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IVCA representation – GAAR & REITs

This document highlights the tax related recommendations to the Ministry of Finance on General Anti-Avoidance Rules ('GAAR') and Real Estate Investment Trusts ('REITs').

A. RATIONALIZATION OF GAAR UNDER THE INCOME TAX ACT, 1961 ('THE ACT')

1. Background & Issue

1.1. The GAAR provisions introduced in the Act vide Chapter X-A provide that an arrangement entered into by an assessee may be declared to be an 'impermissible avoidance arrangement' and the consequence in relation to tax arising therefrom may be determined, subject to the provisions therein, which could include denial of treaty benefits, re-determination of residential status, disregarding of entities / structures etc. These provisions are very widely worded and subjective. On an overall basis, the said provisions would result in a high degree of uncertainty, which is clearly detrimental to the growth of PE/VC investments in India.

1.2. Treaty override

From a VC / PE standpoint, it is critical to have certainty on whether or not offshore VC / PE funds investing into India would be entitled to treaty benefits, as may be applicable. If GAAR is invoked, treaty benefits could be denied. This could effectively make the treaty provisions redundant (in case

where GAAR is invoked), which could have the impact of India breaching the contractual treaty terms and hence international law as well as could impact the foreign flow of funds in India.

1.3. Precise scope & objective guidelines

The language of the conditions triggering GAAR including '*misuse or abuse of provisions of tax laws*', '*lacks commercial substance*', '*not for bona fide purposes*' and '*substantial commercial purpose*' etc are very widely worded and subjective. This could be amenable to various differing interpretations even among the income tax authorities. This would result in significant uncertainty on whether or not offshore India investment structures set up by offshore VC / PE funds would be respected and treaty benefits granted. These provisions could also impact transaction closure/costs owing to uncertainty on witholding tax/representative assessee related liabilities etc.

1.4. Grandfathering for existing structures / arrangements

It is important to grandfather existing structures / arrangements / investments as part of the GAAR provisions and agree from the Revenue authorities' perspective that sham, tax avoidant schemes / structures must not enjoy protection / legitimacy by virtue of grandfathering.

As per Press release dated January 14, 2013 issued by Government of India, it has been stated that investments made before August 30, 2010 i.e. the date of introduction of the Direct Taxes Code, Bill, 2010, will be grandfathered. Further, it has been stated that GAAR is proposed to be effective from April 01, 2016. However, we may also like to re-iterate that GAAR may impact many bona fide structures that have been legitimately put in place based on judicial precedents including those pronounced by the Supreme Court of India and certain circulars issued by the Central Board of Direct Taxes.

Our jurisprudence has always distinguished between tax planning and tax avoidance / evasion; the sanctity of legitimate tax planning has been upheld by the Supreme Court of India on multiple occasions. Owing to the rigour of the proposed GAAR regime, many structures, which may erstwhile have been considered legitimate may get impacted. Such structures have been in existence for several years and many commercial / legal arrangements would have been implemented on the basis thereof at significant cost. It would be prejudicial and unfair to the taxpayer to mid-way subject him to provisions, which did not exist in law when the transactions were entered into.

The Report of the Standing Committee of Finance on the DTC presented before the Speaker on March 9, 2012 ("Standing Committee Report") also states the following:

"It would also be fair to apply GAAR provisions prospectively so that it is not made applicable to existing arrangements/transactions. *Alternatively, suitable grandfathering provisions may be made to protect the interest of the tax- payers who have entered into structures / arrangements under the existing law." <<emphasis supplied>>*

In light of the above, in our view, it would be fair to apply GAAR provisions prospectively i.e. from financial year beginning from April 01, 2015 and all the existing arrangements/transactions up to March 31, 2015 be grandfathered.

2. RECOMMENDATIONS

2.1. Treaty override

Clarity on treaty override in appropriate cases must be made explicit so that India's credibility as a reliable treaty partner is not affected. Based on the Shome Committee recommendation, it may be clarified that in cases where anti-avoidance rules are provided in a tax treaty in the form of Limitation of Benefits article etc. (like India-Singapore Tax Treaty), the GAAR provisions should not override the treaty. Further, where Specific Anti-Avoidance

Rules (SAAR) are applicable to a particular aspect/element, then GAAR shall not be invoked to look into that aspect/element.

2.2. Objective criteria/ conditions

It is submitted that certain objective criteria / conditions be laid down, which if fulfilled would not result in the triggering of GAAR provisions and its consequential implications on any offshore entity including denial of treaty benefits.

Further, it is recommended that the language clarifying the objective criteria / conditions also include examples of where GAAR provisions would not be triggered. Some such examples could be as follows:

i. Pooling

Where the main object of the offshore entity is to undertake investments, it has at least 10 unrelated shareholders from multiple jurisdictions, none of whom holds more than 49% of the capital of such offshore entity.

Pooling in India presents several regulatory challenges including in terms of obtaining several regulatory approvals, ease of repatriation / transfer, shareholder rights etc. It is quite expedient for parties especially based in multiple jurisdictions to pool at a convenient location outside India, both from a regulatory and commercial perspective. Therefore, the requirement to pool must be construed as a strong substance indicator. The above position is supported by certain rulings pronounced by the Authority for Advance Rulings.

ii. Expenditure

An average expenditure of USD 50,000 per year for a period of 24 months immediately preceding the date on which the income in respect of which treaty benefits is claimed has been earned by the offshore entity.

As you may appreciate, incurring of such expenditure will be on operational matters and is a good indicator of substance.

iii. ***Residuary test***

All the under-mentioned conditions to be cumulatively satisfied:

a) At least two directors who are residents of the jurisdiction wherein the overseas entity is incorporated / set up;

b) The control and management is exercised by the board of directors of the overseas entity;

c) Board meetings are conducted only in the jurisdiction of the overseas entity at least once a quarter and are chaired by the resident directors;

d) Registered office is in the overseas entity jurisdiction;

e) Principal bank account is maintained at all times in the overseas entity jurisdiction; unless economic circumstances deem it fit otherwise (e. g. recent developments in Europe)

f) Books of accounts, accounting records and secretarial records are maintained at all times at its registered office in the overseas entity jurisdiction;

g) Statutory auditor is a resident of the overseas entity jurisdiction;

h) Company secretary is a resident of the overseas entity jurisdiction; and

i) Holds a tax residency certificate issued by the tax authorities of the overseas entity jurisdiction.

A cumulative satisfaction of the above criteria would mean that the entity is not a 'post-box entity' and hence, should be entitled to treaty benefits, as applicable.

Note for all the above examples:

i. If any of the above tests is met by the direct / indirect parent entity (ie: holding more than 50 per cent beneficial interest in the capital of the overseas entity or more than 50 per cent voting power of the overseas entity) of the overseas entity and such parent is established in the same jurisdiction as that of the overseas entity, then it shall be deemed that such test is also complied at the overseas entity level.

ii. Where the main purpose of the overseas entity is to make investments and its investment management or related function is undertaken by any other entity set up in the same jurisdiction as that of the overseas entity and such management entity meets any of the aforementioned tests, then it shall be deemed that such test is also complied at the overseas entity level including any subsidiaries of such overseas entity set up in the same jurisdiction.

2.3. Grandfathering provisions

It is humbly submitted that in the interest of fairness and consistency, the proposed GAAR provisions should not be made applicable to existing structures / arrangements / investments, which are legitimate as on March 31, 2015 and ought to be grandfathered. For instance, any offshore investment vehicle, which is incorporated under a valid local law prior to March 31, 2015, holds a valid tax residency certificate and but for the applicability of the GAAR provisions would have been entitled to treaty benefits, ought to be grandfathered.

B. TAX BENEFITS FOR REITs

1. Background

1.1. SEBI had released the Draft SEBI (REIT) Regulations, 2013 ('Draft REIT Regulations'), which were earlier posted for public comments. The REIT regime has been warmly welcomed by the industry and investor community.

1.2. Under the Draft REIT Regulations, REITs can primarily invest in completed, revenue generating real estate assets and distribute major part of the earning among its investor.

1.3. The REIT regime, once implemented, shall provide an alternative option to investors in the real estate sector in the form of an asset backed investment with regular revenue stream. More importantly, REITs shall provide much needed transparency and liquidity the real estate segment in India. From a private equity/ venture capital standpoint, REITs will create exit opportunities for developers and financial investors and free up cash for further development in this sector.

1.4. While the Draft REIT Regulations are a positive step in maturing the real estate market in India, certain key changes are required in the tax regime for REITs to make it an attractive investment option.

2. RECOMMENDATIONS ON KEY CHANGES IN THE TAX REGIME FOR REITs

2.1. Pass through status to REITs

2.1.1. Under the extant tax regime, income earned by REITs shall be subject to tax at multiple levels (including taxes at SPV level), making it a tax inefficient structure. Further, a high tax outflow would substantially reduce return to investors and make REITs inattractive. Hence, keeping in line with international practice, REITs should be subject to single level of taxation.

2.1.2. In order to ensure pass-through status and a single level of taxation for REITs from an income-tax perspective, the following are the suggested recommendations:

Income-tax

- Income earned by SPVs should be exempt from corporate tax/ Minimum Alternate Tax ('MAT')
- Income earned by REITs should be exempt from tax and REITs should be given a pass through status to ensure single level taxation
- Distributions to unit holders could be subjected to tax at a concessional tax rate of 10-15% in the hands of unit holders

Distribution tax

- Distribution by SPVs to REIT should be exempted from distribution tax.
- Distribution by REIT to unit holders should be exempted from distribution tax.

Withholding tax

- Investee companies and REITs should be exempted from withholding requirements.

2.2. Taxes on transfer of real estate assets/ shares of SPV

2.2.1. Currently, the real estate assets (such a land, building etc.) may be housed in a SPV by the real estate developer. Accordingly, transfer of such real estate assets/ shares in the SPV would entail huge capital gains tax and stamp duty cost. It would also not be feasible for the developer to transfer the real estate assets at nominal value since the provisions of section 50C/

section 43CA of the Act would impute the stamp duty value to b[e] deemed sales consideration.

2.2.2. Elimination of capital gains tax and stamp duty cost at the initial stage of transfer of assets/ shares in SPV from the real estate developer to the REIT would assist in making REIT an attractive investment proposition.

2.2.3. In light of the above, the following are the suggested recommendations:

- Capital Gains on initial transfer of real estate assets/ share of SPV by the Sponsor to the REIT should be deferred until the sale of REIT units by the Sponsor since there is no monetization for the Sponsor and also considering that there is a lock-in of 3 years for the Sponsor.
- Stamp duty exemption should be provided: (i) on initial transfer of assets/ shares in SPV into REIT; and (ii) on purchase of real estate assets by REITs.

2.3. Taxes on transfer of units of REITs

2.3.1. As per the Draft REIT Regulations, units of REITs are proposed to be listed on the stock exchange. Accordingly, in order to make REITs attractive, concessional tax regime should be provided for units of REITs [similar to listed shares/ mutual fund units]

2.3.2. In light of the above, the following are the suggested recommendations:

- Purchase/ Sale of units of REITs on the stock exchange should be subject to Securities Transaction Tax ('STT')

- Capital gains on purchase and sale of listed REIT units should be subject to concessional tax regime (0% - 15%), subject to payment of STT