

Investment Opportunities in Indian Real Estate

FOREWORD

"Undeniably tremendous" is how the Investment in Indian real estate is termed. Government of India has recently allowed Non Resident Indians (NRIs) to invest upto 100% (FDI) in Housing and Real Estate Sector for development of serviced plots, construction of built-up residential premises and commercial premises including business centers and offices; development of townships, city and regional level urban infrastructure facilities including both roads and bridges; investment in manufacture of building materials; and investment in participatory ventures in development of serviced plots, construction of built-up residential premises and commercial premises including business centers and offices; and development of townships.

POTENTIAL FOR GROWTH

Real Estate sector is considered as a great employment generator and could be instrumental in growth of cement, steel and other connected industries. A study reveals that for every one crore (10 million) rupees of investment in housing, nearly 290 industries in the building material sector get activated besides the core manufacturing sector constituting cement, steel and bricks. Therefore, investment in housing is capable of achieving a three-in-one solution of employment generation, economic development and human development. Real estate development in India is estimated to be in the region of USD 12 billion, growing at a pace of 30 per cent each year.

Almost 80 per cent of real estate developed is residential space and the rest comprise office, shopping malls, hotels and hospitals. This double-digit growth is mainly attributed to the off-shoring

business, including high-end technology consulting, call centres and programming houses.

INVESTMENT OPPORTUNITIES

Money invested in real estate offers both a regular return on investment as well as a possibility of capital appreciation. With the tax reform measures taken in the last few years, the real estate is considered to be the most lucrative investment sector in the coming years.

Opening up of 100% Foreign Direct Investment (FDI) in the real estate sector, setting up real estate mutual funds coupled with other fiscal reforms like rationalization of stamp duty, property taxes etc. initiated by the Government are steps taken to continue to make the real estate a promising investment option.

The first FDI project for Rs. 100 crore (1 billion) residential township in Gurgaon, North India has already been approved by the Government. It is estimated that urban housing sector would require investments of USD 25 billion over the next five-year period. Urban population is expected to grow from 290 million to 600 million by 2021, while the requirement for housing units will grow to 68 million by 2021. At present, India has only about 19 million housing units. As per a study conducted by the United Nations, by the year 2015, 10 of the world's largest cities will be in Asia (excluding Japan) and three of these will be in India. The projection suggests that the demographic growth will be high and the country is poised for rapid urbanization, which will lead to major developments in real estate and infrastructure projects. The advent of call centers, programming houses and other such BPOs in India has led to an influx of over 785,000 new

jobs. Outsourcing has changed the face of commercial real estate in India, but its greater impact has been the demographic shift characterized by rising disposable incomes and increased consumerism. The real estate market in India predominantly continues to remain unorganized, fairly fragmented, mostly characterized by small players with a local presence. Traditionally, developers were viewed with an element of scepticism. Developers were often identified with dealing with large amounts of unaccounted money, lacked transparency and would use unscrupulous means to obtain various regulatory approvals. Lending to developers was perceived as being risky as builders were known to borrow for one project and utilise it for another or overstretch their limits and not have sufficient funding to complete the building. But things have clearly changed today: for starters, developers have realized the merits of corporatising themselves and enhancing transparency in terms of their financials. While earlier even the reputed builders had difficulty accessing formal channels of credit, today almost every bank and housing finance company has relationship tie-ups with developers and are keen to lend to them at competitive rates. Lenders are also monitoring the projects more closely. For instance, lending to developers is often through an escrow mechanism which ensures that funds are utilised only for that particular designated project.

LEGISLATIVE FRAMEWORK

The matters pertaining to the housing and urban development have been assigned by the Constitution of India to the State Governments. The 74th amendment to the Constitution has further delegated many of these functions to the urban local bodies. Thus, the constitutional and legal authority of the Government of India is limited only to Delhi and other Union Territories and to the subject, which State Legislatures

authorize the Union Parliament to legislate.

The Ministry of Urban Development & Poverty Alleviation is the apex authority of Government of India at the national level to formulate policies, sponsor and support programmes, coordinate the activities of various Central Ministries, State Governments and other nodal authorities and monitor the programmes concerning all the issues of urban development and housing in the country. The national policy issues are decided by the Government of India which also allocate resources to the State Governments through various centrally sponsored schemes, provides finances through national financial institutions and supports various external assistance programmes for housing and urban development in the country as a whole. Policies and programme contents are decided at the time of formulation of Five Year Plans. Further, the fiscal, economic and industrial location decisions of the Government of India have an indirect effect on the pattern of urbanization and real estate investment in the country.

FOREIGN DIRECT INVESTMENT (FDI)

The Foreign Exchange Management Act (FEMA), 1999 is the gateway legislation of India for inbound investments into India. The Income Tax Act, 1961 is the direct tax legislation of India. Presently, FDI upto 100% under the automatic route has been permitted in townships, housing, built-up infrastructure and construction development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure). There is no need for taking prior approval from the Government, but the RBI should be informed within thirty days of the inward remittances or issue of shares to NRI.

The FDI in the above-mentioned areas is subject to the following conditions:

1. Minimum area to be developed under each project would be as under:

- i. In case of development of serviced housing plots, a minimum land area of 10 hectares.
- ii. In case of construction-development projects, a minimum built-up area of 50,000 sq.mts.
- iii. In case of a combination project, any one of the above two conditions would suffice.

2. The investment would further be subject to the following conditions:

- i. The minimum capitalization shall be US\$10 million for a wholly owned subsidiary and US\$5 million for joint ventures with Indian partners. The funds would have to be brought in within six months of commencement of business of the Company.
- ii. Original investment cannot be repatriated before a period of three years from completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB.

3. A minimum of 50 per cent of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor would not be permitted to sell undeveloped plots. The term undeveloped plots means, where roads, water supply, street lighting, drainage, sewerage and other conveniences, as applicable under prescribed regulations, have not been made available. In order to dispose off serviced housing plots, it is necessary that the investor provides this infrastructure and obtains the completion certificate from the concerned local body/service agency.

4. The development to be in accordance with local byelaws, town planning norms, standards

and master plans.

5. The investor shall be responsible for obtaining all necessary approvals, including those of the building/layout plans, developing internal and peripheral areas and other infrastructure facilities, payment of development, external development and other charges and complying with all other requirements as prescribed under applicable rules/bye-laws/regulations of the State Government/Municipal/Local Body concerned.

These conditions have been put to discourage fly by night operators from entering this sector. These conditions are the guiding factors for according approvals. Further, Non Resident Indians (NRIs) are allowed to invest in the following areas in the Housing and Real Estate Sector under the Automatic Route of FDI:

- i. Development of services plots and construction of built up residential premises.
- ii. Investment in real estate covering construction of residential and commercial premises including business centers and offices.
- iii. Development of townships.
- iv. City and regional level urban infrastructure facilities, including both roads and bridges.
- v. Investment in manufacture of building materials.
- vi. Investment in participatory ventures in (i) to (v) above
- vii. Investment in housing finance institutions.

REPATRIATION

The repatriation of principal investment of foreign exchange is permitted, but not before three years from completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Government through the foreign investment promotion board (FIPB).

CONSTRUCTION IN SPECIAL ECONOMIC ZONES (SEZs)

BY PRIVATE/JOINT/STATE SECTOR

- i. 100% FDI permitted in real estate within Special Economic Zone (SEZ).
- ii. 100% FDI permitted to develop township within the SEZ with residential areas, markets, playgrounds, clubs, recreation centers etc.
- iii. Develop Standard Design Factory (SDF) building in existing Special Economic Zones. For this purpose, land already available in the SEZs may be leased or sub-leased to developers on the terms and conditions contained in the guidelines issued for this purpose.
- iv. Full freedom in allocation of developed plots to approved SEZ units on purely commercial basis and competent authority to provide services like water, electricity, security, restaurants, recreation centers etc. on commercial lines.

TAX STRUCTURE

The tax liability upon the income of a company is based on the nature of its income as well as its residential status and is governed by the provisions of Income Tax Act, 1961. A foreign company carrying on operations in India through its branch or project office or simply as exporter of goods/services to India is generally treated as a non-resident and are taxed in India on the following incomes:

- Income received or deemed to be received in India during the previous year,
- Income accrued (or arises) or deemed to accrue

(or arise) in India during the previous year. The following types of income are deemed to accrue or arise in India:

- Income arising from any business connection in India. The term business connection means that a person on behalf of the non-resident performs business acts in India. Only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.
- Interest, royalties and fees for technical services paid by an Indian resident to a non-resident, or paid by one non-resident to another for the purpose of business of the payer in India.

Further, the taxation of a non-resident is also governed by the relevant Double Taxation Avoidance Agreement with the country in which it is resident, where such an agreement exists. Generally these treaties provide for a lower rate of tax on dividend, interest, royalty and technical service fee, or may even exempt such items from taxation in India.

A Wholly Owned Subsidiary or a Joint Venture Company incorporated in India are classified as resident and are subject to tax.

Benefits to investors in Real Estate sector:

1. Construction of residential complexes having more than 12 residential houses or apartments together with common areas and other appurtenances (will take effect from a notified date). The rate of service as on date is at the rate of 10% plus 2% educational cess. But, exemption is granted if the gross turnover does not exceed four lakh per year.

2. Mandatory appropriate authority clearance of Chapter XX-C of the Income Tax Act (1961) has been abolished. It is likely to boost liquidity in the real estate market by boosting transaction volumes. This can also be seen as a cut in the red tape and would also cut timeframes for transaction closure.

3. The repatriation of principal investment of foreign exchange is permitted, but not before three years from completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB.

4. Development of integrated township was to include housing, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems, manufacturers of building materials, development of land and provision of allied infrastructure.

5. In order to allay apprehensions about discrimination, it has been provided that the projects under FDI will be accorded national treatment on par with local developers.

6. The condition that the foreign investor should be in the core business of township development having a successful tract record, no longer exists.

7. Stamp duty on property transactions has been reduced to 5%.

An Overview:

With wide spectrum of changes taking place in the real estate sector in the country coupled with proposed reforms such as computerization of land records, removal of tenancy laws, correction in taxation structure etc., India has emerged as a preferred and lucrative destination for real estate developers/investors. The importance of the housing and real estate sector in India can be judged by the estimate that for every Indian rupee invested in the construction of houses, INR 0.78 is added to the gross domestic product of the country and the real estate sector is subservient to the development of over 250 other ancillary industries.

After agriculture, the real estate sector is the second largest employment generator in India. However, mortgage penetration continues to be abysmally low - in India the mortgage to GDP ratio is about 2%. This compares to a mortgage to GDP ratio of over 51% in USA. However, even if one were to benchmark with more comparable counterparts, the ratio ranges between 15-20% for South East Asian countries. Thus the penetration level of mortgages is miniscule when compared with the shortage of housing units.