REAL ESTATE INVESTMENT TRUSTS

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simple solutions

INTRODUCTION

The Real Estate Development sector in India is mostly fragmented and without any sectoral regulator/ governing body, save and except the wide matrix of laws, both at the state as well as at the national level. Due to complexity of laws, bureaucratic rigmarole, delays in statutory approvals thereby delaying the projects etc all make it a bit difficult for Real Estate developers in India to raise funds for the projects. For instance the long standing demand for a 'single window clearance' for the approvals has not yet seen the light of the day. Also, the reform process of some of the sectoral laws is moving at merely a snail's pace.

In October 2013, Securities and Exchange Board of India (***SEBI***) had issued draft regulations for REITs viz. SEBI (Real Estate Investment Trusts) Regulations, 2013, by way of a consultative paper with a view to seek comments from the public and other stakeholders.

The Finance Bill (02) 2014 (*which has now been enacted as Finance Act (02) 2014*) has provided certain relaxations to REITs by granting pass through status to the same. Further, SEBI at its board meeting dated August 10, 2014 has approved the regulations with respect to REIT - SEBI (Real Estate Investment Trusts) Regulations, 2014 (***REIT Regulations***).

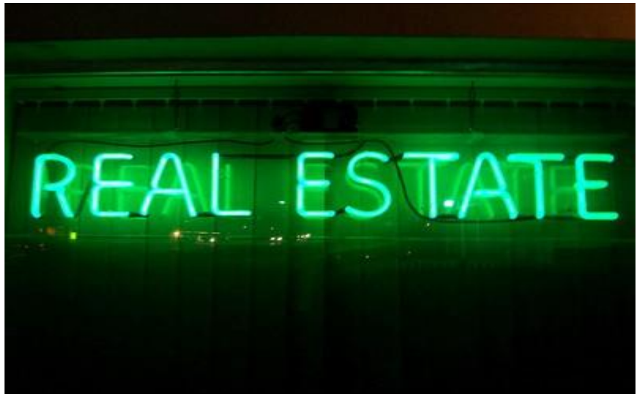
This Note endeavors to consolidate the concept of REIT, salient features of the REIT Regulations and income tax provisions as provided under the Finance Act (02) 2014.

CONCEPT AND MEANING

A REIT is an entity that owns, in most cases operates, income-generating real estate. The REIT structure was designed to provide a real estate investment structure similar to the structure mutual funds provide for investment in stocks.

In many parts of the world, REIT can be publicly or privately held. But in India, SEBI has proposed mandatory listing of units to be issued by REIT. REITs would also enable people to channelize their investments into India's realty sector through a regulated mechanism.

REIT is one of the preferred investment vehicles, since it is being managed by professionals having diverse skill bases in real estate projects. It is also a popular investment option for long term pools of capital viz. pension funds and insurance companies. Moreover, the listed REITs provide the cushion of liquidity to its investors.



REGISTRATION AND STRUCTURE OF REITs

- The REIT Regulations require the registration of REITs with the SEBI, in a manner and by payment of such fees as prescribed under the REIT Regulations, before carrying out any activity.
- The REITs shall be set up as a Trust as per the provisions of the Indian Trusts Act, 1882 and shall have trustee (*to be registered with SEBI*), sponsor, manager and principal valuer as its parties.
- The REIT Regulations provides for certain eligibility requirements for grant of certificate under the REIT Regulations and if those requirements are satisfied, SEBI shall grant the certificate of registration under the REIT Regulations.

MAJOR PARTIES INVOLVED IN REIT ECOSYSTEM

- The **Trustee** shall be independent of sponsor and manager and hold the assets of the REIT in the name of the REIT which would be for the benefit of the investors of the REIT in accordance with the provisions of the Trust Deed as well as the REIT Regulations. The role of Trustee is essentially a supervisory in nature. It should be registered with SEBI under SEBI (Debenture Trustees) Regulations, 1993; not an associate of the sponsor/ manager.
- The **Manager** shall primarily assume all the operational responsibilities with respect to the activity of the REIT. Roles and responsibilities of the manager shall be specified in the agreement entered into between the trustee and the manager. It must have net worth of not less than Rs.5 crores (Rs.50 million), not less than 5 years of experience in fund management/ advisory services/ property management in the real estate industry or in development of real estate; and not less than 2 key personnel in its Investment Committee having not less than 5 years of experience in fund management/ advisory services/ property management in the real estate industry or in development of real estate.
- The **Sponsor** shall be responsible for setting up of the REIT including, appointment of the Trustee. The sponsor shall also be obligated to maintain a certain percentage holding in the REIT so that the Sponsor is also exposed to the same amount of risks to which the investors are also required to face by virtue of their investments in the REIT. Where the sponsor sells its units, the REIT Regulations require the exiting sponsor to scout for another person/ entity to act as the Sponsor. It shall have net worth of at least Rs.20 crores (Rs.200 million) on a consolidated basis and not less than 5 year experience in the real estate industry on an individual basis. A REIT may have multiple sponsors, not more than 3, subject to each holding at least 5% of the units of REIT. Such sponsors shall collectively hold not less than 25% of the units of the REIT for a period of not less than 3 years from the date of listing. After 3 years, the sponsors, collectively, shall hold minimum 15 % of the units of REIT, throughout the life of REIT.

MANNER OF RAISING FUNDS AND LISTING OF UNITS OF REITs

- As per the REIT Regulations, the REITs shall be required to initially raise funds through an initial offer and subsequently through a follow-on offer, rights issue, qualified institutional placement, etc.
- The minimum subscription size for units of REIT shall be Rs.2 lakhs (Rs. 0.2 million). The units offered to public in initial offer shall not be less than 25% of the number of units of the REIT on post issue basis.
- It is mandatory for all REITs to lists its units on a recognized stock exchange and REITs shall make continuous disclosures in terms of the listing agreement. Trading lot for such units shall be Rs.1 lakh (Rs. 0.1 million). The units of REITs shall continue to be listed unless delisted in terms of the REIT Regulations.

- The procedure for listing (including, requirement of minimum subscription amount and minimum number of subscribers) as well as the delisting of units of the REIT is more particularly set out under the REIT Regulations.
- For the purpose of coming out with an initial offer, the asset size under REITs should not be less than Rs.500 crores (Rs.5 billion) which is expected to ensure that initially only large assets and established players enter the market.
- The minimum initial offer size and minimum public float of Rs.250 crores (Rs.2.5 billion) and of 25% respectively has been specified by the regulations in order to ensure adequate public participation and float in the units.
- The funds may be raised by REITs from resident or foreign investor. In case of foreign investors, such foreign invesment shall be subject to guidelines as may be specified by RBI and the Government of India from time to time.

INVESTMENT CONDITIONS AND DIVIDEND POLICY

- invest in the properties, either directly or through a special purpose vehicle (SPV), controlled by the REIT;
- Not less than 80% of the value of the REITs assets shall be in completed and revenue generating properties;
- Not more than 20% of the value of REIT assets shall be invested in developmental properties, mortgage back securities, listed/ unlisted debt of companies/ body corporates in real estate sector and such other avenues as set out under the REIT Regulations. However, investments in developmental properties shall be restricted to 10% of the value of the REIT assets;
- Investment in at least 2 projects with not more than 60% of value of assets invested in one project.
- distribute at least 90% of the net distributable income (after tax) to the investors;
- invest only in assets based in India;
- investment not allowed in vacant land or agricultural land or mortgages, other than mortgage backed securities;
- cannot invest in units of other REITs.

PASS THROUGH STATUS UNDER INCOME TAX ACT

- The Finance Act (02), 2014 has introduced the concept of "business trust" which comprises trust registered as an Infrastructure Investment Trust or a REIT, the units of which are required to be listed on a recognised stock exchange, in accordance with the regulations made under the Securities Exchange Board of India Act, 1992 and notified by the Central Government in this behalf.
- Interest income will not be liable to tax in the hands of the REIT. Further TDS is not required to be deducted by SPV while paying interest to the REIT. However, REIT is required to deduct TDS along with surcharge and cess while distributing interest income to the resident and non resident unit holders.
- Dividend income earned by the REIT from SPVs as well as distribution of distribution income to unit holders by REIT is exempt from tax. The provisions of dividend distribution tax shall be applicable to the SPV.
- Capital Gains earned by REIT shall be taxable as per normal provisions of capital gains. Exemption for unit holders for long term capital gains in relation to the sale of units on recognised stock exchange and the short term capital gains will be taxed @15% in addition to applicable surcharge/ cess.
- In case of other income earned by REIT, the same shall be taxable at the maximum applicable rate.

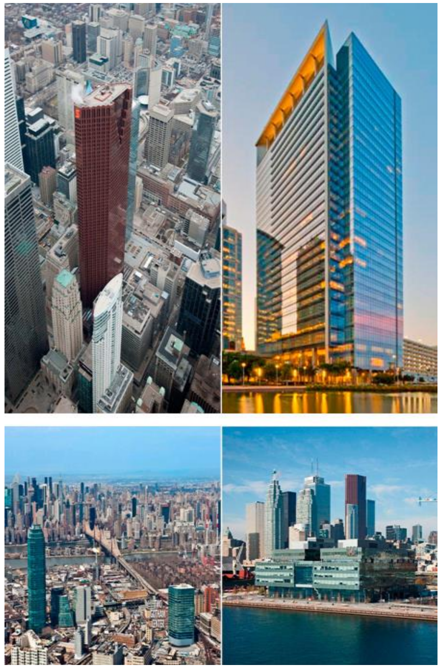
OUR VIEW

REIT provides the real estate sector alternative means to raise funds for the various projects. Actually it appears to be a much needed respite for the cash starved real estate developers. The Developers also stands to gain as there would be an increase in supply of foreign funds for the real estate sector that is under the restricted areas of RBI. However, it will be interesting to see the categories of non resident investors that may be eligible for such investment and terms and conditions that may be issued by the Reserve Bank of India for investing in units of REITs (which is in the form of trust) especially, in current scenario, where Foreign Direct Investment in Trust other than FVCI investment in registered VCF is not permitted.

The REIT Regulations provide that 80% of the value of the REITs assets shall be invested in completed revenue generating properties (which has received Certificate of Occupancy from competent authority). Thus, cost of acquisition of the REIT of such completed projects will be very high.

Although the REIT Regulations provide for mandatory listing of units of the REITs, the level of trading activity in the units of REITs will have to be seen.

The REIT Regulations would provide much needed transparency and is expected to make real estate a bit ‘organised’ to say the least. So it looks like that the momentum started by SEBI has been eventually received the much needed support from the taxation perspective. It will be just the matter of time when SEBI and RBI will notify necessary regulations to open the gate for investment in REIT.



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