Article

Real Estate Investment Trusts: Are they heading towards reality?

Saurav Malpani
Senior Researcher
saurav@vinodkothari.com

August 5, 2014

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Overview of REITs in Indian Context

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Overview of REITs in Indian Context

The development of REITs instrument and its far reaching positive effects have made this instrument popular worldwide for both the investor and for the industry as well. These are considered as the best instruments for the real estate sector in terms of its transparency, liquidity and smooth operations. The Indian real estate markets which are characterized with various obligations right from its acquisitions phase till the disposal has remained as the foremost reason why such regime has not been able to kick start in the Indian Economy.

The article primarily deals with the evolution of REITs structure in India, the role of the market regulator to implement the above investment strategy followed by the cushion of tax pass through as provided in the Finance Act, 2014.

Real Estate Sector- Role in the Indian Economy

Real estate sector plays a pivotal role in the overall growth process of the Indian economy. In order to foster the growth of the sector and to bridge the shortage of ever increasing demand for housing and real estate business, the Government of India vide press note no. 2 of 2005, permitted FDI upto 100%, under the "automatic route" in townships, housing, built-up infrastructure and construction development projects. The introduction of SEZ policy in April 2000 increased the demand for commercial and office spaces. The relevance of the sector could be understood from the fact that it is the second largest employer after agriculture. It contributes around 5% of India's GDP[1]. The Indian real estate market size is expected to touch $180 billion target by 2020. In terms of FDI inflows, cumulative FDI equity inflow in the housing and real estate sector from January 2000 to December 2010 amounts to US $ 10.28 billion, which accounts for 8.09% of the total FDI inflows.[2] Total inflows by way of private equity (PE) funds in real estate sector during the year 2013 were Rs 7,000 crores.[3]

The aftermath of global recession was also felt in Indian economy as the there were sluggish demand in the real estate sector. The bearish mood could be felt from the fact that the sector attracted only Rs 43,151 crores for the FY ending 2013 as compared to Rs 1,01,368 crores during the preceding financial year, according to Centre for Monitoring Indian Economy (CMIE). Some of the problems which were faced in the sector were as follows:

- Prolonged processes for obtaining permit is one of the prominent difficulties faced by the sector;
- Policies regarding land acquisitions are different in each sates and adds misery for investment plan;
- Rates of stamp duty are too high and are subjected to state jurisdictions;
- The heat of increasing interest rate from large global funds;
- Depreciation of rupee against dollar had a terrible impact as the overall costs of borrowings have increased thus resulting in lower bottom lines.

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[1] http://www.ibef.org/pages/real-estate-industry-analysis-march-2013

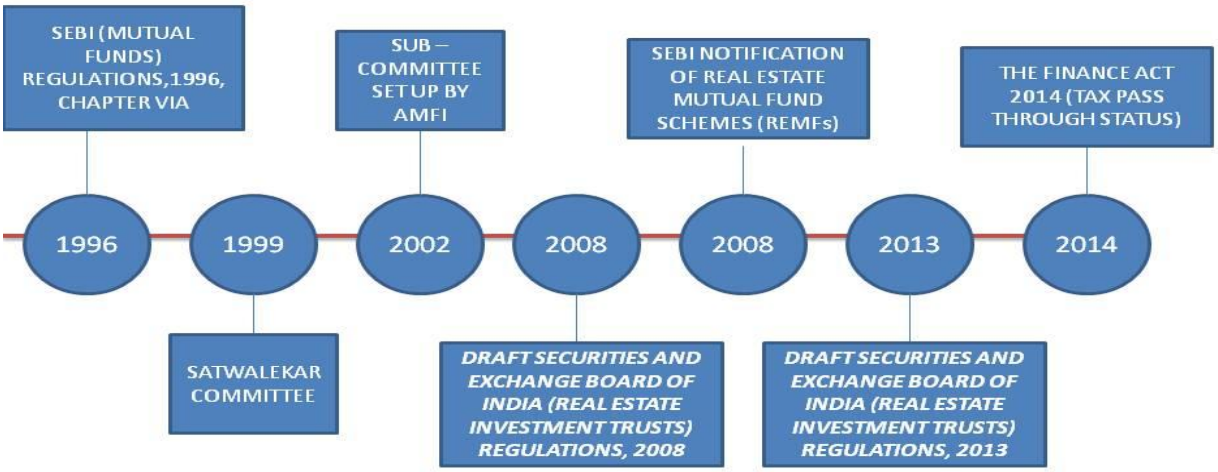
[2] http://www.dipp.nic.in/English/Publications/SIA_NewsLetter/AnnualReport2010/Chapter6.2.iii.pdf

[3] http://www.financialexpress.com/news/private-equity-investments-in-indian-real-estate-surge-13-in-2013-cushman-and-wakefield-report/1228840

Overview of REITs in Indian Context

Evolution of REITs in Indian Economy

The process of bringing the REITs structure in India began in 1996, when the market regulator introduced chapter VIA in the existing mutual fund regulation 1996. The series of events which lead to the current scenario are demonstrated in a diagram below:



SEBI (Mutual Funds) Regulations, 1996

SEBI (Mutual Funds) Regulations, 1996, introduced chapter VIA, laying the guidelines for introduction of Real Estate Mutual Fund Schemes. Some of the provisions of the said regulation are outlined below:

- The schemes should be a close ended scheme and are required to be listed;
- The real estate mutual fund scheme shall not undertake lending or housing finance activities;
- The scheme is required to invest at least 35% of the net assets directly into real estate assets and on aggregate total investment in real estate assets, mortgage backed securities, equity shares or debentures of companies engaged in dealing in real estate assets shall not exceed by 75% ;
- Not more than 30 % of its assets shall be invested in a single city;
- Not more than 15% of its assets shall be invested in a single project;
- Various duties and responsibilities were given to the Asset Management Company and Trustees ;
- There were restrictions imposed for investment in unlisted companies.

Despite the above rules and regulations, the mutual fund industry has been unable to launch REMFs due to lack of clarity, want of transparency and uncertainty prevailing in the real estate sector. Moreover, there being no regulatory framework for the real estate sector for its efficient functioning, have also refrained mutual fund houses from launching such funds.

Satwalekar Committee

The concept of bringing the regime of REIT structure in India began when the Association of Mutual Funds in India (AMFI) appointed a committee headed by Mr. Deepak Satwalekar (known as the "Satwalekar Committee") in December 1999, to explore the opportunities and possibilities of introducing real estate investment schemes for mutual funds in India. The said committee submitted its report in October 2010. Some of the recommendations were:

- Using the mutual fund structure for introducing the Real Estate Investments;
- Using the open ended mutual fund route which was prevailing in UK;
- Amendment in SEBI regulations so as to regulate the establishment and functioning of the real estate mutual fund schemes with all the existing regulations applicable to such mutual funds pertaining to (a) net worth of AMC; (b) existing fee structure; (c) initial launch expenses restricted at 6%; (d) maximum limit of expenses; etc. which were already provided in the mutual fund regulations;
- To restrict the level of investments so as to avoid over-exposure to certain projects, groups or geographic locations;
- Permitting the existing SEBI registered Mutual Funds to launch Real Estate Investment Schemes;

Constitution of Sub-Committee by AMFI[4]

AMFI, on receipt of report from the Satwalekar Committee, established another sub-committee for further investigations and to formulate a working plan for launching Real Estate Investment Schemes. The said committee submitted its report to AMFI in August 2002. Some of the recommendations of the above report are highlighted below:

- The Sub-committee recommended the Trust structure as appropriate for Real Estate investments;
- The Sub-committee acknowledged the fact that REITs gained popularity in USA only after receiving tax benefits. Also tax benefits available to mutual funds were considered as a vital determinant of the success of the domestic mutual fund industry. The Sub-committee hence recommended for drawing taxation benefits for success of the Real Estate investments;
- The Sub-committee agreed with the recommendation of "Satwalekar Committee" on structuring Real Estate investments in the form of Schemes of Mutual Funds (i.e. "REMFs" Real Estate Mutual Funds);

[4] http://web.sebi.gov.in/commreport/amfirep.html

- The Sub-committee denied with the recommendation of the "Satwalekar Committee" on launching the scheme as an open ended. It recommendated that initially it should be a launched as close ended or interval funds;
- The Sub-committee agreed with the recommendation of Satwalekar Committee that the existing SEBI registered Mutual Funds should be allowed to launch Real Estate Investment Schemes;
- The Sub-committee felt that the Government may be requested that there should be no levy of stamp duty when the asset is purchased by the SEBI registered Real Estate Mutual Fund. Alternately, if Stamp Duty needs to be paid on purchase, a set-off of the amount paid should be allowed against future stamp duty payments, when the property is sold;
- The Sub-committee agreed with the recommendation of Satwalekar Committee on restricting the level of investments so as to avoid over-exposure to certain projects, groups or geographic locations; of a Real Estate Investment Scheme.

Role of SEBI in Bringing Globally Accepted Real Estate Investment Regime in Indian Economy

Draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2008[5]

In order to bring the accruing benefits of REITs mechanism in Indian Economy, SEBI brought Draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2008, hereafter stated as "The Regulation" for public comments. Some of the highlights of the regulation can be enumerated as follows:

- Regulation 10 laid the minimum net worth requirement of rupees five crores, for both Real Estate Investment Trust (hereafter stated as "Trust") and Real Estate Investment Management Company (hereafter stated as "Company"). However at the time of making application a minimum net worth of rupees three crores is required.
- Regulation 12 provided the check on the trustees as well as on the directors of the Company to act as the directors in any other associate of the Real Estate Investment Trust or Real Estate Investment Management company to ensure the level of independency;
- Regulation 16 (7) (a), which deals with the rights and obligations of the Trust, provided that the Trust will review all activities of the Company on a quarterly basis;

[5] http://www.sebi.gov.in/commreport/RealEstateReg.pdf

- Regulation 22 (2) provided that unless the scheme obtains credit rating it will not launch any scheme;
- Regulation 28 provided that the maximum period for which the scheme can remain open shall not be more than 90 days;
- Regulation 34 stipulated the units of every scheme to be listed within six weeks from the closure of the scheme;
- Regulation 38 stated the requirement of appointing an independent property valuer;
- Various other requirements relating to disclosure, general obligations were also stated;
- Chapter VII of the said Regulation imposed some limitations such as
    a. No Trust under all its schemes shall have exposure to more than 15% of any single real estate project and not more than 25% of all the real estate projects developed marketed, owned or financed by a group of companies;
    b. Aggregate borrowing shall not exceed one fifth of the value of total gross assets of the scheme;
    c. Minimum 90 % of its annual income after tax is required to be distributed among its unit holders as dividend.

In order to make the Regulation more prominent and strong many suggestions were received. Some of the issues and suggestions can be highlighted below:

- Transaction costs relating to real estate assets in India mainly consist of stamp duties enforced at the state level, ranging from five to fifteen per cent. Since REITs are required to distribute 90 per cent of their income; thus, this additional cost would erode the corpus of the REIT investors;
- Participation of Foreign Investments in REIT by amending the relevant regulations under FEMA;
- Removal of investment limitations;
- Relevant amendments in taxation area to be incorporated so as to provide the taxation benefits.

SEBI Notification on Real Estate Mutual Fund Schemes (REMFs)6

The regulator realized that REIT guidelines may not work in Indian structure as the Indian property market lacks depth and liquidity.[7] Hence the regulator vide Notification dated April 16, 2008 amended SEBI (Mutual Funds) Regulations, 1996 so as to permit mutual funds to launch REMFs. The salient feature of such notification can be summarized as follows:

- Sponsors who seeks to set up new mutual funds, for launching real estate mutual fund schemes should be carrying on the business of real estate for a minimum period of five years;
- The scheme shall be close ended and the units are required to be listed on a recognized stock exchange;
- Net Asset Value (NAV) of the scheme to be declared on a daily basis;
- Minimum 35% of the net assets of scheme are required to be invested in the real estate assets and on aggregate investment in real estate assets, real estate related securities (including mortgage backed securities) shall not be less than 75% of the net assets of the scheme;
- The valuation of each asset is to be valued by two valuers;
- A real estate mutual fund scheme shall not undertake lending or housing finance activities.

The above initiative of the regulator to introduce the scheme could not be put on the reality as it failed to find any takers of the scheme. Some of the issues pertaining to establishment of the REMFs can be summarized as follows:

- The aftermath of Global Recession also played a role as there were liquidity issues;
- India lacked a deep market for mortgage backed securities;
- Levy of stamp duty, which varies from state to state also had its implications;
- There were no defined guidelines on the valuation of the assets;
- There were issues in acquiring real estate properties on long term leases.

Draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013[8]

In the process of bringing the REITs regime in India, the market regulator SEBI, for the third time brought Draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013, (hereafter stated as the "Draft Regulation"). There cannot be any point of

[6] http://www.sebi.gov.in/press/2008/2008101.html

[7] http://articles.economictimes.indiatimes.com/2010-08-10/news/27605070_1_reits-remfs-real-estate-mutual-funds

[8] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1381398382013.pdf

dispute that SEBI did a commendable job in order to introduce the scheme so as to encourage investment in the real estate sector.

Salient features of the Draft Regulation can be enumerated under the following sub heads:

Parties to REITs:

- Sponsor: It means any person who sets up the REIT and hold atleast 25% of the units of the trust;
- Trustee: It means person who holds the REIT assets in trust for the benefit of the unit holders;
- Manager: It means a company which manages assets and investments of the REIT;
- Special Purpose Vehicle (SPV): It means any body corporate in which REIT holds or proposes to hold controlling interest (i.e. 51%);
- Principal Valuer: It means any person who is a registered valuer under Section 247 of the Companies Act, 2013 and assigned as such and who has been appointed by the manager to undertake valuation of real estate assets.

Eligibility Criteria:

- Applicant needs to be a Trust and Trust deed should be registered;
- Sponsor(s) should have a consolidated net worth of atleast Rs 20 crores;
- Each Sponsor should have atleast 5 years of experience in real estate industry;
- Manager should have minimum net worth of Rs 5 crores and should have atleast 5 years experience in fund management/ advisory services/property management in the real estate industry or in development of real estate; and atleast 2 key personnel in its investment committee should individually have atleast 5 years experience in fund management/ advisory services/property management in the real estate industry or in development of real estate;
- Trustees should be registered with SEBI under SEBI (Debenture Trustees) regulations, 1993 and should not be associate of the sponsor/manager/trustee. Atleast 50% of the Trustee's directors should be independent and not related parties to the REIT;
- Principal valuer should not be an associate of the sponsor/manager/trustee and should have atleast 5 years of experience in valuation of real estate;
- All unit holders of the REIT should enjoy equal voting rights.

Provisions relating to offer of units and listing thereon:

- Eligible units are required to be listed;
- Only after registration the REIT shall raise funds by way of initial offer and then subsequently by way of follow-on offers ;

- In order to bring the initial offer the REIT shall have assets worth not less than Rs 1000 crores;
- Minimum offer size should not be less than Rs 250 crores and a minimum public participation should be 25%;
- It proposes that minimum subscription size shall be of Rs 2 lakhs and the unit size shall be of Rs 1 lakh;
- A draft offer document/follow-on offer document shall be filed with the designated stock exchange before filing the initial offer;
- Initial and follow-on offer shall not be open for more than 45 days and 30 days respectfully;
- The advertisement relating to offer document/follow-on offer shall not be misleading and shall contain all such disclosures specified by the regulator;
- The advertisement shall not provide any guaranteed returns to the investors;
- Where the minimum public holding falls below the required percentage or where number of unit holders other than related parties to REIT falls below 20, than these shall be considered as the grounds for delisting of the units. The trustees shall apply for delisting of units.

Provisions relating to investment conditions and dividend policy:

- REITs are allowed to make investments only in securities or in properties in India;
- Investment in vacant land or agricultural land is not allowed;
- Investments in units of other REITs are not allowed;
- REITs may invest in properties either by itself or through SPV provided that the latter holds 90% of the assets directly and REIT holds atleast 51% of the equity shares of the SPV;
- At least 90% of the value of the assets shall be invested in completed and rent generating properties (rent generating properties mean those properties in which 75% of the area has been rented);
- At least 75% of the total revenues should be from renting, leasing and letting of real estate assets at all times;
- There is an upper limit of 10% of the value of assets held by REIT for investment in following:
    a) Listed or unlisted debt of companies;
    b) Mortgage backed securities;
    c) Government securities;
    d) Money market instruments or cash equivalents;
    e) Equity shares of companies which derives atleast 75% of their revenues from real estate activity and are listed on a recognized stock exchange in India;
    f) Developmental properties. However investment can be made in the said proper provided REIT holds the property for atleast 3 years after the completion.

- At least 90% of the net distributable income after tax of the REIT should be distributed to the investors;
- As per the Draft Regulation, the REITs may hold property either by its own or through SPV provided SPV holds at least 90% of the said assets directly;
- Investment upto 100% of the corpus of REIT shall be permitted in a single project subject to the prescribed minimum size i.e. the value of the REIT assets is atleast Rs1000 crores.

Provisions relating to borrowing:

- The aggregate consolidated borrowings shall not be more than 50% of the value of its assets. Moreover if the borrowings exceed 25% of the value of the assets then requirement of credit rating from a credit rating agency and approval of majority of investors has been specified.

Provisions relating to Valuation:

- Physical inspection of the properties are required at least once a year;
- In relating to sale or purchase of properties, a full valuation shall be undertaken considering the fact that the transaction shall not be less than 90% and not more than 110% of the assessed value of the property;
- No valuer shall value the same property for more than four years;
- NAV to be declared at least twice a year.

Provisions relating to Related Party Transaction:

- All related party transactions shall be on arms-length basis and should be in the best interest of the unit holders;
- Where there is a transaction for purchase or sale of properties with any related party a valuation report from 2 independent valuer shall be obtained. Further, the amount of such transaction shall not be greater or less than the average of the two valuations;
- Code of conduct has been also established for REITs and its parties under Schedule VI of the Draft Regulation.

The Finance Act 2014- RIETs becoming a reality

The Finance Act 2014 provided many gifts to the much needed real estate sector. The key announcements for the realty sector were as follows:

- Allocation of Rs 7,060 crores for the development of 100 new smart cities in the country;
- Relaxation in FDI norms by reducing the project size from 50,000 sq meters to 20,000 sq meters and reducing the minimum investment limit from $10 million to $5 million;

- Allocation of Rs 4,000 crores for low-cost housing and Rs 50,000 crores for urban housing;
- Incentives for REITs regime.

The budget has introduced tax incentives for the real estate investment trusts (REITs), which was very much required so as to make the REITs regime a reality for the Indian Economy. With the tax incentives in place, the Securities and Exchange Board of India (SEBI) is likely to formally announce and finalize the REIT regulations that are currently in draft form.

In relation to the tax structure for the REITs following are the parties for whom tax regime has been announced:

- "Business Trusts" means Trusts registered as REITs as per the requirements of the SEBI;
- "Special Purpose Vehicle" (SPV), the Indian Company in which the business trust holds controlling interest (as specified or to be specified by SEBI);
- "Transferor", who exchange shares of the SPV in exchange of the units of the business trust;
- "Unit Holders", who subscribes to the units of the business trust.

The implications on each of the above parties are outlined below:

For Business Trust:

(a) As per SEBI regulations, REITs can either hold the properties alone or through a conduit, known as SPV. However, in order to have taxation benefits Business Trust (REITs) are required to hold properties through SPV, in which it shall hold the controlling interest (i.e. at least 51% of the share capital of the SPV). Thus, being a shareholder trust shall receive dividend from the SPV. The dividend so received shall be exempt in the hands of business trust.

(b) REITs can provide loans to SPV. Interest received from SPV on account of loan given is exempt u/s 10 (23FC) in the hands of the trust;

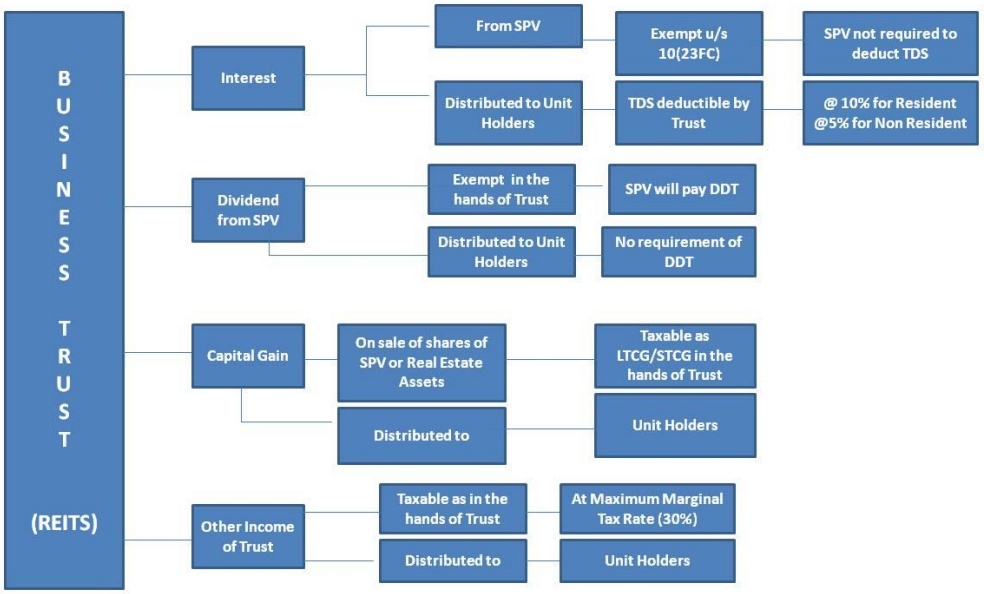
(c) SPV is not required to deduct tax while making payment to the trust, by virtue of insertion of clause (xi) in sub-section (3) of section 194A;

(d) At the time of distributing the above interest component to the unit holders trust shall deduct tax at source u/s 194 LBA at the rate of 10% while making payment to resident unit holders and at the rate of 5% while making payment to non-resident (w.e.f. 01/10/2014);

(e) Any capital gain arising to trust on account of sale of shares in SPV or on account of sale of properties shall be taxable in the hands of trust as LTCG or STCG;

(f) Any other income of the trust, being in the nature of rentals from properties, business profits, lease rentals, etc. shall be taxable in the hands of the trust at the Maximum Marginal Tax Rate of 30%.

The above discussion can be understood from the following diagram:



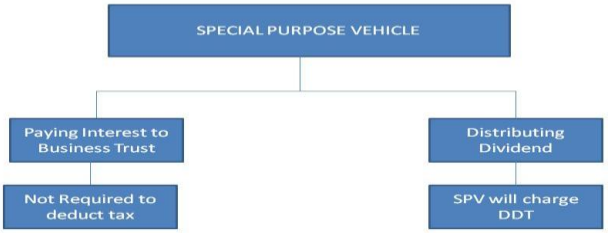
For Special Purpose Vehicle (SPV)

(a) Where the SPV declares dividend, then it is required to pay the dividend distribution tax;

(b) Where the business trust provides loans to SPV, then interest payment by it shall be allowed as an expense and there is no liability on it to deduct tax at source;

(c) Any other income of the SPV shall be computed as per the normal provisions of the Income Tax Act 1961.

The above discussion can be understood from the following diagram:



For Unit Holders

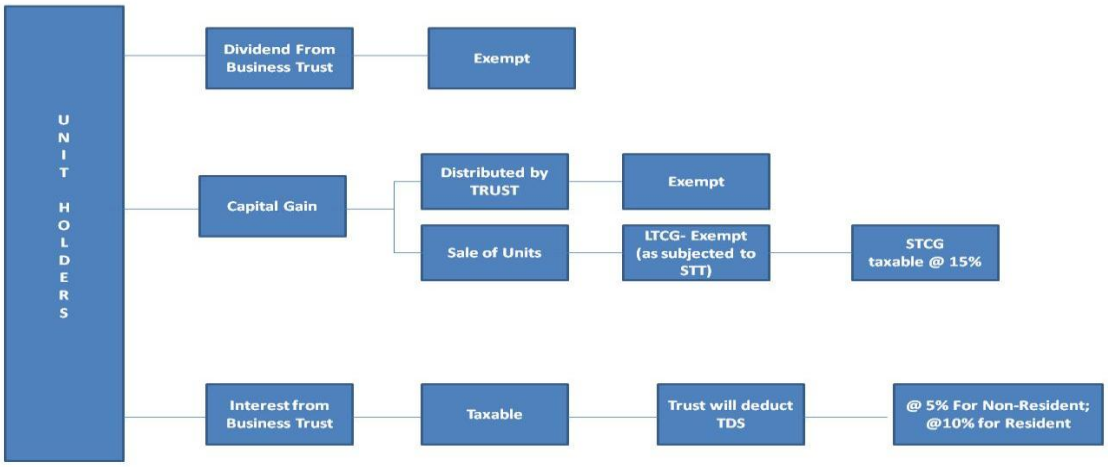
(a) Dividend received from business trust is exempt in the hands of the unit holders u/s 10(23FD);

(b) While receiving interest component, the payer shall withhold tax at source u/s 194LBA at the rate of 10% while making payment to resident unit holders and at the rate of 5% while making payment to non-resident (w.e.f. 01/10/2014). Also the interest income by itself shall be taxable.

(c) As the units of REITs shall be subjected to STT, hence STCG shall be taxable @ 15% and LTCG shall be exempt in terms of section 10(38). However, the proviso clause of section 2(42A) does not include the units of business trust. Thus, in order to claim exemption u/s 10 (38) for Long Term Capital Gain the units are to be held for more than 36 months;

(d) Distribution of capital gain component to unit holders, by the Trust is exempt in the hands of the unit holders.

The above discussion can be understood from the following diagram:



For Transferor/Sponsor

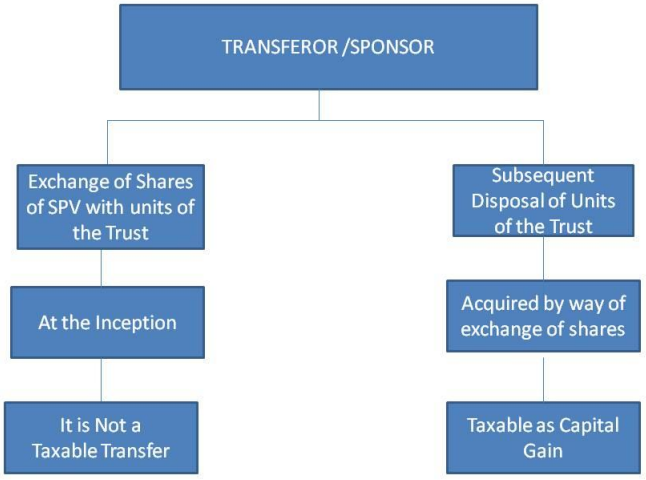
(a) Exchange of shares of SPV for units of business trust at the inception is not taxable as it is not regarded as transfer u/s 47(xvii);

(b) However, at the time when the units of the business trusts are sold, the transferor shall be liable for capital gain tax (either LTCG/STCG), even if sold on a recognized stock exchange as provided in the proviso to section 10(38). Thus even if the above units are subjected to STT and are held for more than 36 months, yet the gain arising on the transfer which is long term in nature shall not be exempted u/s 10(38);

(c) For the purpose of calculating the cost of acquisition of the units of trust so disposed, cost of acquisition of shares in SPV shall be deemed to be the cost of acquisition of the units;

(d) Further, for calculating the period of holding for the units, the holding period of shares shall also be included.

The above discussion can be understood from the following diagram:



The Road Map Ahead:

As the Finance Act 2014 finally provided the tax pass through for the REITs mechanism, market regulator SEBI, is all set to bring the final regulation for REITs, within one month or so, which are currently in the draft form.[9]

Some of the developments amongst industry houses particularly property developers, after the budget can be highlighted below:

- RMZ Corp, which is one of the largest real estate developers in India with over 15 million square feet of prime real estate developments built since its inception in 2002 is planning to raise Rs 9000 crores through REITs[10];
- The stocks in the Realty segment also reacted positively, which were reflected in there share price (DLF up 9.22%, HDIL 5.25%, Indiabulls Real Estate 5.04%) on the very budget day.[11]

[9] http://articles.economictimes.indiatimes.com/2014-07-24/news/51982301_1_employee-welfare-schemes-sebi-board-chairman-u-k-sinha

[10] http://timesofindia.indiatimes.com/business/india-business/RMZ-eyes-Rs-9000-crore-REIT-listing/articleshow/38896257.cms

[11] http://www.business-standard.com/article/news-cm/realty-stocks-reverse-thursday-s-gains-114071100622_1.html