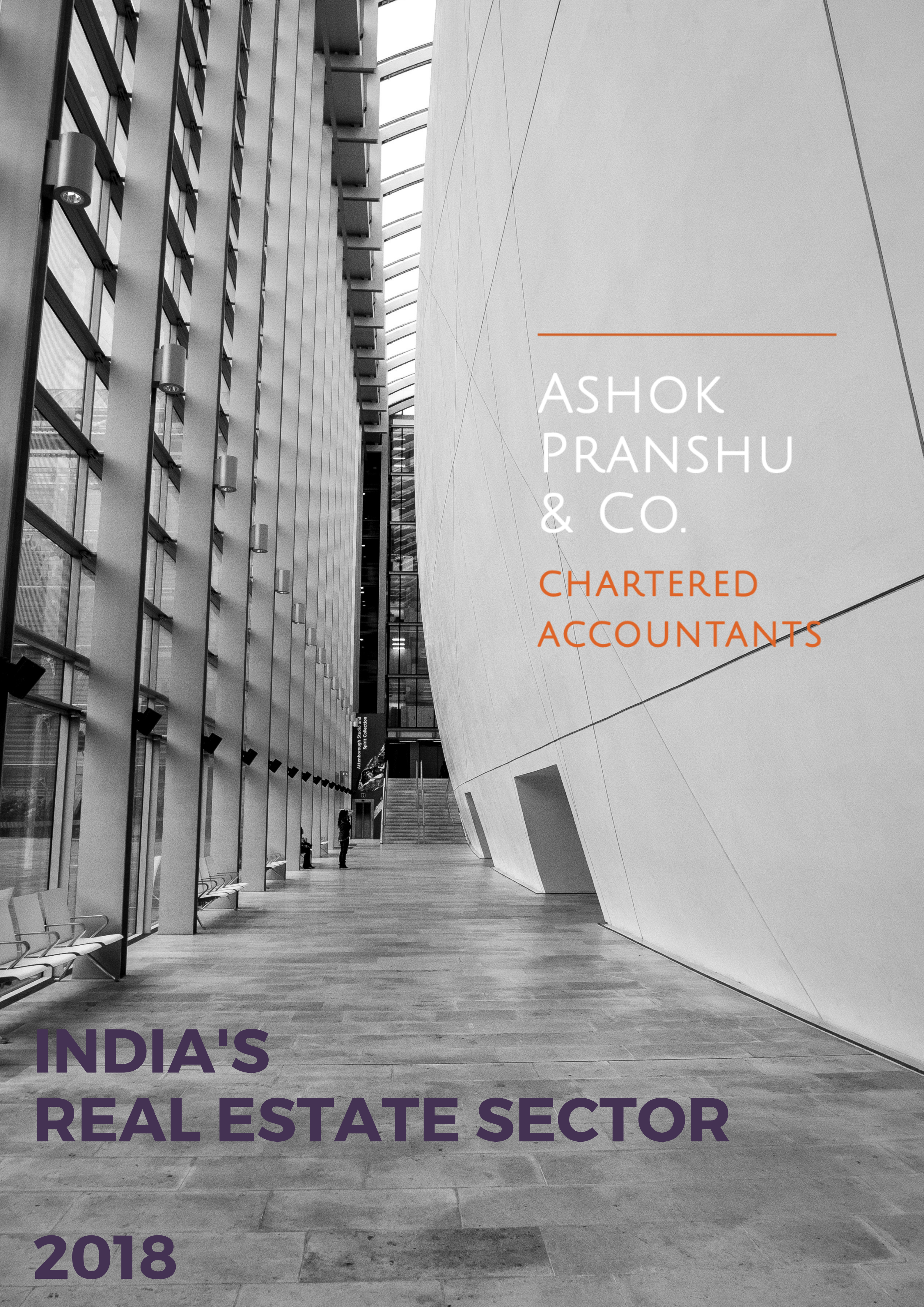

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India's Real Estate Sector

2018

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INTRODUCTION

Real Estate Sector in India has witnessed turmoil in last few years after demonstrating immense growth in the fields of housing as well as commercial retail and office space. The growth numbers made the sector lucrative which attracted many businesses with even limited capital to enter this sector. The real estate sector has a high economic growth potential, however, lack of financial planning, market research, and government initiatives, has resulted in builders and investors clogging up their funds in non-operating assets and creating a huge inventory of housing and commercial spaces without sufficient demand.

Due to the above stated factors, the funds of the genuine investors and buyers are clogged up in land bank in outskirts, which should have been used wisely in completing the ongoing projects in a timely manner. This approach of majority of the players in the market who did not had enough capital and were thriving upon the capital assistance from financial institutions and the genuine buyers have left the genuine investors and buyers stranded. The significant delays in the completion of under construction projects, sometimes by even more than three years, has impacted consumer confidence in the sector.

RECENT TRENDS

Last three-four years were difficult for the real estate sector. The important factor to consider is that the growth of the sector not only depends on the actual consumer but also investors, who generally invests their funds/ income in the real estate. Indian real estate sector thrives because of the flow of the funds in the unorganized parallel economy. However, enhanced government regulations, initiatives and scrutiny has worsened the situation for the flow of funds in the real estate sector thereby effecting the overall growth of the sector.

Although, the measures of the Indian government were aimed at rationalizing the real estate sector in India, however, the multiple actions such as introduction of Real Estate (Regulation and Development) Act, 2016; amendment in Income Tax Act, 1961; Goods and Services Tax Act, 2017; Demonetization and Insolvency and Bankruptcy Code, 2016, in quick succession has brought the development to a stall and have also not been able to provide any mechanism to provide any relief to the genuine buyers and consumers. All these reforms seems to have a positive impact in the long term, however, it has hit the segment hard in the near term.

GLIMPSE OF UNION BUDGET 2018-19

Union Budget 2018 provided for a dedicated Affordable Housing Fund to boost the affordable housing segment, however, the real estate segment which has witnessed the drastic changes, was expecting some prominent reforms in the Union Budget 2018-19 for its revival and growth.

The irony is that the Union Budget 2018-19 was more agriculture sector and farmer centric and has not considered the bleeding situation of the real estate sector in India, due to which the investors and the home buyers have further lost faith in the developers as well as the government.

INCOME TAX ACT, 1961

In recent past, the government of India has made radical changes in the Income Tax Act, 1961 ('**IT Act**'), which has directly and indirectly effected the real estate sector in India. Nevertheless, the Government of India had introduced certain significant amendments in the IT Act to provide some sort of relief and relaxation with an underlying objective of boosting the sector.

The gist of such amendments are as follows:

Relief of 5% difference in consideration and stamp duty valuation

Union Budget 2018-19 amended the provisions of the IT Act providing relief to the tax payers having gains from sale of the immovable property. In terms of the provisions of the IT Act, if the consideration for the sale of the property is less than the stamp duty valuation, then the stamp duty valuation is deemed as the sale consideration for taxation purposes. However, considering the fact that at some places the market price of the immovable property is less then the stamp duty value, to minimize the hardship of tax payers, a relaxation of 5% is provided in the difference in consideration and the stamp duty valuation. In other words, if the consideration is upto 5% less than the stamp duty value of the property, the stamp duty will not be deemed to be the consideration for tax purposes. However, the relaxation of 5% is not much as there are many places, where the market value is around 20% to 25% lower than the stamp duty value.

Period of holding of land and building for long term capital gains reduced from three years to two years

Land and Buildings were considered as long term capital assets if, prior to date of sale they were held for three years or more. However, the IT Act was amended in the year 2017 and now land and buildings are considered as long term capital asset, if they, prior to the date of transfer were held for two years or more. Thus, now if any land and building is sold after two years from the date of purchase, the capital gains would be long term capital gains.

This move of the government was aimed at increasing the circulation of funds and to promote investment in the real estate sector.

Change in Valuation methodology of equity shares of a company

In 2017, the government has changed the valuation rules for computing the fair market value of unquoted equity shares of a company. Prior to 2017, the unquoted equity shares were valued at the book value of the assets and liabilities as on the date of the transfer of the shares. Tax payers used to house their immovable property in an incorporated company structure and used to transfer the shares of the company for indirectly transferring the ownership in the immovable property. In such a scenario, tax payers used to transact at the book value as the valuation rules provided for valuation at the book value. However, the government has amended the same in the year 2017 which now provides for fair market value methodology rather than book value. Now for computing the fair market value of equity shares of a company, stamp duty value of the immovable property housed in the company has to be considered rather than the historical book value. This will bring in the taxation of sale of immovable property directly at par with the taxation of sale of equity shares of a company having an immovable property.

Revenue Recognition: Percentage of Completion Method

Union Budget 2018 introduced a new Section in the IT Act, in view of which the profits and gains arising from the construction contracts shall be determined on the basis of percentage of completion method. Prior to this amendment, there was no mandatory provision for following percentage of completion method for recognition of revenue. There was only a guidance note which was available, which provided for adoption of percentage of completion method for recognition of revenue in case of construction contracts. Since, the guidance note was not mandatory in nature, developers were also following project completion method, which used to delay the collection of tax till the completion of the project.

This amendment will impact the liquidity of the developers in short term who were following project completion method for recognition of revenue instead of percentage of completion method.

Goods and Services Tax Act, 2017

Real Estate Sector in India has long struggled with multiple taxes being levied and charged. From VAT to Service tax being charged by the developers from the customers, to paying Excise, VAT, Service Tax, Octrai and Entry Tax on the inputs used for the construction and development of the project.

Since, development activity included transfer of product in the form of land and building and also included element of service in the form of labour employed for construction of the building, the end customer was charged VAT as well as Service Tax. This always used to create a issue among the developer and the end customer, whereby end customer never been able to understand the levy of both the taxes at the same time.

GST has brought lot of transparency in the real estate sector. Under the GST law all the taxes such as VAT, Service Tax, Excise, Octrai and entry tax have been abolished and now only one tax GST would be levied.

Currently, the sale of land and completed buildings have been kept out of the ambit of GST but it is expected to be taxed within a period of a year. In other words, in case of sale of building where completion certificate is received, no GST would be levied.

On the other hand construction of a complex building, civil structure, or a part thereof, intended for sale to a buyer, wholly or partly, is subject to 12 per cent tax with full Input Tax Credit (ITC), subject to no refund in case of overflow of ITC. In other words, construction services, will invite GST at the rate of 12 per cent, which will apply to developers selling residential units before completion of construction to the home buyers.

Real Estate (Regulation and Development) Act, 2016

Prior to introduction of Real Estate (Regulation and Development) Act, 2016 ('**RERA**'), there was no specific regulation/ code and any specific authority regulating the real estate sector in India. RERA established a regulatory authority in each state and union territory whose function *inter-alia* includes protection of the interests of the stakeholders, accumulating data at a designated repository and creating a robust grievance redressal system.

RERA has laid down the checks and balances and the mandatory compliance which a developer has to undertake before launching a project and till the time of giving possession of the flats to the buyers. RERA makes it mandatory for all the developers to register with the RERA authority before launching of any new project and to keep the customer/ consumer and the authority updated all the time about any changes on development in the project. Further, to prevent the diversion of funds by the developers in other project(s), RERA provides for creating a reserve of 70% of the project receivables in a seperate bank account. The proceeds of such account can only be used towards land and construction expenses and will be required to be certified by a professional. RERA also provides for standardization of sale agreement and provides for stiff penalties and even prosecution in cases of violation.

While the RERA sets the groundwork for fast-tracking dispute resolution, the test for its success, will depend on the timely setting up of these new dispute resolution bodies and how these disputes are resolved expeditiously with a degree of finality.

RERA in the short run aims to consolidate the market, wherein the small players with lack of liquidity will consolidate to comply with the provisions of RERA and provide the completion of the projects in time. In the long run, RERA will strengthen the sentiments of the investors and buyers in this sector and will pave the way for the revival and growth of the industry.

Insolvency and Bankruptcy Code, 2016

Real estate sector in India is hard pressed for liquidity as the demand has diminished and the funds have been clogged up in multiple partially completed projects. Since, the developers in the spate of growth, have diverted the funds of one project into another without focusing on completion of the projects in hand, the result has been undue delay in the completion of the project. This has effected the faith of the consumers in the developer and which eventually resulted into decline in sales and lack of liquidity in market. Developers have also exhausted all their permissible limits with financial institutions also, thereby leaving no scope for further investment other than private equity or collaboration with other developers. At present, the developers are struggling to pay their tax dues, their vendors, employees, the contractors and also are unable to refund the amount which has been received from customers.

In the midst of this struggle, the Government of India enacted Insolvency and Bankruptcy Code, 2016 (**'IBC'**). IBC provides that a financial creditor, operation creditor or corporate debtor itself can file a petition before the Hon'ble National Company Law Tribunal (**'NCLT'**), for initiation of an insolvency resolution process, if the due amount is more than Rs. one lakhs. Thus, financial institutions, and vendors can file a petition before the NCLT to initiate the insolvency process against the developer, in case the developer fails to pay the due outstanding amount.

Recently, NCLT in many cases have accepted the petition of the financial institutions, employees and vendors against the real estate developers and have initiated the insolvency resolution proceedings against them. However, NCLT in many cases has held that home buyers do not fall within the definition of financial creditor as well as operational creditor and hence cannot file a petition for initiation of insolvency proceedings.

In view of the aforesaid decisions of NCLT, government has passed an ordinance on

May 23, 2018, whereby the home buyers are specifically included in the definition of financial creditors. The ordinance is pending for Hon'ble Presidents assent.

This ordinance after coming into force will increase the problem for the real estate developers who have taken funds from the home buyers and have not provided the possession of the property to them.

Considering that the insolvency resolution process is time bound, IBC will be considered by the home buyers as the favorable and most convenient way for initiating the insolvency process against the developer for recovering their hard earned money through the insolvency process.

Promulgation of the recent ordinance would have a drastic effect on the real estate sector, which eventually may lead to insolvency of some of the players and their projects being acquired and completed by the other giant real estate players in the market.

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