



Tax

# India - Real Estate

## *Investment & tax framework – A Walkthrough*

September 2007

AUDIT ■ TAX ■ ADVISORY

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- You are in good company
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# Real Estate in India



# Real Estate - Industry in transition

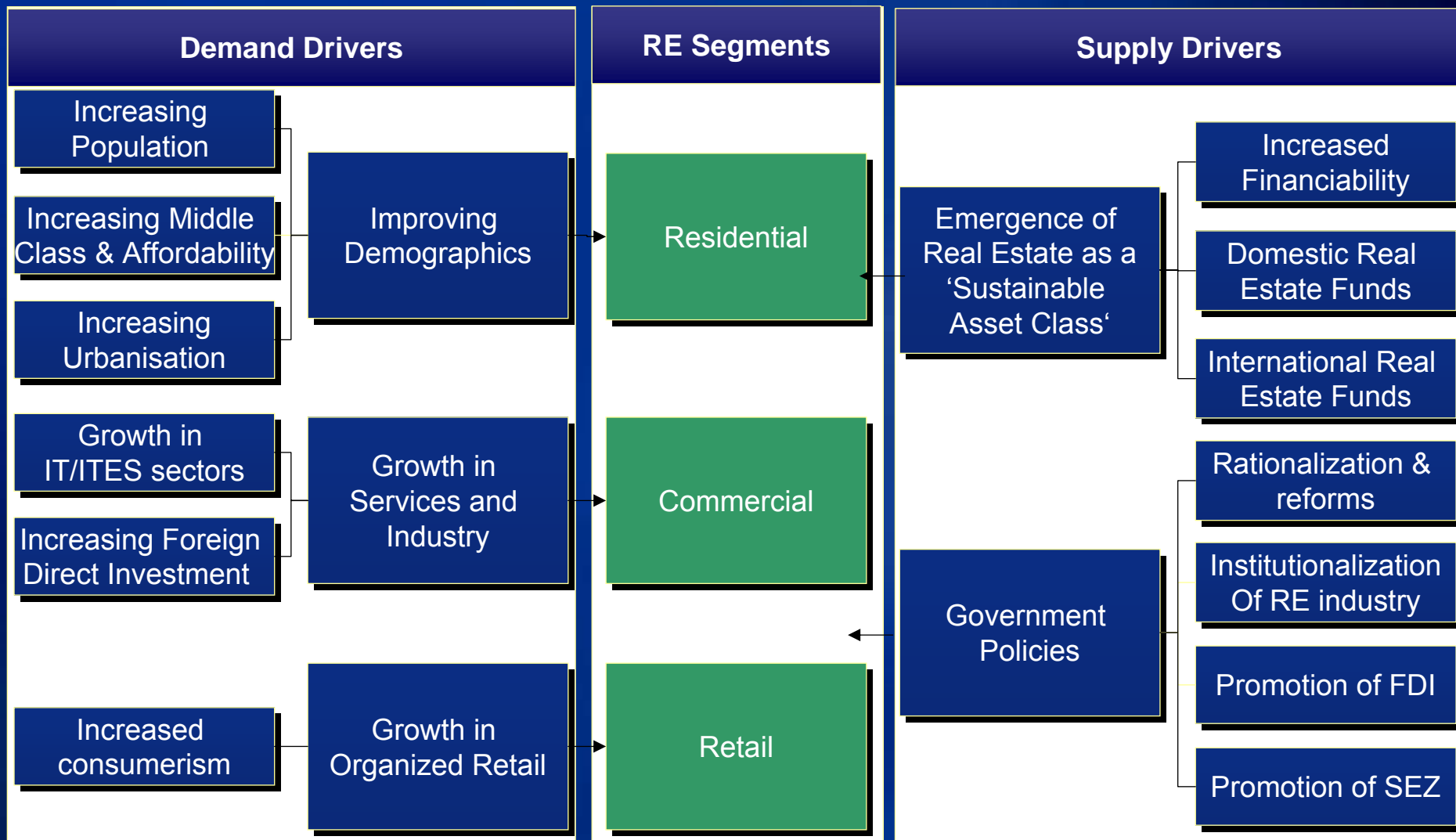
## Then ...

- Traditionally unorganized and locally fragmented
- Characterized by unaccounted money
- Monopoly of High Net Worth Investors
- Lower preference for financing alternatives

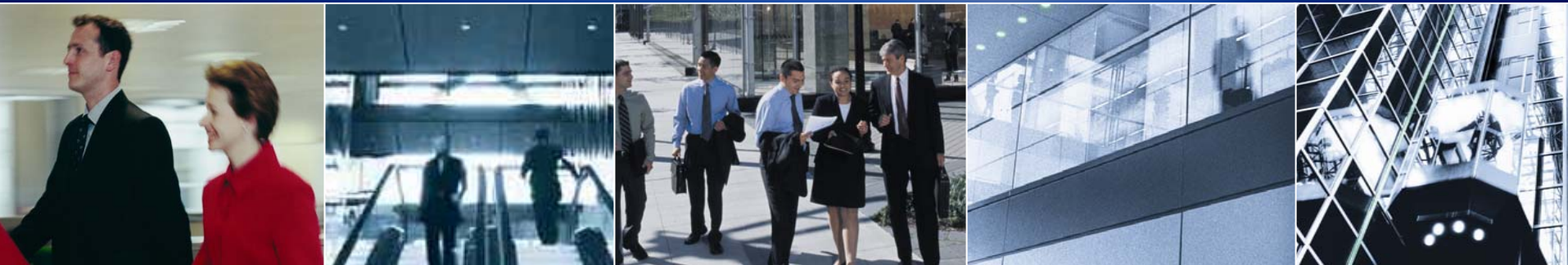
## ... Now

- Increasing institutionalization
- Improving systems and transparency in investment process
- Growing investment by end-users
- Emergence of the mortgage industry

# Real Estate spurred by Demand and Supply drivers



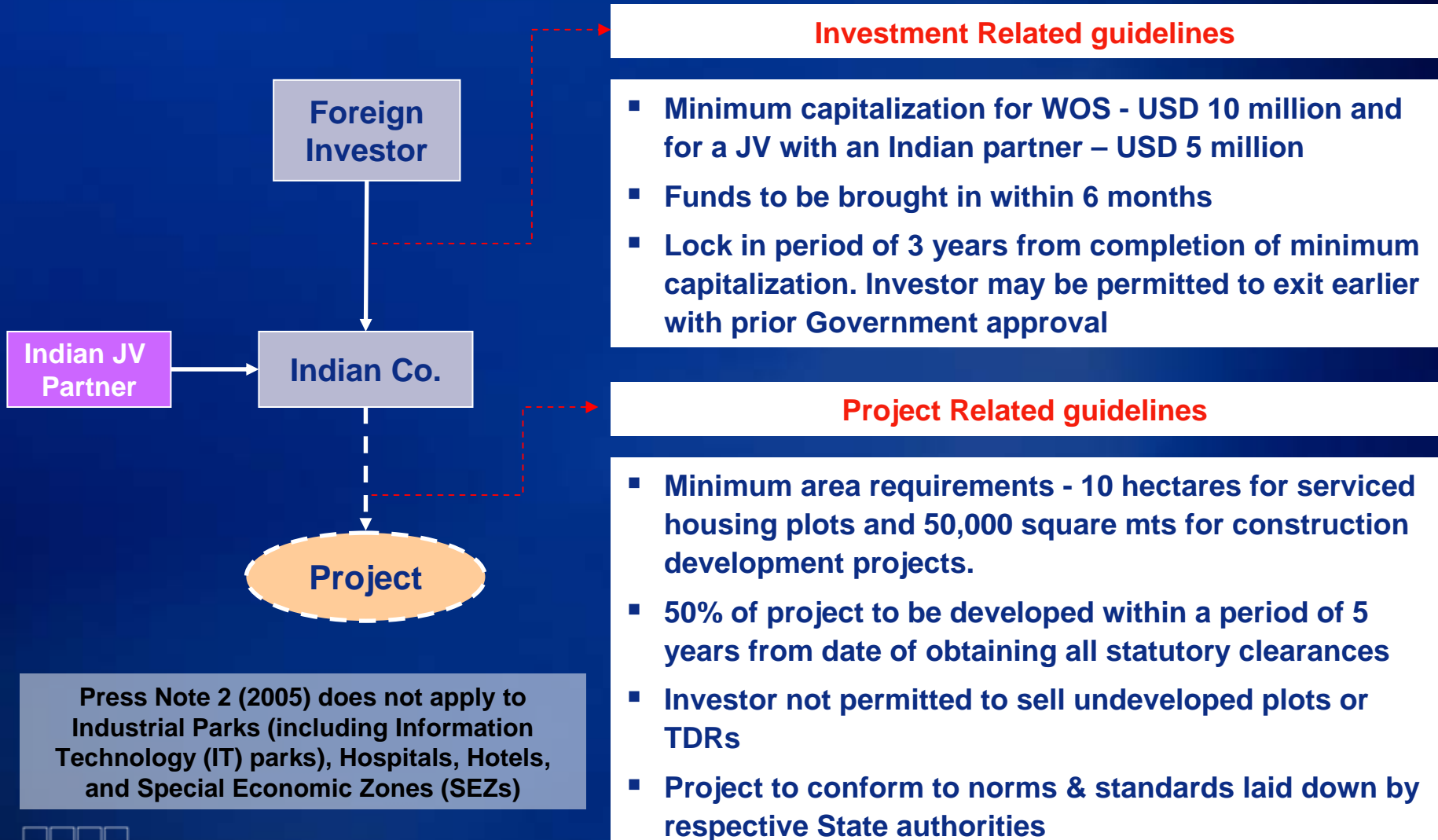
# Where can I invest?



# Asset classes - FDI guidelines

Sr. No.	Category	Guidelines
1.	Office space	<ul style="list-style-type: none"> <li>= 100 percent FDI allowed in construction / development of office buildings, subject to Press Note 2 (2005) conditions</li> <li>= Investment to be greenfield in nature</li> </ul>
2.	Industrial Parks (including IT Parks)	<ul style="list-style-type: none"> <li>= 100 percent FDI allowed</li> <li>= IT Park guidelines to apply</li> </ul>
3.	Residential / townships	<ul style="list-style-type: none"> <li>= 100 percent FDI allowed in any residential development, subject to Press Note 2 (2005) conditions</li> <li>= Investment to be greenfield in nature</li> </ul>
4.	Hotels / service apartments / conventions centers	<ul style="list-style-type: none"> <li>= 100 percent FDI allowed in development and / or acquisition of existing hotel / service apartment</li> </ul>
5.	Shopping centers / malls	<ul style="list-style-type: none"> <li>= 100 percent FDI allowed in any development, subject to Press Note 2 (2005) conditions</li> <li>= Investment to be greenfield in nature</li> </ul>
6.	SEZs	<ul style="list-style-type: none"> <li>= 100 percent FDI allowed</li> <li>= Project to be in accordance with SEZ Act and notified guidelines</li> </ul>

# FDI in Real Estate – Specific Guidelines



# What issues will I face?



# FDI in Real Estate – Few Specific Issues

## ***Status of the Project at the time of investment***

- Greenfield
- Partly constructed
- Fully constructed

## ***Capital Structure for the minimum capitalization***

- Plain Equity or Combination of Equity & Preference
- Securities Premium
- Holding company level vs. SPV Subsidiary level

## ***Lock-in requirements applicable***

- Minimum Capital
- Entire Capital

## ***Uncertain Terminology***

- Built-up area
- Date of commencement of business



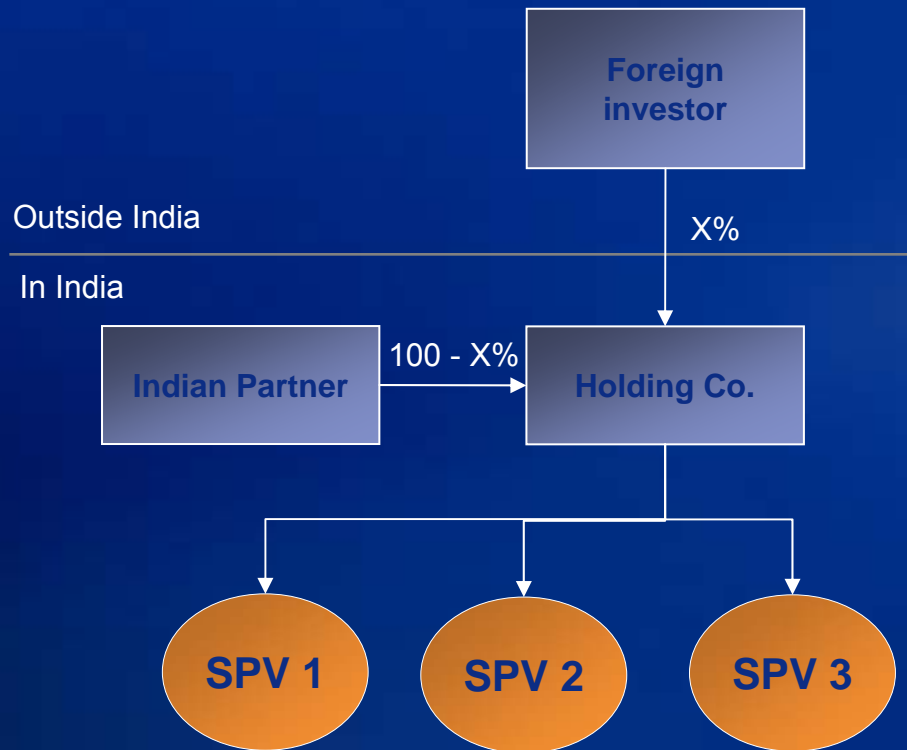
# How do I structure the investments?



# Typical Transaction Structures

## Double layer company structure

Provides flexibility to investors in segregating asset class risk while capturing entire value at the holding company level; may result in tax leakages



## Key considerations

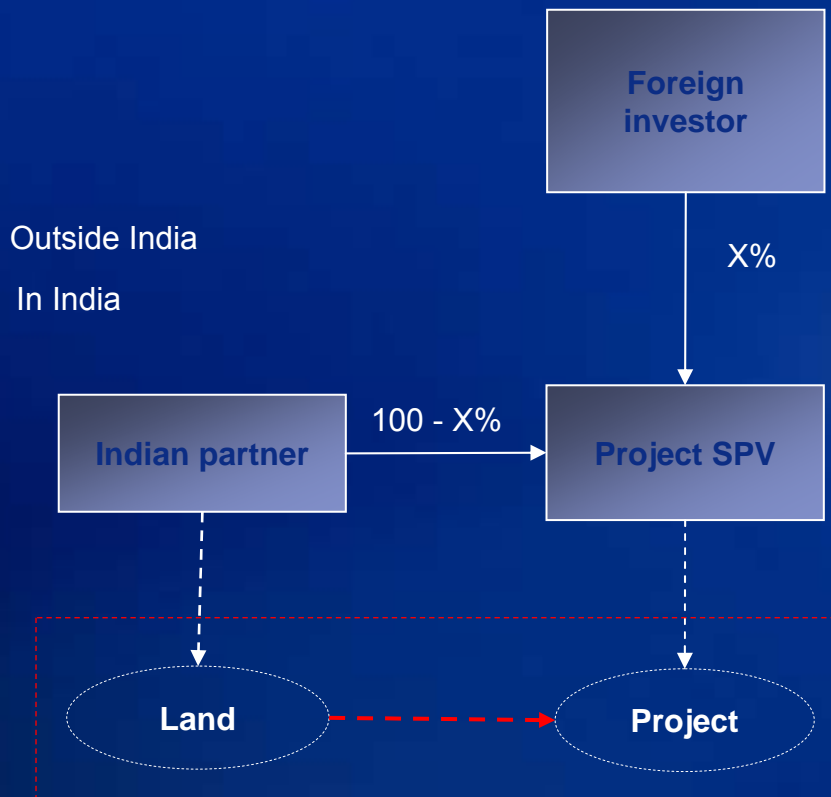
- Investment in Hold Co.: Prior approval required from the FIPB
- Tax inefficiency while up-streaming income: Dual layer in India
- Minimum Capitalization: Holding Co. level vs. SPV level?
- Holding Co.: Characterization as Non-Banking Finance Company (NBFC) under the Foreign Exchange Regulations?
- Transfer of funds within project SPVs: Deemed dividend issues?

**Other variations in the transaction model could be possible depending on the commercial objectives**

# Typical Transaction Structures

## Project specific SPV

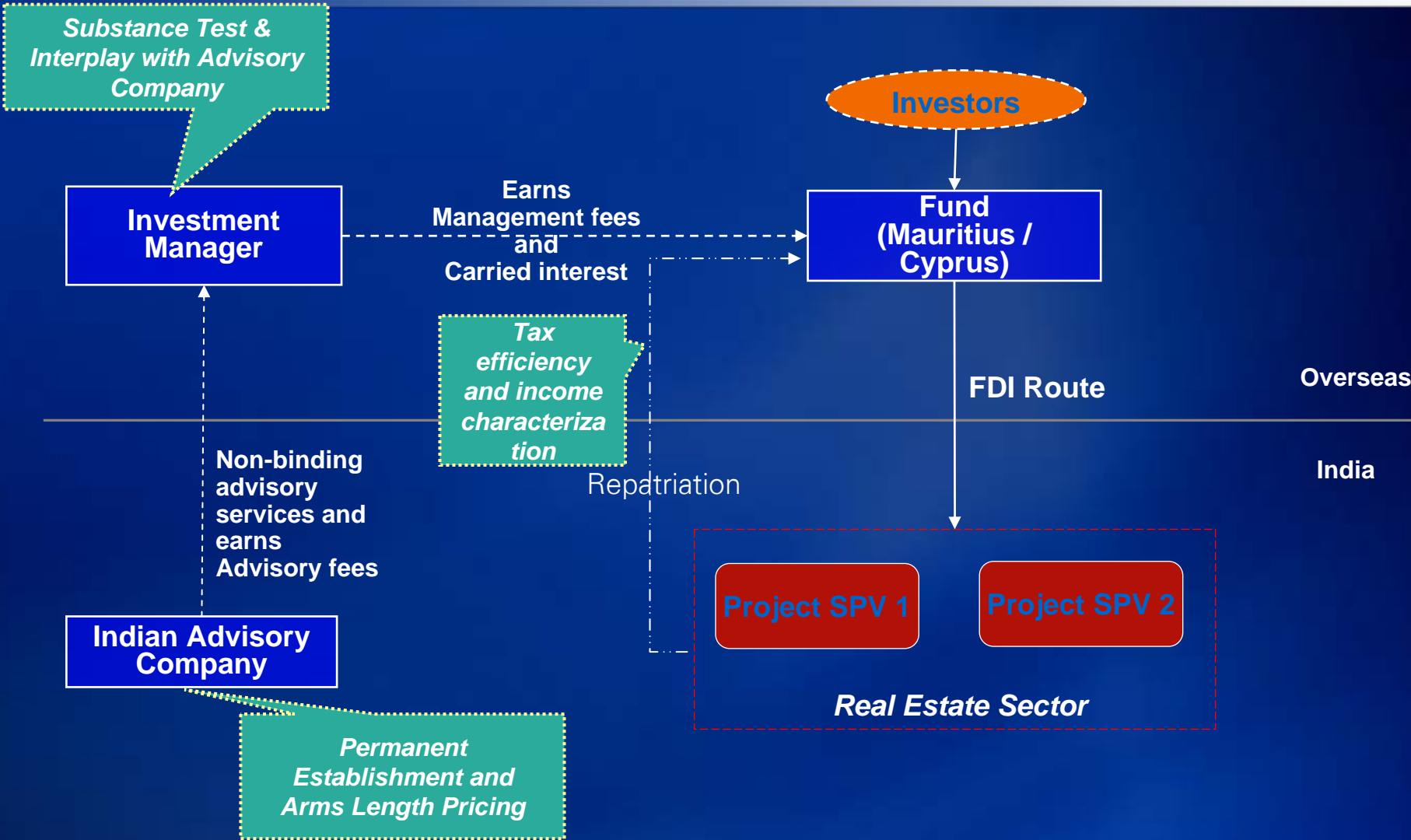
Provides flexibility to investors to do business with different partners



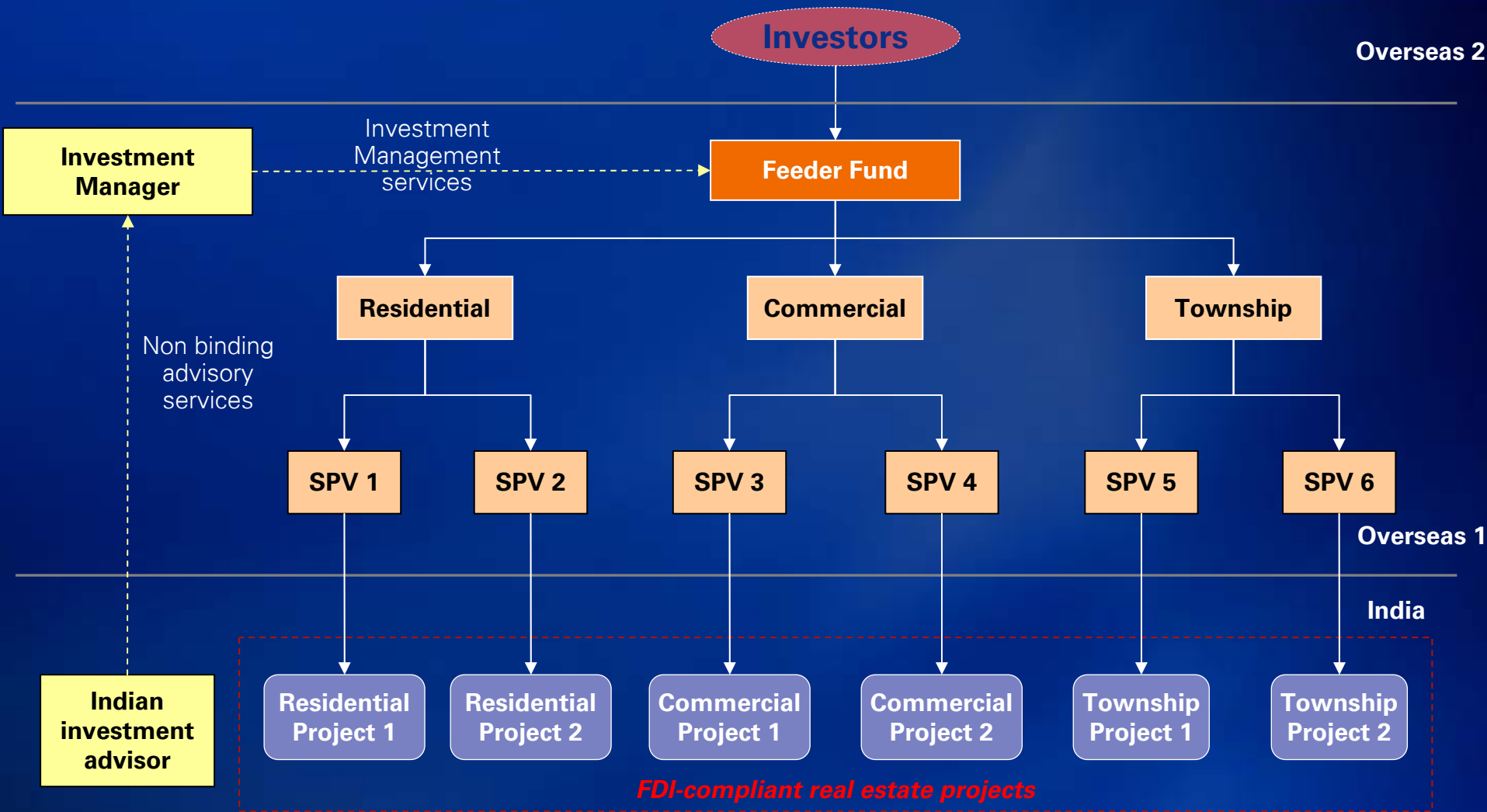
## Key considerations

- Arrangements for early cash out to the Indian developer partner
- Planning efficient exit mechanisms for foreign investors
- Comfort over control of land: transfer of title vs. development rights
- Taxes in relation to transfer of land to the project SPV
- Financing for agricultural land conversion
- Milestones-linked returns to Indian partner (promote structures)

# Fund Structure - Overseas fund



# Fund Structure – Project Specific



# The jurisdiction through which the investments are made would be important in optimizing overall tax incidence...

Income stream	Israel	Mauritius	Singapore	Netherlands	Cyprus
<i>Dividend</i>	Nil. Dividend Distribution Tax (DDT) payable by the Indian Company @ 16.995%	Nil. DDT payable by the Indian Company @ 16.995%	Nil. DDT payable by the Indian Company @ 16.995%	Nil. DDT payable by the Indian Company @ 16.995%	Nil. DDT payable by the Indian Company @ 16.995%
<i>Capital Gains on sales of shares</i>	Taxable in India @ 21.12% (long term capital gains)/ 42.23% (short term capital gains)	Exempt in India	Exempt in India subject to limitation of benefits provisions in India-Singapore tax treaty	Exempt in India if holding is less than 25%	Exempt in India
<i>Interest</i>	Withholding Tax @ 10%	Withholding Tax @ 21.115% / 42.23% (Nil for Mauritian Banking Company)	Withholding Tax @ 15% (10% for Banks / FI / Insurance Co) *	Withholding Tax @ 10% *	Withholding Tax @ 10% *

\* Subject to satisfaction of tests of beneficial ownership

# What are the tax implications?



# Indian Income Tax – a snapshot

## BUILD TO SELL

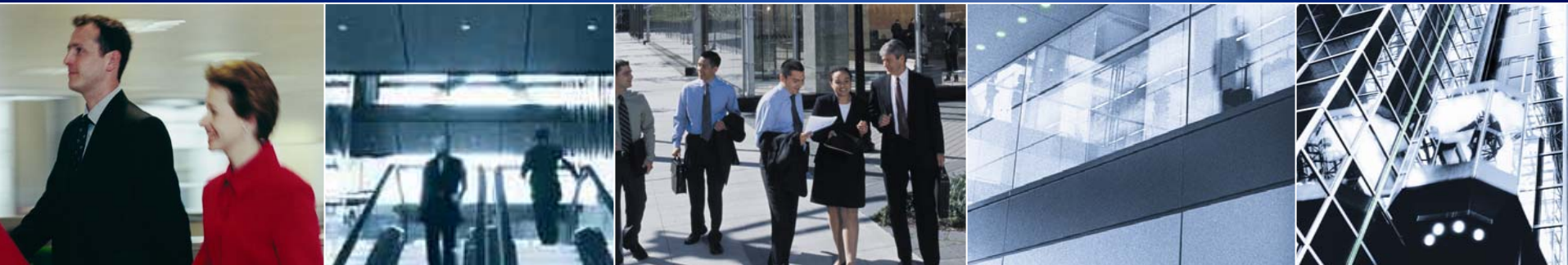
- Taxed on a net income basis at 33.99 per cent.
- All business expenses generally allowable as a tax deduction if -
  - incurred after ‘set up’ of business;
  - revenue in nature;
  - incurred wholly and exclusively for business purposes;
  - after withholding appropriate tax (if any) and paid to the exchequer;
  - reasonable and at an arm’s length price if payable to related party
- Revenue and expenditure recognition as per AS 9, AS 7 and Guidance Note

## BUILD TO LEASE

- Lease rentals earned from letting out of property taxed as Income from House Property.
- Following deductions from lease rentals permissible:
  - Municipal / local taxes and cess levied on property;
  - 30 per cent of net lease rentals (after municipal taxes) towards repairs and maintenance and other costs; and
  - Interest on funds borrowed for acquisition, construction, repairs and renovation / reconstruction of property
- No deduction for tax depreciation

***Tax Incentives available for Industrial Parks, Special Economic Zone and Hotels and Convention Centres***

# How do the numbers look like?



# Promote Structures – Midway Street

**Equity shares – Buy back to be in accordance with corporate law provisions; Pricing guidelines to be applicable on transfer to non-resident**

**Compulsorily convertible instruments (Preference shares and debt) – Should be convertible into equity; Upper cap on dividends**

**Offshore debt and other convertible (optionally / partially) instruments not permitted for real estate related activities except in case of Industrial Parks (including IT parks). Limits on coupon rate and other end use restrictions to be complied with**

**Linked to IRRs generated from the project**

**Linked to agreed benchmark performance / time schedule regarding the development of the project**

**Linked to achievement of pre-agreed rentals or pre-agreed sales price for the property developed**

# Promote Structure – Illustrative Waterfall

- Capital Contribution (foreign investor and Indian developer) - Rs. 100 each
- Net distributable surplus (net of tax) at the end of Year 1 – Rs. 270

*Refund of principle amount to both the parties*

Levels in Waterfall	Amount in Rs.
Distributable Funds	<u>270</u>
Less : 1 <sup>st</sup> level - Principle amount	200
Balance	70

*Balance, to both the parties on the basis of IRR achieved by the project*

IRR	Sharing of profits between Investor and developer	Split of profits of Rs. 70	
		Foreign Investor	Indian Developer
Up to 15%	50:50	15	15
16% to 25%	40:60	8	12
25% to 35%	30:70	6	14
<b>Total</b>		<b>29</b>	<b>41</b>

# An illustrative capital structure presuming investments of USD 20 mn for a wholly owned subsidiary

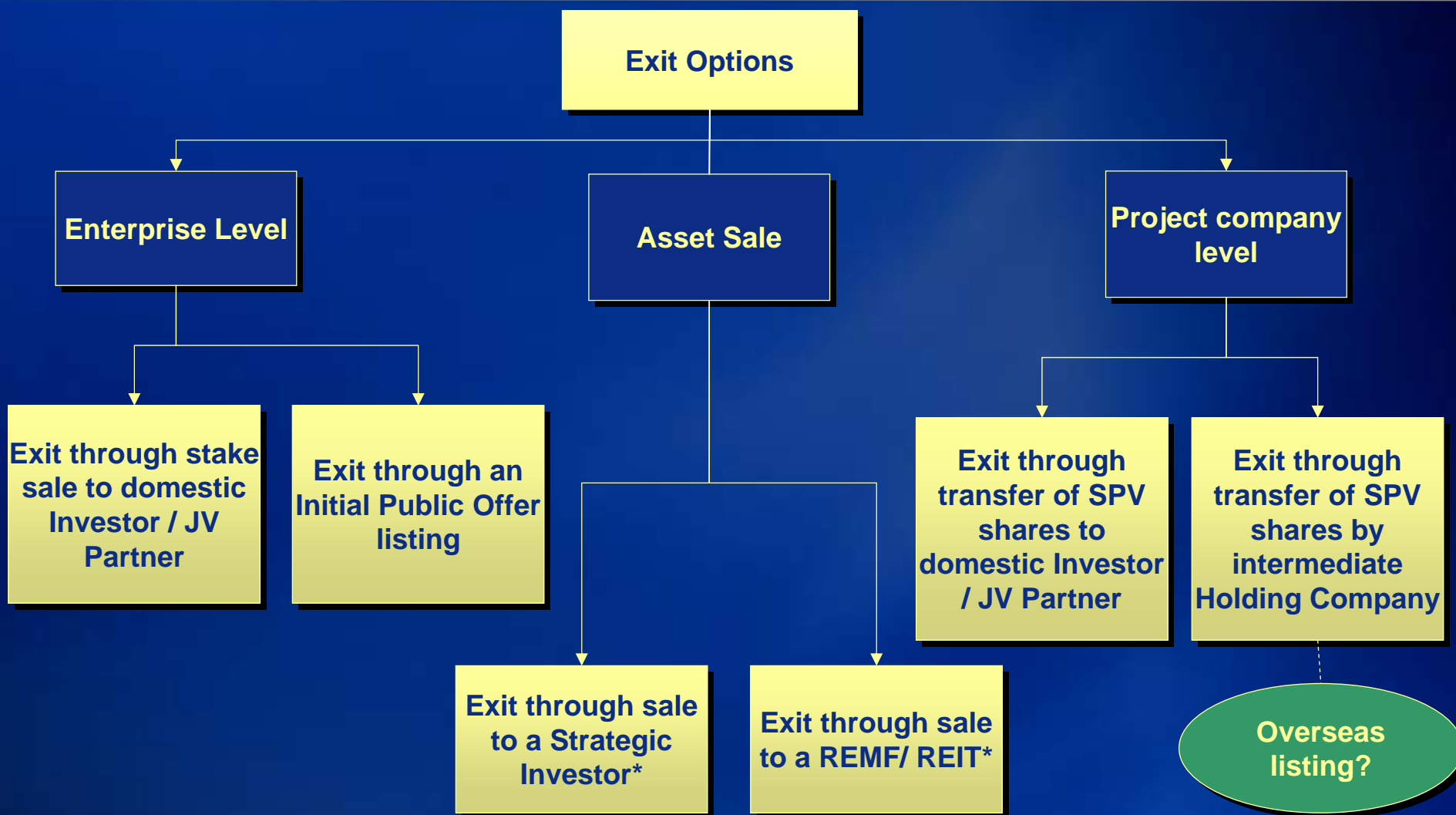
Instrument	Amount (USD) in mn
<u>Equity</u>	<u>4.0</u>
Face value	2.0
Share premium	2.0
<u>Class 'A' Compulsorily Convertible Preference Shares ('CCPS')</u>	<u>6.0</u>
Face value	3.0
Share premium	3.0
<u>Class 'B' CCPS</u>	<u>6.0</u>
Face value	3.0
Share premium	3.0
<u>Compulsorily Convertible Debentures ('CCD')</u>	<u>4.0</u>

## Some parameters to consider

- Different classes of shares in smaller amounts facilitate exit through buy back of an entire class of shares as against pro-rata buy back from all investors in the same class
- Share premium can be utilized for buy back of shares under the Indian corporate laws in the absence of profits
- 100% of the CCPS can be bought back in a single year unlike equity shares where there is a limit of 25% per year
- CCDs facilitate exit and also improve IRRs through regular flow of interest; Withholding tax implications would depend on the jurisdiction of the investing entity

**In Joint Ventures with Indian developers, careful capital structuring would take more emphasis from an exit perspective**

# Exit mechanism – a macro level overview



**\* Real Estate Mutual Fund regulations under formulation**

# Numerical flow – Buy back of shares

Step 1 - An illustrative Balance Sheet at the start of the project

Liabilities	INR	Assets	INR
Equity Shares	100	Land	100
Bank loan	75	Cash / Bank	75
<b>TOTAL</b>	<b>175</b>	<b>TOTAL</b>	<b>175</b>

Step 2 - Presuming the project is constructed and sold at a gain of Rs. 80, the Balance Sheet at the end of the project and after repayment of bank loan would be as follows

Liabilities	INR	Assets	INR
Equity Shares	100	Cash / Bank	180
Profits	80		
<b>TOTAL</b>	<b>180</b>	<b>TOTAL</b>	<b>180</b>

Step 3 –  
Maximum Buy back of shares permissible = 25% of equity share capital i.e. Rs. 25

Maximum value of buy back = 25% of share capital + free reserves i.e. Rs. 45

The Balance sheet after Buy back of shares would be as illustrated

Liabilities	INR	Assets	INR
Equity Shares	75	Cash / Bank	135
Profits	35		
Capital Redemption Reserve *	25		
<b>TOTAL</b>	<b>135</b>	<b>TOTAL</b>	<b>135</b>

\* Can be utilized for issuing bonus shares

# Numerical flow – Buy back of shares...(Contd)

## Capital Gains – Direct Investments

Buy back value of shares	45
Less: Cost of acquisition of shares	25
Capital Gains on Buy back	20
Less: Assuming long term capital gains tax in India @ 21.12%	4
Income up streamed to Israel	16
Total tax impact	4**

## Capital Gains – Investments via IHC

Buy back value of shares	45
Less: Cost of acquisition of shares	25
Capital Gains on Buy back	20
Less: Tax in the India	Nil
Income up streamed to Mauritius / Cyprus / Netherlands / Singapore	20
Less: Tax in Mauritius / Cyprus / Netherlands/ Singapore	Nil*
Income up streamed to Israel	20
Total tax impact	Nil**

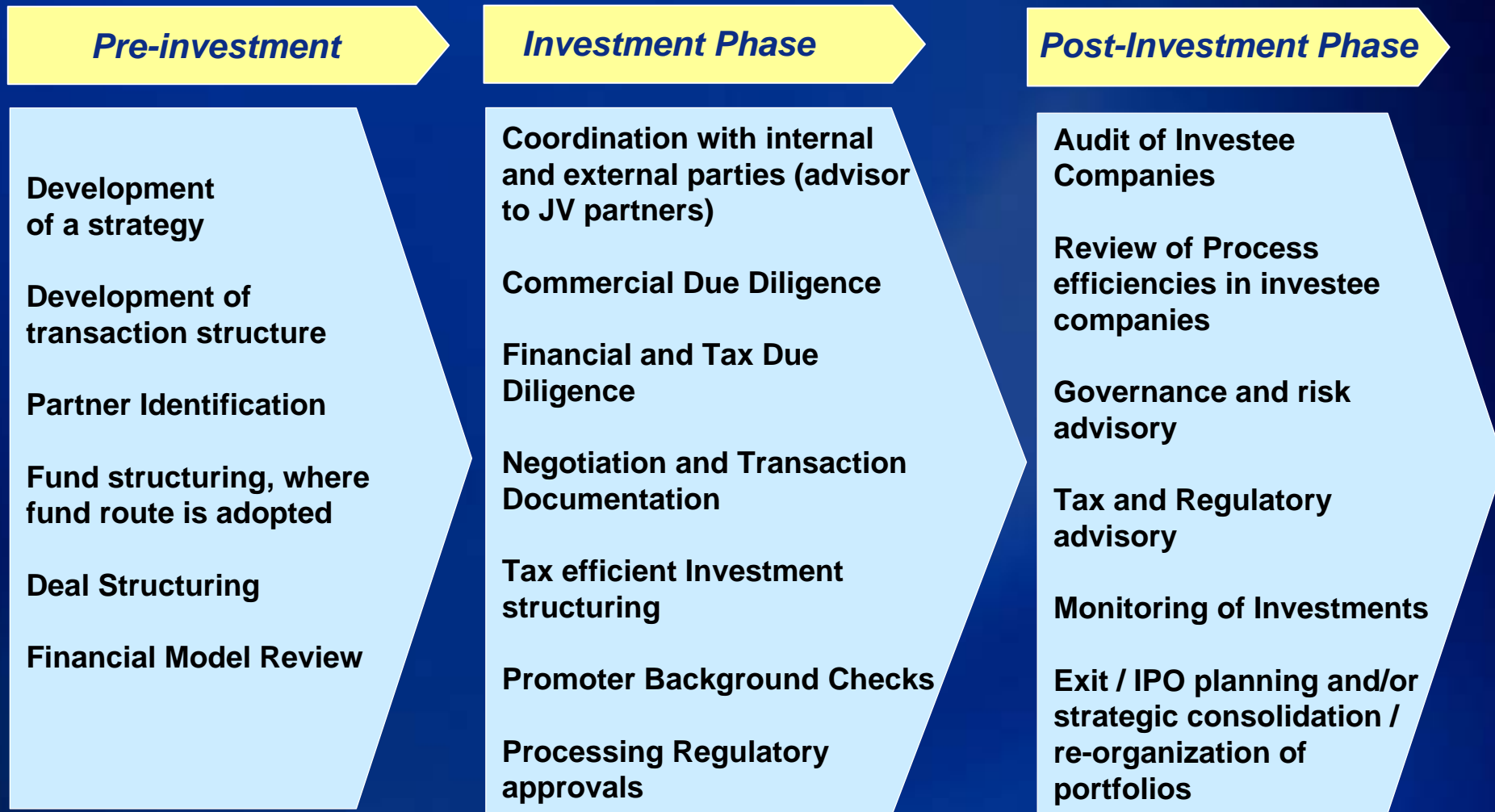
\* Subject to satisfaction of conditions

\*\* Total tax impact does not include taxes paid in Israel and credit for taxes paid in India to be examined

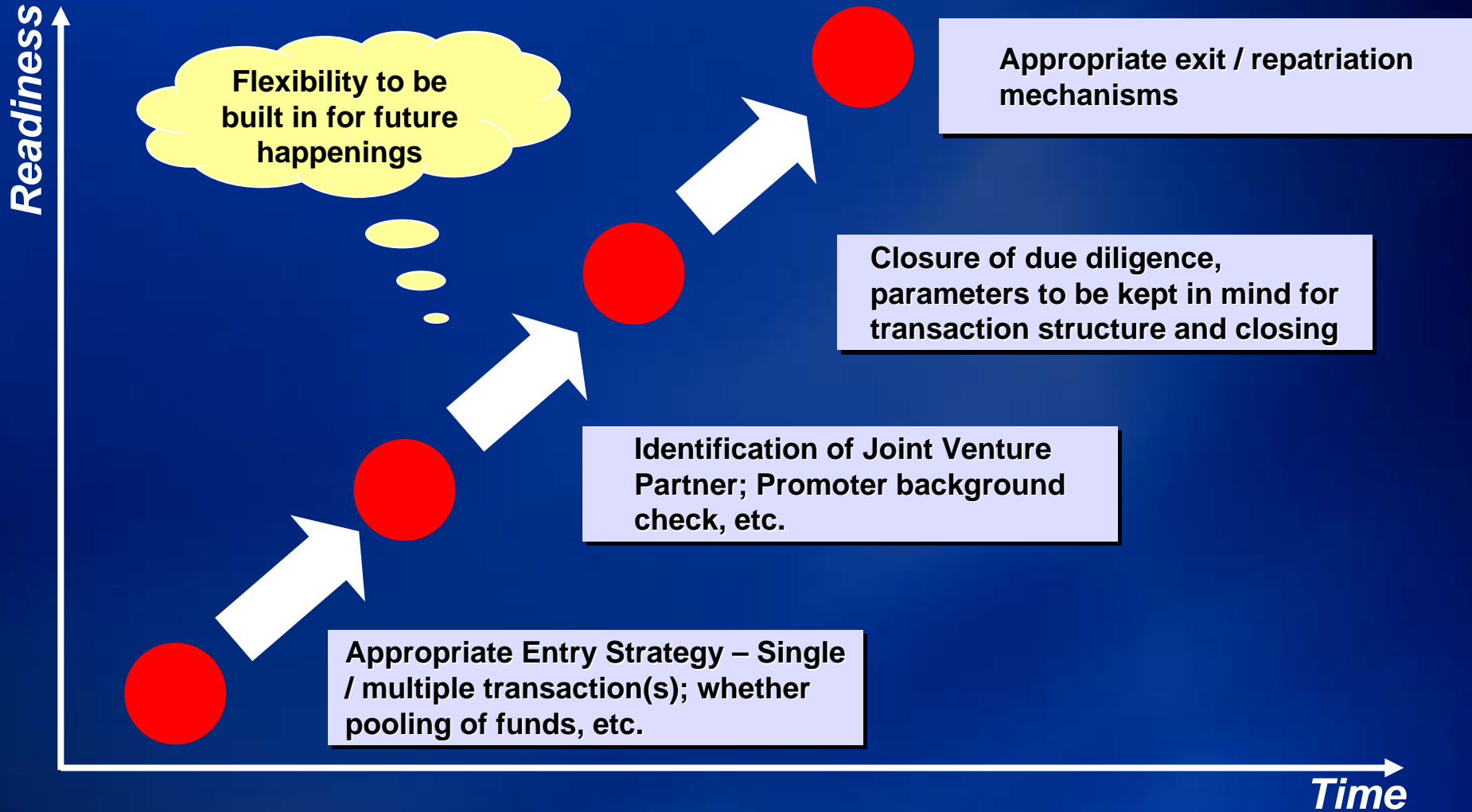
# How can KPMG help?



# KPMG can work with the investor through its entire life cycle



# Way Forward - "The Right Approach"





# You are in good company



# Select Real Estate Experience

## Developer Groups

- Hiranandani Group
- Shapoorji Pallonji Group
- Dewan Housing Finance Limited
- Runwal Group
- Unitech Group
- Indiabulls Realty

## Foreign Funds

- Lehman Brothers Real Estate Limited
- Sun Apollo Real Estate Fund
- Lubert Adler L.P.
- TPG – Axon
- Warburg Pincus
- Trikona Capital
- UBS Realty
- Equity International
- REIT Property Management India
- Xander
- Saffron Capital

## Domestic Funds

- HDFC Real Estate Fund
- Tata Realty & Infrastructure
- Fire Capital
- Peninsula Land Limited

# Our contacts



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