FEMA FOR REAL ESTATE DEVELOPERS


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Background:

The philosophy with respect to Foreign Direct Investment (FDI)/Inbound investment under FEMA has been to permit and promote investment in sectors which lead to employment creation, greater innovation, technology transfers and development of strategic sectors with the objective of enhancing long term sustainable capital in the economy.

Being a capital deficit and developing economy, India has embarked on a liberal path of inviting FDI by opening up majority of the sectors, except for Railways, atomic energy and few others. Also 'Trading sector' has been opened up in a calibrated manner. Retail sector has been opened up off late but with a set of conditions which again has the intention of generating domestic manufacturing or local procurement by foreign retailers.

In this backdrop, we now analyse provisions related to Real Estate Developers under FEMA with respect to FDI.

FDI Provisions under FEMA for Real Estate Developers:

The provisions relating to FDI are governed by Non Debt Instrument Rules, 2019 (NDI Rules). Prior to 2019, the FDI provisions were regulated through Notification 20(R) of 2017 which replaced its prior version Notification No.20.

Real estate development as a sector for FDI has undergone many changes however, the prime objective has always remained underchanged, that is- only construction and development activities are permitted and 'trading in real estate (real estate business) has always remained prohibited.

The term 'real estate business' has been defined in NDI Rules [Note 6 to Para 10.2 of Table to Schedule I of NDI Rules] as under-

Real Estate business means dealing in land and immovable property with a view to earning profit there from and does not include development of townships construction of residential / commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships, construction of residential/commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure townships.

Explanation:

(a) Investment in units of Real estate Investment Trust (REITs) registered and regulated under the Securities and Exchange Board of India (REITs) Regulations, 2014 shall also be excluded from the definition of " real estate business"

(b) Earning of rent income on lease of the property , not amounting to transfer , shall not amount to real estate business

(c) Transfer in relation to real estate includes,

(i) the sale, exchange or relinquishment of the asset ; or

(ii) the extinguishment of any rights therein ; or

(iii) the compulsory acquisition here of under any law ; or

(iv) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act ,1882 (4 of 1882); or

(v) any transaction, by acquiring capital instruments in a company or by way of any arrangement or in any other manner whatsoever, which has the effect of transferring, or enabling the enjoyment of, any immovable property.

--Real estate broking services shall be excluded from the definition of "real estate business" and 100% foreign investments is allowed in real estate broking services under automatic route

Note: It is interesting to observe that renting is excluded from the definition of real estate business [explanation (b) above]. It can therefore be interpreted that Renting income from lease of property is a separate activity and should fall in the eligible category for FDI as there are no other specific restrictions.

Thus, it can be inferred that intention is to promote investment for construction- development and denying foreign investor from indulging in mere buying and selling of immovable properties. Unlike portfolio Investment where Foreign Portfolio Investors (FPI) are allowed to have all modes of transaction in shares and securities viz., Investment, trading and even forward contracts, the Real Estate sector has always remained shielded from such trading or speculative environment.

Another vital restriction has been to prohibit foreign investment in an entity which is engaged in construction of farm houses and trading in TDRs.

While intention is to permit foreign investment in construction-development activities, as an exception, foreign investment is permitted in completed projects for operating and managing townships, malls/shopping complexes and business centres.

Conditions on Construction-development sector:

To further achieve true intent of development of real estate and to discourage trading, the sector has been fastened up with following conditions:

- The investor shall be permitted to exit on (1) completion of the project or (2) after development of trunk infrastructure i.e. roads, water supply, street lighting, drainage and sewerage or (3) after completion of lock-in-period of three years from each tranche of foreign investment. Completion of the project shall be determined as per the local bye-laws/rules and other regulations of State Government.

  Exceptions-

  1. The condition of lock-in-period however, doesn't apply to Hotels and Tourist resorts, Hospitals, SEZs, Educational Institutions, Old Age Homes and investment by NRIs and OCIs.

  2. Foreign investor, however can sell his stake to another foreign investor without any restriction of lock-in-period.

- The project should conform to the norms and standards, including land use requirements and provisions of community amenities and common facilities, as stipulated by Municipal or local body. Indian investee company should obtain necessary approvals from Municipal or local body.
- The Indian investee company is permitted to sell only developed plots. For this purpose, developed plot means – where trunk infrastructure i.e. roads, water supply, street lighting, drainage and sewerage, have been made available.

As can be seen conditions have been placed on construction development activities with an objective to channelize foreign funds for productive purposes rather than luring foreign investor to engage in mere buying-selling. Since inception of FEMA, real estate sector has been kept open only for construction development and that is the reason that real estate sector has never witnessed volatility of the magnitude which one observes in stock market. Even during 2007-08 (U.S sub-prime crisis) global crises, where other economy such as UAE witnessed large exodus of funds and real estate bubble burst, Indian real estate sector never witnessed such situation, thanks to the policy of not permitting foreign investment in real estate business.

LLP and Foreign Investment for construction-development sector-

LLP as an entity is not eligible to receive foreign investment for construction-development activity. In terms of Schedule VI to NDI Rules, foreign investment in LLP is permitted in the sectors where foreign investment up to 100 percent is permitted under automatic route and there are no FDI linked performance conditions.

Since construction-development sector has FDI linked performance conditions, LLP is not eligible entity to receive foreign investment.

Construction-development sector and borrowings in foreign currency- External Commercial Borrowings (ECB)-

A. ECB provisions

In terms of Master Direction on ECB, borrowing is not permitted for Real Estate Activities. The definition of Real Estate Activities is different from that of Real estate business as given in NDI Rules. The definition of Real Estate Activities as per ECB Master Direction is as under-

Any real estate activity involving own or leased property, for buying, selling and renting of commercial and residential properties or land and also includes activities either on a fee or contract basis assigning real estate agents for intermediating in buying, selling, letting or managing real estate.

However, this would not include, (i) construction/development of industrial parks/integrated townships/SEZ (ii) purchase/long term leasing of industrial land as part of new project/modernisation of expansion of existing units and (iii) any activity under 'infrastructure sector' definition.

The analysis of definition suggests that similar to FDI not being permissible for trading in real estate, even ECB is not permissible for buying-selling or renting of commercial and residential properties or land.

Interestingly, exceptions are carved out in the definition of Real Estate Activities for construction of industrial parks, long term leasing of industrial land and activity under 'infrastructure sector'. The issue is therefore, whether construction of commercial or residential premises shall be an eligible activity or not? Can it be said that other than buying selling or renting other construction activities are eligible and exceptions given are further to normal construction activity of residential or commercial premises. The view however emerges is that only exceptions mentioned in the definition are eligible activities for availing ECB. Within infrastructure sector, falls, Affordable Housing and hence if the construction project is for affordable housing same would be eligible for raising of ECB in addition to townships, industrial parks etc. It is further to be noted that ECB can be raised only by companies and not by LLPs.

B. Non Debt- Hybrid Instruments for foreign investment

NDI Rules permit investment in convertible / hybrid instruments such as Convertible Preference shares or Convertible Debentures. Both these instruments have to be compulsorily convertible i.e. CCPS or CCDs, it cannot be optionally convertible.

CCDs can serve the purpose of debt till the time it gets converted into equity. It is worth noting that there is no cap on rate of interest for CCDs as is there in case of ECB.

Investment by NRIs/OCIs on non repatriable basis:

A. Investment in Company or LLP

NRIs and OCIs have one more option of investing i.e. on Non Repatriation basis. Non Repatriation basis would mean that upon disinvestment the sale proceeds would compulsorily be parked in Non Resident Ordinary (NRO) Account. It cannot be credited to NRE Account or buyer cannot remit sale proceeds to overseas bank account of NRI/OCI.

Non Repatriable investment finds its reference in NDI Rules, Schedule IV. Even under Non Repatriable investment, trading in TDRs, construction of farm houses and Real Estate business are prohibited activities.

B. Investment in partnership firm or proprietary concern

NRIs/OCIs have one more option of investing i.e. investment in partnership firm (other than LLP) or proprietary concern. LLP requires one resident designated partner and company requires one resident director. Whereas partnership firm doesn't require any partner to be resident of India. Therefore, though with unlimited contractual liability but at times Partnership firm finds its relevance when NRI group doesn't want any resident designated partner.

The restriction of Real Estate business will continue even for this segment of investment.

Conclusion:

Indian companies engaged in construction-development sector is eligible to receive FDI under automatic route subject to compliance of pricing guidelines and other compliances under FEMA.

LLP engaged in construction- development sector is not eligible to receive Foreign Investment as sector has FDI linked performance conditions.