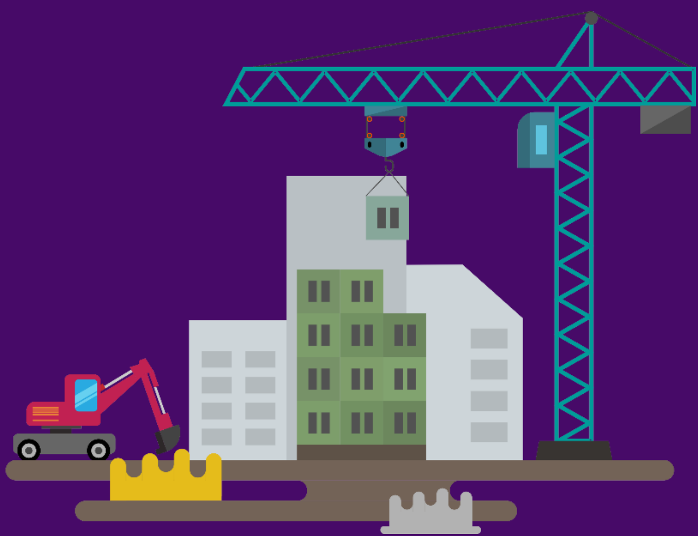
Building, Construction and Real Estate

Union Budget 2016

Post-Budget sectoral point of view



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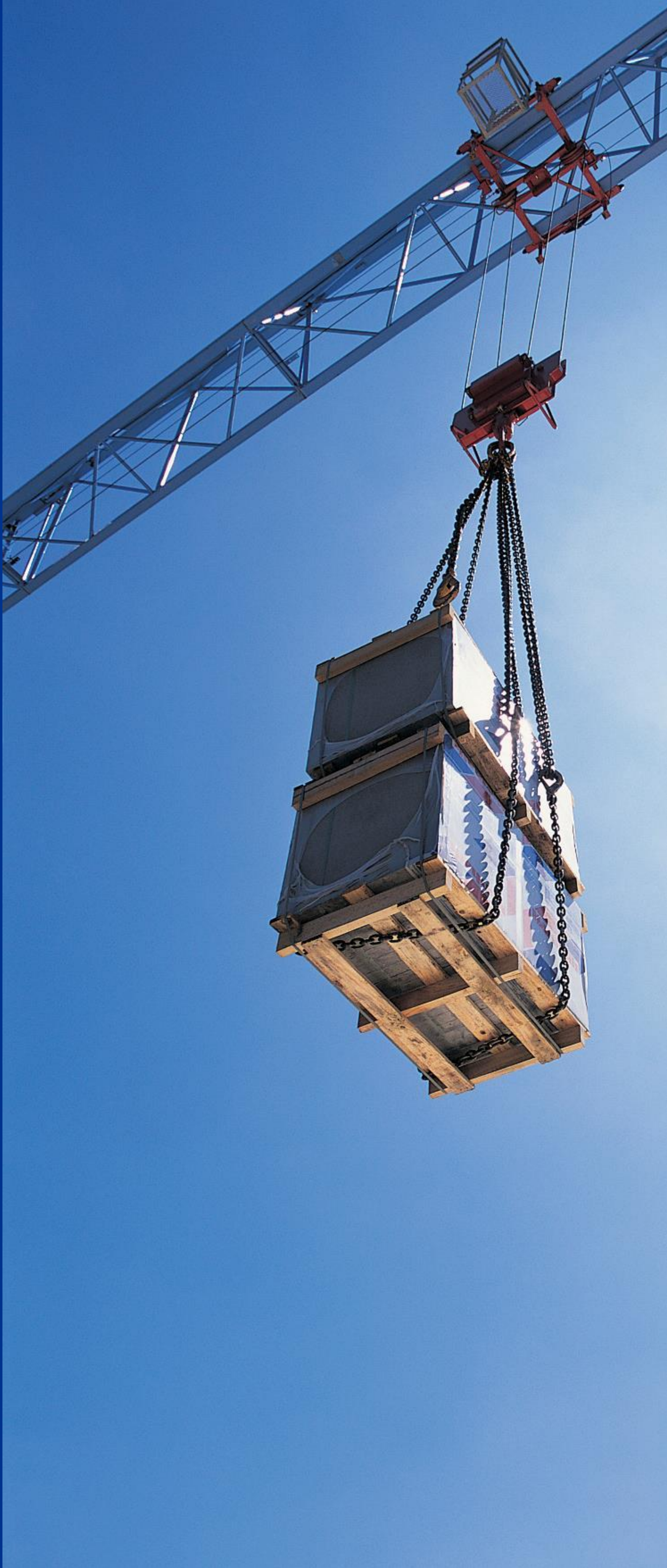

Context

Where we are

Engine of economic growth: The sector, which has forward and backward linkages with more than 250 different sectors, is the second largest employment generator in India after agriculture. The sector correlation with GDP is high at 0.78x (every INR1 invested in the sector directly adds INR0.78 to the GDP) and there is significant room for improvement, as real estate sector correlation in other large economies (such as China, the U.S., the U.K., Germany, Spain) is at least 0.9x.[1]

Contribution to GDP: According to the Economic Survey 2015-16, the real estate sector constituted 7.4 per cent of India's GDP in 2014-15. Both domestic and global slowdown affected the sector, with growth decelerating from 4.4 per cent in 2014-15 to 3.7 per cent in 2015-16.

Improving liquidity: The private equity deals in the Indian real estate sector increased 80 per cent year-on-year in 2015 to INR19,500 crore.[2] However, the Foreign Direct Investment (FDI) was almost negligible in 2015-16 (April to December) to INR673 crore (USD105 million)[3] as most foreign investors preferred quasi-debt deals, which is not captured in FDI.

Prices decline: The property prices have corrected, either directly or indirectly (through promotions, schemes, etc. offered by private players), by about 10 to 15 per cent nationally. Major correction was witnessed in Delhi-NCR, Mumbai and Chennai markets.[4]

Housing credit: The institutional credit growth for housing sector is expected to have improved in 2015-16 to 19.5 per cent from 16.8 per cent witnessed in 2014-15.[5]

Significant supply gap: The urban housing shortage is 19 million units, of which 95.6 per cent is in Lower Income Group (LIG) and Economically Weaker Section (EWS).[6]

Commercial office space leasing strong: The commercial office space maintained its positive momentum through 2015, led by corporate expansion and consolidation as a result of improving business sentiments. In 2015, about 36 million sq ft. of office space was absorbed, which is second best after 2011. Vacancy level fell from 22 per cent in 2014 to 17 per cent in 2015.[7]

Key issues/challenges

To reduce the large supply-demand mismatch, the government needs to address the following issues/challenges:

- It is estimated that the top cities in India have seven lakh units of unsold housing stock, with maximum concentration in the Northern region. At the current rate of absorption, the existing inventory in the Northern region would take 65 months to get absorbed, while in the Western region, it would take 30 months and in Southern region, it is 24 months.[8]
- Scarcity of developable urban land due to limited urban infrastructure and higher controls, resulting in inflation of prices
- Land title related issues and significant land litigations
- Absence of a real estate regulator resulting on lack of transparency and lower investor confidence
- Delay in construction project related approvals resulting in significant schedule and cost overrun in real estate and infrastructure projects
- Lack of a strong micro finance sector makes it difficult for the Economically Weaker Sections (EWS) and Lower Income Groups (LIG) to secure housing finance credit
- Limited access to long-term and low-cost funds, especially from banking channels including external commercial borrowings
- Significant shortage of skilled and unskilled workforce
- Higher rates of statutory charges and taxes tend to inflate the cost of construction, making affordable housing projects financially unviable for developers
- Multiple taxation on real estate development projects increases the overall cost of the project, thereby impacting the affordability for buyers
- Taxation issues hampering REITs from taking off.

1. Housing: The Game Changer, Cushman & Wakefield, January 2014
2. PE investment in realty up 80% at Rs19,500 crore in 2015, Business standard website, 8 February 2016
3. FDI Statistics, DIPP website, accessed 26 February 2016
4. What will 2016 mean for property prices?, NDTV website, accessed 26 February 2016
5. Housing Finance, Crisil Research, November 2015
6. Report of the technical urban group (TG-12) on urban housing shortage 2012-17, Ministry of Housing and Urban Poverty Alleviation, September 2012
7. Net cos take Bengaluru office space leasing to new high, The Times of India website, 5 February 2016; KPMG in India analysis
8. Economic Survey 2015-16, Government of India

Government's stance

- The NDA government introduced several reforms last year, directed towards easing tight liquidity situation in the sector, and boosting affordable housing and urban infrastructure
- The government formalised its vision – 'Housing for All by 2022', which encompasses building six crore housing units through public-private partnership model. Of these, about two crore houses would be built in urban regions and rest in rural regions. Initially, the vision would entail housing stock development in 1,049 cities (278 Class I cities) of 22 states[9]
- The government also formalised several initiatives directed towards improving urban infrastructure. It has already identified 100 cities to be developed as Smart Cities (list of 20 such cities recently announced), identified 500 cities for urban rejuvenation under 'Atal Mission for Rejuvenation and Urban Transformation' (AMRUT), and launched Heritage City Development and Augmentation Yojana (HRIDAY), which would transform urban infrastructure in 12 Heritage Cities[10]
- The government further relaxed foreign direct investment norms by removing the size and investment restrictions. Further, the lock-in restriction was relaxed allowing easy exit to investors. Lastly, the government allowed investors to invest in completed properties, which was not allowed earlier[10]
- The Reserve Bank of India reduced the risk weight for individual housing loans of up to INR75 lakh from 50 per cent to 35 per cent. Further, it increased loan-to-value ratio to 90 for loans up to INR30 lakh.[11]

Expectations (policy/fiscal/tax)

Major expectations of the sector from Union Budget 2016 were:

Direct tax

- Clarity on taxation of Joint Development Agreement transactions especially with respect to point of taxability and manner of taxability
- Deletion of stamp duty valuation based taxation
- Rationalisation of deduction for affordable housing and slum rehabilitation
- Removal of Minimum Alternate Tax levy on SEZs
- Rationalisation of disallowance provisions in respect of exempt income
- Rationalisation of taxation structure of Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs)
- Tax concessions/incentives to home buyers especially to the first time home buyers.

Indirect tax

- Rationalisation of multiple indirect taxes
- Credit of input service tax paid on construction service against leasing activities
- Clarification on non applicability of service tax on Transfer of Development Rights (TDR)
- Benefit for abatement from levy of service tax on all charges such as prime location charges, etc.
- Benefit for abetment from levy of service tax on prime location charges, etc.
- Rationalisation of stamp duty and local levies.

Policy and regulatory

- Accord industry status to the sector, thereby paving the way for reduced cost of funding
- Allow external commercial borrowings in sectors other than affordable housing
- Strengthen micro-finance to facilitate housing credit to economically weaker sections of the society.

9. India soars high, KPMG in India, 2016
10. Economic Survey 2015-16, Government of India
11. RBI allows 90% loan to value ratio on home loans up to INR30lakh, Livemint website, 9 October, 2015

Key policies/fiscal and tax proposals

Key announcements[1]

Major policy announcements

- Sanctioning and building additional one lakh kilometers of road in 2016-17
- Formalised setting up of National Investment and Infrastructure Fund (NIIF) to be funded by INR20,000 crore annually
- Tax free infrastructure bonds for projects in rail, roads and irrigation sector
- Measures to improve ease of doing business in India
- Proposal to introduce Benami Transactions (Prohibition) Bill to curb black money in the form of *benami* property, especially in real estate
- PPP mode of infrastructure development to be revisited and revitalised
- Modernisation of land records programme is expected to be revamped under Digital India initiative. The Finance Minister has allocated INR150 crore for 2016-17 towards this initiatives
- Foy 2016-17, the Finance Minister has allocated INR2.21 lakh crore for infrastructure sector, which is 22 per cent higher than current year allocation. Of the total allocation, INR2.18 lakh crore is allocated for road and rail development.

Key direct tax proposals:

Corporate tax

- Staggered phase-out of exemptions – Road map of phasing out of incentives/concessions provided
- No change in tax rate, surcharge and education cess for companies, except concessional rates for new manufacturing companies/small companies
- 100 per cent tax deduction for profits from affordable housing projects subject to specified conditions such as area restrictions linked to municipal limits and unit size restrictions
- Conversion of company into LLP – An additional condition prescribing threshold of INR5 crore for total assets of the company in any of the three years preceding the year of conversion
- Rationalisation of section 50C (on similar lines as section 43CA) in case of sale consideration is fixed under agreement executed prior to the date of registration of immovable property, subject to fulfillment of certain conditions
- Exemption from paying Dividend Distribution Tax (DDT) for distribution of dividend by wholly owned SPV to REITs/INvITs
- Period of holding for unlisted shares (for long term capital gains computation) to be reduced from three years to two years, as announced by the Finance Minister in his Budget speech (though no specific mention in the fine print)
- Ambit of levy of additional tax on buyback widened to include all kinds of buyback arrangements under the Companies Act. Further clarifications expected on the computation mechanism
- Rationalisation of tax deduction at source related provisions applicable to Alternative Investment Fund (AIF) – Amendment proposed in law to allow foreign investors to avail tax rate applicable under the relevant tax treaty and/or to apply for nil or low withholding tax rate
- One time scheme for voluntary income declaration introduced by the government by payment of 45 per cent of undisclosed income in aggregate
- Dispute Resolution Scheme for income tax litigation introduced by the government for the first time
- Penalty provisions revamped to provide penalty rate of 50 per cent of tax in case of underreporting of income and 200 per cent of tax where there is misreporting of facts
- Legal framework introduced for automation of various processes and paperless assessment.

Housing-related incentives for individuals

- Deduction towards rent payment (non-HRA) under section 80GG raised to INR60,000 from INR24,000. Potential annual savings up to INR12,793
- Threshold for completion of property construction for interest deduction on self-occupied property raised to five years from three years, from year of sanction of loan
- Additional interest deduction of INR50,000 for loan up to INR35 lakh for first time home buyers, where cost of the house does not exceed INR50 lakh.

Personal tax

- No change in tax rates and basic threshold limits
- Additional tax of 10 per cent levied on gross basis on dividend income exceeding INR10 lakh in the hands of resident individuals, HUF and firm
- Surcharge on income exceeding INR1 crore (for individuals/HUF/AOP/BOI) raised to 15 per cent from 12 per cent. MMR of 35.535 per cent from the current 34.608 per cent.
- Retiral schemes brought under the tax regime at the time of withdrawal – withdrawals only up to 40 per cent of accumulated balance of Provident Fund (limits prescribed) and Superannuation Fund exempt from tax

1. Union Budget 2016-17, http://indiabudget.nic.in/glance.asp, 29 February 2016

- Amendment in section 54GB: Capital gains not to be taxed in case of individuals/HUFs transferring their long term capital asset (residential property) and investing in eligible start-ups up to 31 March 2019. Capital gains not to be taxed if invested in notified funds, up to a limit of INR50 lakh
- Receipt of shares by individuals and HUFs in mergers/ demergers excluded from the purview of section 56 (i.e. deemed basis of taxation)
- Long-term capital gains tax in respect of shares of unlisted companies clarified to be taxed at 10 per cent.

Other key proposals

- General Anti Avoidance Rules (GAAR) on track to be implemented from 1 April 2017
- Place of Effective Management (POEM) rules (which deems a foreign company to be a resident in India) deferred by one year, i.e. it is proposed to be applicable from FY2016-17
- Rules to compute disallowance under section 14A (in relation to expenditure incurred for earning exempt income) to be rationalised – Disallowance proposed to be limited to 1 per cent of the average monthly value of investments yielding exempt income, but not exceeding the actual expenditure claimed. Amendment in the relevant rules to be made
- Eligible Foreign Direct Investment (FDI) instruments expanded to include hybrid instruments subject to certain conditions – Detailed provisions and specific changes awaited in this regard
- 100 per cent deduction of profits for three out of five years for start-ups incorporated till 31 March 2019, subject to fulfillment of prescribed conditions. However, MAT provisions will continue to apply
- Concessional tax regime to develop India as a Research and Development hub.

Key indirect tax proposals

- Government to ensure passage of the Constitutional Amendment Bill to implement GST
- 'Krishi Kalyan' cess made applicable on all or any of the taxable services at the rate of 0.5 per cent on the value of such services thereby increasing the effective service tax rate to 15 per cent (effective from 1 June 2016). Krishi Kalyan Cess can be utilised for payment of Krishi Kalyan Cess
- General Basic Customs Duty rates remain unchanged. Thus, the general effective customs duty rate continues to be 26.43 per cent (capital goods)/29.44 per cent (other goods). However, BCD increased from 7.5 per cent to 10 per cent for specified goods of Chapter 84, 85 and 90 e.g. electric motors and generators
- No change in general excise duty rates
- Excise duty on Ready Mix Concrete (RMC) manufactured at the site of construction for use in construction work at such site reduced to nil (effective from 1 March 2016)
- The abatement rate in respect of services by way of construction of residential complex, building, civil structure, or a part thereof rationalised at 70 per cent by merging the existing two rates (70 per cent and 75 per cent depending upon area/sale price) effective from 1 April 2016
- Service tax exemption on construction, erection, commissioning or installation of a new airport/port restored for the contracts entered into prior to 1 March 2015 (effective from 1 March 2016)
- Services by way of construction in respect of the following activities exempted from service tax (effective from 1 March 2016):
  - housing projects under Housing For All (HFA) (Urban) Mission/Pradhan Mantri Awas Yojana (PMAY)
  - low cost houses up to a carpet area of 60 square meters in a housing project under 'Affordable Housing in Partnership' component of PMAY
  - low cost houses up to a carpet area of 60 square meters in a housing project under any housing scheme of the state government
- Service tax on construction, erection, commissioning, etc. of a residential complex provided to government/local authority/governmental authority meant for self-use or use of their employees exempt for the contracts entered into prior to 1 March 2015 (effective from 1 March 2016)
- Rule 6 of CENVAT Credit Rules, 2004 amended with the objective of simplifying and rationalising the same (effective from 1 April 2016)
- Interest rate on delayed payment proposed to be made uniform at 15 per cent. However, in cases where service tax is collected but not deposited, the interest rate would be 24 per cent. Further, where value of taxable services in the preceding year(s) covered by the notice is less than INR60 lakh interest rate would be 12 per cent (effective from date of assent to Finance Bill, 2016)
- Indirect Tax Dispute Resolution Scheme, 2016 introduced and will come into force from 1 June 2016.

Our point of view

Union Budget 2016 was a mixed bag for the real estate sector. The targeted reforms in REITs/InvITs, affordable housing and additional tax benefits for first time home buyers are expected to support growth in the sector.

Removal of Dividend Distribution Tax (DDT) on REITs and INvITs, and reduction in capital gain period to two years was perhaps the most major announcement in the Union Budget.

- These were perhaps the few roadblocks in the REITs take off. Earlier, it was not suitable for an investor to list its properties using REITs as the same would have resulted in reduction in yields by almost 20 per cent due to DDT. With no DDT, listing of properties using REITs or direct acquisition, would make no difference.
- Further, the reduction in period to classify a capital gain as long term has been reduced from three years to two years. This would help attract investors in the real estate market, which was at a disadvantage to the capital market, where long term capital gain period is one year.

Granting 100 per cent tax exemptions for affordable housing projects will go a long way in improving the sentiments as also making the housing affordable. We would have appreciated if MAT was also exempted for such projects. Further, the condition of finishing the project within three years would be a bit challenging and developers would need strong project management skills.

Exemption from service tax on construction of affordable houses up to 60 square metres under any scheme of the central or state government including PPP schemes would help improve affordability.

The Finance Minister allowed an additional interest deduction of INR50,000 per annum for loans up to INR35 lakh sanctioned in 2016-17 for first time home buyers, where cost of house does not exceed INR50 lakh. Although it may help boost the demand for mid-income housing, we expected a higher deduction on this front which would have been in line with market realities.

The enhanced deduction to individuals in relation to rental payments for residential housing may provide some boost to the yield based residential property market.

Rationalisation of tax withholding rates, withholding provisions, measures introduced to reduce litigation and proposal for extensive use of IT technology in the administration of tax matters will go a long way in improving the efficiency and morale of the investors as well as business community.

Overall, the Finance Minister has presented a balanced and progressive budget keeping in mind the global developments, and increased international pressure on introducing tax avoidance measures. On the real estate sector front, the Budget has met some expectations leaving large number of demands unfulfilled thereby not providing the much desired fillip to the growth of the sector which is second largest contributor to country's GDP.

Unfinished agenda

What remains

'Housing for All by 2022', smart cities and infrastructure development has been a focus of this government, and there have been some key announcements in this regard. However, some of the areas that were expected to be addressed but have not been, are discussed hereunder:

- Granting infrastructure status to real estate sector to help channelise higher investment in the sector
- Single window clearance mechanism to reduce gestation period of realty projects
- Allowing developers to raise funds through External Commercial Borrowings (ECB)
- Allowing FDI in LLP engaged in real estate development and construction sector – doing away with performance linked criteria
- Rationalise and revitalise laws related to land acquisition and development, introduce single-window clearance, eliminate multiple local levies and taxes to foster growth of the real estate sector
- The levy of MAT on SEZ developers and SEZ Units have negatively affected India's manufacturing sector global competitive edge. The levy of MAT and other commercial reasons have stalled the development of SEZ for the past few years resulting in significant impact on export potentials, employment generation and overall economic development.
- At present, JDAs as well as development agreements are subject to service tax. This increases the transaction cost as well as affordability of the real estate projects. Further, there are challenges in availing CENVAT credit for service tax so levied. Clarification on non applicability of service tax on transfer of development rights is much needed
- At present, given the controversial judicial precedents, the land owners are subjected to pay tax at the time of entering into joint venture agreements with the developers despite not receiving consideration upfront. This results in significant cash outflow upfront and becomes an issue in finalising the joint venture arrangements. Further, there are challenges on computation of taxable income especially given that consideration in case of area share or revenue share arrangement is reasonably fluid. The JDA is also being viewed by the revenue authorities as creating an 'Association of Person' and thereby taxing the entire profits in the hands of the Association of Persons (AOP) rather than the land owner and developers independently. This increases the overall tax cost as well as litigation with the tax authorities.
- According to SEBI regulations on REITs, developers can transfer their properties to a REIT SPV or to the REIT directly in exchange of units. However, in case of latter, any capital gains arising on such transfer of property is subject to capital gains tax. This creates an uneven treatment between the two processes, and takes away the flexibility provided under the SEBI regulations. Further, any capital gains earned by REIT on sale of shares of REIT SPV or property itself is subject to taxation in the hands of REIT and not in the hands of unit holder. This restricts pass through taxation status for REIT resulting in additional taxation at REIT level
- Exemption from stamp duty on transfer of property to REIT
- Relief to mid-income and high-income tax payers, who have consistently witnessed a higher tax outgo (direct and indirect) in the last few years
- Credit of input service tax paid on construction service against leasing activities
- Rationalisation of multiple indirect taxes, and roadmap for GST roll out
- Rationalisation of stamp duty and local levies.

What is expected going forward

The announcement for removal of DDT on REITs/INvITs is expected to help REITs/INvITs take off. It is estimated that in the short-to-medium term, developers may raise USD8 to10 billion through REITs.

Other than REITs, a progressive step to extend tax incentives to affordable housing development is a welcome step. We expected some additional measures to support the housing demand, which were largely missing in the Union Budget. Further, no clarification was provided on the GST and FDI in multi-brand retail policy.

Going ahead, we hope that certain key legislations such as Real Estate Regulatory Bill, Land Acquisition Bill and GST Bill to be tabled in the Parliament soon, which would help support the growth of the realty sector.

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