

# **REAL ESTATE**

## **Legal and Regulatory Issues and Challenges**

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## **INTRODUCTION**

The term “Real Estate” includes all interests in land whether in one’s possession or on which one has a right or can claim benefit. Real Estate embraces not only the land but all improvements of permanent nature placed on the land such as buildings and other structures that are regarded as part of the land. From the Indian standpoint, there are three broad categories of real estate based on use, namely, residential, commercial (which includes offices, shops and retail spaces, hospitality and all other establishments of commerce where manufacturing or processing activity does not take place) and industrial (typically where manufacturing or processing takes place). Examples of real estate include undeveloped land, residential buildings, commercial buildings, co-operative housing societies, town homes, retail stores, malls and factories.

Worldwide attachment to property is very high and investment in real estate is seen to be the most profitable. The Indian real estate market was, until recently, largely unorganized, fragmented and characterized by small players with relatively low levels of expertise or financial standing. More often than not, such players generally have a localised presence. This scenario underwent a change with in line with the sector’s growth, and as of today, the real estate sector in India is on a rapid growth path. Over a short period of time the industry has evolved from a highly fragmented and unorganised market into a semi-organised market with large number of listed and unlisted companies that are slowly acquiring a pan-India presence.

Several companies in this space are not only expanding geographically, but are also diversifying into the development of Special Economic Zones (“SEZs”), roads, ports etc. Currently the real estate and construction sector is playing a crucial role in the overall development of India’s core infrastructure.

### **REAL ESTATE IN INDIA -MARKET OVERVIEW:**

Real estate in India has seen an extraordinary boom in the last few years. This was ignited and fuelled by two main forces. First, the expanding industrial sector has created a surge in demand for offices building and homes. Second, the government has taken positive steps by permitting foreign direct investment (“FDI”) in the sector.

#### **Commercial real estate**

The commercial real estate segment, primarily office space, has thrived with the growth in the Indian economy. The demand for commercial office space has been driven by the influx of multinational companies (“MNCs”) and growth in the services sector, namely telecom, financial, IT & ITeS, bio-technology and such like.

Progressive liberalisation and relaxation of FDI norms in various sectors have paved

the way for growth in FDI in real estate sector that has led to a rising demand for office space from MNCs and other foreign investors.

Demand for office space is directly linked to addition in number of employees, which in turn is dependent on economic growth. Downturn in commercial real estate market is largely the result of postponement of expansion plans by corporate. Developers may face heat from the ups and down of other sectors since the office space is dependent on performance of IT/ITeS industry. Any unforeseen downturn in the business prospect of the industry would have a significant impact on the vacancy levels of the upcoming commercial office space.

### **Residential sector in real estate**

As shelter is a primary need, this sector too has witnessed substantial growth. Rapid urbanisation, growth of services sector and organised retail, decreasing household sizes (given the movement from the joint family structure to nuclear and/or independent units), a growing number of youth joining the working age population has led to a spiralling demand for quality homes. At the same time acute shortage in middle and lower income groups has seen a rise in the demand for affordable housing which is a priority segment for the government and developers, real estate being considered a necessary investment and easy availability of home loans are the key growth drivers of the residential sector in real estate.

### **Retail real estate**

With FDI being permitted in the retail segment, entry of international retailers and rising consumerism with doubling of disposable income, retailing in India is inching its way towards becoming the next boom industry.

### **Hospitality real estate**

India's hospitality segment has witnessed robust growth in demand, primarily due to strong growth in tourism, including both business and leisure travel. Rising incomes, weekend trips, increased access to travel related information have propelled growth in hospitality segment. India is acquiring recognition as a medical tourism destination, existing hotel operators are scaling up their operations, developers are tying up with major international chains, and hospitality players are diversifying into budget hotels and service apartments. Service apartments, hospitals and wellness spas are gaining popularity.

### **SEZ**

The Government of India introduced Special Economic Zones Act, 2005 to generate additional economic activity, promote exports and create employment

opportunities.

Developing SEZ is about 15 to 20 per cent cheaper than developing a non-SEZ commercial space, given the various fiscal benefits available to SEZ developers- several real estate developers have been involved in developing SEZs. The SEZ policy allows usage of as high as 50 per cent of the SEZ area as non-processing zone offering significant potential for residential and support infrastructure.

#### **EMPLOYMENT OPPORTUNITIES IN REAL ESTATE:**

Employment opportunities in real estate business include the following:

**Broking:** assisting in buying and selling properties;

**Development:** improving land for use by constructing and/or redeveloping buildings;

**Valuation:** rendering professional valuation services;

**Property management:** managing land, building for the owners;

**Marketing:** managing the sale side in the property business;

**Relocation:** rendering services in relation to relocating people or business to different locations/countries.

#### **REGULATORY SCENARIO**

##### **Approval Delays**

Estimates indicate that real estate developers are required to pass the approvals through 150 tables in about 40 departments of central and state governments and municipal corporations. Delays in project approvals add almost 25-30 per cent to the project cost. The major flaw in the approval process is the lack of co-ordination among the multiple authorities dealing with the permissions/approvals. Many times an approval from one department is disapproved by another. Mere policies are not enough, as the problems arise out of overlapping policies and lack of co-ordination among the departments. On an average 2-3 years are required for obtaining the plan sanction, which clearly establishes that the procedure for obtaining approvals is time consuming.

##### **Title**

Lack of clear land titles and litigation has made this industry one of the most opaque and corrupt. Due to massive price appreciation and huge valuations, land scams have become quiet common.

## **Taxes**

The taxability of real estate transactions has been a subject matter of intense dispute and litigation as the Central Government of India, individual state Government and local authorities are empowered to impose various indirect taxes. The industry is waiting for these sectors to be resolved as a uniform tax regime or rationalised tax structure will assist in ensuring affordable real estate development

## **Stamp duty**

Stamp duty to be paid at the time of execution of an instrument varies from 5% to 15% of the value of property in different states. Respective state governments should expedite their reform and levy a uniform rate across the country.

## **OTHER CHALLENGES**

### **Rising cost of finance and limited avenues to fund projects**

Availability of finances at reasonable rates is one of the biggest concerns for real estate developers. The Reserve Bank of India (“**RBI**”) has consistently discouraged banks from lending to the sector by assigning higher provisioning weightages to real estate loans and banning lending for land acquisition, leaving Non Banking Finance Companies (“**NBFC**”) and Private Equity (“**PEs**”) as the only source of finance. Private equity deals are currently transacted at internal rates of returns (“**IRRs**”), or the yield of the investment. High cost of finance coupled with waning demand has disrupted developers’ cash flow situation. This has created two important scenarios in the marketplace. Firstly, developers are now deferring project launches, thereby altering the slated supply. Secondly, high cost of finance restrains them from lowering prices.

### **Ambiguity in FDI policies**

While FDI policies have not changed significantly over the years there were certain ambiguities in the interpretation of the conditions attached to the FDI. Some of these conditions have been clarified. Extending the 3-year lock in requirement to the entire investment rather than the minimum capitalisation amount or introducing minimum alternate tax on SEZ does not instil confidence in investors who invested based on evaluation of certain policies.

### **Input cost inflation**

Raw materials, including steel, cement, sand, bricks, etc, which form major construction cost, have seen significant price escalation over the past few quarters. The sharp inflation in input costs has severely impacted profitability across projects. Short supply of skilled and unskilled labour thereby causing a sharp rise in labor cost.

**Highly regional reach of existing players:**

Considering the peculiar features of the real estate sector, such as the differing tastes of population across geographies, difficulties in land acquisition in different states, absence of business infrastructure to market projects at new locations, numerous approvals to be obtained from different authorities at various stages of construction under the local laws and the long gestation period of projects, most developers prefer to restrict themselves to areas in which conditions are familiar to them. As a result, few players in the country can claim to have established a pan-India foothold.

**Majority of market belonging to unorganized segment:**

The Indian real estate sector is highly fragmented with the disorganized segment consisting of small builders and contractors accounting for a majority of the housing units constructed. As a result, there is a lesser degree of transparency in dealings or sharing of data across players.

**Demand dependent on many factors:**

A challenge that the real estate developers face is generating the requisite demand for the properties constructed. Factors that influence a customer's choice in property are not restricted to quality alone, but are dependent on a number of other external factors such as proximity to urban areas, amenities such as schools, roads, water supply which are often beyond the developer's sphere of reach. Also, demand for housing units is also influenced by policy decisions relating to housing incentives.

**REGULATORY AND POLICY INTERVENTIONS**

A strong regulatory and effective policy framework like introducing uniform tax regime, rationalising stamp duty across states through uniform duty policy, formularisation of effective single window clearance mechanism of approvals should be in place. This would act as a catalyst in fuelling the growth of the real estate sector in India.

**Single Window Clearance**

Streamlining the approval procedure and making it less tedious and more transparent is of paramount importance.

A single window of clearances and a high level body for co-ordination between different central, state and local level agencies to expedite the process and approve projects at a faster pace, simplifying urban development guidelines etc is likely to result in approximately 10-25 % reduction in cost.

A dispute system needs to be in place to settle disputes between various stakeholders in infrastructure development.

Transparency is the main component of the real estate ecosystem and should be maintained between government, developers and buyers.

#### **Land records**

The system of computerisation of land records should be put into place and all land-related data (ownership size, litigations if any) and also other data should be made accessible to public via internet so that the buyers' interest is safeguarded.

#### **FDI Policies- Exit**

A lot of clarity is required to provide a more stable regulatory and less onerous platform for boosting FDI investment in real estate segment.

The general regulatory/tax environment is getting tougher for exits e.g. change in regulation on 3-year lock-in to entire capitalisation instead of minimum is one of the biggest hurdles to PE exit from real estate projects. If a project has generated cash flows such cash flows should be permitted to be repatriated within 3 years or otherwise.

#### **Uniformity in tax regime**

Real estate in India is subject to various taxes such a corporate tax, service tax, value added tax minimum alternate tax, local body tax. Although there is transparency in terms of enactments of these taxes however such regulations differ between states, hence formulation of effective taxation rules to avoid double taxation should be implemented across all states.

#### **Rationalising stamp duty**

The government should rationalise stamp duty across states through uniform duty policy. A more transparent method of market valuation of property should be put into place to avoid arbitrary assessment of property value.

### **COPING STRATEGIES**

#### **Cost control**

For overall development of the sector, in addition to regulatory reforms, developers should consider cost-effective and cost-management strategies to achieve operational efficiencies. Capital-intensive projects that have no impact on the company's revenues in the short term may be put on hold, scaled down or even cancelled.

#### **Twinking business models - joint development arrangements**

The developer can set up a joint venture with land owners since buying involves legal



hassles and huge financial costs. The developer only invests in the buildings of the project without any land assets. This model gives the developer flexibility as the he is not paying interest on loans taken to buy the land. The developer can construct buildings, sell units and continue to maintain holding power in a bad economy.

### **Diversification of Business**

For developing multiple streams of revenue, some cash-rich developers vertically diversified (or attempted to diversify) their businesses into telecommunications, financial services, insurance, etc. Horizontal diversification into services related to property management and leasing also surfaced up as a preferred strategy for dealing with the downturn.

Instead of selling off properties, developers now enter into lease agreements with MNCs and other companies for commercial space. The long-term rental arrangement at reduced rates guarantees a steady stream of income.

### **FUTURE PROSPECT OF REAL ESTATE INDUSTRY**

The real estate market in India is evolving from an unorganised sector to a more institutionalised and corporatized set up. Developers need to display greater transparency and adopt higher governance standards. The government requires taking prudent steps in overhaul old and archaic laws and introducing new reforms which are fair to all stakeholders and address structural problems.

The long-term view on the Indian real estate industry is positive as the fundamental demand drivers such as increasing urbanisation, favourable demographics, growth of services and retail sector and rising incomes are intact. The time has come for us (government and Indians at large) to recognise this fact and the fact that real estate could very well act as a catalyst to a quantum growth of the Indian economy. All that is needed is prompt action and friendly policies.

***The author is a partner of J Sagar & Associates. Views expressed are personal***