Update

Foreign owned or controlled companies: Is sharing of office infrastructure real estate business? DIPP's Clarification may muddle the issue

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Update

If you are a company wholly or majorly owned by non residents, and you allow your sister or subsidiary companies to sit, eat and drink in your office, or share your photocopier, or server, or staff, are you engaged in "real estate business"? The question itself must have startled most: however, a purported clarification of the Department of Industrial Policy and Promotion (DIPP) may actually create a substantial confusion.

Why the question at all?

The reason why the question arises is as follows: "real estate business" is a prohibited business for foreign direct investment in India. The expression "real estate business" is defined in Foreign Exchange Management (Transfer or Issue of Any Foreign Security) (Amendment) Regulations 2004. The definition has consistently been cited in the FDI Policy documents. The definition of "real estate business" is as follows:

p. 'Real estate business' means buying and selling of real estate or trading in Transferable Development Rights (TDRs) but does not include development of townships, construction of residential/commercial premises, roads or bridges;

Looking at the definition above, it is possible to explore the words "buying and selling" of real estate – one of ways of "selling" in context of real estate is leasing/sub leasing. Therefore, if the entity in question is engaged in leasing or sub leasing of real estate, it may be possible to contend that the entity is engaged in real estate business.

Sharing of office infrastructure: a commercial reality

Sharing of office infrastructure among group companies is a widely-prevalent reality of business. Corporate architecture of entities often involves several legal entities, related to each other as holding companies, subsidiaries, associates or affiliates. These entities typically have an interwoven business model. They normally work from the same business premises. They may, for sheer practical reasons, share a common office space, common office infrastructure, common facilities, sometimes even common staff or key managerial personnel. It is quite natural that if the entities are running their business from a common address, it is impossible to do any delineation of space, used by either entity. Since infrastructure (computers, systems, canteen, utilities, etc) are shared, there is no way to identify what is used by whom.

The office premises are typically taken on lease by one of the group entities. Now, how does this entity allow other entities to use the premises? It would not commonly be a case of sub-leasing of the premises to the group entities, for several reasons. Head lease agreements do not generally permit the lessee to sub-lease. In any case, a sub-lease will entail delineation and earmarking of area being sublet, which is not practical.

Hence, in most cases, companies enter into a facility sharing agreement, called by whatever name. This arrangement does not result into creation of sub-lease or leasehold

interest – it simply amounts to a permission to use. In legal parlance such agreement may come close to a license agreement.
Sharing of office infrastructure is a commercial reality which cannot be denied. If there are 5 companies in a business group, it is outrageous to think they will have 5 different offices, 5 different servers, or ERP systems, or key managerial personnel, or legal officers, etc.

The DIPP circular

These circulars are issued with a benign intent – to clarify matters. However, as it quite often happens, half-spoken intent, or unclearly-spoken intent, muddles up the issue altogether. This is the very likely situation with the DIPP Circular.

The Circular in question Circular dated 15th September 2015[1] on "facility sharing arrangements between group companies". The circular says the following: facility sharing arrangements between groups companies in larger interest of business will not be considered as real estate business provided (a) such arrangement is at arms length price in accordance with the relevant provisions of the Income tax Act; and (b) annual lease rent earned by the lessor company does not exceed 5% of its total revenue.

Does it happen at arms length price?

Section 92F(ii) of the Income Tax Act, 1961 defines the term arms length price as follows:
"arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

There are several models of arms-length pricing, viz., comparable uncontrolled price method, resale price method, cost plus method, profit split method, transaction net margin method and so on [Sec 92C of the Income Tax Act]. Arguably, the appropriate method in the present case may be cost plus method, or transaction net margin method.

However, the key issue is, should the company charge any margin on its cost on the sharing of infrastructure? Or should it simply go by a pure reimbursement? Needless to emphasise, the purpose of the infrastructure sharing is not to engage in the business of letting or subletting, or to make proper use of surplus resources, or to minimize costs. The sharing is done purely for reasons of practicality.

If the company starts charging a margin on its costs, there may be several issues. It will then amount to a business transaction, and therefore, one will get into an issue whether the business of providing office infrastructure amounts to a "business", and hence, are

[1]http://dipp.nic.in/English/acts_rules/fdi_clarifications/clarification_FDI%20policy_15092015.pdf

there enabling powers in the Memorandum of Association? The transaction will be a related party transaction[2], and not being in ordinary course of business, it may require approval under sec. 188 of the Companies Act, reporting with the directors' report, etc.
If it is not a pure reimbursement, it may also amount to a service, chargeable to service tax.

In any case, the issue is, if the intent of the transaction is mere mutual facilitation, is it expected that the company enabling the sharing must make a margin? It is almost like saying, if I am going to buy coffee for myself, and looking at the queue at the coffee vendor, my friend asks to get one coffee for him as well, does the law expect I must expect a margin on the coffee I am getting for my friend?

The limits of lease rentals

Not only does the DIPP Circular expect arms length pricing of the facilitation, it also puts a limit of 5% of total revenue on the facility provider. This stipulation will also result into multiple difficulties. First, there are several companies where the head lease is signed with one of the operatioally-less-active company. This may be an investment company in the group, or any other company, not engaged in the core operations. Therefore, the amount charged for the sharing may actually be in excess of 5% of the total revenues.

The facilitating company may not be the recipient of FDI directly – it may either be a subsidiary of a company having FDI, or the collective foreign holding in the company may be exceeding 50%.

Note, also, that the limit of 5% of revenues seems unreasonable, as it is unlikely that the charges for sharing of facilities have any nexus with the revenues. Revenues may be volatile; it Is not possible for the facilitating company to reduce what it is charging from the sharing companies, if the revenues have gone down in a particular year. Doing so will be counter-intuitive, particularly in a year when the revenues of the first company are anyway down.

Likely confusion

The DIPP circular will, in all likelihood, lead to major confusion. The foremost question is – does the Circular necessarily imply that all sharing of infrastructure has to be on arms-length pricing? For domestic transactions, arms length pricing as per Income tax law is applicable on a very limited number of transactions, enumerated in sec. 92BA. If arms' length pricing is not applicable, and the company is simply sharing the infrastructure on actual reimbursement basis (based on an estimated proportion utilised by the sharing company), does that mean there is any violation of the terms of FDI?

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[2] In case of a pure reimbursement, it is possible to argue that there is no transaction at all, as there is no transfer of resources, obligations or services.

Update

It needs to be noted that the DIPP circular does not, by itself, impose a condition that the sharing of infrastructure has to be on arms length basis. The circular is in context of the definition of "real estate business". Sharing of infrastructure is, by no means, a business activity, and hence, cannot be any business at all, not to speak of "real estate business". However, if the entity is at all engaged on sub-leasing of space, then there is a question of limitation of the lease rentals, and arms length pricing.

Conclusion:

There are thousands of FDI companies in business in India, and the Prime Minister's lofty targets of Make in India and Ease of Doing Business in India may envisage substantial further foreign investment into India. Not only FDI companies, there are lots of our home grown, fully Indian companies, which are regarded as "foreign owned or controlled companies" by virtue of a regulatory definition of "indirect foreign investment".

The present circular will cause existing infrastructure sharing arrangements of most of such companies to be re-examined. We are of the view that the Circular creates more issues than it resolves.

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