

**REITs:**  
**Providing Liquidity to  
Illiquid Assets!!**

- **Anup P. Shah**

**27<sup>th</sup> December, 2014**

**Seminar on Real Estate**

**WIRC of ICAI**

# Commercial Concept

# REITs in USA

- **Established in 1960**
- **300+ REITs in USA**
- **Market Cap of 216 Listed REITs = \$816 bn.**
- **Own \$1.7 tn of Commercial RE**
  - **Over 40,000 Commercial Properties owned by REITs**
- **Paid \$34 bn in Dividends in 2013**
- **Avg. Debt Ratio : 46%**
- **Raised \$35 bn from Public in 2014**

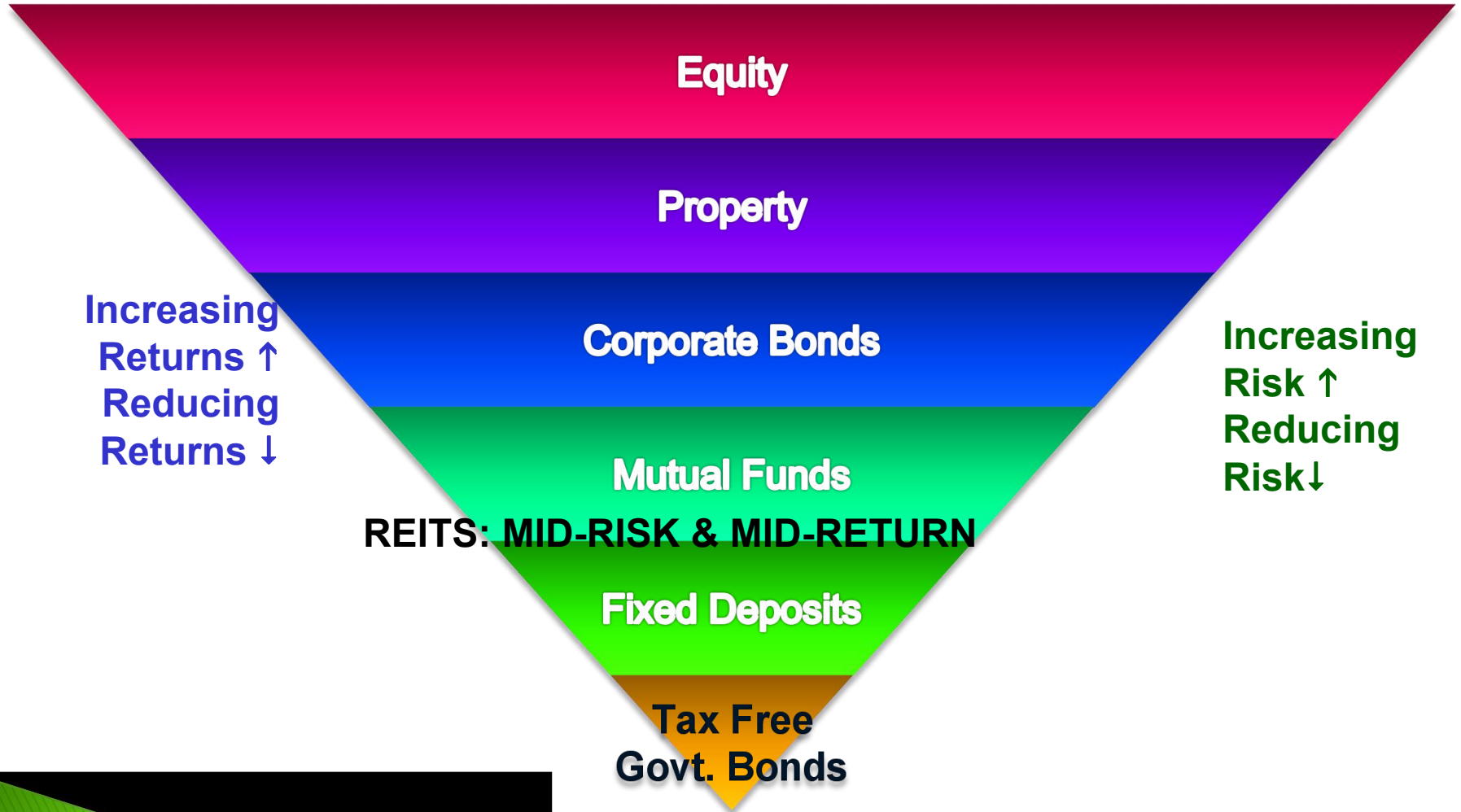
# Commercial Concept

- **Popular way of monetising commercial real estate**
- **Excellent value unlocking tool for Developers, esp. In Retail & Commercial space.**
- **India has over 350 million sq.ft. of Grade A leased offices which can be monetised through REITs**
- **Developers often prefer a lease model for commercial spaces.**
- **REITs typically invest in constructed and leased-out comm'l properties**

# Commercial Concept

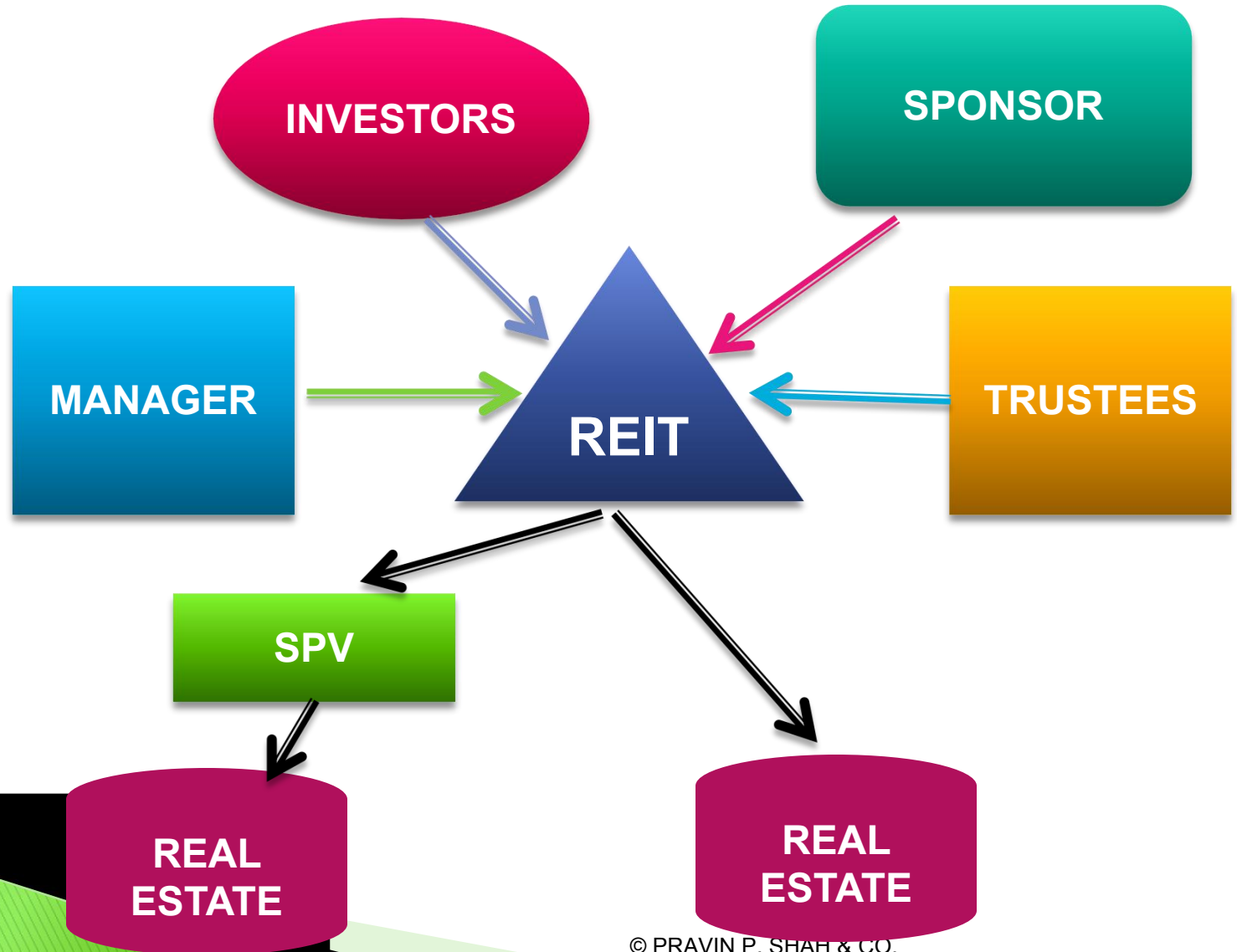
- **Developers often prefer a lease model for commercial spaces**
- **REIT makes IPO to various investors and raises funds**
- **REIT acquires the leased assets from developers or shares in the company (SPV) owning such assets**
- **Risk element associated with real estate of investing in under construction properties is substantially done away with**

# Investment Classes



# Regulatory Aspects

# REIT-Structure





# Key Players

- ▶ **Concept similar to a MF**
  - **REIT – A Trust**
  - **Sponsor – Developer who sets up the Trust**
    - **Introduces his Yield Portfolio in the REIT**
  - **Trustees – of the REIT**
  - **Manager – Professional Manager (AMC)**
  - **Unitholders – Investors of the REIT**
  - **Valuer – Values the REIT's portfolio**

# Sponsor

- **Sets up the REIT**
  - **Max. 3 sponsors**
  - **Net Worth as a whole  $\geq$  Rs. 100 cr.**
    - **If multiple then each  $\geq$  Rs. 20 cr.**
  - **5 Yrs experience in RE Indst / Fund Mgmt / Development**
    - **If Developer = at least 2 Projects completed**

# Manager

- **Manages the REIT = similar to AMC in MF**
  - **Net Worth  $\geq$  Rs. 10 cr. If Co. Or Net Assets  $\geq$  Rs. 10 cr. if LLP**
  - **5 Yrs experience in Advisory / Fund Mgmt / Property Mgmt in in RE Ind or Development**
  - **At least 2 key personnel with 5 Yrs exp.**
  - **50% of Board is Independent & Not on Other REITs**

# IPO

- **Must within 3 yrs of Regn. else cancellation**
  - **Min. Value  $\geq$  Rs. 500 cr.**
  - **IPO Size  $\geq$  25% to Public**
  - **Offer Size  $\geq$  Rs. 250 cr.**
  - **Subsequent: FPOs, Pref. QIP, Bonus, Rights, OFS, etc.**
- **Sponsor:**
  - **Must hold 25% of Total units post IPO**
  - **Must hold 15% of Units in aggregate at all times**
    - **Individually 5% at all times**
  - **3 Yrs lock-in from listing + Re-designate New Sponsor**

# Investors

- ▶ **REIT can allot units to both residents and non-residents.**
- ▶ **Investment by non-residents shall be subject to FEMA Regulations**
- ▶ **REITs should have a minimum of 200 public unit holders at any point in time**
- ▶ **Minimum subscription – Rs 200,000 with minimum tradable lots of Rs 100,000**

▶

# Listing & Delisting

- **Continued Listing:**
  - **Public: 25% of all Units + 200 Holders at all times**
- **Compulsory Delisting**
  - **Public Holding or Number dips**
  - **No Projects in REIT > 6 mts.**
  - **Can also go for Voluntary Delisting**
- **Redemption of units:**
  - **Only at Buyback or Delisting**

# Investment by REITs



# Investment by REITs

- **REIT must invest at least 80% of the value of the REIT assets in completed and rent generating properties:**
  - **A completed property = property for which OC is received.**
  - **A rent generating property = rented / leased out**
    - **Draft: At least 75% area should be leased out**
  - **If project in phases = only rent-generating portion considered**
  - **75% of Revenues of REIT from Renting, Leasing of Real Estate Assets**
  - **Min. Two Projects but Max. 60% of Assets' Value from One Project**
  - **Can be Commercial / Res / Retail but must be Rented out**



# Investment by REITs

- **80% of REIT assets in completed & rent generating properties:**
  - Real Estate / Property ~ Land (leasehold or freehold), Buildings, Garages, Warehouses, Parkings /TDR
  - Any Asset = Infrastructure ≠ Real Estate / Property
  - Could be owned directly / via SPV ~ **Hard Assets possible**
  - SPV = Co. or LLP
    - Min. 50% held by REIT
    - Min. 80% of Assets of SPV in direct Properties (not in other SPVs)
    - No Other Activity by SPV
    - **Must be an Indian Company only cannot be Foreign SPV**

# Investment by REITs

- **80% of REIT assets in completed & rent generating properties:**
  - Can co-invest on not less favourable terms
  - No other Shareholder of SPV can have rights which prevent REITs from Dividend Payout obligations
  - REIT would appoint 1 Rep. on BoD of SPV
  - REIT will vote on GMs of SPVs
  - Can't invest in
    - Vacant land
    - Agr. Land
    - Mortgages (other than mortgage-backed securities)

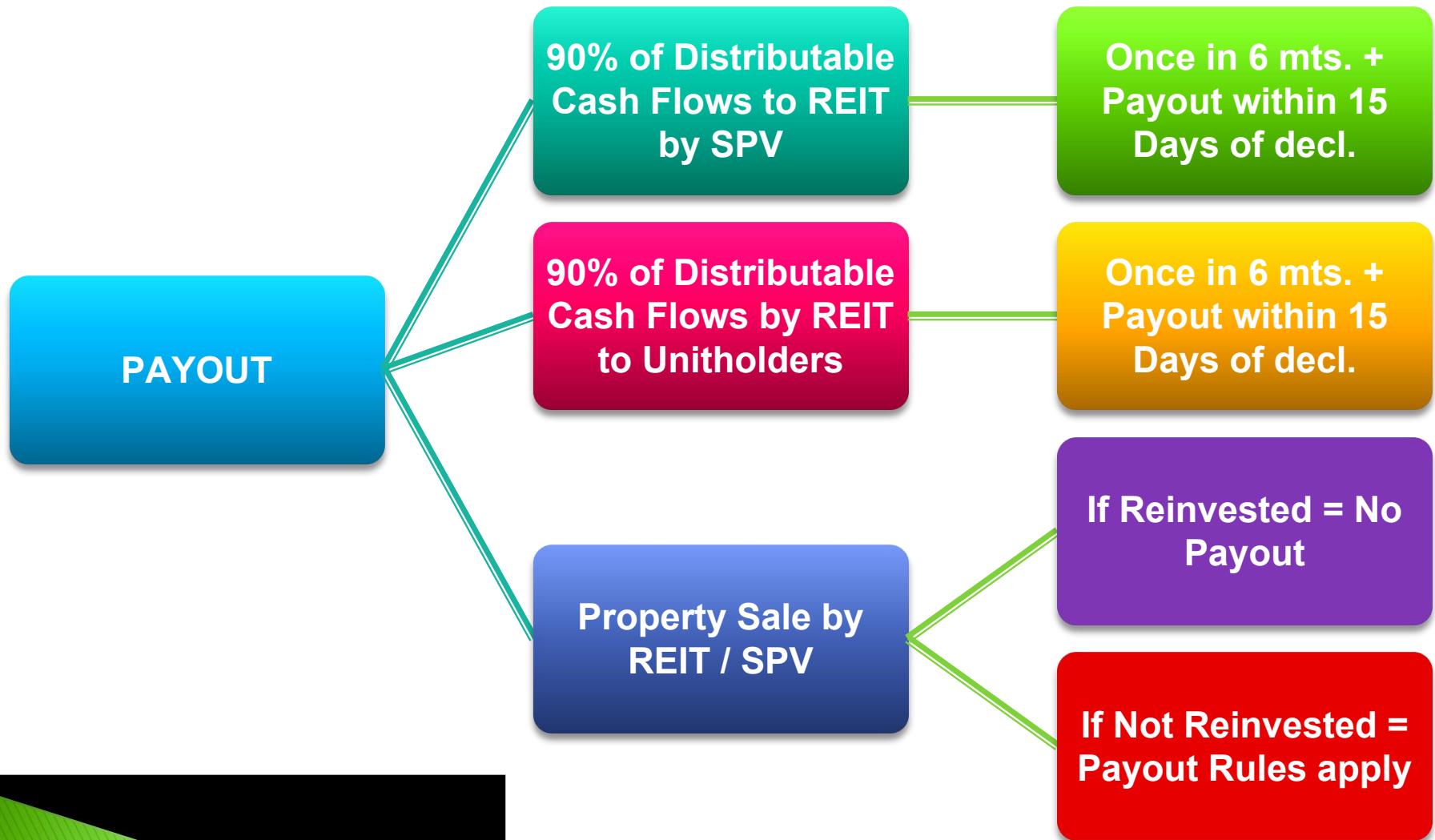
# Investment by REITs

- **Balance 20% in other assets**
  - **Of which max. 10% in under-construction properties / completed but rent generating properties**
    - **But REIT must hold for Min. 3 Years**
  - **Debt of Realty Cos.**
  - **Listed Equity Shares which get 75% Income from Real Estate**
  - **Unutilised FSI of a Project in which it has made investment**
  - **MMF / FDs**
  - **Can't invest in Units of other REITs**
- **For sale of Property or sale of shares in SPV by REIT  $\geq$  10% of Value of REIT = Approval of Unit holders**

# Leveraging

- **Aggregate Borrowings & Deferred Payments  $\leq$  49% of Value of REIT Assets**
  - **Not Including Refundable Deposits of Tenants**
  - **If Borrowings  $>$  25% of REIT Assets, then for fresh leveraging:**
    - **Credit Rating**
    - **Approval of Unit Holders**

# Dividend Payout Policy



# Valuation

- ▶ **Key to Mutual Fund is NAV ~ same is the case with a REIT**
- ▶ **Full valuation of REIT's assets - Min. at Year End by 30<sup>th</sup> June**
- ▶ **Full valuation includes a detailed valuation of all assets**
- ▶ **Half yearly valuation a must for key changes in past 6 months**
- ▶ **A valuation is also required to purchase or sell a property.**
  - **Variation in excess of 10% to the valuation requires Unitholders' approval**
- ▶ **CAs with 10 years experience can act as Valuer / Regd. Valuer under Companies Act**

▶ 4 years

# RPTs

RPT	Compliance
Purchase / sale of Properties at any time	Price = Avg of 2 Ind. Valn. Reports
RPT before IPO	Disclosures in Prospectus + Proper Agr.
RPT after IPO	Disclosures to St.Ex. + UH's prior Approval if RPT $\geq$ 10% Value of REITs
Lease to RPs by REIT	Valuer's Fairness Opinion if: <ul style="list-style-type: none"> <li>• Lease Area &gt; 20% of total area</li> <li>• Value of leased area &gt; 20% of REIT Value</li> <li>• Rentals &gt; 20% of Total Rental</li> </ul>
2 or more REITs with Common Manager	Deemed RPT
RP has competing business with REIT activities	Details in Prospectus

# Auditor of REITs

- **Appointed for max. 5 yrs + reappoint. for another 5 years**
- **Audit Min. Twice a Yr – Sept & March**
  - **A/R within 45 days of these periods to St Ex.**
- **A/C & Auditing Standards may be specified by SEBI**
- **A/C, B/s, P&L, CF give T & F View of State of Affairs**
- **Right of access to all Books & Vouchers pertaining to REIT**
  - **Right to Info. & Expl. Pertaining to REIT as he deems fit from:**
    - **Employees of REIT**
    - **Parties to REIT / SPV**
    - **Any other person in possession of such information**



# Taxation Aspects

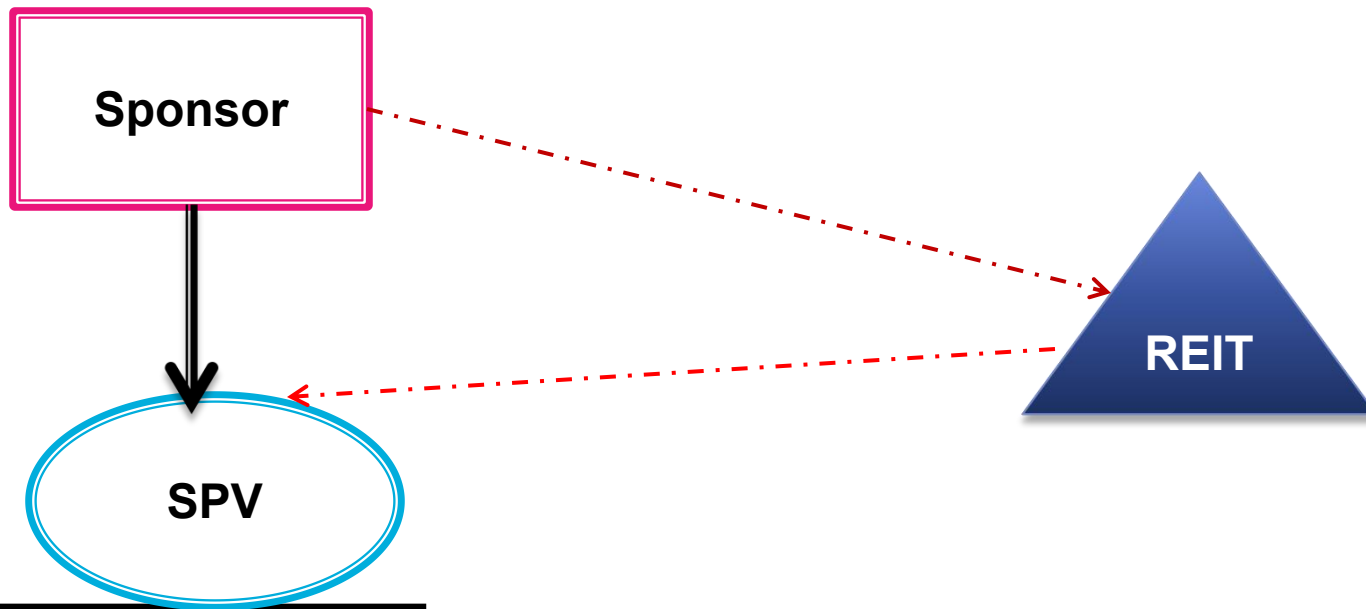
# Income Streams

Entity	Income Stream
<b>SPV</b>	<ul style="list-style-type: none"><li>• Lease Rentals from renting out property</li><li>• Capital Gains on selling the Yield Properties</li></ul>
<b>REIT</b>	Dividends distributed / Interest paid by SPV
<b>Unitholders</b>	<ul style="list-style-type: none"><li>• Distributions made by the REIT</li><li>• Sale of Units on Stock Exchange / Off-market</li></ul>
<b>Sponsor</b>	Same as Unitholders
<b>Manager</b>	AMC Fees + Carry (2-20 Model?)
<b>Trustees</b>	Trusteeship Fees

# Taxation – Sponsor / Developer

## ► Exchange of SPV shares for REIT Units

- Transfer Exempt u/s.47(xvii) ∴ No CGT ~ If SPV Capital Asset of Developer
- But MAT yet applicable – Of what use is this exemption??
- Q. What if shares of SPV treated as Stock in trade of Developer?
- Similar Exemption NA for Physical Assets exchanged with REIT!



# Taxation – Sponsor / Developer

- ▶ **Sale of REIT Units: On Market OR Off-Market**
  - **Taxable as Capital Gains – Exemption u/s.10(38) Not Available**
    - Thus, gains on exchange postponed but not fully exempt
  - **Cost of REIT Units = Cost of shares of SPV**
  - **Period of holding shares of SPV added to that of Units**
  - **LTCG if > 36 months, else STCG**
  - **STCG u/s.111A – Taxed @ Normal Slab Rates**
  - **LTCG**
    - Taxed @ 20% with Indexation or
    - 10% without Indexation
  - **can be set-off against LTCG on Units**

# Taxation – Sponsor / Developer

- ▶ **Sale of REIT Units: On Market OR Off-Market**
  - If Shares of SPV held as Business Assets by Developer
  - **Exchange = Taxable u/s. 28**
  - Q. of Valuation of Units of REIT received in return of shares
  - FMV of Units becomes sale consideration
  - FMV of Units would become cost of acquisition of Units when subsequently sold by Developer

# Taxation – SPV

## ▶ Tax

- Normal Tax @ 30% + SC + Cess
- No Exemption from MAT @ 20% - Big Negative

## ▶ Interest to REIT

- REIT is a Pass-through Vehicle
- No TDS @ 10% on Payment to REIT

## ▶ Dividend distributed to REIT

- DDT u/s.115-O payable @ 20%
- Biggest Disadvantage of current regime

Investor drastically

# Taxation – SPV

## ▶ Income stream of SPV

- House Property Income
- Disputes over whether Fair Market Rent can be substituted for Actual rent received by SPV
  - Can Notional Interest on security deposit be added back?
  - **Moni Subba (Del FB)**
  - **Tip Top Typography (Bom)**
  - **KD Ambani (Bom)**

# Taxation – REIT

## ▶ Interest from SPV

- Exempt u/s.10(23FC)
- No Tax in hands of REIT, i.e., REIT is a Pass-through Vehicle
- No TDS by SPV also

## ▶ Dividend from SPV

- Exempt in hands of REIT
- SPV pays DDT @ 20%

## ▶ Sale of Assets by REIT

- Capital Gain Taxable at applicable rates



# Taxation – REIT

- ▶ **Any Other Income**
  - ▶ **Taxable at MMR @ 30% u/s.115UA**
    - ▶ **HPI if Assets held directly by REITs**
    - ▶ **Management Fees charged from SPVs, if any?**
  - ▶ **REITs must file Return of Income**

# Distribution to Unitholders by REIT – Withholding Taxes

- ▶ **Distribution relation to Interest from SPV**
  - TDS by REIT @ 5% on payment to Non-Residents
  - TDS by REIT @ 10% on payment to Residents
- ▶ **Distribution relation to Dividend from SPV**
  - Exempt – No TDS
- ▶ **Distribution relation to Capital Gain on Sale of Assets by REIT**
  - Exempt – No TDS

# Taxation – Investors / Unitholders

## ▶ Interest from REIT

- Residents: TDS by REIT @ 10% & Taxable @ Normal Rates
- Non-Residents: TDS by REIT @ 5%

## ▶ Dividend from REIT

- Exempt – No TDS by REIT whether Resident or Non-Resident Unitholders

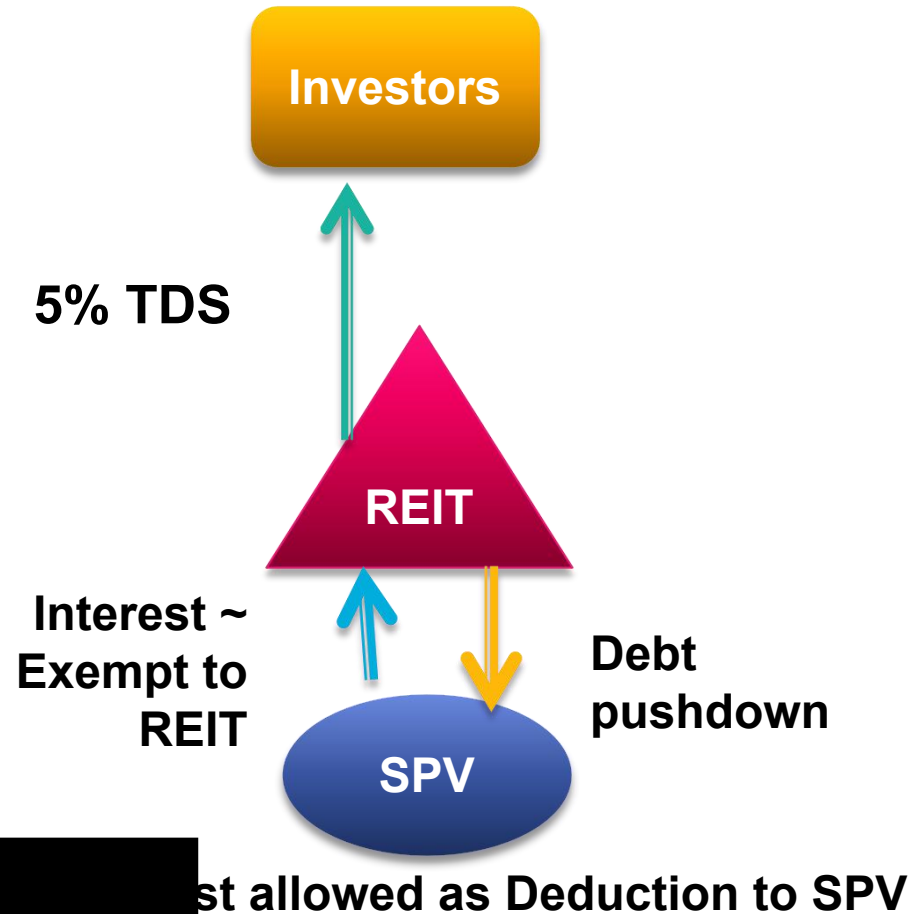
## ▶ Distribution of Capital Gain on Sale of Assets by REIT

- Exempt – No TDS by REIT whether Resident or Non-Resident Unitholders

## ▶ Capital Gain on Transfer of Units

- On-Market: LTCG – Exempt / STCG – Taxed @ 15% - **Not for Developer**
- Off-Market: LTCG – Taxed @ 20% with Indexation / 10@ without Indexation
- Off-Market: STCG – Taxed @ Normal Slab Rates

# Possible Tax Savings?



# Possible Tax Savings?

- **How would REIT acquire Debt Securities of SPV?**
  - **Exchange with Sponsor?**
    - No tax break for Sponsor
  - **Invest in fresh Debt issued by SPV out of IPO proceeds**
    - What would SPV do with this fresh debt?
    - Acquire assets from Sponsor – NO CGT Exemption on this Sale to Sponsor
  - **Heads, Sponsor loses, Tails REITs wins!!**

# Possible Tax Savings

- **Consider SPV as a LLP**
  - **No DDT @ 20% -Huge Saving!**
  - **Share of Profits given to REIT = exempt for REIT**
  - **No MAT**
  - **Negative: No CGT exemption to Developer on exchange of Interest in LLP for Units of REIT unlike in Co.**
    - **Investors gain at cost of Developer?**

# Speed Breakers

# Speed Breakers Ahead

- **Drive with Caution!**
  - **Stamp Duty on SPVisation**
    - **Property held in Flagship Co. or directly to SPV**
    - **5% in Maharashtra on SDRRV**
    - **Exchange attracts SD on Higher of two values**
    - **SD Exemption for Transfer to 90%+ Sub?**
    - **Available in Maharashtra?**
    - **Yet Valid?**
    - **Should there not be an Exemption for SPVs for REITs?**



# Speed Breakers Ahead

- **Income-tax Hurdles**
  - **Sponsor**
    - **Period of holding for Listed Units is 3 years to qualify as LT?**
    - **Exemption only on transfer of SPV Shares and not on transfer of Real Estate**
  - **Investors**
    - **Availability of Foreign Tax Credit for non-resident Unit holders of taxes paid by SPV**

# Speed Breakers Ahead

- **FEMA**
  - **Auto Route for Foreign Investment in REITs?**
  - **Auto Route for Swap by Foreign Sponsors of SPVs**
  - **FIPB Approval required?**
  - **RFPIs can Invest?**
  - **Renting of Properties ~ Is it not RE Business as per RBI?**
  - **ECBs by SPVs and REITs not allowed**
- **Other**
  - **State Rent Control Laws should not be a Hindrance**
  - **Property Taxes should not be a dampener!**

# Thank You