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REIT INDIA

Facilitating Easier Investment In Real Estate

Introduction

After about five years of releasing its first draft regulations for Real Estate Investment Trusts (REITs), the SEBI came out with a Consultation Paper together with Draft (Real Estate Investment Trusts) Regulations[1] for public feedback on 10 October 2013. SEBI first introduced REITs in 2008, but the draft regulations at the time did not create much excitement due to the multiple drawbacks including taxation issues, issues with valuation of properties and other miscellaneous issues.

REITs are pooled investment entities where the corpus is invested primarily in completed, revenue-generating/income yielding real estate assets and distribute a major part of the revenue/income generated among their investors. Typically, the income of REITs comes from the rentals received from such properties. In the US, REITs were introduced since 1960 and other countries subsequently followed.

Most first world countries already have laws allowing and regulating REITs. Today, there are over 200 REITs in the US which have aggregately raised a capital of around $44.4 billion, which amounts to 93% of the real estate market in the US[2]. In Asia, countries such as Hong Kong and Singapore have allowed REITs since the early 2000s. Asiaâ€™s REIT market too is valued at over $140 billion, approximately seventy five times what it was in 2001.[3]

According to the SEBI and industry players, REITs provide several advantages to investors, including: (a) REITs are managed by professional managers who usually have diverse skill in property development, leasing and management, (b) REITs, due to economies of scale provide an opportunity to invest in properties which they otherwise are not available to individual investors, (c) Listed REITs provide liquidity thus providing easy exit to the investors, and (d) REITs bring in transparency and accountability in the real estate sector[4]. Other advantages are less direct, including transparency and better corporate governance.

However, REITs have their fair share of potential pitfalls. Primarily, the issue of double taxation is a major drawback and needs to be dealt with.

Taxation of REITs

If REITs are introduced in the current form, they may attract as much as 43% tax, which many fear would make REITs unviable for investors. Further, issues including dual tax incidence, stamp duties and exchange control laws which prohibit foreign investments come up which may affect the success and popularity of REITs. The draft Regulations themselves are silent on taxation.

However, recent reports suggest that the SEBI is likely to propose tax breaks and incentives for REITs, including four key changes in the taxation norms for REITS â€“ (a) capital gains tax; (b) tax on income from rent and appreciation in asset prices; (c) dividend distribution tax (DDT); and (d) securities transaction tax (STT), i.e. if REIT units are listed on exchanges. [5]

SEBI's primary intention for suggesting these changes is to make the REITs tax pass-through instruments like mutual funds, which attract tax only at investor level. This means that instead of taxing investors at the fund level and then at the individual level, investors will be taxed only at the time of distribution of dividend, capital gains or gains in interest by the investor as an individual. Several commentators have also advocated that REITs in India be taxed much as they are taxed abroad, i.e., they may be taxed either at the asset level or at the distribution (dividend) level.

Under the current regime, this is taxable under capital gains tax. In addition to this, since units of REITs are likely to be traded on exchanges, they are likely to attract STT. The current rate of STT varies from 0.025% to 0.1% of the transaction value for equity. At present, there is no clarity on whether capital gains or STT, or both, will apply to REITs.

Among other things, to ensure regular income to the investors, SEBI has mandated that the REIT must distribute at least 90% of the net distributable income after tax to the unit-holders. This will naturally attract DDT. At present, DDT is stipulated at 16.22% at the stage of distribution of dividends. This too will need to be looked into by the SEBI.

The draft REIT Regulations permit REITs to invest in properties directly or through special purpose vehicles (SPVs), where these SPVs hold at least 90% of their assets directly in the properties.

Stamp Duty

Transfer of assets by a sponsor to the REIT at the initial stage of setting up could be regarded as conveyance, attracting stamp duty on conveyance which is as high as 5% on any average across all states. This shall increase the initial cost of acquisition of a Property/asset under REIT.

Draft REIT Regulations

In India, a REIT will be in the form of a Trust under the provisions of the Indian Trusts Act, 1882.

As per the draft Regulations, registration of a REIT is compulsory. A REIT is required to have certain parties to the REIT, which include: sponsor, re-designated sponsor, manager, trustee, auditor, valuer, principal valuer etc, each of whom have certain obligations and responsibilities.

SEBI has in its Consultation Paper stated that till the market develops, units of the REITs may be offered only to HNIs/institutions and therefore,

and has hence proposed that the minimum subscription size shall be Rs. 2 lakhs and the each unit size shall be Rs. 1 lakh. This is an interesting provision (or reasoning), given that REITs as a concept envisage making real estate investment accessible to persons who would ordinarily not have access to invest in such properties. However at the same time, considering the instability of the real estate market, the concern shown by SEBI does not appear to be unfounded and may act as safeguard towards the small investors from losing money who are induced to invest through active marketing and promotions of investment opportunity.

The draft Regulations envisage an initial offer and a follow on offer (if required) and eventual allotment of units of the REIT. An initial offer by REIT can only be made if the following conditions, among others, are fulfilled:

- *the value of REIT assets is not less than Rs. 1000 crore;*
  Although it is not clarified that there need to be a singly property or basket of investment, the size of the asset proposed is substantially high. Also the method of valuation to be adopted to determine the fair value of asset shall be a challenge as diverse methods of valuation shall give a range of the values to the same property.
- *the value of the units proposed to be offered to the public is not less than 25% of the value of the REIT;*
  This shall result in the sponsor not holding more that 75%. This provision shall ensure fair amount of participation and control by investors which shall be healthy for the REIT.
- *the offer size is not less than Rs. 250 crore.*
  The offer size appears to be high and therefore the return on the offer size shall be challenge. Minimum return expected from the investment by Indian Investors shall be 8-9%per annum to make it a preferable choice over and above the fixed deposit rate which is around 7-8 % per annum. Therefore the property shall be required to generate a net income of atleast Rs.22-25 crores per annum on Rs.250 crores. Although the return/income may not be difficult, to generate such income from the asset with consistency may appear to be a challenge as constantly changing taxation by state and municipal bodies and additional levies have caused increase in the outgoings which eat up the net revenue in hand. Also fluctuating rental rates have resulted in migration of end user to reasonable and affordable rentals thereby making 100% occupancy of the properties a challenge.
- *No REIT will be allowed to invest in vacant or agricultural land or mortgages other than mortgage-backed securities.*
  This appears to be a correct move as dependency on agriculture for employment is very high even today in India. By permitting investments in agricultural land, the cost to yield ratio, which is already very high, may go higher because of investments being permitted. This may result in landlessness of farmers and may bring economical imbalance. Similarly, considering the intent of the REIT, bar from investment in mortgages appears to be a correct move.
- *A sponsor of a REIT is required to maintain a holding of 25% in the REIT at all times. A sponsor selling its unit holdings is required to arrange for another entity to act as the re-designated sponsor. Sponsors also need to meet a certain criteria in terms of net worth. Further, there are stringent provisions in place for related party transactions.*
  This aforesaid provision shall add to the initial investment of a REIT over and above the initial cost of acquisition of the Property which

also appears to be high, making REIT less attractive. But at the same time, higher holding shall ensure dedicated and unfettered management of the REIT by Sponsor which shall act in the benefit of the Investor and shall minimize malpractices and mismanagement by the Sponsor.

Lastly, it is interesting to note that the REIT may invite for subscription and allot units to any persons, whether Indian or foreign, provided that in case of foreign investors, such investment shall be subject to the RBI guidelines.

Here, caution needs to be taken in permitting foreign investments in REITS in India. Today, multinational companies/foreign companies account to majority demand of rental properties which is acting as a good source of foreign exchange. However, in the event foreign investment are permitted in REITs, the earnings made by way of rental income shall be automatically repatriated outside the country through income payouts under REITS to foreign investor. Therefore, tax planners should ensure that such conditions are not imposed whereby the Indian residents/country shall tend to lose its revenue in the long run.

Conclusion

There is a growing lobby for the REITs to be permitted in India. Organizations such as the Asia Pacific Real Estate Association (APREA) have been working closely with government bodies such as the SEBI, canvassing the opening up of the real estate sector. India is an attractive real estate and infrastructure location for foreign investors; however, while current FDI norms permit 100% FDI under the Automatic Route in construction development, the same is subject to various compliances and restrictions. Permitting REITs will go a long way in easing investment into real estate in India, for resident investors as well as for foreigners.

There is a major concern that if certain open-minded tax concessions are not granted, the draft REIT Regulations may languish once again and local investors may lose interest. Further, granting tax breaks will allow for a level playing field in India vis-à-vis real estate markets abroad, which will be more attractive to international investors. However, with the excitement of a new investment opportunity, hasty decisions should not be taken whereby investor are promised more than what can be delivered by REIT and thereby leave the investor with a sense of having been short changed.

Considering the present political scenario, the Bill shall shape up only after the 2014 elections.

- By Anshuman Jagtap (Senior Associate) & Anirudh Hariani (Associate)

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1. See 'Consultation paper on draft SEBI (Real Estate Investment Trusts) Regulations, 2013', available at http://w w w .sebi.gov.in/cms/sebi_data/attachdocs/1381398382013.pdf (last visited on 10 November 2013).
2. Information Memorandum on REITs dated 29 October 2013, published by the Asia Pacific Real Estate Association (APREA).
3. Ibid.
4. Ibid, Background.
5. 'Sebi plans to suggest changes in tax treatment of REITs', 7 November 2013, Live Mint and the Wall Street Journal.

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