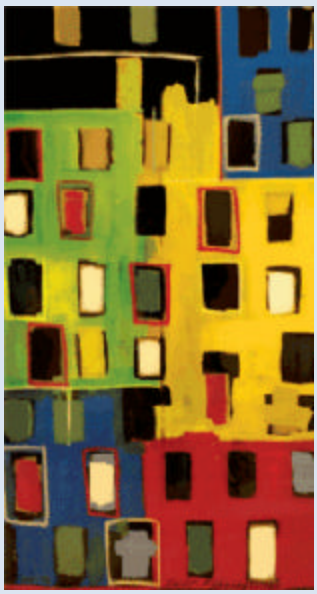
REAL ESTATE INVESTMENTS



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Background

The potential is undeniable-with a size close to USD 14 billion and growth rate of around 30 percent every year, the Indian realty sector was bound to witness a sudden upsurge on account of multiple factors including rising domestic demand from the IT, ITES and the manufacturing sector, increased disposable income in the hands of individuals, unprecedented growth in the domestic consumerism, stable interest rate regime and last but not the least, the opening up of the real estate sector to foreign investment. On account of the attractiveness of the returns and the great potential ahead, it was not surprising to see the advent of dedicated real estate funds ("**REFs**") being floated to tap the appetite of domestic and foreign investors alike. The names doing the rounds are IndiaREIT, HDFC, Red Fort, ICICI Ventures, IL&FS, Kotak, Ascendas, Pantaloon and some others. Thus, this special feature analyzes the legal, regulatory and tax implications impacting India focussed REFs.

Advantage India

Real estate is one of the fastest growing sectors in India. Market analysis pegs returns from realty in India at an average of 14 percent annually, with research estimates indicating that the Indian real estate market is expected to grow from the current USD 14 billion to a USD 102 billion in the next 10 years[1]. Indian real estate has huge potential demand in almost every sector especially commercial, residential, retail, industrial, hospitality, healthcare, special economic zones, etc. Commercial office space requirement is led by the burgeoning outsourcing and Information Technology Industry, and led to increase exponentially as the outsourcing boom moves into the manufacturing sector.

Exchange Control Implications

Prior to June 1, 2000, foreign investment in Indian securities, including the acquisition, sale and transfer of securities of Indian companies, was regulated by the Foreign Exchange Regulation Act, 1973 ("**FERA**") and the notifications issued by the Reserve Bank of India ("**RBI**") thereunder. Foreign investments into India are now regulated by the provisions of the Foreign Exchange Management Act, 1999 and the rules and regulations issued thereunder by the RBI or Central Government, as the case may be **(**"**FEMA**"**)**.

By and large, foreign direct investment is now permitted in almost all sectors in India via the "automatic route," save for some exceptional cases such as atomic energy, gambling, etc. (commonly referred to as the "negative list"). Under the automatic route, the details of the investments must be filed with the RBI within the prescribed time. However, if the investment is not in accordance with the prescribed guidelines or if the activity falls under the negative list, prior approval has to be obtained from the Foreign Investment Promotion Board ("**FIPB**").

With this brief discussion on the potential of the housing and real estate sector, we now proceed to discuss the legal, regulatory and tax implications of structuring India centric REFs, including some of the recent developments on the regulatory front impacting the structuring and commercial decisions for REFs.

As per section 6 of FEMA, "any person may sell or draw foreign exchange to or from an authorized person for a capital account transaction". In other words, capital account transactions are prohibited unless specifically permitted by the RBI in pursuance of regulations issued under section 6(3) read with section 47 of FEMA.

[1] http://www.icicibankcom/pfsuser/icicibank/ibank-nri/nrinewversion/commerciaLrealestate.htm, visited on November 4, 2005

Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 **("TISPRO Regulations")** are the relevant regulations issued by the RBI in this regard.

Sub regulation 4 of the TISPRO Regulations stipulates that an Indian entity shall not issue any security to a person resident outside India or shall not record in its books any transfer of security from or to such person unless permitted under FEMA.

Sub regulation 5 of the TISPRO Regulations lay down the conditions subject to which foreign investors would be permitted to invest into Indian securities. For sake of analysis, the sub-regulation 5 has been classified into its sub components in Table 1.

Classification of Sub Regulation 5 of TISPRO Regulations

Sub regulation	Deals with	Applicable schedule
5(1)	Investments by foreign individuals (other than citizens of Bangladesh and Pakistan) and foreign entities	Schedule 1
5(2)	Investments by registered Foreign Institutional Investors ("FIIs")	Schedule 2
5(3)(i)	Investments by Non Resident Indians ("NRIs") under Portfolio Investment Scheme in shares and debentures of an Indian Company	Schedule 3
5(3)(ii)	Investments by NRIs other than under Portfolio Investment Scheme in shares and debentures of an Indian Company on non-repatriation basis	Schedule 4
5(4)	Investments by NRIs or registered FIIs in securities other than shares and debentures of an Indian Company	Schedule 5
5(5)	Investments by registered Foreign Venture Capital Investors	Schedule 6
5(6)	Investments by registered FIIs in exchange traded derivative contracts	-
5(7)	Investments by NRI s out of INR funds on non-repatriation basis	-

Each of the schedules to the TISPRO Regulations (as referred to in the above Table 1) lay down specific conditions governing the investment by that particular category of investors. For example, the Foreign Direct Investment ("**FDI**") Scheme (that stipulates the sectoral caps) forms part of Schedule 1 to the TISPRO Regulations.

Only NRIs/Persons of Indian Origin[2] ("**PIOs**") are permitted to invest in real estate and housing property and not other foreign residents, while infrastructure projects, integrated townships and other construction-development projects involving large infusion of foreign investments have been opened up for other foreign investors, albeit, subject to various conditions.

Investments by NRIs

As per TISPRO Regulations, NRIs are permitted to invest in the following activities in the real estate sector:

- Development of serviced plots and construction of built up residential premises;
- Investment in real estate covering construction of residential and commercial premises including business centers and offices;
- Development of townships;
- City and regional level urban infrastructure facilities;
- Investment in manufacture of building materials (which is also open to FDI);
- Investment in participatory ventures in the above; and
- Investment in housing finance institutions (which are also open to FDI as non-banking finance companies).

While the above list appears broader than the opportunities open for foreign investors (discussed herein below), the TISPRO Regulations unfortunately are silent as to whether NRIs investing through their offshore companies or through offshore REFs, would still be entitled to investment opportunities specified for NRIs, or whether such offshore companies owned 100 percent by NRIs would be regarded as 'foreign investor' and thus be ineligible for the above broader investment opportunities.

In addition to the above, NRIs and PIOs can acquire any immoveable property in India other than agricultural land/plantations/farmhouse, by way of purchase, gift or inheritance. In case of sale of such property, the NRIs/PIOs are permitted to repatriate the sale proceeds, subject to the following conditions[3]:

- In case of residential property, repatriation is allowed only up to a maximum of two properties;
- The amount to be repatriated cannot exceed the amount paid for acquisition of immovable property in foreign exchange;
- In the case of purchase of the property out of rupee funds, repatriation is allowed from the Non Resident Ordinary accounts up to USD 1 million per year, provided the property and/or sale proceeds in the NRO account.

Investments By Other Foreign Investors

The first step towards opening of the real estate sector for foreign investors was taken by the Government of India vide issue of Press Note No. 4 (2001 series) which permitted FDI up to 100% for development of integrated townships[4], including housing, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems and manufacture of building

[2] PIO means an individual, not being a citizen of Pakistan, Bangladesh, Sri Lanka, China, Iran, Nepal or Bhutan, who (i) at any time held Indian Passport or (ii) ho or either of whose father or grandfather was a citizen of India by virtue of Constitution of India or the Citizenship Act,1955.

[3] Investments under the Foreign Exchange Management (Acquisition and Transfer of Immoveable Property in India) Regulations, 2000 issued by the RBI.

[4] Development of land and providing allied infrastructure was considered forming an integrated part of township's development.

materials. Thus, while FDI in integrated townships was opened up in 2001, the real boost for foreign investment came with the issue of Press Note 2 (2005 series) dated March 3, 2005 ("**Press Note 2**") which not only dilutes the minimum development area for integrated townships from 100 acres to 25 acres but more importantly opened up the sector for foreign investment in many other forms of construction and development. Therefore, as per Press Note 2, 100 percent foreign investment is now 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), through the automatic route, subject to satisfaction of following conditions:

- Minimum area to be developed under each project:

  - in case of development of serviced housing plots, a minimum land area of 10 hectares;
  - in case of construction-development projects, a minimum built-up area of 50,000 square meters; and
  - in case of a combination project, any one of the above two conditions would suffice.

- Capitalization and lock-in requirements:

  - minimum capitalization of USD 10 million for wholly owned subsidiaries and USD 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.
  - original investment, i.e. the minimum capitalization amount cannot be repatriated before a period of three years from date of completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB.

- At least 50 percent 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.

  For the purpose of Press Note 2, "undeveloped plots" would mean where roads, water supply, street lighting, drainage, sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available. It will be necessary that the investor provides this infrastructure and obtains the completion certificate from the concerned local body/service agency before he would be allowed to dispose off serviced housing plots.

- 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.

Please refer to the actual text of Press Note 2 attached herewith in **Annexure 1**.

Despite the further liberalized policy introduced by Press Note 2, several questions remain unanswered

in the press note. For example, whether foreign investment is permitted only at the "initial" or "development stage" or whether a foreign investor can participate in a project till an "occupation certificate" is issued. Also, it is unclear as to whether the minimum capitalization has to be brought in within 6 months of commencement of business of the Indian company or within 6 months of signing of the investment agreement by the foreign investor. On account of the growth and economic opportunities of this sector, a clarification on these ambiguities is a must.

Apart from the above, foreign investment is also permitted in the following activities:

Roads & Highways, Ports and Harbours

100 percent FDI is permitted under the automatic route in projects for construction and maintenance of roads, highways, vehicular bridges, toll roads, vehicular tunnels, ports and harbours.

Airports

Upto 100 percent FDI permitted. However, investment by foreign investors beyond 74 percent requires prior approval of the FIPB.

Mass Rapid Metro Transit System

FDI up to 100 percent is permitted on an automatic basis in Mass Rapid Metro Transit System in all metres, including associated real estate development.

Special Economic Zones

100 percent FDI is permitted under the automatic route. Conditions relating to area, minimum outlay, etc. would be such as may be stipulated under the Special Economic Zones Act 2005 and rules issued thereunder.

Industrial Parks, Model Towns and Growth Centres

FDI up to 100 percent is permitted in Industrial Parks subject to the approval of Empowered Committee that has been setup by the Government of India and, *inter alia*, the following conditions:

- The industrial park should comprise of a minimum of 10 units and no single unit shall occupy more than 50% of the allocable area.

- The minimum percentage of the area to be allocated for industrial activity shall not be less than 66% of the total allocable area.

In the above context, the term “allocable area” in the industrial park means–

(a) In the case of plots of developed land – the net site area available for allocation to the units, excluding the area for common facilities.

(b) In the case of built up space – the floor area and built up space utilized for providing common facilities.

(c) In the case of combination of developed land and built-up space – the net site and floor area available for allocation to the units excluding the site area and built up space utilized for providing common facilties .

Health care

100 percent FDI is allowed in this sector.

Hotels & Tourism

100 percent FDI is permitted. Hotels include restaurants, beach resorts, and other tourist complexes providing accommodation and/or catering and food facilities to tourists. Tourism related industry include travel agencies, tour operating agencies and tourist transport operating agencies, units providing facilities for cultural, adventure and wild life experience to tourists, surface, air and water transport facilities to tourists, leisure, entertainment, amusement, sports, and health units for tourists and Convention/Seminar units and organizations.

Pricing Constraints

FEMA also regulates the price at which a foreign investor invests into an Indian company. Accordingly, shares in an unlisted Indian company[9] may be freely issued to a foreign investor, subject to the following conditions being satisfied:

- The foreign investor subscribes to the Indian company's shares at a price that is not lower than the floor price computed on the basis of the "ex-CCI" formula which is the equivalent to the average of Net Asset Value per share and Profits Earnings Capacity Value per share;

- The consideration for the subscription is brought into India prior to or at the time of the allotment of shares to the foreign investor.

If any of the above conditions is not complied with, then the prior approval of the FIPB and/or the RBI would be required. However, if the foreign investor is a Foreign Venture Capital Investor registered with the Securities Exchange Board of India ("**SEBI**"), then the above pricing restrictions would not apply.

Acquisition of Shares through Secondary Purchase

Generally, for any transfer of shares between residents and non-residents resulting from purchase or sale transaction, no prior permission of the FIPB or the RBI is required provided such transfer of shares is done in compliance with the guidelines issued by the RBI and the price for such transfer is in accordance with the RBI pricing guidelines in this regard. As per the pricing guidelines, in respect of an investment into an unlisted company, the price is based on the "ex-CCI formula" and in case of listed companies; the pricing should be based on the trading price of the shares on a stock exchange and in respect of exit from an unlisted company, the price is based on the price determined by the investment banker or the chartered accountant and in case of listed companies; the pricing should be based on the trading price of the shares on a stock exchange. However, a specific exemption from the above pricing guidelines has been made for SEBI registered Foreign Venture Capital Investors.

Existing Joint Venture or Collaborations

As discussed above, under the Indian exchange control regime, FDI is permitted in various sectors in India without prior regulatory approval. However, as per the erstwhile Press Note 18 (of 1998) this automatic route of making investments into India was not available in the event the foreign investor "has or had any previous joint venture ("**JV**") or technology transfer/trademark agreement in the same or allied field". This condition was laid down in the guidelines pertaining to approval of foreign/technical collaborations under the automatic route with previous ventures/tie-up in India issued on December 14, 1998 by the Ministry of Commerce, Government of India (and commonly referred to as Press Note 18). Thus, where the foreign investor did not qualify for the automatic route, he needed to seek the prior approval of the FIPB by filing justification and proof before the FIPB that the new undertaking would not jeopardize the interests of the existing JV or technology/trademark partner.

After several representations and back-and-forth by Government of India on this issue, Press Note 18 was finally scrapped and replaced by the new Press Note 1 (2005 series) dated January 12,2005.

The said Press Note No. 1 has narrowed down the scope of the policy issue depicted under Press Note 18 to JVs under the "same" field. Thus, as per Press Note 1, prior FIPB approval is required only in cases where the foreign investor has an existing JV or technology transfer or trademark agreement in the "same" field. The onus to provide requisite justification as also proof that the new proposal would or would not jeopardise the existing JV or other stakeholders would lie equally on the foreign investor or technology supplier and the Indian partner. Further, Press Note 3 (2005 series) has clarified that "existing" means JV or technology transfer or trademark agreements existing as on the date of Press Note 1, viz. January 12,2005.

Even if the foreign investment is falling in the "same" field, the Government has carved out following exceptions, for which no prior FIPB approval is required:

- Investments are made by Venture Capital Funds registered with the SEBI;
- The existing JV investment by either party is less than 3 percent;
- The existing JV or collaboration is defunct or sick.

Debt Structuring

Leveraging is a critical component in structuring of real estate investments into India. Foreign debt structuring would especially trigger certain additional compliances under the Indian exchange control regime. Any debt to be taken by an Indian company from foreign sources has to comply with the External Commercial Borrowing Guidelines ("**ECB Guidelines**") issued by the RBI[5].

As per the ECB Guidelines, external borrowings are permitted on an automatic basis (i.e. without any prior regulatory approval) provided such borrowings comply with the conditions stipulated therein, *inter alia*, such as:

- Lender should qualify as a "recognized lender" as contemplated under the ECB Guidelines (e.g. suppliers of equipment, foreign collaborators, foreign equity holders, etc.);

- Minimum maturity period (e.g. in case of ECBs above USD 20 million and up to USD 500 million, the minimum average maturity is stipulated as 5 years);

[5] Circular no 16 dated October 4, 2004, A.P. (DIR Series) Circular No. 5 dated August 1, 2005

- Maximum amount of ECB which can be raised in one financial year (viz. USD 500 million for corporates and USD 5 million for non-governmental organizations engaged in micro finance activities);

- All-in-cost ceilings (which includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre payment fee, and fees payable in Indian Rupees, which is 200 basis points above 6 month LIBOR in case of ECBs having an average maturity period of between 3 to 5 years and 350 basis points above 6 month LIBOR in case of ECBs having an average maturity period of more than 5 years);

- End-use restrictions, e.g. ECB proceeds cannot be used for working capital, general corporate purpose, acquisition of shares by an Indian company, repayment of existing Rupee loans, for investment in real estate activities, etc.

Here it would be pertinent to note that in case of the end use restriction with regard to "real estate" activities, the ECB Guidelines provide that utilisation of ECB proceeds is not permitted in real estate including towards development of integrated townships, the same being allowed prior to the promulgation of the RBI Circular bearing number RBI/2006-2007/409 A. P. (DIR Series) Circular No. 60, dated May 21, 2007.

In case of debt being raised by Indian companies from local banks, the RBI has issued some indicative guidelines for banks to put in place a "risk management system" for identification, assessment and containing risks undertaken by banks in terms of their exposure to the real estate sector. The RBI has also prescribed certain additional disclosure norms for banks to report their real estate exposures to the RBI, as follows[6]:

- Direct exposure;

- Residential Mortgages-lendings fully secured by mortgages (self occupied by borrower or rented), individual housing loans up to Rs.15 lakh to be shown separately;

- Commercial real estate-lendings fully secured by mortgages, including non fund based limits;

- Indirect exposure - fund based and non-fund based exposures on National Housing Bank and housing finance companies;

- Annual reports of the banks should also disclose the gross exposure to real estate sector, including the direct and indirect exposure as above.

Use of instruments

As per the RBI Circulars dated June 7, 2008 and June 8, 2008, FDI can be routed into Indian investee companies by using fully and compulsorily convertible preference shares or fully and compulsorily convertible debentures, and non-convertible, partially convertible or optionally convertible preference shares and/or debentures shall be considered to be ECB and therefore, be subject to the aforesaid ECB Guidelines.

These fully and compulsorily convertible preference shares and fully and compulsorily convertible debentures are regarded at par with equity shares and hence the same are permissible as FDI. Further,

[6] Ref. RBI/2004-05/ 503, DBS.CO.PP.BC 21 /11.01.005/2004-05,dated June 29, 2005

FDI as routed through the issuance or purchase of the same shall be considered towards satisfying the minimum capitalization norms.

Venture Capital Regime

In April 2004, SEBI opened a small window for real estate investments under the Venture Capital Fund ("**VCF**") and Foreign Venture C apital Investor ("**FVCI**") regime.

Investments by VCFs are governed by the SEBI (VCF) Regulations, 1996 ("**VCF Regulations**") whereas investments by FVCIs are governed by the SEBI (FVCI) Regulations, 2000 ("**FVCI Regulations**"). SEBI amended the VCF and FVCI Regulations by removing "real estate" from the Third Schedule-Negative List to these regulations. Thus, VCFs and FVCIs can invest in venture capital undertakings ("**VCUs**") engaged in real estate activities, subject to the investment conditions and restrictions as stipulated in the respective regulations. However, it is pertinent to note that since the last 2 years, SEBI has not granted any FVCI approval to any of the foreign investors for investing in real estate sector in India. For details regarding the investment conditions and restrictions as enumerated in the VCF Regulations, please refer to the attached **Annexure 2**.

One of the important developments on the VCF front is the recent de-recognition of venture capital sector as a priority sector by RBI. Historically speaking, as per RBI's Master Circular on Lending to Priority Sector, investments made by the scheduled commercial banks in venture capital were reckoned under "priority sector lending", provided the VCFs/companies were registered with SEBI under the VCF Regulations. On July 1, 2005, this treatment was revoked by RBI and accordingly:

- Fresh investments by banks on or after July 1, 2005 in venture capital shall not be eligible for classification under priority sector lending;

- Investments, which have already been made/to be made by banks up to June 30, 2005, in venture capital shall not be eligible for classification under priority sector lending with effect from April 1, 2006.

This could have an impact on the marketing of REF securities as domestic banks have traditionally been one of the largest investors in VCFs.

On the FVCI front, the benefits available to a foreign investor which registers itself as an FVCI are as follows:

- As per the notification issued by the RBI, FVCIs benefit from free entry and exit pricing. Under the FEMA, the entry and exit pricing of non-resident investors under the FDI route is regulated. A special exemption has been granted to FVCIs whereby they will be exempted from both the entry and exit pricing regulations.

- SEBI has also exempted transfer of shares from FVCIs to the promoters from the public offer provisions under the Takeover Code, if the portfolio company gets listed post investment This ensures that if the promoters have to buy back the shares from the FVCIs, they will not be burdened with the public offer requirement which otherwise could require them to make an offer to the other shareholders of the company to buy from them up to 20 percent of the paid-up capital of the company.

- FVCIs registered with SEBI have been accorded "Qualified Institutional Buyer" status and would accordingly be eligible for subscribing to securities at the initial public offering of a Venture Capital Undertaking through the book-building route.

- Under the SEBI (Disclosure and Investor Protection) Guidelines, 2000, the entire pre-issue share capital of a company going in for an IPO is locked for a period of one-year from the date of allotment in the public issue. However, an exemption has been granted to domestic VCFs and FVCIs registered with SEBI, if the VCF and the FVCI have been holding shares in the issuer company at least a year prior to the filing of the offer document with SEBI. This would essentially allow the FVCIs to exit from their investments post-listing.

- Generally the definition of a 'promoter' under the SEBI (Disclosure and Investor Protection) Guidelines, 2000 is very broad and includes any person who has a role to play in the decision of a company going in for an IPO. A private equity investor generally reserves certain veto rights in the company and in most cases is actively involved in the IPO decision by the Company. If the private equity investor is not registered as FVCI, there is a possibility that the private equity investor be treated as a part of the promoter group thereby subjecting it to certain onerous requirements otherwise applicable to promoters. SEBI has clarified that a SEBI registered VCF or an FVCI would not be treated as 'promoter' for the purpose of the above guidelines.

- As indicated earlier, SEBI has not granted any FVCI registrations to any foreign investor for the past 2 to 2½ years on account of certain policy-level issues and hence majority of foreign investments in Indian realty sector have been made under the FDI regime.

Possible Structures – Fund Formation

From the structuring perspective, the structures that can be evolved would depend on the type of investors, jurisdiction of investors and the type of real estate projects being targeted. The REF could either be a pure domestic fund set up as a VCF/VCC or a pure offshore fund set up as a company or FVCI, which would invest into domestic companies (VCUs) engaged in real estate activities. Several variants could then be carved out resulting in parallel or unified structures.

The structuring exercise also entails deciding upon an appropriate jurisdiction for setting up the fund. While India has a sizeable treaty network, not many of the treaties offer exemption from tax on capital gains, as is the case with Mauritius, Cyprus, Netherlands, etc. In this regard, Singapore is the "new kid on the block" as it offers same benefit on capital gains as the Mauritius treaty and thus becomes a jurisdiction worth exploring for structuring of the offshore pooling vehicle. Accordingly, as per the Protocol to the India-Singapore tax treaty; a Singapore fund can now enjoy the same Indian capital gains tax exemption as is the case with a Mauritius fund claiming under India-Mauritius tax treaty. However, the availability of capital gains tax exemption under the Protocol is subject to the following "limitation of benefits" provisions:

- the Singapore resident should not so arrange his affairs with the primary purpose of taking advantage of the benefits of the India-Singapore tax treaty. This would include instances where the resident does not have any bona fide business activities in Singapore;

- the Singapore resident should not be a shell/conduit company;

  For the purposes of this provision, a shell/conduit company is any legal entity falling within the definition of a resident with negligible or nil business operations or with no real and continuous business activities being carried out in Singapore. In addition –

  - a Singapore resident shall be deemed to be a shell/conduit company if its total annual expenditure on operations in Singapore is less than S$200,000, in the immediately preceding period of 24 months from

the date the gains arise; or

- a Singapore resident is deemed not to be a shell/conduit company if it is listed on a recognised stock exchange in Singapore.

Thus, as is evident from the above, the limitation provisions stipulated under the Protocol may pose difficulties in claiming benefits under the India-Singapore tax treaty, there being no such caveats under the India-Mauritius tax treaty or for that matter under the India-Cyprus tax treaty. However, it is also pertinent to note that the India-Cyprus tax treaty is currently under renegotiation and it may be possible that the provisions relating to capital gains tax exemption benefits provided by the treaty may be amended. Accordingly, Mauritius still remains the most preferred jurisdiction to invest in Indian real estate sector.

In case of REFs, the choice narrows down further as India reserves the right to tax gains on direct or indirect holdings in properties. Added complications arise on account of the desire to use structured products for investments, entailing a regular flow of interest income to investors. In this scenario, Cyprus appears to be a more promising jurisdiction than Mauritius , especially since investor confidence is growing on account of its accession to the EU. The other critical component to be borne in mind while performing the structuring exercise is the exposure to Permanent Establishment ("**PE**"). PE is that degree of economic penetration which according to the agreement of treaty partners justifies a nation in treating a foreign person for income tax purposes in the same manner as domestic persons are treated[7]. It is pertinent to note that any profits derived from transfer of shares of an Indian company would be regarded as capital gains only if the foreign investor does not have a PE in India. Here it would be pertinent to note the observations of the Andhra Pradesh High Court in the case of *CIT* vs. *Visakhapatnam Port Trust*[8]:

"In our opinion, the words "permanent establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country."

Thus, according to Article 7 read with Article 5 of the tax treaties, the business of a foreign entity is subject to tax in India only to the extent the same is attributable to its PE in India. Thus, while structuring it is important to ensure that no PE exposure is created for the offshore pooling vehicle or the offshore investors as this may lead to loss of capital gains tax exemption under the tax treaty and may trigger Indian tax implications. A PE could be created if the offshore pooling vehicle/investor is regarded to have a fixed place of business in India, or has an office in India, or has a dependent agent in India. Further, it is important to note that in case offshore pooling vehicle/investor coming from a non treaty country, this exposure gets enhanced as the PE-equivalent concept under the ITA, viz. Business Connection ("**BC**") has a broader gamut and is defined in less clearer terms as compared to PE under a tax treaty scenario. While the PE/BC exposures may be structurally addressed, it is equally important that the checks-and-balances built into the structures are adhered to in practical and factual terms as determination of PE/BC is a fact driven exercise and there is no straight jacket formula available to mitigate the risk in its entirety.

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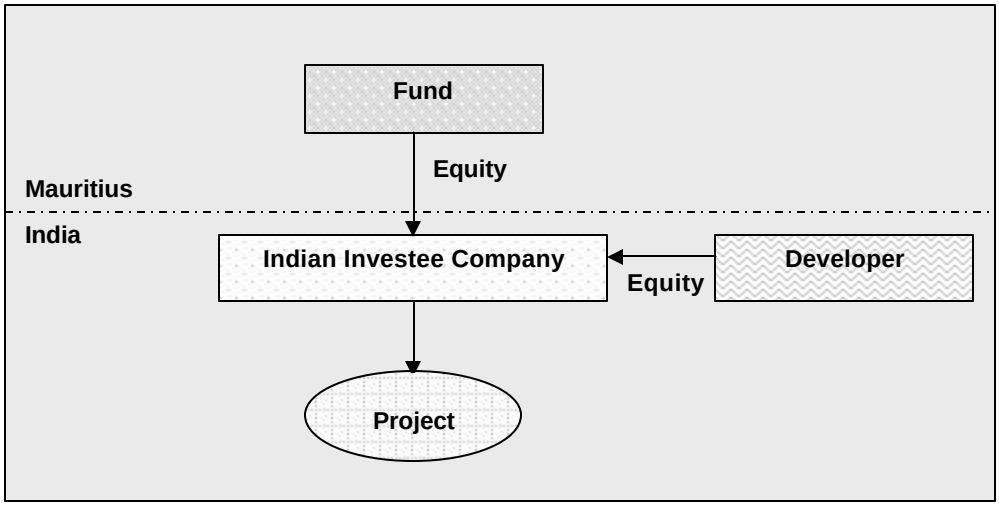
[7] John Huston and Lee Williams, Permanent Establishments a planning primer [1993]

[8] 146 ITR 162 (AP)

Possible structures – REF Investments

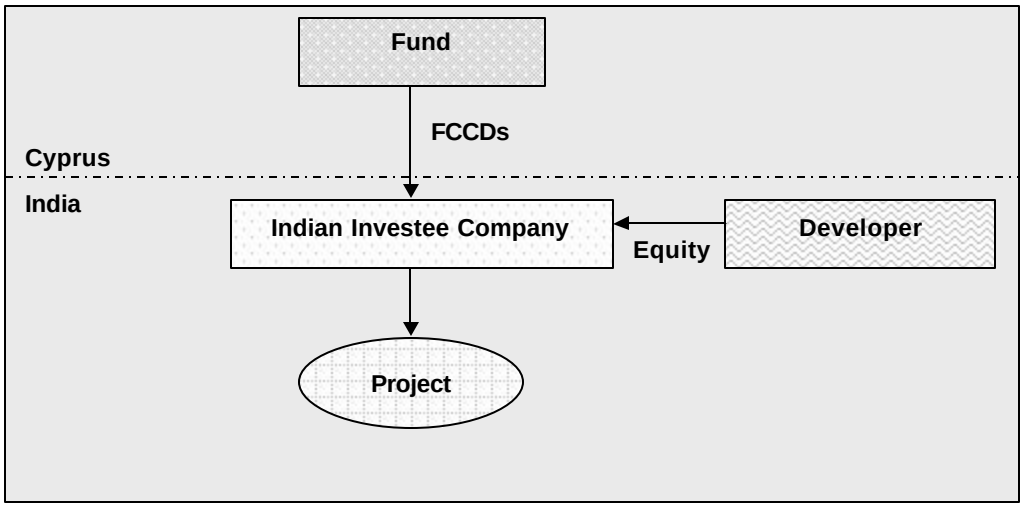
By using the various tax-friendly jurisdictions, the following legal, tax and exchange-control efficient structures for routing REF investments could be explored:

- *Mauritius-India Structure*



In this structure, the India-Mauritius tax treaty can be used to maximize the capital gains tax exemption benefits arising from exit by the Mauritius Fund. The equity shares and/or fully and compulsorily convertible preference shares ("**FCCPS**") could be issued or purchased under the FDI route by the Investor. This structure, besides being legally compliant, shall also be tax-efficient because, at the time of exit of the Investor, the capital gains tax as arising out of the transfer of the equity shares and/or FCCPS by the Investor shall be exempt from tax on account of the India-Mauritius tax treaty.

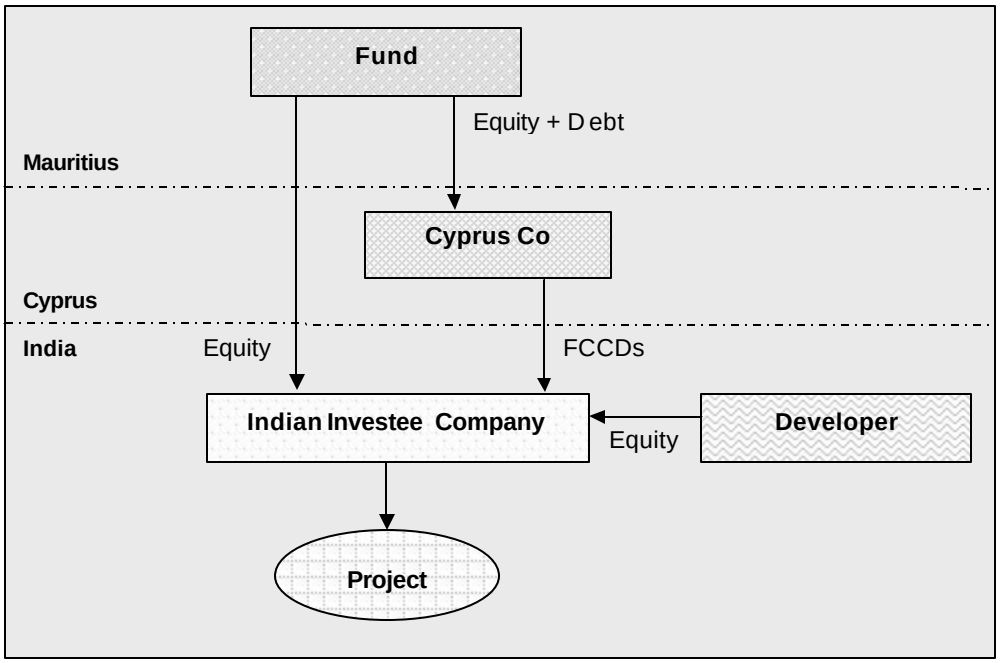
- *Cyprus-India Structure*



This structure is distinct from the above structure on account of the fact that instead of equity or quasi-equity, quasi-debt instrument in the form of fully and compulsorily convertible debentures ("**FCCDs**") is used. As per the India-Cyprus tax treaty, the withholding tax rate on the interest paid on the FCCDs by the Indian company is reduced to 10%. Moreover, the Indian company gets the benefit of 33.99% tax saved by virtue of getting a tax deduction for such interest paid from its taxable income. Furthermore, the aforesaid India-Cyprus tax treaty also provides the same exemption with reference to capital gains tax as the India-Mauritius Double Taxation Avoidance Agreement.

However, there are news reports that suggest that the India-Cyprus tax treaty is undergoing renegotiation and that the provisions relating to capital gains tax exemption benefits may be amended.

- *Mauritius- Cyprus- India Structure*



This structure is a combination of the previous two structures. It envisages the investment by way of equity, FCCPS as well as FCCDs. This structure could be explored depending on the commercials of the transaction.

A Few Posers?

In the backdrop of the regulatory and tax regime for India centric REFs discussed above, the following emerge as the key considerations in structuring of REFs:

- Need and options for segregation of funds pooled from NRIs, non NRIs and domestic investors - this is critical as it could impact the down line investment opportunities for the REFs;

- Structuring of the foreign investment under the FDI route versus the FVCI route - the ultimate choice of regime being driven by strategic and commercial considerations;

- Structuring of the management structure - domestic versus offshore manager, combination structures,

etc. Structuring imperatives for incentivising the employees of offshore/domestic manager and foreign management team add to the significance of the structuring exercise;

- Structuring of creation of a pledge on the Indian immovable property in favour of a non-resident as a collateral for securing FCCDs;

- Structuring of the products to be offered to the clients depending on the risk appetite and preferences of the investors;

- Structuring of exit opportunities, listing options: domestic and abroad.

Tax Implications

- **General**

Taxation of income in India is governed by the provisions of the ITA as amended by the Finance Acts, from time to time. The ITA lays down elaborate provisions in respect of chargeability to tax, determination of residency, computation of income, et al. Residents are subjected to tax in India on their worldwide income, whereas non-residents are taxed only on Indian source income, i.e. incomes received in India, income that accrues or arises to them in India or is deemed to accrue or arise in India[9]. Section 9 of the ITA stipulates the types of income, which under certain circumstances are deemed to accrue or arise in India, such as interest, royalty, income from any capital asset situated in India, etc. However, in case of a non resident taxpayer being resident of a country with which India has signed a tax treaty, he has the option of being taxed as per the ITA; only to the extent the provisions of the ITA are more beneficial to him[10].

- **Taxation of Investee Companies**

An investee company being a company incorporated in India is regarded as a tax resident of India and is subject to taxation in India on its worldwide income. Currently, domestic companies are taxed at the rate of 33.99 percent on their net profits. Every Indian company distributing dividends to its shareholders is required to pay a Dividend Distribution Tax ("**DDT**") of 16.995 percent. The dividends so paid by the Indian company are tax-exempt in the hands of the shareholders, irrespective of their residential status. Please note that the DDT is payable by the Indian company despite the fact that the profits from which the dividends are being distributed may be enjoying tax holiday/exemptions except in the case where the dividends are paid by a developer of special economic zone.

Characterization of income

The income of the investee company, depending on the facts and circumstances of the case, may be characterized as "business income" or "income from house property". In the event, the income is characterized and taxed as business income then same is subjected to the full corporate tax of 33.99 percent on net income, i.e. net of all business related expenses and specific tax holidays/exemptions[11] being claimed by the investee company.

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[9] Section 4 and 5 of the ITA Section 90(2) of the ITA

[10] Unless specified otherwise, all income tax rates mentioned in this article are inclusive of the currently applicable surcharge at the rate of 10 percent on domestic companies and 2.5 percent in case of foreign companies and the education cess of 3 percent on tax and surcharge.

[11] Under sections 80IA/IB of the ITA

In case income of the investee company is taxable as income from house property, only two deductions are available, first being the standard deduction at the rate of 30 percent against the annual value and second being deductions for interest payments if the investee company has borrowed funds for purposes of acquisition, construction, repair, renewal or reconstruction of the property. There is no limit on the amount of interest deductible in case of commercial properties and thus if the interest payable exceeds the rental income, the unabsorbed interest can be carried forward for set off in future years.

Interest Income

Any interest that accrues to an offshore fund is subject to a withholding tax of 10.56 percent in case of interest on Foreign Currency Convertible Bonds issued by the investee company under the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme 1993 (the "Scheme"), or 21.115 percent on loans made to investee company in non-Indian currency not under the Scheme (e.g. under the ECB route) and at the rate of 42.23 percent in case of loans made to the investee companies in Indian currency. The withholding tax rates could stand reduced under the tax treaty, if any, between India and home jurisdiction of the offshore fund. Interest payments to investors in a domestic fund would attract interest withholding at varying rates depending on the tax classification of the investor in the domestic fund.

Capital Gains

Currently, under the ITA, gains are classified as short-term and long-term depending upon the period of holding[12]. Long-term capital gains earned by an investee company upon sale of any property would be taxed at the rate of 22.66 percent and 33.99 percent in case of short-term capital gains. However, if the income from sale of property is characterized as business income, then the tax rate would be 33.99 percent. Accordingly, one would need to pay attention to the characterization of the gains as business income or capital gains which would again depend on the facts and circumstances of each case.

Minimum Alternate Tax

Where the tax payable by the investee company is less than 10 percent of its book profits, the tax will be deemed to be 10 percent (excluding surcharge and education cess) of such book profits as Minimum Alternate Tax.

Wealth tax

Buildings, residential and commercial premises held by the investee company will be regarded as assets as defined under Section 2(ea) of the Wealth Tax Act, 1957 and thus be eligible to wealth tax in the hands of the investee company at the rate of 1 percent on its net wealth in excess of the base exemption of INR 15,00,000. However, commercial and business assets are exempt from wealth tax.

[12] Gains earned on sale of assets (other than shares) if held for 36 months or less are classified as short term capital gains, whereas gains earned on sale such assets if held for more than 36 months are classified as long term capital gains.

Service Tax

The service tax regime was introduced vide Chapter V to the Finance Act, 1994. Subsequent Finance Acts, (1996 to 2003) have widened the service tax net by way of amendments to Finance Act, 1994. Service tax is levied on specified "taxable services" at the rate of 12.36[13] percent on the "gross amount" charged by the service provider for the taxable services rendered by him. The Finance Act, 2004 has introduced "construction services" as a taxable service and thus such services provided by the investee company would be subject to service tax in India. Further, the Finance Act, 2007, has brought services provided in relation to renting of immovable property, other than residential properties and vacant land, for use in the course or furtherance of business or commerce under the service tax regime.

Stamp Duty and other taxes

The real estate activities of the VCU would be subject to stamp duties and other local/municipal taxes, property taxes, which would differ from State to State, city to city and between municipals jurisdictions. Stamp duties may range between 3 to 14 percent.

Special Economic Zones

A Special Economic Zone ("**SEZ**") is a specified, delineated and duty-free geographical region that has different economic laws from those of the country in which it is situated. To provide a stable economic environment for the promotion of export-import of goods in a quick, efficient and trouble-free manner, the Government of India enacted the Special Economic Zones Act, 2005. Developers of SEZs and units set up in SEZs enjoy several fiscal benefits, such as exemption from income tax for specified periods, customs and excise duty exemptions, etc. A unit in the SEZ must however be net foreign exchange positive within a certain period. If a target company is a unit in an SEZ, or registered as any kind of export oriented unit ("**EOU**"), then its assets may be bonded by the customs authorities, and in such a case, they must be debonded prior to the transfer. 100 per cent of the profits of the developer arising from the business of developing an SEZ, notified after April 1, 2005 under the SEZ Act, shall be deducted from taxable income. This deduction can be claimed at the option of the assessee for any 10 consecutive years out of 15 years beginning from the year in which the SEZ has been notified by the Central Government. If a developer who sets up an SEZ after April 1, 2005, transfers the operation and maintenance of the SEZ to another developer, the transferee is entitled to the above deduction of profit for the remaining period. Further, the units set up in an SEZ which have begun to manufacture / provide services during the financial year beginning April 1, 2005 will get the following exemptions :

- 100% exemption of profits and gains from business for the first 5 years;
- 50% exemption on profits and gains from business for the next 5 years; and
- 50% exemption to the extent that such amounts are re-invested in the SEZ Special Reserve Account

➢ **Taxation of VCF/VCC**

As per section 10(23FB) of ITA, a VCF registered with the SEBI under the VCF Regulations is accorded a "pass through" status for income tax purposes, provided that it has been set up to raise funds for investments in "Venture Capital Undertakings" i.e. unlisted or to be listed Indian portfolio companies, in

[13] Excluding currently applicable education cess of 3 percent on service tax

certain specified sectors. These sectors include:

- nano-technology,
- information technology relating to hardware and software development,
- seed research and development,
- bio-technology,
- research and development of new chemical entities in the pharmaceuticals sector,
- production of bio-fuels,
- building and operating certain hotel and convention centers,
- dairy and poultry industries, and
- developing or operating and maintaining or developing, operating and maintaining certain infrastructure facilities.

If the VCF is given pass through status, the income of the VCF is taxable only in the hands of the investors.

Accordingly, the VCF, which is to be organised as a trust ("**Trust**") shall be accorded pass through status and will be tax exempt in India in respect of any income arising out of investments made in the specified sectors. The investors will be taxable in India in respect of income distributed by the Trust. As per the provisions of section 115U of the ITA, any income distributed by the Trust will be chargeable to tax in the hands of the investors in the same manner as if it were the income of the investors, had they made such investments directly in the Indian portfolio companies.

In the event that the Trust does not make investments into the specified sectors contained in section 10(23FB), pass through status will not be available to it under section 10(23FB) in spite of being registered as a VCF with the SEBI. However, the Trust may still be permitted pass through status as per the provisions of sections 161 to 164 of the ITA. In case of investments by the Trust in the real estate sector, the benefits of section 10 (23FB) will not be available and hence the Trust would be required to claim exemption under section 161 to 164 of the ITA. Similar provisions are also applicable to trusts not registered with SEBI.

- **Taxation of Offshore Fund**

The dividends earned by an offshore fund would be tax exempt in its hands. Interest income would be taxed at the rates mentioned under the heading "interest' above. Capital gains would be taxed at the rate of 0 percent/10.56 percent/21.115 percent/31.67 percent/42.23 percent depending on the nature of security, period of holding and type of investor. As stated above, under certain treaties, capital gains are given partial or complete exemption from capital gains tax. On the other hand, if the income from investments are taxed as business income in the hands of the offshore fund set up as a company, then as stated above, such gains would not be subjected to tax in India in the absence of a PE/BC in India or would be taxed at the rate of 42.23 percent on the gains attributable to the PE/BC in India.

Recent Developments

- **REITs**

Real Estate Investment Trusts ("**REITs**"), as commonly understood in the international context, are currently non-existent in India, although the same stand proposed through the draft SEBI (Real Estate Investment Trusts) Regulations, 2007 ("**REITs Regulations**"). This is a result of the several representations as made by players in the real estate industry to permit setting-up of REITs in India.

Why REITs?

The success of the REITs regime in offshore jurisdictions is an indication that REITs are not only popular but also inevitable on account of the following important benefits that they offer to small investors:

- Liquidity

  REITs have helped turn real estate liquid. Through the publicly traded REITs structure, investors can buy and sell interests in diversified portfolios of properties-as well as the management associated with them on an instantaneous basis.

- Security

  Because real estate is a physical asset with a long life during which it has the potential to produce income, investors always have viewed real estate as an investment option with security. Through REIT structures, small investors have the added level of security that was not available earlier. Low levels of debt practiced by several REITs also mean greater security for financial system as a whole.

- Diversification

  Investing in REITs and other publicly traded real estate companies provides diversification benefits because the correlation of REIT returns with the returns of other market sectors is relatively low. The correlation of returns in two different investment categories need not be negative to benefit from diversification. Even low to moderate positive correlation may help to increase long-term risk-adjusted returns[14].

- Performance

  Since their inception, REITs have provided competitive investment performance. REITs market performance has been roughly comparable to that of Standard & Poor's 500 Index and has exceeded returns on fixed debt instruments or direct investment in real estate. Since globally REITs also pay out annually almost all of their taxable income, a significant component of total return reliably comes from dividends[15].

Key highlights of the draft REITs Regulations

- Eligibility Criteria for Registration

  REIT shall be required to have a minimum net worth of Rs. 50,000,000 i.e. approx. USD 1,250,000. However, the REIT would also be eligible for registration, if it has a net worth of Rs. 30,000,000 i.e. approx. USD 750,000 which can be increased to Rs 50,000,000 i.e. approx.USD 1,250,000 within three years from the date of registration with SEBI. Further, the REIT should have adequate infrastructure and good professionals with requisite relevant experience.

- *Scheme*

[14] http://www.dollardex.com/sg/index.cfmcurrent/contents/reitoverview&contentID-2289 visited on November 4, 2005.

[15] The REIT IPO Source Book Planning for Real Estate Investment Trust Initial Public Offering.

The schemes offered by a REIT ("**Scheme**") shall be close-ended and cannot be open for subscription for a period of more than ninety days. This means that the unit holders cannot redeem their units in the Scheme, but can exit by selling the units on the stock exchange. Further, the Scheme cannot guarantee or assure any returns to the unit holders but only mention indicative return assessed by an appraising agency and stated in monetary terms. A Scheme shall be launched only upon obtaining a rating from a credit rating agency and being appraised by an appraising agency.

- Trust Vehicle and Trustees

REITs Regulations provide that a Scheme shall be launched only by a trust registered under the Indian Trusts Act, 1882 and the trust deed shall provide for undertaking real estate investments as per REITs Regulations. The trustees of a REIT should be either a scheduled bank, trust company of such a scheduled bank, public financial institution, insurance company, or a body corporate.

- Investment Limitations

A REIT shall be allowed to only invest in real estate which is generally income generating. However, a REIT shall also be allowed to invest in a building, which is unoccupied and non-income generating, or under redevelopment, provided the aggregate contract value of such properties does not exceed 20% of Scheme's total Net Asset Value. REIT shall not be allowed to invest in vacant land or participate in property development activities.

A REIT under all its Schemes shall not have exposure of more than 15% of any single real estate project and 25% of all the real estate projects developed, marketed, owned or financed by a single group of companies.

- Borrowing Restrictions

A Scheme can borrow for funding investments and operating expenses but it cannot borrow more than one-fifth of the value of the Scheme's total gross assets.

- Distribution to Unit holders

The Scheme is required to distribute to unit holders at least 90% of its annual net profit after tax as dividends every year.

- Listing

The REITs Regulations provide for compulsory listing of the Scheme on the stock exchanges immediately after the allotment of the units to the unit holders but not later than six weeks from the date of closure of the Scheme on the stock exchange.

- Fees

The application fees and registration fees payable for a REIT to SEBI shall be Rs. 25,000 (i.e. approx. USD 625) and Rs. 1,000,000 (i.e. approx. USD 25,000) respectively. Further, the filing fees for the offer document shall be Rs. 25,000 (i.e. approx. USD 625). In addition to above, the annual fees shall also be payable by a REIT depending on the Net Asset Value of the REIT.

- Independence

  At least 50% of the trustees of the REIT shall be independent persons and not directly or indirectly associated with the persons having a control over the REIT.

- Valuation Report

  Every Scheme shall be required to appoint an independent property valuer ("**Principal Valuer**") who will submit valuation report on properties to be acquired or sold by the Scheme or where new units are offered by the Scheme. The Principal Valuer shall follow the valuation methodology based on the 'valuation standards on properties' published from time-to-time by the concerned Indian institute or the international valuation standards issued from time-to-time by the International Valuation Standards Committee.

- Real Estate Investment Management Company ("**REIM**")

  The Schemes shall be managed by a REIM and the REIM shall be registered with SEBI. The eligibility criteria, application and registration fees and criteria for independence for REIM are similar to criteria prescribed for a REIT.

  It shall be the responsibility of the REIM to calculate the Net Asset Value of the Schemes of the REIT on the basis of the annual valuation report and disclose the same to the unit holders as per the frequencies specified by SEBI.

  REIM shall prepare quarterly report on its activities and submit the same to the trustees of the Trust within one month of the expiry of each quarter. The REIM shall also have certain other reporting requirements to SEBI.

- Implications

  The following shall be implications of the draft REITs Regulations:

  - REITs could now directly invest in real estate properties unlike a domestic venture capital fund which currently is required to invest in a venture capital undertaking which in turn can own properties. This direct investment by REITs for owning underlying properties will help in reducing taxes by eliminating one entity layer in the ownership structure.

  - It remains to be seen whether a REIT would be eligible for a tax pass through under the domestic tax laws, as is currently available in developed countries, if at least 90% of its annual net profit after tax is distributed as dividends every year to the unit holders as per the REITs Regulations.

  - REITs will help private equity investors to exit from their investments in real estate projects with a shorter payback period as against the current scenario where they have to stay invested for usually four to six years till the real estate projects are completed.

  - It remains unclear from the REITs Regulations and the same will unfold over a period of time as to whether the REITs regime will be open for investment by foreign investors.

- No mechanism has been prescribed under the REITs Regulations for the migration of the existing schemes registered under the SEBI (Venture Capital Funds) Regulations, 1996 to the proposed REITs regime. Accordingly, the existing domestic venture capital funds will have to wait for some more time to get a clear picture on migration of their existing schemes into a REIT Scheme.

- As per the REITs Regulations, the development risk has been capped at 20% of the Scheme's Net Asset Value which is in line with the laws in developed countries.

- For the foreign fund managers proposing to set up their REIT in India, it remains to be seen whether they will be allowed to set up their REIM in India under the automatic route as is currently available to other foreign owned asset management companies.

- REITs will offer a convenient tool to retail investors, which will relieve them of the necessity to select, acquire, get registered and sell real estate properties and will help minimize the risks related to real estate investments. It remains to be seen whether the Indian REITs regime, once operational, will be able to garner as much interest as currently garnered by offshore REITs regimes in Singapore, Hong Kong, Australia, etc.

➢ **REMFs**

While the REITs Regulations are still in the draft form, SEBI has amended the SEBI (Mutual Funds) Regulations, 1996 ("**MF Regulations**"), on April 16, 2008, to include a new chapter 49A which provides for setting up and operations of Real Estate Mutual Funds ("**REMFs**").

Key Highlights of the REMF Regulations

Certain key features of the REMF Regulations are discussed below –

➢ Eligibility

- In order to set up a new REMF, the sponsor should be carrying on the business in real estate for a period at least five years and fulfill all other eligibility criteria applicable for sponsoring a mutual fund, which provide that the sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions. The term "sound track record" means the sponsor should

  (i) have a networth which is positive in all the immediately preceding five years;

  (ii) the sponsor's networth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company;

  (iii) the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year;

  (iv) the sponsor is a fit and proper person;

  (v) the sponsor has contributed or contributes at least 40% to the net worth of the asset management company, provided that any person who holds 40% or more of the net worth of an asset management company shall be deemed to be a sponsor and will be required to fulfill the eligibility criteria specified in these MF Regulations; and

(vi) the sponsor or any of its directors or the principal officer to be employed by the mutual fund should not have been guilty of fraud or has not been convicted of an offence involving moral turpitude or has not been found guilty of any economic offence

- Existing mutual funds can launch REMFs if they have adequate number of experienced key personnel / directors.

- Interestingly, if the REMF has no key personnel with experience in finance and financial services, then 100% of the net assets will be required to be invested in real estate assets.

➢ Investment restrictions

- REMFs are required to invest at least 35% of its net assets in real estate assets and can invest the balance in mortgage backed securities, securities of companies engaged in dealing in real estate assets or in undertaking real estate development projects and other securities, provided that, if taken together, investments by the REMF in real estate assets, real estate related securities (including mortgage backed securities) should not be less than 75% of the net assets of the REMF. The balance 25% can be invested by the REMF in any other securities. Regulation 49A of the REMF Regulations defines a 'real estate asset' as an identifiable immovable property (i) which is located within India in a specified area (to be specified by the SEBI); (ii) on which construction is complete and which is usable; (iii) which is evidenced by valid title documents; (iv) which is legally transferable; (v) which is free from all encumbrances; and (vi) which is not subject matter of any litigation. The REMF Regulations specifically exclude projects under construction, vacant land, deserted property, land specified for agricultural use etc.

- REMFs are not permitted to transfer real estate assets amongst its schemes.

- REMFs are prohibited from engaging in the business of lending or housing finance activities.

- REMF are not permitted to invest more than (i) 30% of all its net assets in more than one city, unless disclosed in the offer document; (ii) 15% of its net assets in a single real estate project; (iii) 25% of the issued capital of an unlisted company under all schemes together; and (iv) 15% of net assets of any of its schemes in equity / debentures of an unlisted company.

- REMFs are prohibited from investing in (i) unlisted securities of the sponsor, its associate or its group company; or (ii) assets owned / previously owned by sponsor or the asset management company or their associates during the past 5 years. REMFs, may, however, invest in listed securities of such companies provided that such investment does not exceed 25% of its net assets.

➢ Valuation of assets

- Each real estate asset of an REMF should be valued by two valuers accredited by a credit rating agency registered with the SEBI and appointed by the asset management company.

- The valuation must take place every 90 days from date of purchase of the real estate asset, and the lower of the two values should be taken for the computation of net asset value ("**NAV**").

- The NAV is required to be disclosed on a daily basis.

➢ Tax Regime

- All income arising from the REMF registered under Section 10 (23D) of the Income Tax Act, 1961 will be tax exempt at the hands of the REMF.

- Under the provisions of Section 10 (35) of the Income Tax Act, 1961 the returns received by the unit holders from the REMF will be tax exempt.

- REMF will be liable to pay additional income tax on distributions of returns at the rate of 12.5% for individuals and 20% for others if it is not regarded as an equity oriented fund.

- Unit holder will be exempt from long term capital gains tax if the units are purchased on the floor of a stock exchange and the securities transaction tax thereon has been paid.

➢ REITs v. REMFs – An Analysis

- Investment Ability: Whilst REITs are required to invest only in real estate assets and cannot invest in securities, REMFs can invest in securities as well. The unique ability of REMFs to make hybrid investments (in securities and real estate) will not only allow them to make high risk high return investments in securities of a company undertaking construction development projects, but will also give them the leeway to acquire such real estate projects once they are completed.

- Development Risk: REMFs are not permitted to invest in developing properties, which may mitigate the returns on real estate assets. REITs are permitted to invest in underdeveloped properties up to 20% of their corpus.

- Valuation: Unlike REITs, where the valuation of the property is required to be done by a SEBI registered valuer having a net worth of at least 5 crores, the valuers in case of REMFs are not required to be registered with the SEBI or satisfy such net worth requirements.

- Taxation: Whilst the tax treatment of REITs is still unclear, tax treatment of REMFs, in line with mutual funds, is relatively certain. It, however, remains to be seen whether REMFs will be regarded as equity oriented funds or not. This is because a mutual fund qualifies as an "equity oriented" mutual fund, only if more than 65% of its total net assets are invested in equity shares of domestic companies, and the REMF Regulations require that only up to 65% of the net assets of an REMF be invested in securities.

➢ Implications: Much in line with the REITs, REMFs are likely to have similar implications, which are as follows:

- Enhanced participation: Domestic retail investors can now participate in the growing real estate market in India, which they were otherwise unable to owing to soaring real estate prices.

- Property: The requirement of the real estate assets to be entirely free from litigation in case of an REMF may not be practical, and it would have been better if certain threshold for litigation was stipulated.

- Venture Capital: The REMF Regulations might disappoint a host of venture capital investors that were anxiously waiting for the REMF Regulations to convert themselves into REMFs as not only do the REMF Regulations not provide for any rollover mechanism, they also prohibit REMFs from acquiring real estate assets owned by the sponsor, or the asset management company, or any of its associates during the past 5 years.

- Exit mechanism: REMFs will help private equity investors to exit from their investments in real estate projects with a shorter payback period as against the current scenario where they have to stay invested for usually 4 to 6 years till the real estate projects are completed. However, such an exit may be impacted by the restriction on an REMF to purchase assets from sponsors or their associates as mentioned earlier.

- Valuation: Further, the requirement to value the real estate assets every 90 days may not be practical in the Indian scenario and a period of 6 months for such valuations may have better suited. Such frequent valuations will only add to the administrative costs and expenses of REMF.

- Tax mitigation: REMFs can now directly invest in real estate assets unlike a domestic venture capital fund which is required to invest in a venture capital undertaking which in turn can own properties. This direct investment by REMF for owning underlying properties will help in reducing taxes by eliminating one entity layer in the ownership structure.

- Stamp duty implication: Heavy stamp duty rates might make investments in real estate assets unattractive. Recently, the government was deliberating on waiving the stamp duty for REITs in accordance with international norms, and it remains to be seen if the waivers will extend to REMFs as well.

- Professionalism and transparency: REMFs will not only be instrumental in the growth and maturity of the real estate sector, they will also facilitate professional management, good corporate governance, transparency and more importantly alleviation of black money from real estate sector in India.

- FIIs: Though there is nothing in the extant REMF Regulations to exclude Foreign Institutional Investors from investing in REMFs, it remains to be seen whether restrictions would be imposed on FII investment in REMFs.

Essentially, the REMF Regulations will provide a platform for diversification and give investors a professionally managed investment in real estate as an asset class and result in price discovery of real estate projects as mutual funds will conduct greater due diligence and check the fundamentals (location, commercial viability and other aspects of realty projects) prior to making the investment.

Whilst REMFs are likely to go a long way in unlocking value and enhancing investor participation in real estate, especially in a country like India where real estate and gold remain the traditional investment favorites of households, it remains to be seen whether the globally successful REITs, regarded as specialized mutual funds with the ability to invest directly into real estate, will be able to outshine the newly launched REMFs in terms of investor participation and investment returns.

Conclusion

The Indian real estate industry is evolving from an "unorganized" sector to a more institutionalized and corporatized set up. The participation of foreign investment of specialized players and sophisticated investors in this transition phase will bring in transparency, accountability and emphasis on quality. The statistics doing the rounds these days evidently support the belief that Indian real estate sector promises to be a big draw for foreign investments into the country for times to come. Since real estate investment requires a longer term commitment from investors and the fact that foreign investors are willing to commit billions of dollars in this sector, demonstrates their growing confidence in the Indian economy. Further, the housing and real estate

industry has significant linkages with other secto rs of the economy and over 250 associated industries. A unit increase in expenditure in this sector has a multiplier effect and the capacity to generate income as high as five times.

India has come long way from the high tax rates and opaque administration days. Millennial India is a package deal of a vibrant democracy, a large reservoir of skilled manpower, an economy at the cutting edge of new technology and above all a huge and growing domestic market, healthy growth rate of approx. 8 percent p.a., implementation of second generation, infrastructure, advancements, exchange controls relaxations and government's commitment to move towards more transparency and simplification of the regulatory and tax regime to bring it at par with the best international practices-all add up to make India an attractive investment destination.

Annexure 1

Press Note 2 (2005)

Subject: Foreign Direct Investment (FDI) in townships, housing, built-up infrastructure and construction-development projects

With a view to catalysing investment in townships, housing, built-up infrastructure and construction-development projects as an instrument to generate economic activity, create new employment opportunities and add to the available housing stock and built-up infrastructure, the Government has decided to allow FDI up to 100% under the automatic route 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),subject to the following guidelines:

a. Minimum area to be developed undereach 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 ofthe above two conditions would suffice.

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

   i. Minimum capitalization of US $10 million for wholly owned subsidiaries 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 ofthe Governmentthrough the FIPB.

c At least 50% 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. For the purpose of these guidelines, "undeveloped plots" will mean where roads, water supply, street lighting, drainage, sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available. It will be necessary that the investor provides this infrastructure and obtains the completion certificate from the concerned local body/service agency before he would be allowed to dispose of serviced housing plots.

d. 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 ofthe State Government/Municipal/Local Body concerned.

e. The investor shall be responsible for obtaining all necessary approvals, includi ng 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 ofthe State Government/ Municipal/Local Body concerned.

f. The State Government/ Municipal/ Local Body concerned, which approves the building/ development plans, would monitor compliance ofthe above conditions by the developer.

Annexure 2

Investment Conditions and Restrictions under the VCF Regulations

Minimum investments a venture capital fund :

A (1) A venture capital fund may raise monies from any investor whether Indian, foreign or non-resident Indians by-way of issue of units.

(2) No venture capital fund set up as a company or any scheme of a venture capital fund setup as a trust shall accept any investment from any investor which is less than five lakh rupees:

Provided that nothing contained in sub-regulation (2) shall apply to investors who are, -

employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust- or the employees of the fund manager or asset management company.

(3) Each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors for contribution of an amount of at least Rupees five crores before the start of operations by the venture capital fund.

Investment conditions and restrictions:

B All investment made or to be made by a venture capital fund shall be subject to the following conditions, namely: -

a) venture capital fund shall disclose the investment strategy at the time of application for registration;

b) venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking;

c) shall not invest in the associated companies; and

d) venture capital fund shall make investment as enumerated below:

(i) at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking.

(ii) Not more than 33.33% of the investible funds maybe invested by way of
a) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed

b) debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity

c) Preferential allotment of equity shares of a listed company subject to lock in period of one year

d) the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed

Explanation-1 For the purpose of these regulations, "a financially weak com pan/ means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year

e) Special Purpose Vehicles which are created by a venture capital fund for the purpose of facilitating or promoting investment in accordance with these Regulations.

Explanation-The investment conditions and restrictions stipulated in clause (d) of regulation 12 shall be achieved by the venture capital fund by the end of its life cycle, (e) Venture capital fund shall disclose the duration of life cycle of the fund.

Prohibition on listing

13. No venture capital fund shall be entitled to get its units listed on any recognised stock exchange till the expiry of three years from the date of the issuance of units by the venture capital fund.