Opportunities for Chartered Accountants in the Sector of Real Estate and Infrastructure Investment Trusts

Through SEBI (Real Estate Investment Trusts) Regulations, 2014 and SEBI (Infrastructure Investment Trusts) Regulations, 2014, the Securities and Exchange Board of India (SEBI) laid down a framework for Real Estate Investment Trusts and Infrastructure Investment Trusts and their registration and regulation in India in September 2014. Way back in 2008, it had introduced the legal framework for real estate mutual funds by way of SEBI (Mutual Funds) (Amendment) Regulations, 2008. Real estate investment trusts are said to offer their investors an opportunity to invest in a professionally managed portfolio of real estate. Individuals invest in these trusts by purchasing the units of trust. Read on to get an idea about the real estate investment trusts and understand their benefits and risks, vis-à-vis the regulations that exist in India…

CA. Rishabh R. Adukia

(The author is a member of the Institute who may be contacted at adukia.rishabh@gmail.com.)

Introduction

The Securities and Exchange Board of India (SEBI) notified the SEBI (Real Estate Investment Trusts) Regulations, 2014 and SEBI (Infrastructure Investment Trusts) Regulations 2014 on 26th September 2014 and laid down a framework for Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) and their registration and regulation in India. As per these regulations, both REITs and InvITs have to be registered as Trusts under the Indian Trusts Act, 1882.

SEBI had introduced legal framework for real estate mutual funds on 16th April 2008 by way of SEBI (Mutual Funds) (Amendment) Regulations, 2008 and inserted Chapter VI A – Real Estate Mutual Funds Schemes (REMFs) and that for Infrastructure Debt Funds was added by inserting Chapter VI B - Infrastructure Debt Fund Schemes on 30th August 2011 to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.

REITS

REITs are often described as instruments that offer investors an opportunity to invest in a professionally managed portfolio of real estate, through the purchase of a publicly-traded investment product. Individuals invest in a REIT by purchasing units of the trust, similar to the shares of a common stock. The investment objective of REITs is to provide unit holders with dividend income, usually from rental income.

REITs are collective investment schemes that invest in a portfolio of income generating real estate assets such as shopping malls, offices, hotels or serviced apartments, usually established with a view to generate income for unit holders. Assets of REITs are professionally managed and revenues generated from assets (primarily rental income) are normally distributed at regular intervals to the unit holder. Investment goals for REITs are much the same as the goals of an investment in stocks – current income distribution and long-term appreciation potential.

The unit holder of a REIT can share the benefits and risks of owning a portfolio of property assets which typically distribute income at regular intervals. REITs normally have regular cash flows as their revenues are derived from rental payments under contractually-binding lease agreements with specific tenures, in most cases. Units of REITs are listed on the Stock Exchange and are bought and sold like other listed securities.

Infrastructure investment trusts (InvITs) are a new instrument aimed at attracting more investments into the infrastructure sector. Globally, it has been observed that several financing/refinancing structures exist which have provided a boost to infrastructure sector/specific sub-sectors including business trust model in Singapore and Hong Kong, Master Limited Partnerships in the USA, various securitisation structures, *etc.* InvITs are proposed to provide a suitable structure for financing/refinancing of infrastructure projects in the country and bring

higher standards of governance into infrastructure development and management and distribution of income from assets so as to attract investor interest.

Structure of REITs

REITs are structured as trusts and thus the assets of a REIT are held by an independent trustee on behalf of unit holders. The trustee has duties as laid out in the trust deed for the REIT which typically include ensuring compliance with applicable laws, as well as protecting the rights of unit holders.

In a typical REIT structure, money is raised from unit holders through an Initial Public Offer (IPO) and used by the company to purchase a pool of real estate properties. These properties are then leased out to tenants; and in return, the income flows back to the unit holders (investors) as income distributions (dividends).

In most cases, a sponsor or a major shareholder is also present. For example, if a property developer launches a REIT, he may choose to keep X% (say 30% to 50%) stake in the REITs itself. Like any other investor, the developer in this instance will receive income distributed as dividends, where applicable.

The underlying real estate properties are managed by a property manager and the REIT itself is managed by a REIT manager in exchange for a fee. The underlying assets are held by a trustee on behalf of the investors.

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History of REITs

REITs were created in the United States when President Dwight D. Eisenhower signed into law the REIT Act title contained in the Cigar Excise Tax Extension of 1960. REITs were created by Congress in order to give all investors the opportunity to invest in large-scale, diversified portfolios of income-producing real estate in the same way they typically invest in other asset classes – through the purchase and sale of liquid securities.

Since then, more than 20 countries around the world have established REIT regimes, with more countries in the works. The spread of the REIT approach to real estate investment around the world has also increased awareness and acceptance of investing in global real estate securities.

Around the time of their creation in 1960, the first REITs primarily consisted of mortgage companies. The industry experienced significant expansion in the late 1960s and early 1970s. The growth primarily resulted from the increased use of mortgage REITs in land development and construction deals. The Tax Reform Act of 1976 of US authorised REITs to be established as corporations in addition to business trusts.

Under U.S. Federal income tax law, a REIT is any corporation, trust or association that acts as an investment agent specialising in real estate and real estate mortgages under Internal Revenue Code Section 856. To be a REIT, a company must distribute at least 90 % of its taxable income to shareholders annually in the form of dividends.

Benefits of REITs

- REITs typically own multi-property portfolios with diversified tenant pools. This reduces the risk of relying on a single property and tenant which one faces when directly owning a real estate property.
- The REIT investor enjoys the advantage of the power of the pool of capital to acquire interests in much larger opportunities than would be available to their personal capital alone.
- Compared to investing directly in real estate properties, REIT investment offers the advantage of liquidity – the ease of converting assets into cash. REITs are listed on the stock exchange and one can trade a REIT throughout the trading day, and it is easier to buy and sell a REIT than to buy and sell properties.
- The process of buying or selling a REIT is transparent and flexible, just like trading stocks listed on the exchange. Investors can access information on the REIT prices and trade REITs throughout the trading day.

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Risks of REITs

The risks associated with a REIT investment vary and depend on the unique characteristics and features of each REIT, as well as the geographical location of the investments.

REITs are traded on the stock exchange and the prices are subject to demand and supply conditions, just like other stocks. Investors could receive less than the original investment amount when they sell their units in a REIT. The prices generally reflect investors' confidence in the economy, the property market and its returns, the REIT management, interest rates, and many other factors. Like other stocks, investors must be able to tolerate such price movements.

Dividends may not be paid if a REIT reports an operating loss. For example, tenancy agreements of the underlying properties could be renewed at a lower rental rate than the previous agreement or the occupancy rate could fall.

If a substantial portion of the value of a REIT's assets is derived from one or a few properties, one may be exposed to a greater risk of loss if something untoward should happen to one of these properties. Similarly, if a REIT depends on only a few tenants for its lease income, there is exposure to a greater risk of these tenants not being able to fulfill their lease obligations.

Although investors are able to exit their investments easily by selling it on the stock exchange, the real estate fund itself may be relatively less liquid compared to funds investing in financial securities such as stocks and bonds. This is because it is difficult to quickly find buyers and sellers for property, especially if the value of the property is high. As a result, it may be difficult for REITs to vary their investment portfolio or sell its assets on short notice should there be adverse economic conditions or exceptional circumstances.

Where a REIT uses debt to finance the acquisition of underlying properties, there is leverage risk. As is the case with other listed companies, in the event of an insolvency of the REIT, the assets of the REIT will be used to pay off debtors first. Any remaining value will then be distributed to unit holders.

As REITs distribute a large amount of their income to unit holders, they may not have the ability to build up cash reserves to repay loans as they fall due. Thus they will typically seek financing by entering into new borrowing agreements, or other capitalisation measures such as rights or bond issues. One potential risk is higher refinancing cost when loans are due for renewal. Another risk is that a REIT which is unable to secure refinancing may be required to sell off some properties if they are mortgaged under the loan. These risks could affect the unit price and income distribution of a REIT.

SEBI (Real Estate Investment Trusts) Regulations, 2014

The Securities and Exchange Board of India (SEBI) on 26th September 2014 notified the norms for listing of REITs, which would help attract more funds in a transparent manner into the realty sector. For investors, the benefits are faster partial or full exit from project, and better valuations. To unit holders, they bring regular income, hedge against inflation, the option to invest in real estate with limited investment and a share of the upside in capital values. The regulation lays the framework for Real Estate Investment Trusts and registration and regulation.

Sponsor, Trustee and Manager are the main parties to the REIT.

SEBI (Infrastructure Investment Trusts) Regulations, 2014

On 26th September 2014, SEBI notified norms for InvITs which are somewhat similar to REITs.

Salient features of the InvIT Regulations are as follows –

- InvITs shall be set up as a trust and registered with SEBI. It shall have parties such as Trustee, Sponsor(s), Investment Manager and Project Manager.
- InvITs shall invest in infrastructure projects, either directly or through SPV. In case of PPP

projects, such investments should only be through SPV. An InvIT shall hold or propose to hold controlling interest and more than 50% of the equity share capital or interest in the underlying SPV, except where the same is not possible because of a regulatory requirement/ requirement emanating from the concession agreement.
- Sponsor(s) of an InvIT shall, collectively, hold not less than 25% of the total units of the InvIT on post issue basis for a period of at least 3 years.
- The proposed holding of an InvIT in the underlying assets shall be not less than ₹500 crore and the offer size of the InvIT shall not be less then ₹250 crore at the time of initial offer of units.
- An InvIT which proposes to invest at least 80% of the value of the assets in the completed and revenue generating infrastructure assets, should raise funds only through public issue of units. The minimum subscription from any investor in initial and follow-on offer shall be ten lakh rupees

Taxation of REITs & InvITs

The Income-tax Act, 1961 (amended by Finance Act 2014) provides a new taxation regime for REIT and InvIT. To achieve the objective of these types of Trust to its fullest extent a new terminology "Business Trust" has been inserted.

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Section 115UA deals with the tax on income of unit holders and business trusts. Any income distributed by a business trust to its unit holders shall be deemed to be of the same nature and in the same proportion in the hands of the unit holder as it had been received by, or accrued to, the business trust.

According to Section 2(13A) of Income-tax Act, 1961, Business Trust means a Trust registered as an Infrastructure Investment Trust or a Real Estate Investment Trust, the units of which are required to be listed on a recognised stock exchange, in accordance with the regulations made under the Securities Exchange Board of India Act, 1992 and notified by the Central Government in this behalf.

The listed units of a business trust, when traded on a recognised stock exchange, would attract same levy of securities transaction tax (STT), and would be given the same tax benefits in respect of taxability of capital gains as equity shares of a company *i.e.*, long term capital gains, would be exempt and short term capital gains would be taxable at the rate of 15%.

In case of capital gains arising to the sponsor at the time of exchange of shares in SPVs with units of the business trust, the taxation of gains shall be deferred and taxed at the time of disposal of units by the sponsor. However, the preferential capital gains regime (consequential to levy of STT) available in respect of units of business trust will not be available to the sponsor in respect of these units at the time of disposal. Further, for the purpose of computing capital gain, the cost of these units shall be considered as cost of the shares to the sponsor. The holding period of shares shall also be included in the holding period of such units.

The income by way of interest received by the business trust from SPV is accorded pass through treatment *i.e.*, there is no taxation of such interest income in the hands of the trust and no withholding tax at the level of SPV. However, withholding tax at the rate of 5% in case of payment of interest component of income distributed to non-resident unit holders, at the rate of 10% in respect of payment of interest component of distributed income to a resident unit holder shall be effected by the trust. (Section194LBA)

The dividend received by the trust shall be subject to dividend distribution tax at the level of SPV but will be exempt in the hands of the trust, and the dividend component of the income distributed by the trust to unit holders will also be exempt.

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Conclusion

In India, of the estimated 350 million square feet of 'Grade A' office space — valued at around $65-70 billion — concentrated in the major urban centres, about 80-100 million sq. ft is estimated to be eligible for REITs in the next 2-3 years, valued at about $15-20 billion, according to a recent study. Hence the entry of REITs in the Indian market is expected to infuse a large dose of liquidity into the cash-strapped commercial real estate sector and also bring in huge opportunities for professionals.

Professional Opportunities for Chartered Accountants

1. Consultation in formation of REITs and InvITs
2. Drafting of REIT/ InvIT trust deed
3. Structuring of business transactions – direct investments/ investments through SPV
4. Consulting for investors and units buyers
5. Accounting of trusts and SPVs
6. Advising/ consulting on taxation aspects
7. Valuation of properties
8. FDI in trusts
9. Accounting for construction
10. Accounting for infrastructure projects
11. Registration of SPVs
12. Registration of trusts
13. Advisor to managers/ trustees/ sponsors
14. Advisor to registrar and transfer agents for units
15. Listing of units on exchanges
16. Drafting of conveyance deeds, transfer deeds and agreements, *etc.* ■