Real Estate Update

November 16, 2015

FDI IN REAL ESTATE: FURTHER LIBERALIZED

INVITATION – ROUND TABLE AND WEBINAR

Real Estate and Structured Finance: Fund Raising and Fund Investments - Innovative and Emerging Structures

In this round table, we discuss the most recent amendments to the FDI policy relevant to construction development, and other structures and strategies for foreign investment in real estate and structured finance that we see as innovative and emerging in our role as legal and tax consultants to LPs, GPs and offshore private equity funds.

REGISTER

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Time:

Thursday, November 19, 2015, 5:00 PM – 6:30 PM (IST)

Cocktails: 6:30 PM – 7:30 PM (IST)

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In a recent press note issued on November 10, 2015 ("**PN 2015**"), the Central Government, in furtherance of its objective to attract greater foreign direct investment ("**FDI**"), has announced significant relaxations to the consolidated foreign direct policy of India ("**FDI Policy**"). Consequently, substantial changes have also been announced to the FDI provisions governing the construction-development sector.

Last year, the government through Press Note 10 of 2014 and clarifications on Press Note 10 of 2014 issued by DIPP ("**PN 2014**")[1] introduced extensive amendments to the FDI provisions relating to the construction-development sector. However, certain critical ambiguities still prevailed and the amendments introduced by PN 2014 were counter-productive to the objective which the government intended to achieve. PN 2015 has now ironed out most of the unresolved creases, and is likely to serve as a huge fillip to foreign investors intending to acquire equity interest in the real estate space.

In this hotline, we analyze the changes brought about by PN 2015, specifically with respect to the construction-development sector.

CHANGES AND ANALYSIS

Removal of minimum land stipulation

Proposed changes as per PN 2015	Existing FDI Policy
No minimum area requirement	Minimum floor area to be developed under each project would be 20,000 sq. meters for construction-development projects.

- The reduction of the minimum area requirements from 50,000 sq. meters to 20,000 sq. meters by PN 2014 was a welcome step towards encouraging further foreign investment into the construction-development sector, since availability of 50,000 sq. meters in Tier I cities was a challenge. Hence, removal of the minimum land area requirement under PN 2015 is an enormous step towards deregulation of foreign investment into the real estate sector in India.

- This change also sets to rest the debate on floor area versus built up area.

Removal of minimum capitalization requirement

Proposed changes as per PN 2015	Existing FDI Policy
No minimum capitalization requirement any more.	Minimum capitalization of USD 5 million to be brought in within 6 (six) months of the commencement of the project.

- Whilst the removal of minimum capitalization requirements will be extremely beneficial to small projects, the challenge to an FDI investor in the current regime was not the requirement of bringing in the minimum capitalization, but the timing when it had to be brought in. The intent of the government on this issue has been clear from the beginning that minimum capitalization must be achieved at the earliest possible stage of a project. Hence, the government mandated (per the Existing FDI Policy) that the minimum capitalization condition had to be fulfilled within 6 months from the commencement of a project. Further, the government even clarified that 'date of commencement' should be identified as the date of approval of building plan/ layout plan. However, pegging the time to 'commencement of project' was felt counter-productive since foreign investors were precluded from investment post the IOD/ sanction plan stage.
- While the minimum capitalization norms have been removed, it remains to be seen if the government prescribes any timeline at which stage the foreign investment must come in, and whether the pegging of investment to 'commencement of project' will be removed in entirety.
- Additionally, it is also to be seen if it is prescribed in what stage can a project qualify as being in the 'construction-development' phase, since PN 2014 did mention that subsequent tranches of foreign investment can be brought in only up to 10 years from the commencement of the Project.

Lock-in restrictions

Proposed changes as per PN 2015	Existing FDI Policy
The investor is permitted to exit from the investment: (i) after 3 years from the date of each tranche of foreign investment, or (ii) on the completion of the project; or (iii) on the completion / development of trunk infrastructure. Transfer of stake by a non-resident investor to another non-resident investor, without any repatriation of investment would **not** be subject to any lock-in or prior FIPB approval.	The investor is permitted to exit from the investment upon: (i) development of trunk infrastructure, or (ii) the completion of the project. Repatriation of FDI or transfer of stake by a non-resident investor to another non-resident investor would require prior FIPB approval.

- The Existing FDI Policy mandates that the earliest exit available for a foreign investor will be after the 'trunk infrastructure' of a project is developed. However, development of 'trunk infrastructure' was more suited in context of serviced housing plots, but not in context of 'heart-of-the-city' projects where all parameters of trunk infrastructure were already satisfied (for instance, in redevelopment projects). In such situations, there was thus a question as to whether exit could be achieved only after the completion of the project, since trunk infrastructure was already present at the time of investment. PN 2015 now allows for a more rationalized approach for exit by bringing in the 3 year lock-in period and hence foreign investors who had run out of money to develop the trunk infrastructure can now exit post the expiry of the 3 year period. This is a major relaxation especially in context of large projects which have not been successful, but the foreign investors wish to exit.
- The intent behind the 3 year lock-in is to ensure committed capital which should be used for development purposes. However, the 3 year lock in period should not be read in insolation, and the 'real estate business' restriction under capital account regulations should be adhered to.[2] Hence, before achieving an exit, foreign investors must put in all possible efforts to ensure that developers have put their best foot forward to utilize the foreign capital for development purposes.
- PN 2015 also makes a path breaking change by allowing non-resident to non-resident transfers without the requirement of obtaining any approval. PN 2 of 2005 and PN 2014, have always restricted non-resident to non-resident transfers without the approval of FIPB during the lock-in (whether in context of (i) the 3 year lock-in; or (ii) development of trunk infrastructure; or (iii) completion of the project). Consequently, questions were raised as to whether the intent is to lock-in the investor or the investment. The challenge was that for the new foreign investor, the lock-in restarted from the date such new investor acquired the shares. PN 2015 now seems to clarify that only the investment is locked–in and not the investor, and hence a non-resident may transfer its shares at any time to another non-resident investor under the automatic route.

Multiple phases - Each a separate project

Proposed changes as per PN 2015	Existing FDI Policy
Each phase of a project to be considered a separate project for the purposes of the FDI Policy	No such clarification

- The Existing FDI Policy does not clarify whether a 'project' would include all phases or single phase of a project. Further, as mentioned above, since the Existing FDI Policy mandated that the earliest possible exit was after construction of 'trunk infrastructure', investors were unsure whether investment in a particular phase of a multi-phased project was locked-in till 'trunk infrastructure' was developed for all phases of the project. PN 2015 now clarifies that all FDI conditions will be seen on a 'phase' specific basis and hence, so long as the exit criteria for one particular phase is satisfied, foreign investors should be able to exit from their investment in that phase. It remains to be seen how the term 'phase' evolves to be interpreted, whether on a sanction plan basis or otherwise.

Completed Assets

Proposed changes as per PN 2015	Existing FDI Policy

Vaibhav Parikh, Partner, Nishith Desai Associate on Tech, M&A, and Ease of Doing Business
March 19, 2025

SIAC 2025 Rules: Key changes & Implications
February 18, 2025

100% FDI was permitted under automatic route into completed projects for operation and management of townships, malls/ shopping complexes and business centers. Transfer of control from residents to non-residents as a consequence of foreign investment is also permitted. Earning of rent or income from the lease of the project would not tantamount to 'real estate business'.	100% FDI was permitted under automatic route into completed projects for operation and management of townships, malls/ shopping complexes and business centers.

- PN 2014, for the first time, had clarified that foreign investment into completed projects for operation and management of townships, malls/ shopping complexes and business centers was permitted. However, there was still a debate if foreign investment was permitted only in companies involved in the operation – management of such assets or even in companies which owned such completed assets. This has been detailed in our previous hotline here.

- That position now seems to be clarified since PN 2015 clearly sets out that income earned by way of rent / income on lease not amounting to 'transfer' does not tantamount to '*real estate business*'. However, investment in completed assets has only been cautiously opened up by restricting 'transfers' in any manner. The term 'transfer' is defined very widely[3] (and includes relinquishment of asset or extinguishment of any right), and its significance will have to be analyzed further on a case-by-case basis. Further, certain provisions of the definition of 'transfer' (such as compulsory acquisition of law) seems misplaced from an FDI perspective, which is perhaps because the definition of the term 'transfer' is a direct import from Section 2 (47) of the Income Tax, 1961. Nonetheless, in light of the clarification afforded by PN 2015, foreign investment in yield generating stabilized assets such as malls, business centers, etc. will be permitted.

OTHER CHANGES

100% FDI permitted in limited liability partnerships ("LLP")

FDI in LLPs was hitherto permitted under the approval route, in sectors where 100% FDI was permitted under the automatic route, and where there were no FDI linked performance conditions.

PN 2015 has now permitted 100% FDI in LLPs under the automatic route for sectors in which 100% FDI is permitted under the automatic route without any conditions. LLPs engaged in the construction-development sector would still not be permitted to receive FDI under the automatic route, since there are a number of FDI linked performance conditions for the construction-development sector.

In a sector where setting up of special purposes vehicles for housing separate projects coupled with the perpetual requirement to upstream funds, LLPs are becoming the preferred vehicle for developers domestically. Given the tax optimization that the LLP as a vehicle provides, the government seems to have missed the opportunity to permit FDI in LLPs for construction-development sector to attract further FDI.

Non-resident investment

Under the FDI regulations, non-resident Indians ("**NRI**") were provided certain exemptions from minimum capitalization, minimum area and lock –in restrictions in cases of direct investments by NRIs in their individual capacity. Subsequently, Press Note 7 of 2015 further liberalized the investments by NRIs on non-repatriation basis under Schedule 4 of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000 to be treated at par with domestic investment. Being treated at par with domestic investors meant that the investment was not subject to any of the conditions to be complied with under the FDI Policy.

However, in order to attract further investment by NRIs, PN 2015 has now clarified that the relaxation extended to NRIs (i.e. treatment at par with domestic investors) will also apply to companies, trusts and partnership firms, incorporated outside India and owned and controlled by NRIs. Such intermediated investment regime for NRIs will be hugely beneficial since now NRIs will be able to pool their capital in optimal jurisdictions for investment into India. Further, based on PN 7 (and now this PN 2015) a technical argument may also be made that NRI investment will now be permitted in AIFs / LLPs, though such investment decisions should ideally be made post discussions with the regulators.

On a separate note, the Government must also permit NRI owned entities to be qualified for procuring an FPI Category III registration so that NRIs can also make investments in listed bonds of real estate companies.

CONCLUSION

These proposed changes will certainly open-up the construction-development sector further, and will augment foreign investment into the Indian real estate sector. PN 2015 is still not law and we will have to wait for the final amendments; however, considering the resurgence of equity interest in real estate, PN 2015 could not have been better timed. While a number of issues have been sorted, few things to further accentuate interest would be a clear entitlement of NRIs to invest in AIFs and LLPs (on repatriable basis), opening up foreign investment in real estate LLPs, allowing foreign participation in real estate focused AIFs and streamlining REIT taxation.

– Shreyas Bhushan, Abhinav Harlalka & Ruchir Sinha
You can direct your queries or comments to the authors

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[1] Please see an analysis of the changes brought about by Press Note 10 of 2014 here and here.

[2] Regulation 4 of the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000 mandates that no person resident outside India shall make investment in India, in any form, in any company or partnership firm or proprietary concern or any entity, whether incorporated or not, which is engaged or proposes to engage in 'real estate business'.

[3] "**Transfer**", in relation to FDI policy on the sector, includes: (a) the sale, exchange or relinquishment of the asset; or (b) the extinguishment of any rights therein; or (c) the compulsory acquisition thereof under any law; or (d) 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 (e) any transaction, by acquiring shares in a company or by way of any

agreement or any arrangement or in any other manner whatsoever, which has the effect of transferring, or enabling the enjoyment of, any immovable property.