

ANALYSIS OF REIT REGULATIONS

MARCH 2015



India REIT Regulations- A Holistic Perspective

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The Real Estate Investment Trust (REIT) - an investment vehicle that invests in rent-yielding completed real estate properties has the potential to transform the Indian real estate sector. Currently, developers incur huge capital expenditure especially in Commercial Real Estate (CRE), on land, construction, interior fit-outs, etc. which remain locked for years until the asset generates returns to break-even. REIT will help attracting long-term financing from domestic as well as foreign sources. This could improve fund availability to real estate developers and reduce some burden on completed assets by allowing owners of such assets to raise capital from investors against issue of units. Further, for the investors, the REIT can provide a new investment vehicle with ongoing returns, elevated transparency and governance standards.

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Making REITs
Successful in India

Importance of a Real Estate Investment Trust (REIT) in the Indian context

A REIT could have a large opportunity in the Indian real estate market with a growing economy, existing portfolio of commercial real estate and conducive investment climate.

Alternative investment opportunity:

A REIT could provide an attractive alternative investment instrument in the Indian financial markets. Introduction of REIT can be a boon for developers and more so to the real estate investors as it helps in negating the shortcomings of investing in physical real estate. This new investment vehicle offers an exit opportunity to developers thereby enabling them to monetise their real estate. While on the other hand, mandatory listing of the REITs on recognised stock exchanges will offer an easy entry and exit mechanism for investors. With respect to providing liquidity to the investors, REIT may be at par with equity shares trading on the exchange.



Being a new investment instrument for an Indian investor it is imperative to study the performance of REITs, globally. Over the past decade, returns on equity of traded REITs has comparatively over performed the returns on leading stock markets indexes, across the world. REITs across the globe have provided five year returns in the range of 12 to 24 per cent. With Japanese and Malaysian markets providing returns in the range of 7 to 12 per cent,¹ expectations from Asian economies are on the rise.

Following are some key highlights of the performance of REITs in key markets as per S&P Dow Jones at five year and ten year milestones.



¹ Refer Table 1

Following are some key highlights of the performance of REITs in key markets as per S&P Dow Jones at five year and ten year milestones.

Table 1

Country	REIT Performance as per S&P Dow Jones	
	5 year	10 year
Americas		
U.S.	15.93%	8.35%
Europe		
France	8.95%	13.62%
United Kingdom	12.20%	N.A.
Pacific		
Australia	8.62%	3.56%
Asia		
Japan	11.75%	6.32%
Singapore	14.35%	14.06%
Hong kong	23.80%	14.32%
Malaysia	6.82%	N.A.

Source: Dow Jones Real Estate Indices – S&P Global Property Indices Quantitative Analysis Report for Q3 2014

It is expected that a REIT in India would give returns similar to that of other countries represented on the table. It is expected that a diversified REIT only focusing on rental income can generate returns in the range of 9 to 11 per cent with an additional return of 2 to 3 per cent on capital appreciation, annually.

Professionalism and transparency in real estate investments:

A REIT could help in bringing the much required professionalism and transparency in the real estate sector in India. It shall be governed by the SEBI guidelines, which would help ensure transparency and accountability of REITs. A REIT would have to appoint an independent trustee, managers, auditor and valuer to help ensure that the functioning of a REIT is transparent. Moreover, experiences in different facets of the real estate business are a prerequisite for the appointment of a manager in a REIT, thereby helping in ensuring professionalism in real estate investments.

Opportunity for liquidation of assets:

A REIT could provide developers and large investors of commercial real estate to tap into the REIT market for investment in the real estate assets. It could provide a long awaited exit opportunity to developers and Private Equity (PE) investors, with an option to retain a large share and diversify a smaller portion to unlock the potential of the assets. The liquidity generated could help developers with much needed capital to invest in future projects or complete existing projects. Moreover, a REIT as an investment vehicle has a huge opportunity in India. As on October 2014, India has a rent yielding office inventory to the tune of 425million sq ft valued in excess of USD 52billion.² Apart from this, there are other properties like warehousing, retail malls, shopping centers, school buildings, etc. which could be considered for REIT.

²Refer Table 5 of this Report

Conducive investment environment

01/ 

Growing economy

The thriving economy could be a key driver for growth of the REIT regime in the Indian market. The business confidence index has strengthened and the economy is looking forward to another phase of decent growth, with political stability and a government focusing on growth.

02/ 

Increasing working age population

UN World Population prospects, projects Indian median population from 26.4 in 2013 to 36.7 in 2050³, this signifies a large pool of young population in India. This employable young workforce demands employment and could attract global corporates especially in IT-ITES and promote the development of commercial real estate.

03/ 

Housing and urban infrastructure requirement

To support the increasing population, huge investments are required to meet India's housing needs, and additional investments would be required for commercial and urban infrastructure to support the housing growth. India needs to develop almost 45 to 50 million housing units by 2028.⁴

04/ 

Disposable income and retirement savings

Increase in income of working age population, would result an increase in disposable income. This disposable income gives individuals flexibility to invest in long-term investment options for future savings.

05/ 

Worldwide, an affordable office space

India is one of the countries globally offering affordable prime spaces, with high growth potential. The availability of such assets is expected to find takers for REITs in India.



³ http://esa.un.org/wpp/documentation/pdf/WPP2012_%20KEY%20FINDINGS.pdf

⁴ KPMG in India Analysis; KPMG Report 'Indian Real Estate - Opening Doors, 2014'

India REIT regulations

Initially proposed in December 2008 by the Securities and Exchange Board of India (SEBI), the SEBI (Real Estate Investment Trusts) Regulations, 2014 ('REIT Regulations') have been notified.

Several developers, financial institutions and private equity players that have been preparing their real estate portfolio for the new investment environment will be ready to offer their investment propositions to investors, beginning 2015.





Table 2

Guidelines applicable to REITs:

Category	Aspect	Guidelines
 Fund-raising conditions	Initial offer of units to third parties	<ul style="list-style-type: none"> Only through public issue
	Investment by foreigners	<ul style="list-style-type: none"> Allowed under REIT Regulations. However, subject to permission in keeping with the Department of Industrial Policy and Promotion (DIPP) guidelines, which actually prohibit FDI in real estate business .It is also subject to the RBI guidelines and the government, as specified from time to time FDI is permitted in construction-development: townships, housing etc. with an exit option to investors on completion of projects or after development of trunk infrastructure.⁵ Currently, the guidelines for foreign investment in REITs are awaited.
	Listing	<ul style="list-style-type: none"> Mandatory
	Manager	<ul style="list-style-type: none"> Can be a body corporate, company or LLP incorporated in India An entity separate from the Sponsor Minimum five years' experience in fund management or advisory services or property management in real estate industry or in development of real estate (at the manager or associate level) Minimum two key personnel having minimum five years' experience in fund management or advisory services or property management in real estate industry or in development of real estate Minimum 50% of the directors/members of the governing board have to be independent
	Minimum Net worth of the REIT manager	<ul style="list-style-type: none"> For a body corporate or a company: ₹100 million; LLP: Net tangible assets of value ₹100 million
	Offer size (assets under REIT)	<ul style="list-style-type: none"> REIT assets of ₹ 5 billion at the time of public offering Minimum offer size: ₹ 2.5 billion; Minimum float: 25%
	Sponsor	<ul style="list-style-type: none"> Sponsor may be any person(s) who set(s) up a REIT Multiple (maximum: 3) Minimum experience requirement: 5 years in development of real estate or fund management in the real estate industry (at the sponsor or associate level) Wherein the sponsor is a developer, at least two projects of the sponsor should have been completed
	Net worth of the REIT sponsor	<ul style="list-style-type: none"> ₹200 million (minimum) on an individual basis and ₹ 1,000 million (minimum) on a collective basis
	Sponsor investment	<ul style="list-style-type: none"> Sponsors can collectively hold a minimum of 25% for the initial three years, followed by 15% thereafter. They are individually to hold a minimum of 5% at all times. A sponsor can re-designate another sponsor as long as the re-designated sponsor satisfies the qualifying requirements and holds the minimum percentage of units.
	Ticket size for investors in REIT	<ul style="list-style-type: none"> ₹2,00,000 for public (initial as well as follow-on) offer and ₹1,00,000 post listing. Minimum 200 public unit holders at all times
	Trustee	<ul style="list-style-type: none"> Registered with the SEBI as a Debenture Trustee Independent from the Sponsor/ Manager

Guidelines applicable to REITs:

Category	Aspect	Guidelines
 <p>Investment conditions</p>	Acquisition and disposal of assets	<ul style="list-style-type: none"> For related party transactions, purchase or sale should be in accordance with two independent valuations and must be at a price not greater than (in case of purchase)/not lesser than (in case of sale), the average of the two independent valuations. For non-related party transactions, purchase or sale, should be in accordance with the valuation undertaken by the valuer of the REIT and shall be subject to prior approval of the unit holders, only if the purchase is at a value greater than 110% or if the sale is at a value lesser than 90% of the value of the property as assessed by the valuer.
	Asset class	<ul style="list-style-type: none"> Rent-yielding assets (office, retail, hospitality, warehouses, conference centres, etc.).
	Asset disposition	<ul style="list-style-type: none"> Post the holding period of 3 years, asset churning is allowed, subject to prior permission of the unit holder, wherein the value of the transaction exceeds 10% of the value of the REIT assets in a financial year.
	Asset location	<ul style="list-style-type: none"> India
	Asset restrictions	<ul style="list-style-type: none"> At least 80% in completed and rent-generating real estate Completed and rent-generating properties from the date of purchase by REIT or SPV and under-construction properties from the date of completion are to be held by the REIT for a minimum of three years. A maximum of 20% of the total REIT assets may be invested in the following: <ul style="list-style-type: none"> Debt of companies/body corporates in the real estate sector, Mortgage Backed Securities (MBS), government securities, Money market instruments/cash equivalents Listed equity of companies having 75% or more operating revenue from real estate activity Unutilised Floor Space Index (FSI) and Transferable Development Rights (TDR) for utilisation in investee projects Under-construction properties/completed but not rent-generating properties, subject to a cap of 10% of the value of the REIT assets Investment in other REITs is not allowed.
	Income distribution	<ul style="list-style-type: none"> 90% of the net distributable cash flow is to be distributed among the unit holders not less than once every six months.
	Income restrictions	<ul style="list-style-type: none"> A minimum of 75% of the revenue of the REIT and the SPV, except gains arising from the disposal of properties, should come from rental, leasing and letting or any other income incidental to the leasing of assets.

Category	Aspect	Guidelines
	Investment structuring	<ul style="list-style-type: none"> Direct investments by the REIT or through a SPV in India that owns a minimum of 80% of its assets directly in properties (only one level SPV is permitted). The REIT should have a minimum of 50% in the SPV. Limited Liability Partnership (LLP) as a Special Purpose Vehicle (SPV) is allowed Sponsor must transfer/undertake to transfer entire shareholding or interest in the SPV unless required otherwise by law. Co-investor in the SPV cannot be on more favourable terms than the REIT. 90% of the net distributable cash flow is to be distributed by the SPV to the REIT not less than once every six months.
	Land	<ul style="list-style-type: none"> Investments in agricultural land or mortgage are not allowed. Vacant land is allowed where it forms a contiguous extension of an existing project being implemented in stages
	Leverage	<ul style="list-style-type: none"> A maximum of 49% of the value of REIT assets. Mandatory credit rating and investor approval above 25%
	No. of projects	<ul style="list-style-type: none"> A minimum of two projects, directly or through the SPV, with not more than 60% of the value of assets in one project
	Related party transactions	<ul style="list-style-type: none"> Allowed on an arm's-length basis
	Disclosure of valuation reports	Half yearly and annual
 Valuation of assets	Net Asset Value (NAV) declaration	<ul style="list-style-type: none"> Twice a year To be in line with international valuation standards and valuation standards as specified by ICAI for valuation of real estate assets
	Valuation criteria	<ul style="list-style-type: none"> ICAI standards to prevail in case of conflict

⁵ FDI is allowed in certain completed assets like Industrial Parks, Special Economic Zones, operation and management of townships, malls/shopping complexes and business centres etc. (CONSOLIDATED FDI POLICY read with Press Note No. 10 of the 2014 series)

Structure of REITs in India



The REIT regulations have sought to create an ecosystem by detailing the role and responsibilities of each stakeholder and laying down the conditions for operating and managing a REIT in India. The guidelines pertaining to fund raising and investments outline the fundamentals of REITs in the country, and have been listed in Table 2. Channelising a portion of public savings into real estate was one of the objectives of these guidelines. In the absence of the REIT Regulations, the nearest alternative to property investment was private equity funds that operate within the SEBI (Alternative Investment Fund) Regulations, 2012 (SAFR).

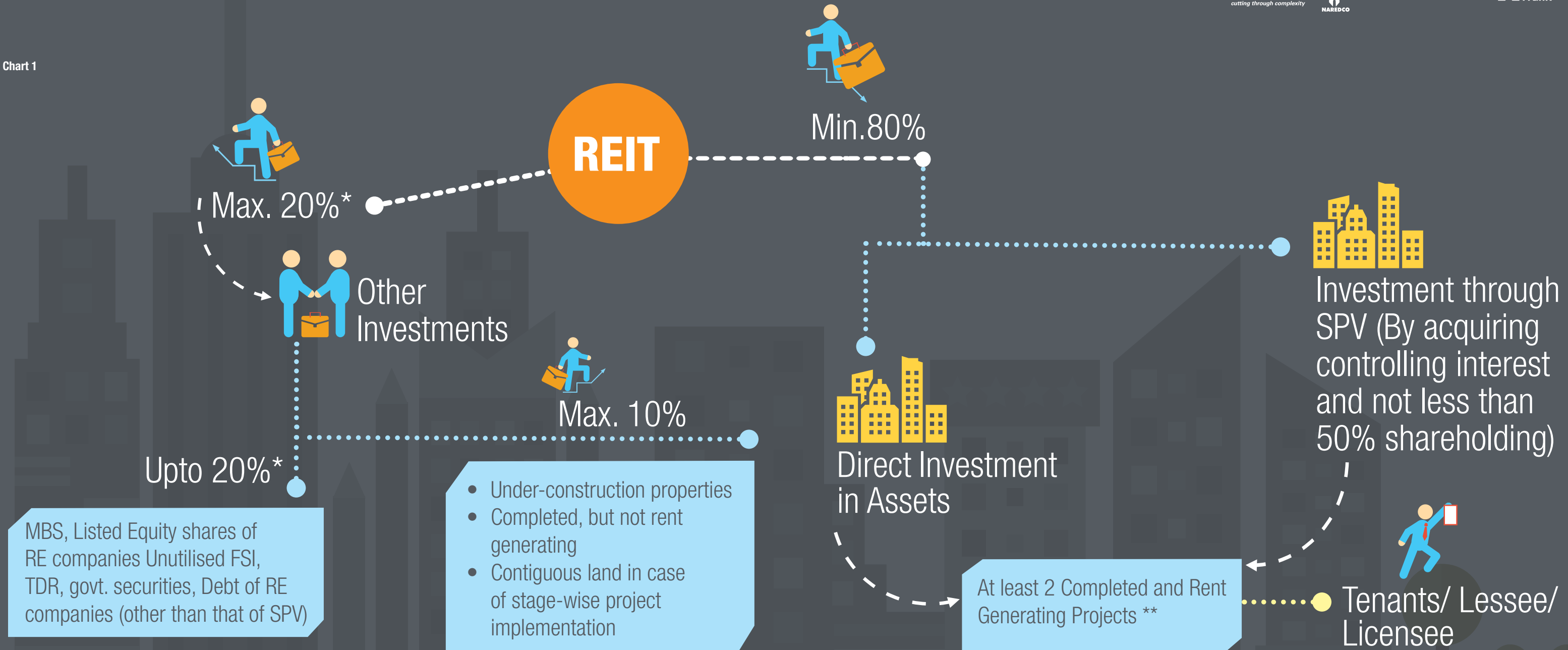
However, besides characteristic differences, the ticket size of the investments under the SAFR was high, at ₹10 million. This caused small investors who showed interest in investing in property to invest in physical assets directly, which are fraught with their own share of complexities. In contrast, the REIT investment vehicle will allow investments as low as ₹0.2 million in the case of public offers, and ₹0.1 million in subsequent trading on recognised stock exchanges. This provides liquidity, easy entry-exit for unit holders comparable to shares and allows developers to monetise their real estate assets with an option to retain a large share and diversify a smaller portion to unlock the potential of the assets.



The REIT Regulations also allow foreigners to buy units of a REIT, thereby channelising overseas investments of sovereign wealth funds, retirement funds and High Net-worth Individuals, among others. This can infuse equity in the cash-strapped real estate assets and help attract long-term financing from domestic/foreign sources, thereby reducing the burden on the banking sector. Currently, the FDI regulations by DIPP allow investments in under-construction real estate and completed projects for operation and management of townships, malls/ shopping complexes and business centers. However, the guidelines for direct foreign investment in REITs are awaited.

In the draft REIT Regulations, 2013 for the initial offer, a REIT was required to have assets of ₹ 10 billion. This condition has been halved since the draft guidelines were introduced in October 2013, thereby making it easier for several smaller players to enter the REIT market. In addition, the regulations also allow multiple sponsors (a maximum of three) for a REIT. The draft guidelines allowed only a single sponsor to promote a REIT. Hence, coupled with a lower asset size to begin with, the provision for multiple sponsors can be encouraging for several small and regional players.

Chart 1



*Including under-construction/ developmental properties **Not more than 60% of assets to be in one Project

Source: SEBI, Knight Frank Research, Hariani & Co

As indicated in chart 1, with respect to investments by the REIT, at least 80 per cent should be in completed and revenue-generating real estate. This is lower than the requirement of 90 per cent as specified in the draft guidelines. Further, a maximum of 20 per cent instead of 10 per cent, is allowed in debt, MBS, government securities, money market

instruments/cash equivalents and the equity of companies having 75 per cent or more from real estate activity (including a maximum investment of 10 per cent in under-construction real estate). Increasing the limit from the 10 per cent overall limit for such instruments/investments specified in the draft guidelines, the relaxation allows higher liquidity for the REIT manager while

restricting the risk of under-construction projects to 10 per cent. It also allows investment in FSI and TDR for utilisation in investee projects but not for trading/liquidity purpose. The move is practical, considering cities like Mumbai, where TDR and FSI involvement in development is the norm.

Under the draft guidelines, the entire REIT assets could be in a single project worth a minimum of ₹10 billion. Addressing the risk associated with such an investment, the REIT Regulations have necessitated investment in a minimum of two projects, wherein not more than 60 per cent of the value can be invested in one asset.

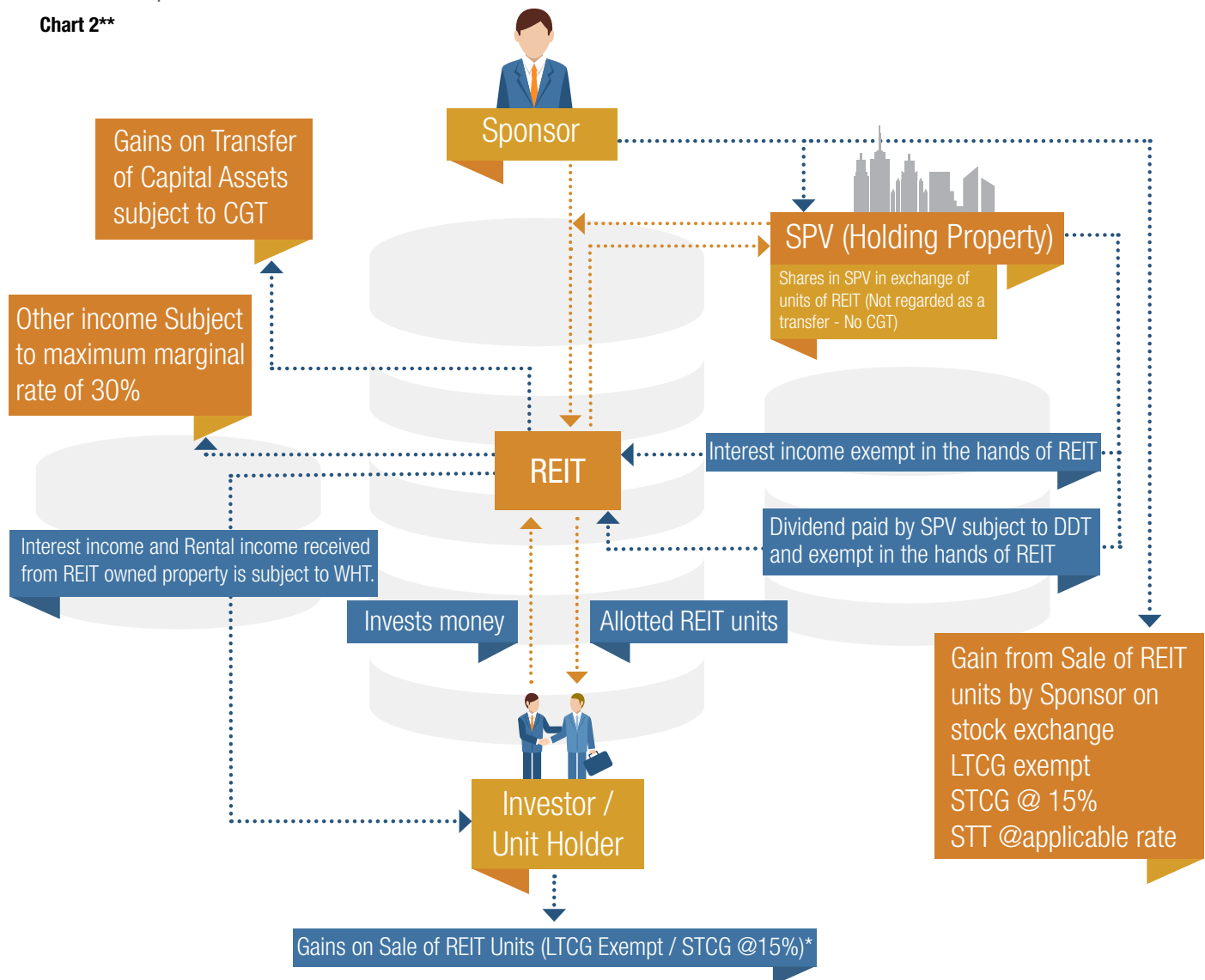
Further, under the draft guidelines, not more than 20 per cent of REIT assets would be rented to related parties. The said threshold has now been removed subject to valuation requirements and obtaining of required approvals from unit holders. This could open up doors for large listed companies like banks, stock exchanges,

etc. who hold substantial office properties to monetise their properties by carrying out a sale and leaseback with a REIT.

Tax implications

The Finance (No. 2) Act, 2014 and the recent Finance Bill, 2015 (not enacted yet) clearly spell out the tax treatment of possible income streams for all stakeholders in the REIT, as per the Chart below.

Chart 2**



* REIT Units sold on STOCK Exchange

1. STCG less than or equal to 36 months
2. LTCG more than 36 months

** The above tax implications are subject to the effective date of the relevant income tax provisions

Accordingly, the tax implications which will arise on account of capital gains, rental income, dividend income and interest income are listed below:



Capital gains

a. Sponsors' tax liability on the transfer of shares in SPV

No capital gains tax arises on the initial transfer of shares of the SPV to a REIT in exchange of units of the REIT by the sponsor.

Further, it has been proposed in the Finance Bill, 2015, that at the time of disposal of the above REIT units (under an IPO listing or sale on stock exchange thereafter), the sponsor of REITs would be eligible for concessional capital gains tax regime on par with other investors. Accordingly, long term capital gains (LTCG) on transfer of units would be exempt and short term capital gains (STCG) would be taxable at the rate of 15 per cent provided applicable Securities Transaction Tax

('STT') is paid on the sale of such units..

This is similar to an IPO of a company where LTCG arising to the promoter on sale of shares through an offer for sale or on the stock exchange post listing is exempt from tax. Given that both are similar in terms of public listing, parity may make it lucrative for sponsors to opt for a REIT. In doing so, the Revenue authorities have tried to address the sponsors' apprehension regarding high costs of setting-up a REIT.

The Income-tax Act, 1961 ('the Act') states that acquisition cost of the shares of the SPV as well as the date on which the shares were originally purchased should be considered while computing the capital gains tax on sale of REIT units held by a sponsor.

b. Business trust's tax liability on the disposal of assets

Any gains/income arising out of disposal of assets by the REIT (typically real estate assets or shares in SPV) would attract capital gains tax, depending on whether the gains are short-term or long-term in nature.

c. Unit holders' tax liability on the sale of REIT units on the stock exchange

If the unit holders sell the units of the REIT on the stock exchange after holding it for more than 36 months, the capital gain arising on sale of such units of REIT will be exempt from tax. However, transfers within the 36 month period will attract short-term capital gains tax at a concessional tax rate of 15 per cent. Such sale of units on the stock exchange shall be subject to STT on transaction value.



Rental income

a. Rental income received by the REIT

The Finance Bill, 2015 has proposed that the rental income arising to REIT from the real estate assets directly held by the REIT would be eligible for pass through status. Accordingly, such income will be exempt in the hands of REIT.

Further, the tenant or lessee is not required

to withhold tax on payment of rent to the REIT.

b. REIT distributing rental income to unit holders

Distribution of rental income by REIT to the REIT unit holders is chargeable to tax in the hands of the REIT unit holders on distribution.

The REIT is required to withhold tax at 10 per cent on distribution of such income to the resident unit holders and at the applicable rates on distribution to the non-resident (not being a company) or foreign company unit holders.



Dividend income

a. Distribution of dividend by SPV

If the SPV is a company, it has to adhere to the regulations of the Companies Act. According to the Act, any company paying dividend would attract Dividend Distribution Tax (DDT) at 17.65 per cent excluding surcharge and education cess. Hence, the dividend paid by the SPV to the REIT would attract DDT.

b. REIT receiving dividend from SPV

The dividend received by the REIT from the SPV would be subject to DDT at the level of SPV and therefore it will be exempt in the hands of a REIT.

also exempted. This is because REITs are intended to be pass through entities.

c. REIT distributing dividend received from SPV to unit holders

By the logic of REIT receiving dividends, the REIT unit holders receiving dividends are



Interest

a. REIT receiving interest

If the SPV is funded through interest-bearing debt by the REIT, any interest paid by the SPV to the REIT would not be taxable. Additionally, the SPV's tax liability will decrease, as interest is a tax deductible

b. REIT distributing interest received from SPV to unit holders

The interest income earned by the REIT from the SPV would not be taxable in itself (as mentioned above), but would be taxable in the hands of the unit holders.

The unit holder(s) will be subject to

withholding tax on the interest component of the distributed income at 5 per cent for a non-resident and 10 per cent for resident unit holders. It is worthwhile to note that for the non-residents, 5 percent is the final tax incidence on such interest income.



Other income distributed by REIT to unit-holders

Distributed income received by the unit holder from the REIT, except the proportionate interest and rental income (as discussed above) will be exempt under the provisions of the Income Tax Act, 1961.



A lower withholding tax rate of 5 per cent on interest income in case of ECBs availed by a REIT.

The beneficial provision of lower rate of withholding tax is now available also to REIT, subject to the conditions as mentioned in the Act.

Table 3

Bird's eye view of taxability at various levels in a REIT structure is tabulated below:

Nature of Income Level	Interest paid by SPV	Rental Income on property held by REIT directly	Dividend on shares of SPV	Capital gains on sale of shares of SPV/sale of properties held by REIT directly	Other income	Capital gains on market transfer of units of REIT by unitholders / Sponsors*
Unit holder	REIT distributing the interest from SPV subject to WHT at 5 % - NRs (No further tax in the hands of unit holder)	Taxable in the hands of unit holder Further, REIT to withhold tax @ 10% if distributed to resident unit holder and at the applicable rate in force if distributed to non-resident unit holder (not being a company) or a foreign company	Exempt	Exempt	Exempt	STCG - 15% (held for 36 months or less)
	WHT at 10% - R (Taxed at applicable rates in the hands of unit holder)					LTCG – Exempt (held for more than 36 months)
REIT	Exempt	Exempt	Exempt	Tax rate applicable depending on period of holding, etc.	Tax at 30%	NA
SPV (in the form of a company)	Tax break available on interest (subject to conditions), no WHT applicable on interest payment	NA	DDT at 17.65%	NA	NA	NA

Above rates are excluding surcharge and education cess

* Sale on the stock exchange shall be subject to securities transaction tax

Other taxation provisions relevant to a REIT structure:

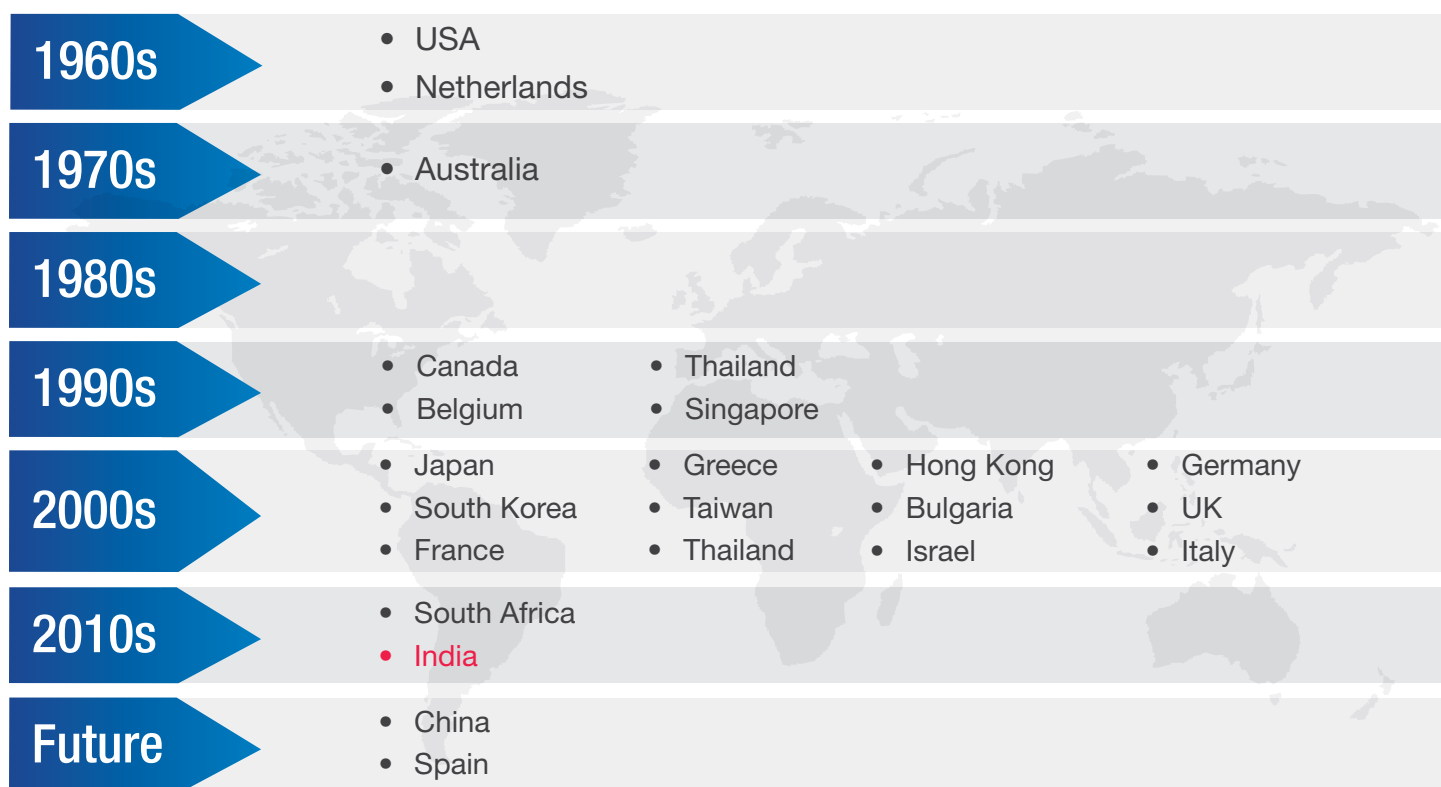
Taxation on capital gains arising to a sponsor on exchange of shares in SPVs with units of the REITs, arises only at the point of ultimate transfer of REIT units and the exchange of shares with REIT units is not considered as a transfer. Holding period and cost of shares of SPV in the hands of a sponsor available on ultimate transfer of REIT units. The capital gain tax rate will be applicable depending on short-term/long-term in nature.

Interest paid to non-resident lenders in case of monies borrowed by REITs in foreign currency, taxable at 5% subject to specified conditions

History and Regulatory reforms of REIT markets

REIT or a similar structure is a globally accepted investment vehicle for investing in real estate properties. More than 20 countries now have REIT or a similar structure. Since, its inception in the 1960s in the USA the REIT market is continuously developing across the world. In Asia, Japan was the first country to introduce REIT, later on followed by various Asian countries like Singapore, Indonesia, South Korea, etc. Presently, Japan and Singapore are the market leaders in Asia for REIT. The diagram below showcases the emergence of REIT across the world.

Chart 3

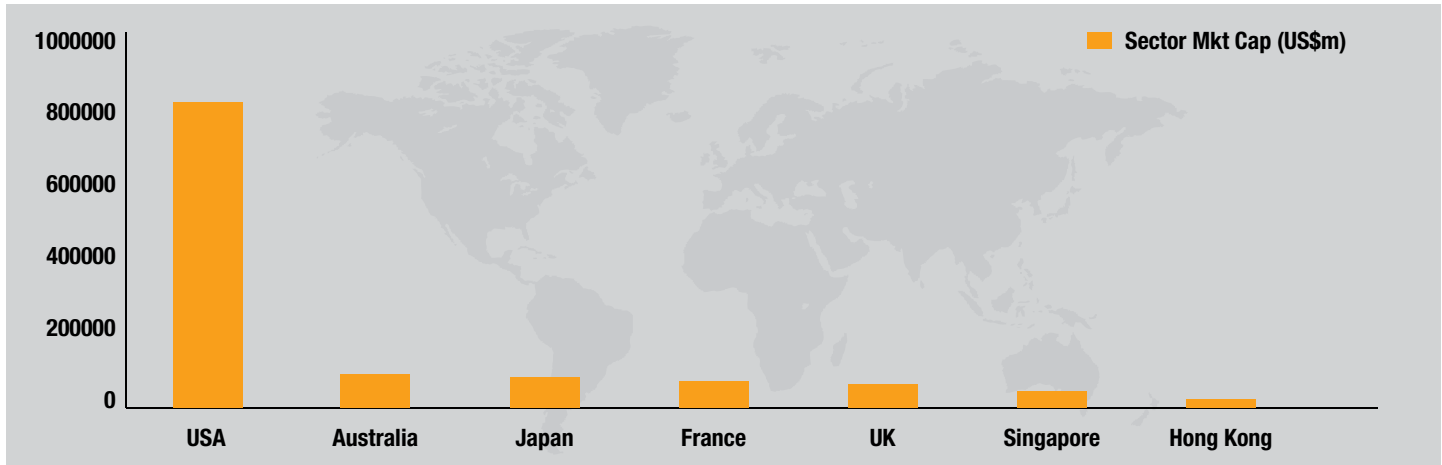


Though the REIT structure across the globe has many similarities or “standard structures”, its success and growth have not been the same across countries. There are instances in some countries where the journey to establish a REIT has not been devoid of hurdles. A study of the history of REIT structures in overseas countries could be relevant to analyse the future of REIT in India⁶.

⁶ Hong Kong Financial Services Development Council – FSDC Research Paper No. 04, November 2013 and EPRA Global REIT Survey, July 2014

The chart below showcases market cap of REIT across leading countries.

Chart 4



Source: EPRA Global REIT Survey 2014

Evolution of the U.S. REIT Market

The U.S. REIT market journey began in the 1960s. In the 1970s and 1980s it was at a developing phase. It was in the 1990s, where the sector had achieved a substantial growth due to increase in acceptance of REIT among the investors as an alternative mode of investment in real estate properties. The reason behind such growth was majorly because of positive changes in the U.S. tax and regulatory laws.

The U.S. REITs are classified on the basis of their investment form such as equity REITs, investing directly in properties and mortgage REITs, investing in housing loans and other real estate finance, which can be managed either internally or externally.

The two important tax and regulatory breakthroughs for the U.S.

REITs have been the Tax Reform Act, 1986 ('TRA') and the REIT Modernisation Act ('RMA') effective from 2001. The TRA pushed for real estate investments to become more tax-transparent and for integration of REITs with ancillary real estate business, like property management, leasing or development, thereby facilitating more effective management of REITs. While the RMA made way for creation of taxable REIT subsidiaries ('TRS'), which can independently engage in such ancillary business activities.

During the 55 years of REIT history, the U.S. REIT market has gone through a roller coaster ride of success, failure, development and change which has transformed today's REIT as an important vehicle for investment into real estate properties across the world.

Evolution of the Australian REIT ('A-REIT') Market

Australia is one of the leaders in establishing a REIT regime and the first Australian REIT was established in 1971. Australian REITs (erstwhile famous as the Listed Property Trust or 'LPT') are relatively simpler tax effective corporate structures enabling pooled property investment. Following the first Australian REIT, the market for listed Australian REITs developed progressively until the 1980s. However, the Australian REIT market received a boost from the lessons learned from the failure of the commercial property market in the early 1990s an essential lesson being the importance of holding some liquid assets along with holding direct properties.

REITs offered a convenient mechanism effectively blending investment in property along with a good liquidity position. This led to a huge roar in the Australian REIT market during the late 1990s, reinforced by both private players as well as institutions, around 60 REITs were listed on the ASX during this time. Further, increase in the popularity of stapled securities and internationalisation of Australian REITs further pushed the growth of the Australian REIT market.

Evolution of the Singapore REIT ('S-REIT') Market

Singapore, along with Japan, is one of the market leaders in the Asian region. The first Singapore REIT ('S-REIT') was established and listed in July 2002. The growth of S-REITs market after the launch of the first REIT was slow until 2005. However, post the declaration of the policy of remission of stamp duty in 2005, the S-REITs market experienced a major boost and the number of REITs more than doubled by 2006.

The year 2009 was the first year, when the value of S-REITs assets were significantly written down owing to the impact of the great global financial crisis in 2008. However, S-REITs market gradually improved back to the normal conditions.

Most initial S-REITs are focused on domestic property portfolio, while the more recent S-REITs have expanded their property portfolio base to include overseas, primarily regional properties from China, Japan, Australia and India. Since 2010, Singapore REIT market has achieved huge success with increased focus on securitisation, overseas exposure in the S-REITs.

In the recent Singapore Budget, to continue to promote the listing of REITs in Singapore and strengthen Singapore's position as a REITs hub in Asia, the package of tax concessions for REITs has been reviewed. The package of income tax concessions for REITs has been extended to March 31, 2020.

Evolution of the Hong Kong REIT ('H-REIT') Market

H-REIT was introduced through the Hong Kong REIT Code in 2003. However, since its emergence, the H-REIT market growth has been sluggish. Its development story significantly lags behind the other REIT markets in the Asia-Pacific region mainly due to relative restrictiveness and want of some tangible incentives.

Recognising the need of the current REIT market, the Securities and Futures Commission (SFC) has revised Hong Kong's Code on Real Estate Investment Trusts (REITs) on August 29, 2014, taking immediate effect. Under the new regime, Hong Kong's REIT portfolios have been expanded to allow investment in retail properties, commercial and hotel properties, as well as properties in Mainland China. Further permission has now been granted for REITs

to invest in developing properties, as also engage in development activities and to purchase financial instruments (including local and foreign property funds), subject to the criteria of minimum investment in rent-generating property. In addition, appropriate provisions have been introduced to ensure transparency in a REIT's activities.

Going by the fact that regulatory changes play an important role in evolution of the REITs, it could be interesting to see how markets react to the recent changes to the Hong Kong REIT regime.

Evolution of the Japanese REIT ('J-REIT') Market

Japan is a leading REIT market in Asia. The first two J-REITs were listed in 2001 and thereafter the J-REIT market grew rapidly with around 41 J-REITs listed by early 2007.

The swiftness of this growth mechanism can be credited to efficient tax and regulatory reforms. Reforms such as lowered tax rate on

capital gains and dividends, allowing funds-of-funds to invest in REITs further enhanced the growth and appeal of REITs. Other factors such as large gap ("spread") between dividend yields of J-REITs and interest yields of 10 year government bonds, track record of stable dividends among listed names greatly contributed in promoting J-REITs as a lucrative investment alternative.

The J-REIT market demonstrated a reverse trend since mid 2007. Several steps such as raising funds from Japanese banks through various mechanisms as well as tax reforms such as allowing retention of negative goodwill brought about at the right time which have facilitated the effective functioning of J-REITs market.

Evolution of the United Kingdom REIT ('U.K.-REIT') Market

The U.K. REIT vehicle was launched with effect from 1 January 2007 by the Finance Act 2006. Within the first year of the regime itself, the number of registered REITs grew significantly, but since then the growth has been sluggish.

The U.K. REIT regime operates through a combination of legislation (primary and secondary) plus guidance. The primary legislation has been reworked as part of a project to simplify the U.K.'s tax legislation which forms part of the Corporation Tax Act 2010. The legislation now separates the property rental business from the other business activities termed as the residual business for taxation purposes.

Over the seven years from its launch, the U.K. REIT regime has evolved with a number of changes that have resulted in a more attractive REIT regime which are worthwhile to note. Key changes brought about in the regime were, relaxation of listing requirement to allow listing on secondary markets, abolition of flat 2 per cent tax charged on value of properties of groups entering the REIT market, allowing cash to be a good asset for the business test of 75:25 as also modification of stamp duty on bulk purchases of residential property, which were especially aimed at encouraging smaller real estate players seeking to start-up REITs and boosting the residential property markets.

Conclusion: REIT markets evolve with market conditions and regulatory changes

The REIT market over the years has showcased a similar growth phase in various countries like the U.S., Australia and Singapore. Initially, there was slow growth, which gradually moved to substantial growth with changes in the REIT tax and regulatory regime to make it commercially acceptable among the investors, this was followed by sector consolidation. Internationalisation of REIT has deepened the global real estate sector and boosted market liquidity.

Key takeaways from international REITs which currently do not form part of the REIT regime in India are the concepts of stamp duty

remission, overseas property portfolio and clarity on tax issues. Additionally, it is worth noting that, mere legalising REITs does not guarantee that it will take off. REIT regulators have to ensure that the REIT regime is continuously reviewed in accordance with the changing requirement of the real estate market.

Making REITs successful in India



Tax related

Tax efficiency can be critical to the success of REITs. While the basic framework for one-level taxation has been laid down by the Finance (No. 2) Act, 2014 and supplemented by the Finance Bill, 2015 certain challenges persist in structuring a REIT. It is critical that the government considers further amendments to the Income tax Act to provide a tax efficient and stable regime for REITs in India. Some of the key challenges in the current taxation regime at various levels of the REIT structure are elaborated below:

- Provisions are made to exempt the transfer of shares of the SPV by the sponsor in exchange of REIT units and not direct transfer of the property to the REIT. Holding property can be beneficial as it saves on SPV level distribution taxes, however the lack of exemption to sponsors is likely to deter direct holding of properties by REITs.



- The exchange of shares of the SPV for units of REIT would happen at the market value and could result in profit in the hands of the Sponsor, which could entail tax liability in the hands of the Sponsor under the provisions of Minimum Alternate Tax ('MAT'). Since exchange of shares for REIT units is merely to set-up the REIT and is not per se a commercial transaction, the Government may consider exempting the same from MAT.
- In a case where the SPV is primarily funded by share capital, normal corporate taxes would be applicable at the SPV level and any distribution of profits by the SPV would entail distribution taxes. Exemption from distribution taxes should be provided to the SPV to the extent it distributes dividends to the REIT.

- Requirement of holding the REIT units for more than 36 months to qualify as long-term capital asset may act as a disincentive for investors to invest in the REIT vis-à-vis listed equity shares where the period of holding to qualify as long-term capital asset is more than 12 months. Parity is required to make it lucrative for investors to invest in units of a REIT.
- The REIT should be made a complete pass-through vehicle as against the current provisions which allows pass-through only

with respect to interest income from SPV and rental income which is taxed in the hands of the investors directly while capital gains and other income is taxed at a REIT level and exempt in the hands of the investors.

Exchange control related

Allowing foreign investment in REITs can be critical to create the necessary liquidity and depth in the market post listing of the REIT. Further, many foreign private equity players are currently invested in commercial stabilised assets and should be allowed to sponsor/ manage the REIT. Amendment to the foreign exchange control regulations on the following lines would be critical in this respect:

- Foreign portfolio investors and non-resident Indians should be permitted to invest in units of a REIT without any cap or restriction on the units that can be acquired.

- Foreign sponsors should be allowed to acquire units of REITs under automatic route. In such a case, swap of existing shares of SPV held by a non-resident sponsor with the units of a REIT should be permitted under automatic route.
- It should be clarified that a REIT with majority foreign ownership would not be subject to downstream conditionalities related to FDI.
- Managers of a REIT having FDI should be treated as a non fund based activity and should not be subject to the capitalisation norms applicable to fund based activities.



Stamp duty related

Given that there are no corporate tax related concessions at the SPV level, it would seem attractive for REITs to hold the properties directly. However, this may not be feasible for REITs in India given the high state stamp duties and registration costs applicable in various states on acquisition of properties.

The transfer of assets at the initial stage of setting-up a REIT could be regarded as a transfer, which may attract stamp duty thereon, which, ranges from approximately 5 per cent to 10 per cent depending upon the state in which the property is located.

In this regard, the government ought to consider making the stamp duty uniform across the states or consider waiving the stamp duty where a REIT holds property over a specified period of years, in line with Singapore REITs or alternatively, the state governments could consider a one-time waiver of stamp duty on transfer of assets to REITs or SPVs owned by REITs.

Table 4

Rates for stamp duties and registration costs in some key cities are provided below:

Cities	Stamp duties	Registration charges
Mumbai, Pune (Maharashtra)	5%	1%
Delhi	4-6%	1%
Gurgaon	6-8%	INR 100- 15000
Chennai	7%	1%
Hyderabad	5%	0.50%
Bengaluru	5%	1%
Kolkata	6-6%	1.10%

Source: Government websites

Other regulations

Further, changes in some other regulations can help to enhance the REIT regime in India. Some of the potential changes are stated below:

- Inclusion of units of REITs set-up as a trust in the definition of 'security' as per the Securities Contract (Regulation) Act, 1956
- Changes in the SEBI Foreign Portfolio Investors (FPI) regulations and Foreign Exchange Management Act (FEMA) to allow foreign investment in units of REITs at the time of an IPO or listing on the stock exchange
- Insurance Regulatory and Development Authority's (IRDA) investment regulations to be tweaked to allow insurance companies to invest in REITs, thereby enabling REITs to have a wider investor base. Similarly, changes should be brought about in the provident fund regime, by notifying REITs as an eligible investment in the prescribed pattern of investment.

Concluding remarks

In the near future, we expect the REIT vehicle to increase the depth of the Indian property market through enhanced transparency and governance standards along with monitoring of the REIT's performance on a regular basis by the financial media. The REIT Regulations fix the roles and responsibilities of stakeholders with respect to the underlying property in terms of valuation, structural audit, safety audit and insurance of the property at regular time periods. Besides adequate and timely disclosure on important developments relating to the REIT, it also prescribes the quantum and timelines for income distribution. In case of violations on aspects ranging from delay in allotment of units to distribution of income to unit holders, it has listed the consequences as well.

Table 5

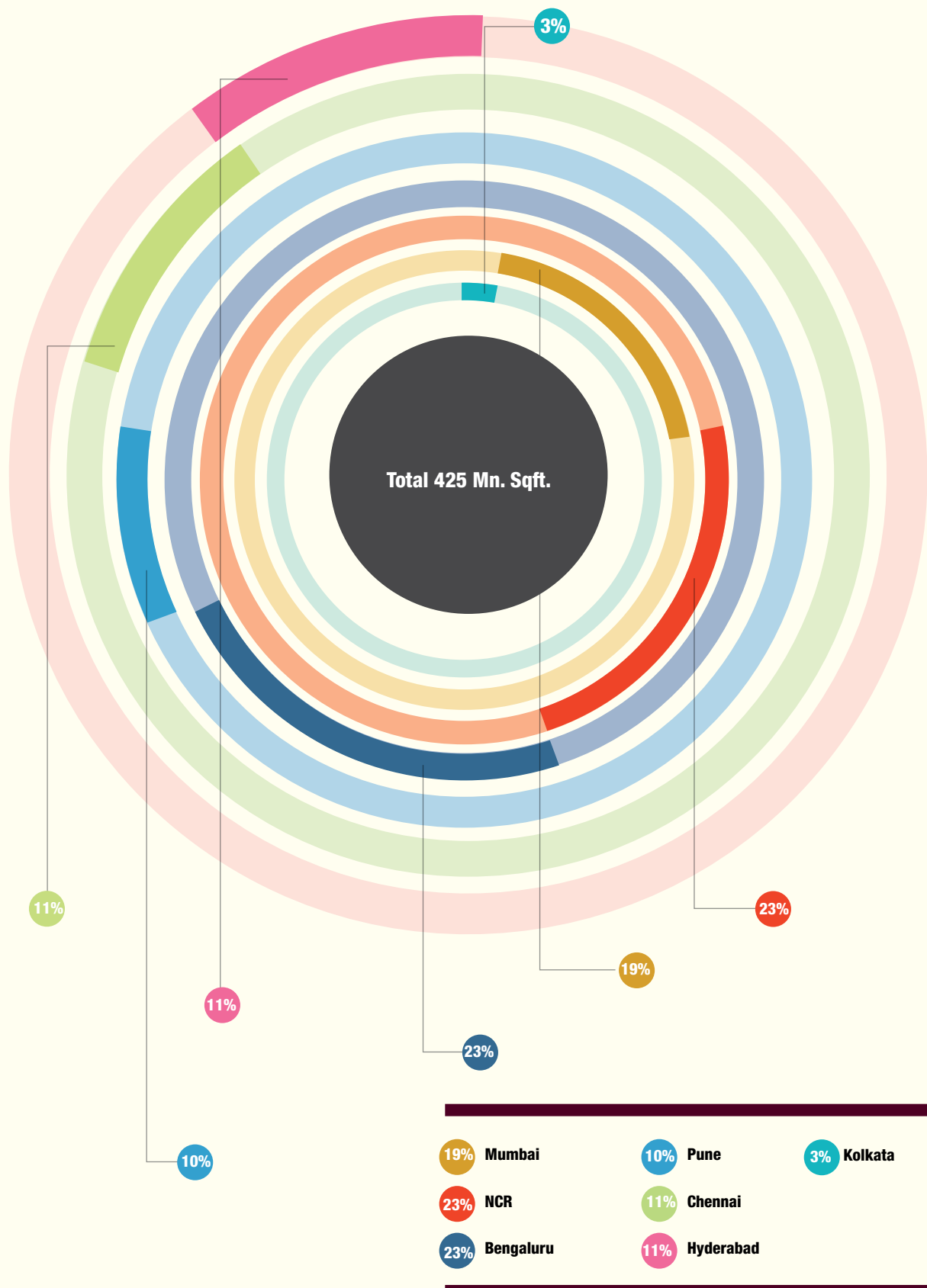
Select eligible REIT property segments

Property type	Potential REIT-able space (million sq ft)	Potential Value (USD billion)
Office	425	52
Retail	64	16
Warehouse	919	28
Total	1,408	96

Source: Knight Frank Research

Distribution of occupied office space

Chart 4



The REIT-able arena may cover completed and rent-generating real estate assets. It is estimated approximately USD 96 billion or 1.41 billion sqft occupied CRE across office, retail and warehouse segments that could potentially benefit from the REIT opportunity. In the case of office and retail, the top seven cities, namely Mumbai, NCR, Bengaluru, Chennai, Hyderabad, Kolkata and Pune, have been considered. The all-India estimate for warehouse market sizing has been considered from our recently-launched India Logistics and Warehousing Report 2014. The ambit of the REIT-able universe extends to almost all rent-generating real estate. As a result, rented residential property can also be considered for the purpose of REITs. However, on account of the absence of an institutional rental market in the residential segment, it has not been considered in our REIT-able space estimates.

Learning from lessons of other countries, it is evident that the success of REITs in any country depends on that country's capability to customise the rules and regulations governing REITs in such a way that they fit into their own markets. The support of governing authorities to help ensure a less restrictive REIT regime and favourable tax transparency status can be a critical factor in the development of a vibrant REIT sector in a new market. While there is huge potential, how much and how soon this is harnessed will depend on the overall economic momentum and the acceptance of REIT as an investment vehicle.

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