015. GAAR will apply retrospectively insofar as income arising from structures set up post August 30, 2010 would be captured under GAAR.

V. 2013 Budget

2013 Budget did make a few interesting changes from the perspective of the foreign investment into real estate.

While 2014 has already started with the introduction of FPI regime and legitimizing of put options, with the general elections around the corner, 2014 looks to be equally exciting.

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You can direct your queries or comments to the authors

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