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REAL ESTATE INVESTMENT TRUSTS (REITS) FOR REAL ESTATE FUNDING IN INDIA: CHALLENGES AND PROSPECTS

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Abstract
Indian real estate sector is going through a phase of changeover in the process of its development. From being an unorganized sector traditionally, the Indian real estate sector is gradually moving to become a more organized one. Financial crisis in 2008 impacted the Indian economy at large and the real estate sector in particular. The industry in India faced the heat of the global crisis in terms of a demand slowdown and more specifically severe liquidity crunch. An underdeveloped capital and debt market, coupled with limited options for raising funds further dampen cash blockage for the developers specially those who are owning or developing commercial assets. After 2008, there was a major transformation of the investment sentiment for this sector. In addition to traditional source of funding, the policy changed by Government of India (GOI) has opened up the floodgates for funds from global Real Estate Funds, Private Equity Funds, hedge funds, and strategic investors or foreign developers.

Real Estate Investment Trusts (REITs) is a recent development in the area of investment vehicle of real estate sector. REITs markets first emerged in the 1960s in the US, followed by Australia in the early 1970s. From the late 1990s, and particularly the early 2000s, various Asian governments have been passing legislation which allows the establishment of REITs. In India, the Securities and Exchange Board of India (SEBI) notified the SEBI (Real Estate Investment Trusts) Regulations, 2014 on 26th September 2014 and laid down a framework for REITs and its registration and regulation in India. This paper is an empirical study on the basis of secondary data which examines various issues related with REITs in India besides highlighting its' genesis and development.

Key Words: Financial Crisis, Liquidity Crunch, Real Estate, Real Estate Investment Trusts, SEBI.

1. Backdrop

Indian real estate sector is going through a phase of changeover in the process of its development. From being an unorganized sector traditionally, the Indian real estate sector is gradually moving to become a more organized one. Financial crisis in 2008 impacted the Indian economy at large and the real estate sector in particular. The industry in India faced the heat of the global crisis in terms of a demand slowdown and more specifically severe liquidity crunch. An underdeveloped capital and debt market, coupled with limited options for raising funds further dampen cash blockage for the developers specially those who are owning or developing commercial assets. After 2008, there was a major transformation of the investment sentiment for this sector. In addition to traditional source of funding, the policy changed by Government of India (GOI) has opened up the floodgates for funds from global Real Estate Funds, Private Equity Funds, hedge funds, and strategic investors or foreign developers.

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2. What is REITs?

Real Estate Investment Trusts (REITs) is a collective investment vehicle that invests in a diversified pool of professionally managed, investment grade real estate. The assets are typically office, residential, retail, hospitality and industrial, logistics property or any other income-generating property. Some REITs specialise in one asset type, while others offer a mixed portfolio. But the real estate should provide investors with steady income generated from rent under lease contracts and potentially capital growth.

REIT usually offers the investors with high yields and a highly liquid method of investing in real estate. It is actually a real estate company that offers common shares to the public. Thus, a REIT stock is similar to any other stock that represents ownership in an operating business. A REIT has two unique features — its primary function is to manage income-producing properties and Generally, REITs are closed-ended or open-ended companies or trusts that hold, manage, lease, develop and/or maintain real estate for investment purposes. They tend to have a broad shareholder base and are often, but not always, traded on a public stock exchange. REITs receive special tax consideration and are characterized by low transaction costs. The US

House of Representatives describes the primary motivation for introducing real estate investment trusts (REITs) as "to provide all investors with the same opportunity to invest in large-scale commercial real estate that previously was open only to large financial institutions and wealthy individuals through direct investment in such real estate".

3. Common Features of REITs

REITs generally have the following characteristics

- They are corporatized vehicles that pool money from investors for investment in real estate assets.
- REITs can only be used to invest in completed properties and not under-construction (Work-in-progress) projects.
- They are listed and freely traded on stock exchanges.
- The revenue source for REITs involve regular lease rentals and asset sale proceeds.
- Usually, REITs are closed-ended funds. The UK, however, has open-ended REIT schemes.
- REITs are mandatorily required to distribute 90% of their net income to investors every year.
- Internationally, REITs are allowed to raise debt.
- REITs are required to publish the fair value of assets and net present values (NPVs) of schemes in accordance with prescribed norms and at regular intervals.
- A REIT has a "pass-through" status for tax purposes. There is a single point tax on the investor.

4. Genesis and Development of REITs in the World

REITs were emerged in the US during the mid-1960s as a means of providing small investors the opportunity to invest in commercial real estate or mortgage lending. After gaining popularity in the US market, REITs were introduced in Australia. From the late 1990s, and particularly the early 2000s, Asian governments have been passing legislation which allows the establishment of REITs, giving tax concessions which replicate the taxation treatment of REITs globally, particularly in the US and Australia. This reflects a better understanding of the benefits REITs which offer both as an investment class and in improving the built environment and promoting economic growth.

Genesis and Development of Listed REITs

1960	1970	1980	1990	2000	2010
United States (1960)		Australia (1971)	Canada (1994)	Japan (2000)	Nigeria (2010)
Netherlands (1969)			Ghana (1994)	South Korea (2001)	Mexico (2011)
			Belgium (1995)	Singapore (2002)	Thailand (2012)
			Brazil (1995)	France (2003)	Finland (2013)
			Turkey (1999)	Taiwan (2003)	Ireland (2013)
			Greece (1999)	Hong-Kong (2003)	Pakistan (2013)
				Bulgaria (2005)	South Africa (2013)
				Malaysia (2005)	
				Germany (2007)	
				United Kingdom (2007)	
				Italy (2007)	
				New Zealand (2007)	

* Legislative framework in place: India, China and Spain (2014)

5. Genesis of REITs in India

The process of bringing the REITs structure in India began in 1996. The Security Exchange Board of India (Mutual Funds) Regulations, 1996, introduced chapter VIA, highlighting the guidelines for introduction of Real Estate Mutual Fund Schemes (REMFs). However, the mutual fund industry fails to launch REMFs due to lack of clarity, want of transparency and uncertainty prevailing in the real estate sector. Moreover, lack of regulatory framework for the real estate sector refrained mutual fund houses from launching such funds.

In December, 1999, the Association of Mutual Funds in India (AMFI) appointed a committee headed by Mr. Deepak Satwalekar (known as the "Satwalekar Committee"), to explore the opportunities and possibilities of introducing real estate investment schemes for mutual funds in India. In its report (submitted in October, 2010) the committee recommended the introduction of Open ended mutual fund structure for Real Estate Investment. On receipt of report from the Satwalekar Committee, AMFI has established another sub-committee for further investigations and to devise a working plan for launching Real Estate Investment Schemes. The said committee submitted its report to AMFI in August 2002. The Sub-committee agreed with the suggestions of "Satwalekar Committee" and recommended the 'Trust' structure as appropriate for Real Estate investments; the committee also opined for a tax benefit to the stakeholders and close ended scheme instead of open ended scheme.

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, or "The Regulation" for public comments. Many suggestions were received in order to make "the Regulation" more prominent and sturdy e.g. Participation of Foreign Investments in REIT, minimisation of transaction cost, relevant amendment in the taxation area etc. However, the regulator realized that REIT guidelines may not work in Indian structure as the Indian property market lacks profundity and liquidity. Hence the SEBI vide Notification dated April 16, 2008 amended SEBI (Mutual Funds) Regulations, 1996 so as to permit mutual funds to launch REMFs. However, the 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 involves in establishment of the REMFs are as follows:

- The aftermath of Global Recession play a crucial role in liquidity issues;
- A sound market for mortgage backed securities is lacking in India;
- Implication of stamp duty, which varies from state to state in this continent;
- No clear cut guidelines for the valuation of the assets;
- There were also some issues related with the acquiring real estate properties on long term leases.

In the process of bringing the REITs regime in India, the market regulator SEBI, for the third time on October 10, 2013 tabled the draft consultation paper on Real Estate Investment Trust (REIT) Regulations, or "the Draft Regulation". On 26th September, 2014, after getting positive feedback from all the stakeholders, SEBI notified the Real Estate Investment Trusts Regulations, 2014 and laid down a framework for its successful functioning. As per these regulations, REITs has to be registered as Trusts under the Indian Trusts Act, 1882. Further, the taxation structure of REITs was incorporated in the Income Tax Act, 1961 ("ITA") by the Finance Act 2014.

6. **SEBI Rules for REITs**

Recently, SEBI has approved basic rules for REITs called SEBI (Real Estate Investment Trusts) Regulations, 2014. These rules, in brief, are:

1. REITs shall be set up as a trust and registered with SEBI with the parties such as Trustee, Sponsor(s) and Manager.
2. The trustee of a REIT shall be a SEBI registered debenture trustee who should not be an associate of the Sponsor/Manager.
3. REIT shall invest in commercial real estate assets, either directly or through SPVs. In such SPVs, the REIT shall hold or proposes to hold controlling interest and not less than 50 % of the equity share capital or interest. Further, such SPVs shall hold a minimum of 80 % of its assets directly in properties and shall not invest in other SPVs.
4. Once registered, the REIT can raise funds through an initial offer. Subsequent arranging of funds may be made through follow-on offer, rights issue, qualified institutional placement, etc. The minimum subscription size for units of REIT shall be INR 2 lakhs. The units offered to the public in initial offer should be minimum 25 % of the number of units in the REIT on post-issue basis.
5. Units of REITs should be listed on a recognised stock exchange and a continuous disclosure in terms of the listing agreement is required. Trading lot for such units shall be INR 1 lakh.
6. Value of the assets owned or proposed to be owned by REIT should be a minimum of INR 500 crore to qualify for an IPO and minimum issue size for initial offer shall be INR 250 crore.
7. The role of the trustee is to watch the activity of the REIT and the manager assumes operational responsibilities relating to the REIT. Responsibilities of the parties involved are given in the Regulations.
8. An REIT may have multiple sponsors, not more than three, subject to each holding at least 5 % of the units of the REIT. Such sponsors shall collectively hold not less than 25 % of the units of the REIT for a period of minimum three years from the date of listing. After three years, the sponsors, collectively, shall hold at least 15 % of the units of REIT for the rest of life of REIT.
9. 80 % of the value of the REIT assets should be consist of 'completed and revenue generating properties' and a maximum of 20 % of the value of REIT assets may be invested in the followings:
    - Developmental properties;
    - Mortgage backed securities;
    - Listed or unlisted debt of companies or body corporate in real estate sector;
    - Equity shares of companies listed on a recognised stock exchange in India who's' 75 % of operating income consist of revenue from real estate activity;
    - Government securities, money market instruments or cash equivalents. However, investments in developmental properties shall be limited to 10 % of the value of the REIT assets.

1. An REIT shall invest in at least two projects with a maximum allotment of 60 % of value of assets in one project.
2. REIT shall allocate a minimum of 90 % of the net distributable cash flows on a half yearly basis to its investors, subject to the applicable laws.
3. REIT, through a valuer, shall undertake full valuation on a yearly basis and updation of the same on a half yearly basis; it should declare NAV within 15 days from the date of such valuation or updation.
4. The borrowings and deferred payments of the REIT shall not exceed 49 % of the value of the REIT assets at a consolidated level. In case such borrowings or deferred payments exceed 25 % of the value of the REIT assets, approval from unit holders and also a credit rating is required.
5. Detailed provisions for related party transactions, valuation of assets, disclosure requirements, rights of unit holders, *etc.* are provided in the Regulations. However, for any issue demanding unit holders' approval, voting by a person who is a related party in such transaction as well as its associates shall not be considered.

7. Challenges and Prospects of REITs in India

7.1. Taxation Related Challenges/ Recommendations

Considering international experience, tax efficiency is necessary to the success of REITs in India. While the essential framework for one-level taxation has been laid down in the Finance Act, 2014, certain challenges still exist in structuring a REIT. It is critical that the GOI should consider further amendments to the Income Tax Act to present a tax efficient and stable regime for REITs in India. Some of the key challenges in the current taxation regime at the various levels of the REIT structure are discussed below:-

- Capital gains arising on exchange of shares of SPV primarily held by the Sponsor in lieu of units of REIT (at the time of set up of REIT) should not be taxable at the time of such exchange. However, subsequent transfer of such REIT unit shall be taxable at regular rate of tax valid for capital gains i.e. 20 per cent for LTCG and 30 per cent for STCG. For this purpose, cost and period of holing of the shares of SPV should be considered in computing the capital gains on subsequent transfer of units. This is unlike an IPO of a company where LTCG arising to the promoters on sale of shares through an offer for sale or on the stock exchange post listing is exempt from tax. Given that both are same in terms of public listing, parity is required to make it rewarding for sponsors to go for a REIT.
- Provisions in tax is required for the subsequent transfer of REIT units received in exchange of shares of the SPV but limited up to the value of the property at the time of such exchange and not in respect of the appreciation in the value thereof or the value of the REIT units thereafter. The gain accruing on account of appreciation in the market value after transfer to REIT and listing of REIT units should be treated as any other investment in REIT units and should not be taxed.
- Necessary provisions should be made in the Income Tax Act to exempt the exchange of REIT units only against the shares of the SPV and not direct transfer of the property to the REIT; however, the SEBI regulation allow the REIT to hold the asset directly as well. Absence of specific tax provisions to exempt such transfer of property to the REIT directly will act as a dampener especially where properties are not held by the sponsor in separate SPVs.
- The exchange of shares of the SPV for units of REIT should be made at the market value and should not result in augmentation in profit of the Sponsor; which may entail tax liability in the hands of the Sponsor under the provisions of Minimum Alternative Tax (MAT) even though there is no taxation under normal provisions.
- When SPV is primarily funded by the share capital, normal corporate tax can be applicable at the SPV level; therefore any distribution of profits by the SPV would entail distribution tax. This can absorb a significant portion of the yield and make it considerably unattractive for investors to participate. A minimum exemption from the distribution tax should be allowed to the SPV to the extent it distributes dividends to the REIT.
- Capital structure of SPV which are primarily funded by share capital may need to be re-structured to a sensible mix of debt and equity for the REIT to be able to extract cash from the SPV by fulfilling tax and regulatory provisions. It should be specifically clarified that any interest paid by SPV to the REIT is a deductable expenditure from a tax perspective.
- Requirement of holding the REIT units for more than 36 months to identify as long term assets may dishearten the investors to invest in REIT *vis-a-vis* listed equity shares where the period of holding to qualify as long term assets is more than 12 months. Therefore parity is required to make it lucrative for investors to invest in units of REIT.
- The REIT should make a complete pass through vehicle as against the current provisions which allow such advantages only with respect to interest income from the SPVs which is taxed in the hands of the investors directly while other income is taxed at REIT level and exempt in the hands of the investor.

7.2. Exchange Control Related Challenges/ Recommendations

Allowing foreign institutional investment in REITs is vital for creating adequate liquidity and depth in the market (post listing of REIT). Again, many foreign private players are currently invested in commercial stabilised assets and should be

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allowed to manage or sponsor the REIT. Therefore, necessary amendment of foreign exchange control regulation is required in the following ways –

- Foreign portfolio investors and High net worth individuals (HNIs) should be allowed to invest in units of REIT without any cap or restriction on the units that can be purchased.
- 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 non-resident sponsor with the units of REIT should be legalized under the automatic route.
- It should be clarified that a REIT with majority foreign ownership should not be affected by the downstream conditionality related to Foreign Direct Investment (FDI).
- Management and control of REIT having FDI should be treated as a non-fund based activity and should not be assessed in terms of capitalisation norms applicable to fund based activities.
- REITs should be permitted to avail External Commercial Borrowings (ECBs) from non-residents.

7.3. Market Related Challenges/ Recommendations

Over the past few years, the commercial rental yield in India is in the range of 6.5 % to 10 % p.a. But, at this level of yield, income arising from REIT would be incompetent as compare to bank deposits or liquid fund where the return is around 8 % p.a.; therefore, REITs should look at capital appreciating in properties under the condition of high volatility in prices of commercial real assets which may result increase in riskiness of the investment in REITs. Thus there is a persistent challenge in maintaining the yield from REITs higher than other investment avenues to attract the investors.

8. Conclusion

Urbanisation is a trend which probably cannot be reversed or avoided in India. Having realised the potential and need for an adequate urban development strategy, the GOI has taken significant steps by allocating significant amount of funds towards urban infrastructure. As a growth carrier, it is essential to develop the real estate sector to support the growth of over 300 other sectors and employment. However, the key challenge is the lack of technology and funding, where a massive gap is exists. Realising the challenges at hand, several key reforms have been introduced recently and many more are lined up to improve global inflow of funds and promote growth of the sector. Launch of REITs in current times is expected to be a major relief for developers and can be an important reform in the real estate sector. REITs could be a game changer for commercial real estate sector in India, which is beginning to see a renewed interest from global investors. However there are some taxation and regulatory aspects with respect to pricing and asset quality, which needs detailed planning on behalf of GOI.

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