

REITs- Key Considerations and the Way Forward



Rajiv Luthra
Founder & Managing Partner
Luthra & Luthra Law Offices



Vishal Yaduvanshi
Partner
Luthra & Luthra Law Offices

1. Background

Providing investors an investment opportunity in stable, income-generating developed properties on one hand, and facilitating developers to exit mature projects and gain liquidity on the other hand, a real estate investment trust (“REIT”) is an established investment vehicle in a number of developed economies. In India too, with a growing real estate sector, the need for such an investment vehicle was felt for some time.

The Securities and Exchange Board of India (“SEBI”) had previously released draft guidelines for REITs in 2008. While the draft guidelines of

2008 provided for a REIT to float various schemes, the draft guidelines were later withdrawn. Subsequently, SEBI permitted mutual funds asset management companies to launch real estate mutual funds. However, primarily, on account of challenges in compliance with certain standard mutual funds norms, this product failed to launch in the market.

While the real estate sector in India has continued to grow, capital markets investment in this sector over the past few years has been slow. In this backdrop, SEBI has notified the SEBI (Real Estate Investment Trusts) Regulations, 2014 (“REIT Regulations”).

Before we move on to the listing and challenges faced on REIT transactions in India, we set out below a quick snapshot of the REIT structure as contemplated under the REIT Regulations. REITs in India are required to be set up as private trusts under the Indian Trusts Act, 1882 and should be registered with SEBI under the REIT Regulations.

- (i) **Parties:** The principal parties in a REIT are the sponsor, the trustee and the manager. The sponsor sets up the REIT and appoints a trustee, and while its day to day operation and management is conducted by a manager appointed by the trustee. The trustee holds the property on behalf of the unit holders and plays a supervisory role. There can be up to three sponsors of a REIT, collectively holding a minimum of 15% (25% for the first 3 years) of the total outstanding units of the REIT at all times.
 - (ii) **Structure:** A sponsor must transfer the controlling interest and at least 50% of the equity share capital in the special purpose vehicle (SPV) to the REIT. The sponsor can retain only such equity share or interest in the SPV as may be requirement by applicable law or as specified by a regulatory authority. The SPV shall only engage in activity of holding and developing property, and shall hold at least 80% of its assets directly in properties and cannot invest in other SPVs.
 - (iii) **Investment conditions:** The value of assets owned by a REIT shall be at least Rs. 500 crores at listing. A minimum 80% of value of the REIT assets should be invested in completed and rent generating properties and only up to 10% of the value can be invested in under-developed projects. REITs can only invest in securities, properties or transferable development rights in India and are prohibited from investing in vacant land or agricultural land or mortgages (other than mortgage backed securities) or units of other REITs.
 - (iv) **Income and Distribution:** At least 75% of the revenues of a REIT (other than gains on account of disposal of properties) should come from rental, leasing and letting out real estate at all times. At least 90% of net distributable income of a REIT (and the downstream SPV) is required to be distributed to unit holders.
 - (v) **Borrowings:** Aggregate consolidated borrowings and deferred payments of a REIT shall not exceed 49% of the value of the REIT assets.
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Listing

A REIT is required to make initial offer of its units mandatorily by way of public offering. The units proposed to be offered to the public should be at least 25% of the total outstanding units of the REIT. In order to undertake the public offering-

- (i) The manager shall file a draft offer document with SEBI and designated stock exchange and document shall be made available for public review.
- (ii) SEBI may communicate its comments within 21 working days.
- (iii) The final offer document, incorporating the comments received, shall be filed with designated stock exchange at least five working days before opening of the offer.
- (iv) The offering to public can be open for subscription for a period of up to 30 days and price of units issued shall be determined by way of book building method.
- (v) The public offering shall be considered to be successful if at least 75% of the issue size is subscribed and at least 200 subscribers are allotted units under the offering.

The initial offer by a REIT shall be made within three years from the date of registration with SEBI and not more than six months from the date of observations from SEBI. The minimum offer size offered to public in the initial offer shall be at least Rs. 250 crores and minimum subscription from each applicant in the initial offer shall be Rs. two lakhs.

2. Key issues for consideration

Disclosure requirements

The REIT Regulations require considerably limited disclosures in the offer document compared to requirements for initial listing of equity shares. There is no requirement to make extensive disclosure about the sponsor or entities related to sponsor (disclosed as promoter group and group companies in equity offerings). Further, unlike equity offerings, disclosures on litigations can be limited to only material litigations and regulatory actions. However, there are certain disclosure requirements which merit further consideration:

- (i) The entities for which material litigations are required to be disclosed need to be clarified. The REIT Regulations suggest that such disclosures should be provided for 'associates' (either of sponsor, manager, trustee or valuer) and the definition of 'associate' is quite broad. If a literal interpretation of the regulations is applied, it will cover large number of entities, some of which may not be relevant to the REIT and may be considered to defeat the purpose of providing limited disclosure of litigations.
- (ii) The REIT Regulations require disclosure of projections of income of the REIT over the next three years. While disclosure of projections in offer document is not permitted in various jurisdictions, and in some jurisdictions, such disclosure is required to be limited to a much shorter period. If the requirement to disclose projections in the offer document continues to be mandatory, it may result in the offering by REIT not to be made to investors in many key jurisdictions which may affect the success of such an offering.

Asset structure

The REIT Regulations suggest that a REIT can own its properties either directly or through an SPV. In case of acquisition of, and holding of assets through, an SPV, the regulations require that the REIT should hold a controlling interest in the SPV. However, the REIT is required to hold at least 50% of equity share capital of the SPV and does not recognize any other form or manner of control that can be exercised by the REIT over the SPV, for this purpose. This may result in lack of structuring options available with the sponsors while setting up a REIT.

Further, in case a REIT holds assets through an SPV, the REIT Regulations mandate that such SPV should hold at least 80% of its assets directly in properties and should not invest in other SPVs. In other words, the regulations suggest only level of subsidiary through which REIT can hold its properties. It is interesting to note that comparable provisions under the rules for the Companies Act, 2013 provide for more than one level of step-down subsidiaries for a company.

Leaseback of the REIT assets

As a departure from the draft of the REIT Regulations, which allowed a REIT to lease a maximum of 20% of the area of its assets to its related parties, the REIT Regulations provide that a REIT can lease its entire rental area to related parties, subject to a fairness opinion from valuer and approval of the unit holders. This enables entities that own and utilise real estate assets to package and transfer the property into a REIT and then enter into a lease back arrangement with the REIT for the continued use of the property. This has the potential to become a major focus of interest for large group and corporates possessing considerable real estate assets.

Voting rights and classes of units

Subsequent to the initial public offering, a REIT is permitted to raise capital, *inter alia*, by way of preferential allotment, rights issue and qualified institutional placement. However, as per the REIT Regulations, no unit holder shall have any preferential voting or other rights over any other unit holder. Further, the REIT Regulations require that there shall not be multiple classes of units of a REIT. This may limit the flexibility of a REIT in raising future capital by inviting different class and categories of investors.

Related party transactions

The parties considered to be related to the REIT are the sponsor, trustee, manager, any unit holder holding, directly or indirectly, more than 20% of the units of the REIT and associates, sponsors, directors and partners of all such entities. The REIT Regulations propose to strictly regulate the related party transactions a REIT enters into. For instance, if total value of all related party transactions, in a financial year, pertaining to acquisition or sale of properties exceeds 10% of the value of the REIT or if funds borrowed from related parties in a financial year exceed 10% of total consolidated borrowings of the REIT, prior approval will be required from unit holders for any such subsequent transaction with any related party. Such restrictions may be an important factor to consider for large groups and real estate players.

Change in sponsor or manager

The REIT Regulations prescribe various matters for which prior approval of the unit holders is required. The process and procedure may vary depending on the matter put forward for consideration of the unit holders. The requirements of the approval of the unit holders are especially stringent in case of a proposal for change in the manager or the sponsor of the REIT. For such matters, 'super majority' of the unit holders should consent to the proposal (i.e. the number of unit holders approving the proposal will need to be at least three times more than the number of unit holders against the proposal). Further, voting by any person who is related party (or its associate) in such transaction shall not be considered. In case of proposal for change in sponsor (or change in control of the sponsor), if the proposal is rejected by the unit holders, for such change in sponsor to be undertaken, the new sponsor will need to provide an exit to all dissenting unit holders. Such strict requirements and measures have been put in place to ensure that sponsors 'have skin in the game' and continue to be invested in the business of the REIT.

3. Way forward for the REITs

While the REITs Regulations and general investment trusts framework have been getting their share of attention and focus from the regulators, there remain certain areas which need further consideration and clarity, which can help the sponsor and investor communities to pursue their interest in REITs in India further. We discuss below some of the key areas which may require such attention:

Resolving conflict of interest between REIT and sponsor

Given that sponsor will typically be entities that are engaged in development of real estate properties, the regulatory regime in many overseas jurisdictions require REITs to adopt certain measures to guard against any conflict of interest that may arise in the future. One of the key measures is for the sponsor to provide a 'right of first refusal' to the REIT, whereby the sponsor shall provide the REIT a first right over new property to be acquired by the sponsor or over existing property proposed to be sold by the sponsor, including for any competing assets. While REIT Regulations do make a mention of possible existence of such a mechanism, it has not been made mandatory. Given that in many overseas jurisdictions also, such a provision is required only by the regulator at the stage of review of offer document, SEBI's approach towards such a key concept in a REIT structure remains to be seen.

Participation by foreign and institutional investors

The REIT Regulations stipulate that investment by foreign investors shall be subject to RBI guidelines. Under the extant foreign investment laws, foreign investment in trusts (other than through a mutual fund structure) as well as in completed real estate assets is restricted. The government has recently, as a matter of policy, approved a proposal to enable foreign investors to participate in REITs. However, the extant provisions of law are yet to be amended by the Reserve Bank of India and till then there remains a lack of clarity on details and conditions under which the foreign investors may invest in REITs. Also, from the perspective of investment by investors in India, it will be important to cover units of REITs as 'security' under SCRA and bring REIT within its ambit.

Taxation

Critical amendments have been made in the taxation laws to provide REITs a pass through tax status to exempt the interest income earned from an SPV and rental income earned on properties directly owned by REITs in its hands. These incomes will be taxed in the hands of unit holders to the extent of amount distributed. Further, a sponsor swapping the shares of an SPV with the units of REITs have been exempted from capital gains tax and further sale of these units would be taxable in a similar manner as if the direct investment been made in the shares of a listed SPV. Notional gain (if any) arising on swapping of shares with units have been kept outside the purview of Minimum Alternate Tax.

These moves have brought in required certainty on taxation aspects and such concessional regime will encourage the sponsor of REITs. However, there are certain aspects that could be addressed to make it more tax efficient. The Government should consider extending the exemption to capital gains arising on the direct transfer of property by sponsor in exchange of REIT units and exemption should also be available from dividend distribution tax on dividend distributed by SPV to the REIT. In addition, the period of holding should be reduced to 12 months (as against 36 months) in order for REIT units to qualify as long term capital assets to take benefit of exemption / concessional tax rates.

4. Conclusion

The introduction of the REIT Regulations by SEBI represents a positive attempt by SEBI and the government to provide liquidity to the real estate sector and strengthen the Indian capital markets. REITs are beneficial not only for the sponsors but also the investors and the REIT Regulations reflect the effort of the regulator as a genuine attempt to align the framework in India with international best practices. However, before REITs actually take off in India, few other changes may be required to be introduced, especially from securities and exchange control laws and taxation laws perspective.

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