

FDI IN REAL ESTATE DEVELOPMENT SECTOR– THE HINDRANCE IN THE BLESSING

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*Published in the NATIONAL REALTY
(Volume I, Issue XIII, June 2008)*

Ever since the year 2001, when the gates of real estate were thrown open to Foreign Direct Investment, Real Estate sector has seen scorching growth to the near-about of 30 per cent and has emerged as one of the most appealing investment areas for domestic as well as foreign investors.

The Indian Real Estate Development Sector has witnessed a mammoth revolution, driven by the booming economy, favourable demographics and liberalised foreign direct investment regime. Real Estate Development encompasses activities such as townships development, housing, built up infrastructure and construction – development projects. For the purposes of simplicity, throughout this Article, the sector of real estate in which foreign investment is permissible shall be referred to as ‘Real Estate Development Sector’.

Foreign Investment in India can either come through the Automatic Route or the Government Route (also known as the Approval Route). Under the Automatic Route, the foreign investor is not required to obtain prior permissions or approvals from the Government of India or the Reserve Bank of India for the purpose of making the investment. Under the Approval Route, the foreign investor is required to obtain prior approval of the Government of India or the Reserve Bank of India or the Foreign Investment Promotion Board or the Ministry of Finance, as may be required, for the purpose of making the investment¹.

¹ *Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 (FEM (TIS) Regulations).*

Real Estate Development Sector was not open to foreign investment through the Automatic Route till recently. By Press Note No.2 (2005 Series)² ('**PN 2/2005**'), Foreign Direct Investment in Real Estate Development Sector was allowed under the Automatic Route. In other words Persons Resident Outside India ('**Foreign Investors**') were allowed to invest to an extent of 100% into an Indian entity involved in real estate development in the country without seeking prior permission of the Government of India or the Reserve Bank of India or the Foreign Investment Promotion Board or the Ministry of Finance, as may be required, subject to the conditions prescribed. This Press Note laid down the policy as regards investment by foreign investors into the Real Estate Development Sector. However, it is pertinent to note that the conditions and requisites detailed in this Press Note are not applicable to Non Resident Indians ('**NRIs**') investing in real estate or Real Estate Development Sector. NRIs may invest in housing and real estate development projects across the country, without any conditions, for upto an extent of 100%. However, inward remittance of foreign investment in agriculture is prohibited not only for foreign investors but also for NRIs.

The issuance of PN 2/2005, although on the one hand has boosted and given great impetus to the influx of foreign direct investment in Real Estate Development Sector in India but on the other hand has also raised a number of ambiguities in the minds of foreign investors as PN 2/2005 shoulders countless loop holes which need to be plugged by the Government before the investments take on a different tangent and the hype and hoopla about the predicted investments in the Real Estate Development Sector, today, condenses.

Lets analyze the ambiguities apparent in the policy laid down under PN 2/2005 with respect to requisites, requirements and procedure for investment in the Real Estate Development Sector. These requirements are broadly

² Press Note No.2 (2005 Series) issued by Department of Industrial Policy and Promotion, Secretariat of Industrial Assistance (FC Division), Ministry of Commerce and Industry, Government of India issued on 03rd March, 2005.

pertaining to areas like what would fall under the scope of real estate development, the area to be developed by the developer, minimum capitalization to be brought in by the foreign investor, lock in requirements on the investment made, involvement of local authorities in execution of the proposed real estate project, etc. It is these that require careful scrutiny because of the way they have been drafted and the ambiguity arising out of them.

However, before we venture into the ambiguities apparent on the face of PN 2/2005, it is important to focus first on the issues which do not find a direct mention in the Press Note but have a more serious bearing and therefore need to be addressed first and foremost.

1. **Use of agricultural land for real estate development**

Foreign investment, in 'agricultural or plantation activities'³, in any form, is prohibited under the FEMA Regulations⁴. Given the minimum area restrictions imposed under the PN 2/2005, many developers feel that such areas can be developed subsequent to acquisition of vast expanses of agricultural land and upon getting the permitted land usage changed to suit their respective development requirements. It would be difficult to find non-agricultural land in urban areas to undertake extensive real estate development at economical costs for end users. However, there is this school of thought which opines that if agricultural lands are acquired for the purpose of activities of Real Estate Development, such acquisition is permissible. The irony being that this school does not find any supporters in the Indian Government.

The Department of Industrial Promotion and Policy is of the view that agricultural land cannot be acquired using the funds infused by foreign

³ 'Agriculture' does not include Floriculture, Horticulture, Development of seeds, Animal Husbandry, Pisciculture and Cultivation of vegetables, mushrooms etc. under controlled conditions and services related to agro and allied sectors and 'Plantation' excludes Tea Plantations.

⁴ Master Circular No.02/2007-2008.

investors under the Foreign Direct Investment scheme⁵. The rationale for such a view seems to be that purchase of agricultural land using Foreign Direct Investment funds, before approval from local authorities to convert such land for non-agricultural purposes, is considered purchase for the purpose of agricultural activities. Such a conclusion may not be on the basis of sound logic, when it is evident that the purchase of agricultural land is to use it for real estate development. However, until conversion of land is permitted one cannot be entirely sure whether the approval for change of land use would be accorded or not. Therefore, if permission to change the land use for non-agricultural purposes is not granted, the funds may actually end up being used for purchase of agricultural lands, an activity strictly prohibited under the Foreign Direct Investment Policy of India. Our Policy makers are required to direct a lot of thought to this aspect.

However, the resultant effect of the present Foreign Direct Investment Policy is that Indian Developer has to first acquire agricultural lands and get the necessary approvals/clearances for conversion of the land for non-agricultural purposes from local authorities before they can look for foreign partners for the project. Yet again the irony that once the land use is converted to non-agriculture, the value of the land continues to mount enormously and the resultant effect is that the foreign investment does not remain an attractive prospect for the foreign investor.

2. **Problems in acquiring land – Land Ceiling**

As explained above, compliance with the minimum area requirements under PN 2/2005 in the long term would require conversion of agricultural land into land usable for real estate development. However, land reform legislations in various States limit the amount of land holding that can be held by persons to levels lower than the minimum

⁵ Based upon queries raised on the official website of Department of Industrial Policy and Promotion. <http://dipp.nic.in/>

requirement level under the Press Note. To illustrate, under PN 2/2005 for development of serviced housing plots, the minimum area to be developed is 10 hectares. However, under Punjab Land Reforms Act, 1972 the 'permissible area' that can be held by an individual *cannot* be more than 7 hectares in case the land is capable of yielding at least two crops in a year.⁶ To overcome this problem of land ceiling and avoid the cap applicable upon a single entity, lands are being purchased by developers through or by a number of entities, which in turn contributes in further complicating the procedure of acquisition of land. So a re-look into the existing local land reform laws is necessary.

3. **Downstream Investment**

Another concern that requires attention of the policy makers is the multiplicity of approvals and permissions required for downstream investment by 100 per cent foreign owned Indian holding / subsidiary companies where only "holding" operation is involved and all subsequent/downstream investments to be carried out through downstream entities would require prior approval of the Government. For setting up such 100 per cent foreign owned holding / subsidiary companies, prior approval of the Foreign Investment Promotion Board is required. The Government of India first addressed the issue of downstream investment by issuing Guidelines for consideration of Foreign Direct Investment proposals by the Foreign Investment Promotion Board⁷, with the intent to assist the Foreign Investment Promotion Board to consider proposals wherein downstream investment by 100 per cent foreign owned holding companies also found a mention. The guidelines categorically provided that proposals of 100 per cent foreign owned holding / subsidiary companies for all

⁶ Section 4(2)(a) of the Punjab Land Reforms Act, 1972.

⁷ Press Note No.3 (1997 Series) dated 17.01.1997 issued by the Secretariat of Industrial Assistance (FC Division), Department of Industrial Policy and Promotion, Ministry of Industry, Government of India.

subsequent / downstream investments would require prior approval of the Foreign Investment Promotion Board.

However, the policy makers, with an intent to simplify the Foreign Direct Investment norms, issued another Press Note being Press Note No.9⁸ wherein it was decided to permit foreign owned Indian holding companies to make downstream investment in Annexure III activities, which qualify for automatic approval subject to the conditions laid therein. Therefore, although the policy makers are treading towards making the Foreign Direct Investment Policy investment friendly but these inch by inch measures may not give the resultant effect and a more proactive approach may actually pave way for higher investments into India.

Now that we have taken reviewed issues that are not apparent of the face of PN 2/2005 but still prove to be an impediment to foreign investors, let us now look into the conditions prescribed in PN 2/2005 for investment in the Real Estate Development Sector.

1. **Scope of investment**

PN 2/2005 categorically details the scope of investment for foreign investors in real estate. Accordingly, investments can be made in townships development, housing, built up infrastructure and construction – development projects.

2. **Minimum area**

There is further a minimum area requirement prescribed for the purposes of investment by foreign investors. PN 2/2005 prescribes the minimum area to be developed under each project. The requirements are as follows:

- b. In case of development of serviced housing plots, a minimum land area of 10 hectares;

⁸ Press Note No.9 (1999 Series) dated 12.04.1999 issued by the Department of Industrial Policy and Promotion, Ministry of Industry, Government of India.

- c. In case of construction-development projects, a minimum built up area of 50,000 square meters;
- d. In case of a combination project, anyone of the above two conditions would suffice.

The ambiguity that arises here is that although the framers of the Foreign Direct Investment guidelines tried to cover all possible forms of development and construction specific to the area to be covered therein, but they left a loose stitch by not mentioning exactly what built-up area means. This confusion arises because of the current market practice of using different terms in the real estate industry like 'built-up area', 'super built-up area', 'carpet area' etc. with no authoritative definition anywhere to be found. Due to the ambiguity, the calculation of the area may vary upto even 50% causing a major variance for the purpose of computation of the permissible investment and accordingly, the different connotations of the terminology used can have a strong bearing upon developers and investors. To make the picture clearer, the framers could use the terminology to be '*Floor Space Index*' or '*Floor Area Ratio*', which makes the requirement crystal clear in the mind of the investor.

3. **Minimum capitalization**

PN 2/2005 stipulates a minimum capitalization requirement for foreign investors investing in the Real Estate Development Sector. For Wholly Owned Subsidiaries of foreign companies, the minimum capitalization requirement is US\$ 10 million. In case of a joint venture with an Indian partner, the minimum capitalization requirement is US\$ 5 million.

The ambiguity that arises in this situation is with regard to the computation of the value of minimum investment. It is pertinent to note whether the value of investment is to comprise only the face value of the securities or also the premium charged upon the issuance of the same. The corpus of minimum investment by foreign investors

significantly depends on the basis of its computation, which still needs to be clarified by the framers.

The Department of Industrial Policy and Promotion is, however, of the view that the minimum capitalization amount has to be fulfilled in the form of paid up capital and is not inclusive of the premium paid. However, this observation is not based on any regulation issued either by the Reserve Bank of India or by the Securities Exchange Board of India, the primary institutions for regulating the traffic of foreign investment into and out of the country.⁹

4. **Commencement of business of Company**

PN 2/2005 also stipulates that the foreign funds / foreign investments have to be brought in within 6 months of the 'commencement of business' of the company.

Now, the question that arises here is what would tantamount to commencement of business of any Company especially in the case of a foreign investor. Common sense would say that it should be the date on which the Joint Venture Agreement or the Joint Development Agreement or such like agreements or arrangement are executed between the foreign investor and the Indian company. However, in common parlance the date of commencement of business of a Company is usually the date on which the Company is duly incorporated under the laws of the Country.

The above issue is echoed in the Federation of Indian Chambers of Commerce and Industry survey report on Foreign Direct Investment in real estate in the following terms:

".....the problem arises when the FDI is brought in an existing company which is operational for more than six months before the date of signing agreement with FDI partner, which date should be considered

⁹ Based upon queries raised on the official website of Department of Industrial Policy and promotion. <http://dipp.nic.in/>

as date of commencement of business of the company? The Government should clearly spell out the implication of the term 'commencement of business'. It needs to be clarified that the 'date of commencement of business' is the date on which the joint venture agreement or joint development arrangement or any other form of agreement for development activities in India is signed by the foreign investor or the date of incorporation of a company, as the case may be. This ambiguity must be clarified in subsequent legislations or administrative notices."¹⁰

5. **Repatriation of funds**

The Press Note, further stipulates that the 'original investment' is not to be repatriated before a period of 3 (Three) years from the completion of minimum capitalization. However, early exit is possible with prior approval from the FIPB.

Obviously, the first question that comes to ones mind is, what comprises the '*original investment*'? Could it be the amount of first installment or the first tranche (incase the investment is being remitted in tranches) or the entire corpus of the minimum capitalization.

What about the return that accrues to the investor during such lock-in period? Is it entitled to repatriate the returns in totality, which does not form part of the original investment? Well, there are numerous questions that follow the first. The Press Note must state in utmost clarity what it contemplates by the term 'original investment' lest the country loses on its much deserved wealth and capital.

Clarity in the Press Note and regulations monitoring the Foreign Direct Investment policy in real estate development is mandated today for making more effective and conducive grounds for foreign investments.

Conclusion

¹⁰ "Survey Report On Foreign Direct Investment In Real Estate" by FICCI; <http://www.ficci.com/surveys/fdi-survey-real.pdf>

The importance of foreign investment into real estate development cannot be disputed. The ever increasing demand for housing, commercial space, townships and infrastructure in India can be timely catered to only if foreign investment into this sector is allowed. Foreign participation will also bring in quality and professionalism in the manner in which real estate development takes place in the country.

The Central Government has recognized this and amended the regulations from time to time to make it convenient for foreign entry into this sector. Foreign Direct Investment assumes a greater role among the various possible routes for foreign participation in this sector because firstly, investment through Foreign Direct Investment not only makes the foreign investor invest in the sector but also makes the foreign entity participate and monitor the way in which the foreign funds are used; and secondly, with ban on certain routes like External Commercial Borrowings/ Fully Currency Convertible Bonds, etc. makes Foreign Direct Investment scheme the only possible route for foreign investors to invest in this sector.

However, problems in the Foreign Direct Investment Policy as highlighted herein have to be addressed if at all the Foreign Direct Investment route has to continue being the attractive mode of investment for foreign investors. Secondly, local laws and approval mechanisms have to get a revamp because improvements in the Foreign Direct Investment Policy will be of no avail if the Foreign Investor is faced with hurdles in the implementation of the projects undertaken under the Foreign Direct Investment Policy.

What is required at this stage is a simplified and expeditious procedure with an intent to (i) invite more Foreign Direct Investment; (ii) make projects more cost effective which inturn will attract more and more foreign investors in the Real Estate Development Sector and boost the Indian economy.