Standpunkt 34

IRE|BS International Real Estate Business School Universität Regensburg

19.12.2014

Real Estate Investment Mechanism in India - An Overview

Anish Rock, participant of the Executive MBA in Real Estate program at the International Real Estate Business School (**IRE**BS)

Preamble

'India' being the land of opportunities for doing global business has opened doors to several international players to invest in the real estate and construction sector across the country. With an estimated known population of 1.21 billion and the economy back on a track with GDP recorded at 5.7% in Q2, 2014 from the erstwhile slowdown of 4.7% in Q2, 2013, the country is now all poised to witness growth ahead. During the recent lok sabha (lower house of the parliament) elections of May 2014, India has been successful in having a new stable government with the Bharatiya Janata Party (BJP) evolving as the single largest party (about 52% of the total 545 seats) having its seat in the parliament under the leadership of a visionary prime minister 'Modi'. This has significantly reduced the talked about political risk in the country as opposed to the erstwhile Government which was in a state of policy paralysis during the past few years. The formation of new government has triggered positive sentiments to the growth of the economy.

Per the Central Statistics Organization (CSO) data, during Q3 2006 and Q3 2009 India's GDP recorded was the highest at 9.8% and over the years since then witnessed a gradual deceleration with the lowest growth rate recorded at 4.6% during Q4, 2013. Some of the reasons attributed to this fact are the global slowdown, high interest rates and inflation, lack of overseas credit, sluggish domestic activities/low industrial output and weak private-sector investment.

Rapid urbanization, positive demographics (young population and growth in nuclear families), rising income levels and growth in the manufacturing and services sector being the key enablers have paved way for the Indian real estate sector to attract investments largely in the form of FDI from all parts of the globe as well as domestic capital within the country.

India Fact File:

Parameter	Statistics
Land Area	3,287,240.00 sq.km.[1]
Total Population and Urban Population	1.21 Billion and 377 million[1]
Average Household Size	5.0[2]
Key Economic Activities	Agriculture Information Technology Services Manufacturing and Construction
Target GDP India	5.5% to 5.6%[3]
GDP Growth Recorded for the Quarter April – June 2014	5.7%[4]
Inflation Rate	6.46%[5]
Base Rate and Bench Mark Prime Lending Rate (BPLR)	10% and 14.75%[6]
Savings Deposit and Term Deposit Rate	4% and 8% to 9.05%[7]
Repo Rate and Reverse Repo Rate	8% and 7%[7]
Long Term Government Bond Yield (2019)	8.0907%[7]
Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)	4% and 22%[7]
Foreign Exchange Rates[8]:	
INR / 1 USD	61.3175
INR / 1 EURO	78.1430
INR / 1 GBP	99.0032
Foreign Direct Investment (FDI) in Housing and Real Estate	USD 224.5 Billion[8] The construction sector accounted for 10.51% of Total FDI Inflows.
Listed Capital Markets Market Capitalisation of Top 25 Real Estate Developers Listed on the National Stock Exchange (NSE), India	USD 15.4 Billion[8]
Bank Credit to Real Estate	Residential: USD 92.3 Billion[8] Commercial: USD 25.4 Billion[8]
Private Equity in Real Estate	USD 41.8 Billion Institutional Capital Raised[8] USD 7.5 Billion Ongoing Fund Raising[8]
Market Value of Investable Real Estate in Residential and Office in India	USD 381.3 Billion[8]

Union Budget India 2014-15 Highlights for Real Estate Sector

The recent union budget of July 2014 had positive announcements for the real estate sector and some of the key considerations are as below:

- Relaxation of FDI conditions for real estate / construction-development projects
- REIT and Infrastructure Investment Trust tax pass through status
- Development of 100 smart cities in India with allocation of Rs. 7050 Crores (approximately USD 1.2 Billion)
- Allocation of Rs. 8000 Crores (approximately USD 1.33 Billion) to finance low cost affordable housing through National Housing Board (NHB)
- Road and highway development (urban transportation) through 3P model (Public Private Partnership). An investment of Rs. 37880 Crores (approximately USD 6.3 Billion) in the National Highway Authority of India (NHAI) with a target to construct 8500 kms of national highways during the current financial year (2014 – 15)
- Special Economic Zones (SEZ) as an instrument towards better infrastructure and land utilization
- Rural Infrastructure Development Fund (RIDF) corpus at Rs. 30000 Crores (approximately USD 5 Billion)
- FDI allowed in Manufacturing and Defence up to 49% with Indian management and control under the Foreign Investment Promotion Board (FIPB) route

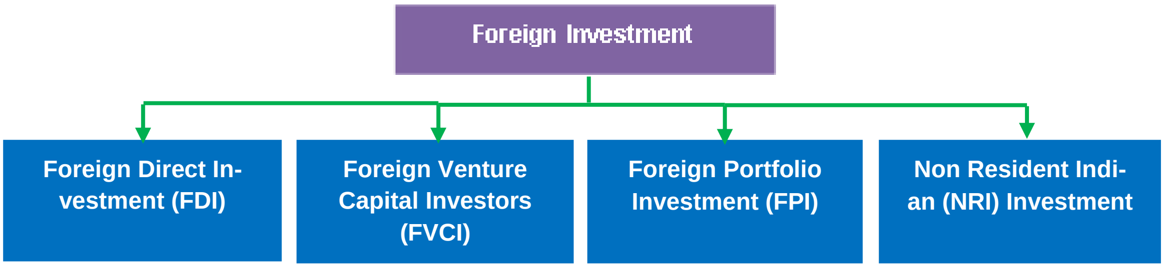
Classification / Asset Class(s)

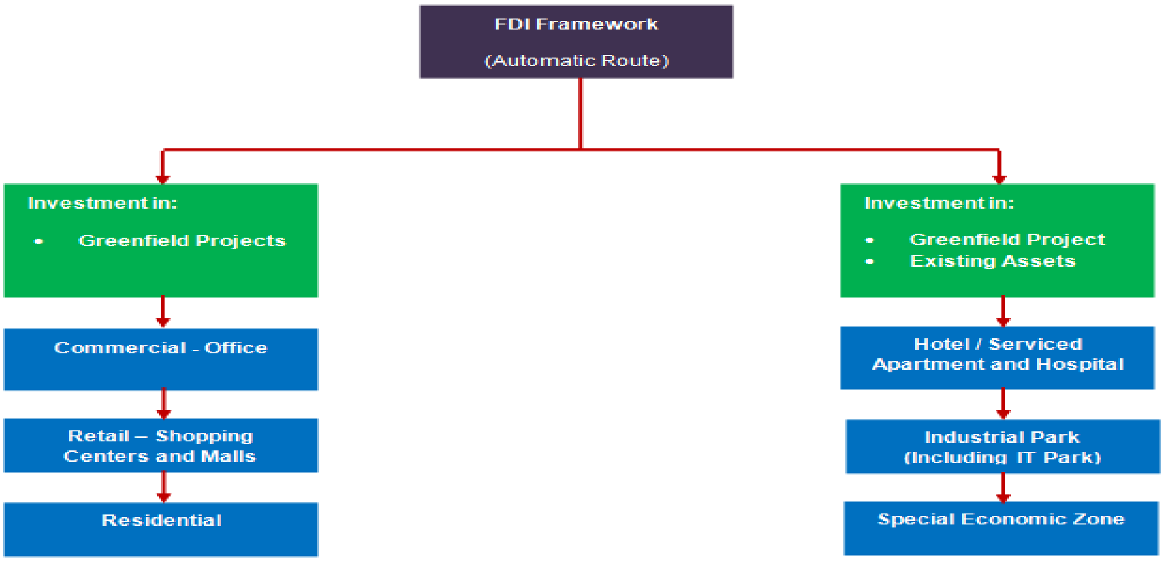
The spectrum of real estate in India is primarily as below:
- Residential – Plots, Apartments, Condominiums, Rowhouses / Townhouses and Villas
- Commercial – Office (Built-To-Suit, Multi Tenanted Facilities) and Retail (High Street Shopping Centers, Malls)
- Hospitality – Hotels and Resorts
- Industrial – Logistics and Warehousing Facilities
- Industrial Parks – Including IT Parks under Software Technology Parks of India (STPI) and Special Economic Zones (SEZ) – Multiproduct, Sector specific and Free-trade Warehousing Zone
- Ancillary products in health care, education, recreation facilities to mention a few.

Regulation

Foreign investments in India are under the jurisdiction of the following regulators:
1. Reserve Bank of India (RBI)
2. Foreign Investment Promotion Board (FIPB)
3. Department of Industrial and Information Policy (DIPP)

If the securities are listed or offered to the public, dealings in such securities is regulated by the Securities and Exchange Board of India (”SEBI”). Foreign investment into India is regulated under Foreign Exchange Management Act, 1999 (“FEMA”) and the regulations there under, primarily Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (“TISPRO Regulations”).





In general, a foreign investor entering / willing to do real estate business in India has to comply with the minimum FDI norms stipulated by the Government of India – Department of Industrial Policy and Promotion (DIPP). In the recent union budget of 2014 -15, the Government relaxed the FDI conditions thus opening doors to foreign investment on a friendly business note. 100% FDI under the automatic route allowed 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). Some of the important FDI guidelines10 now applicable are:

Minimum Area
• Construction development projects – built-up area of 20000 sqm • Development of serviced housing plots - 10 Hectares (about 25 acres of land) • Combination projects – either any one of the above two conditions would suffice
Minimum Capitalisation
• Wholly owned subsidiary – USD 5 Million • Joint Venture with Indian Partners – USD 5 Million
Time Frame
• FDI cannot be repatriated before 3 years from the completion of minimum capitalisation, however, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB • At least 50% of the project must be developed within a period of five years from the date of obtaining all statutory clearances
Prohibitions
• FDI in real estate business and construction of farm house • Investor not permitted to sell undeveloped plots • Payment cannot be made through traveller's cheques or foreign currencies • Purchase of agriculture land/plantation property/farm houses by NRIs/PIOs requires RBI permission
Exceptions
• Hotels and tourism, hospitals and SEZ projects have the benefits of exemptions from the conditions of minimum area, minimum capitalisation and time frame • Investments made by NRIs in townships, built-up infrastructure and construction development projects have exemptions to minimum area, minimum capitalisation and time frame
Industrial Parks
• FDI in industrial parks not subjected to the above conditionalities, provided the following criteria is met: 1. Minimum of ten units and no single unit shall occupy more than 50% of the total allocable area 2. Minimum industrial area to be allocated for industrial activity shall not be less than 66% of the total allocable area
Notes:

- The project shall conform to the norms and standards, including land use requirements and provision of community amenities and common facilities, as laid down in the applicable building control regulations, bye-laws, rules, and other regulations of the State Government/Municipal/Local Body concerned.
- 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. The State Government/ Municipal/ Local Body concerned, which approves the building / development plans, would monitor compliance of the above conditions by the developer.

Tax Framework

Tax framework in India – Real Estate Specific

Taxation

Direct Taxes

- Direct Development
- Joint Development
- Leasing
- Incentives

Indirect Taxes

- Stamp Duty
- Service Tax
- Value Added Tax (VAT)

Dividend Distribution Tax - Indian Company	**16.22%**
No withholding tax is applicable on dividends as dividends declared by the Indian company are tax free for all share holders	
Withholding tax on dividends received by an Indian company from a foreign company (holding 26% or more equity share)	**16.22%**
Withholding tax for technical service fee paid to a non-resident (subject to DTAA, availability of PAN in India else rate is 20%)	**10%**
Withholding tax for Royalty paid to a non-resident (subject to DTAA, availability of PAN in India else rate is 20%)	**25%**
Withholding tax on a foreign currency loan availed by an Indian company from a non resident	**21.01%**
Capital Gains for transfer of assets other than shares held by Indian Company for more than 3 years	**21.63%**
Capital Gains for transfer of assets other than shares held by foreign Company for more than 3 years Note: If the asset is held for a shorter duration, then tax arising from the transfer shall be taxed at normal income tax rates	**21.02%**
Minimum Alternate Tax – Domestic	**20.01%**
Minimum Alternate Tax – Foreign	**19.44%**
Corporate Income Tax on Business Income – Domestic Company	**33.99%**
Corporate Income Tax on Business Income – Foreign Company	**43.26%**

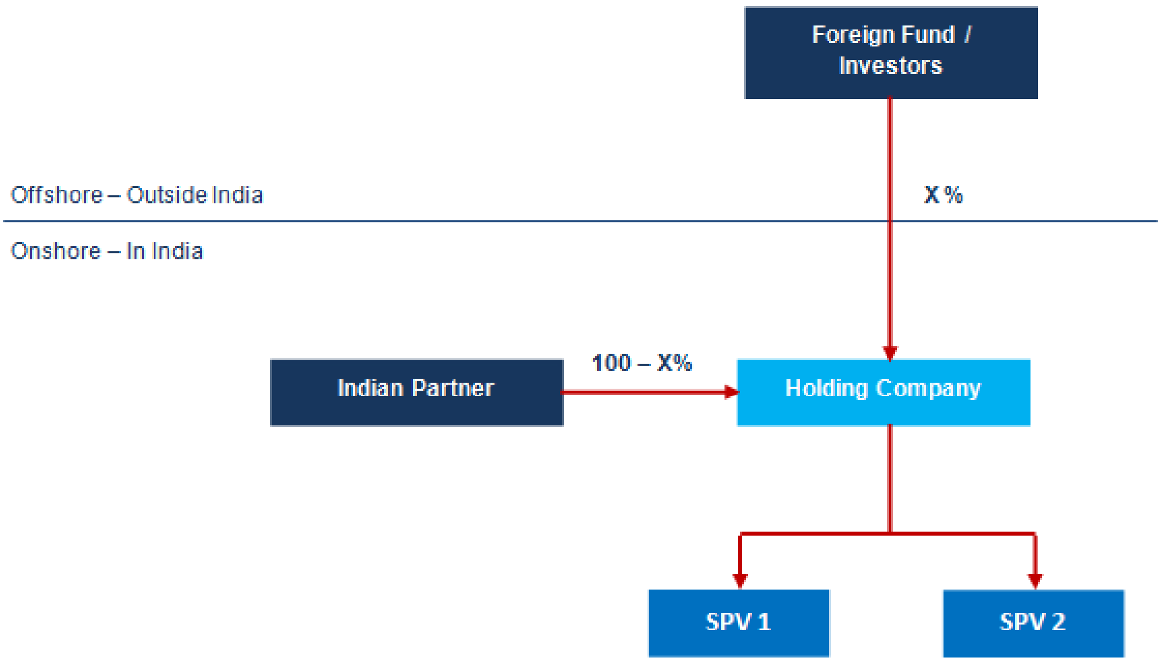
Stamp Duty (State specific - vary from state to state – the rate mentioned is for key states in India)	**3% to 8%**
Service Tax	(specific depending on the mode of taxation of the project)
Value added Tax	(state specific depending on the mode of taxation of the project)

Legal Framework

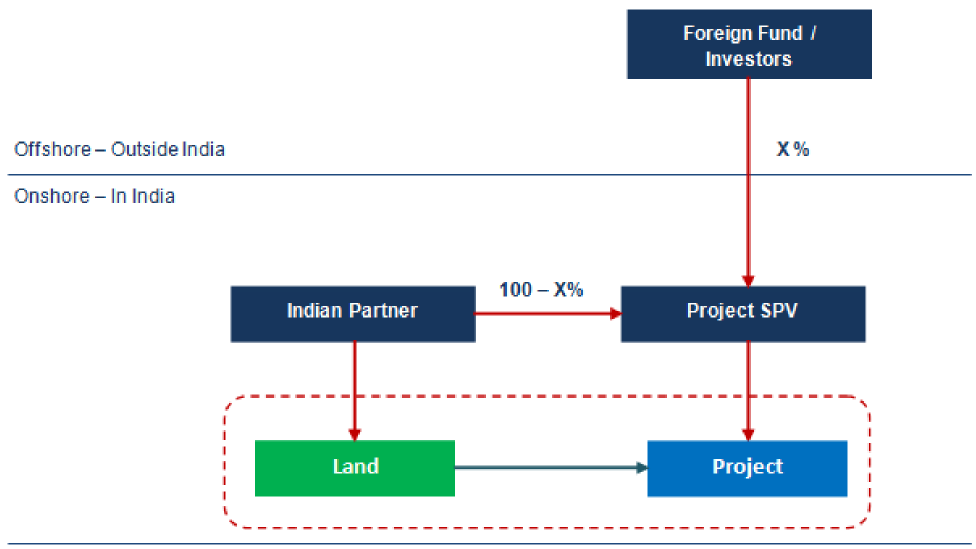
The Company's Act of 2013 introduced new provisions with respect to the following:
- Shares with differential rights
- Listed company
- Inter-corporate loans
- Deposits
- Insider trading
- Squeeze out provisions
- Directors
- Subsidiary and associate company
- Merger of an Indian company with offshore company

Typical Transaction Structure

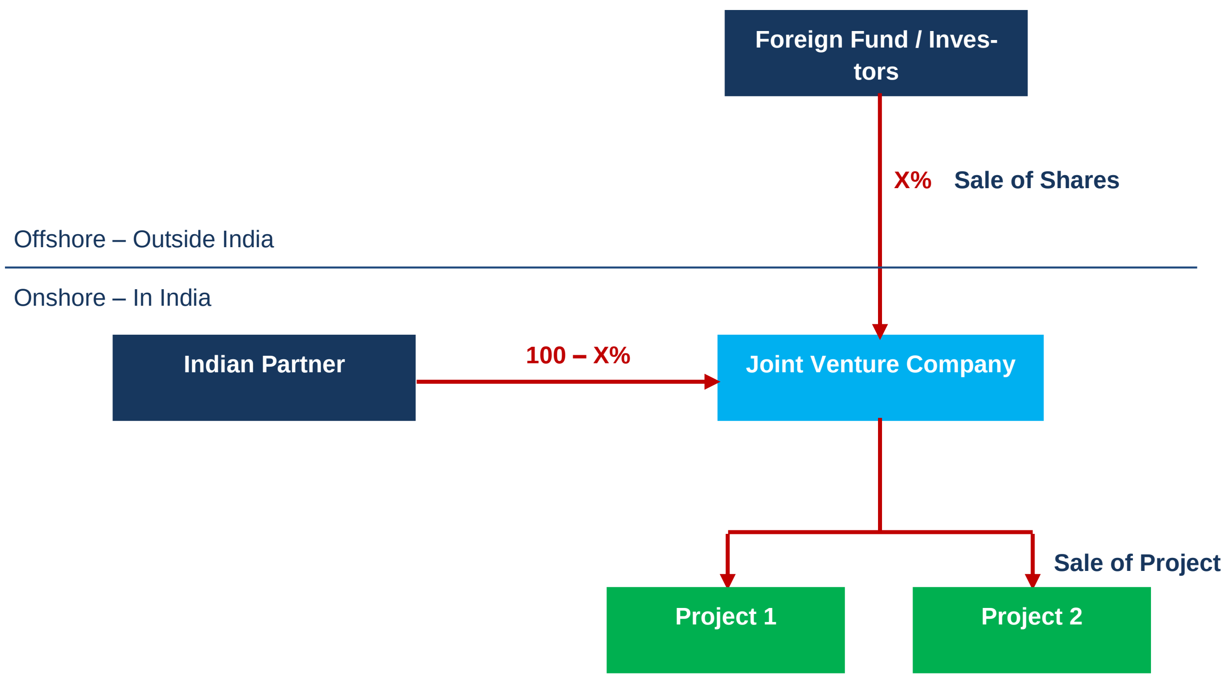
Equity Investment at Holding Company Level



<u>Equity Investment at Project SPV Level</u>



Typical Exit Mechanism – Foreign Company



Key Considerations – Sale of Shares

- Holding period for long term characterization of capital gains – 12 months(only in case of listed securities),in case of Unlisted securities is 36 months
- Long term capital gains tax at 21.02%

Key Considerations – Sale of Project

- Sale of project with holding period for long term characterization for capital gains – 36 months
- Repatriation through dividend, the dividend distribution tax applicable for Indian company at 16.22% / long term capital gains tax at 21.02%
- Transaction costs (state specific depending on the location of the project)

Conclusion

Foreign funds or Investors investing in real estate in India must evaluate potential opportunities with reference to the market - economic, regulatory, legal and taxation framework for safe entry and exit mechanism. The following transaction parameters14 would be of useful substance when considered whilst executing transactions:

- Regulations – foreign investment, capital markets, exit options
- Type of instrument – equity / debt / preference / convertible / FDI / repatriation / taxation
- Deal structuring – commercial structuring / promote structuring / tax structuring
- Taxation – treaty benefits
- Corporate governance – board representation, voting powers, related party transactions
- Exit options – exit through sale in India / dividend distribution / sale of shares at overseas level / IPO listing

For the sources used we refer to the original publication.
First publication: Institute of Revenues Rating and Valuation (IRRV), Valuer edition, page 18-21.

Anish Rock MRICS, FIRRV

Phone: +49 152 135 1094
E-mail: anishrock@gmail.com

Anish Rock is currently pursuing EMBA in Real Estate at **IRE**BS and internship with RREEF, Germany.

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