

INDIA: ON THE 'REIT' PATH[†]

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I. INTRODUCTION

The growing scale of operations of the Indian corporate sector has increased the demand for commercial buildings, residential properties and spaces including warehouses and shopping centres. This surge in demand has consequently fuelled the need to expand investment in the real estate sector.

Traditionally, the only sources of financial support for this sector have been the banks, financial institutions, and in some cases, private players. Regulated means for investment in real estate have been continually formed and evolved to provide for this sector; though these have been circumscribed by direct engagement with physical properties. It is in this scenario that a relatively modern source of investment in real estate properties, being the real estate investment trust (REIT), has been seen as the way forward.¹

REIT serves as an alternative for investors who are averse to investing in physical properties due to the monetary quantum involved, and the risks that may arise including unsupervised and arbitrary rent generated from such properties. Investors can buy and sell units of REIT on various stock exchanges, making investment easier as well as ensuring liquidity and transactional transparency compared to acquisition of a

[†] The article reflects the position of law as on 17 January 2017.

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¹ See Consultation paper on the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013, *see also* Hemant Goyal & Sandhya Gupta, 'REITs to Boost Growth and Transparency in Indian Real Estate Sector' *HG Legal Resources*, available at <https://www.hg.org/article.asp?id=33321> (last visited 17 January 2017).

physical property.² It pools investor money in order to invest in real estate properties,³ and provides time-bound, regulated and regular rental income to the investors. With the introduction of REITs in India, a person can reap benefits of such regulated and assured rent by investing a minimum of two lakh rupees in REIT units.⁴

The framework of the REIT was developed in the United States of America (USA). It laid the foundation for an entity that undertakes investment in commercial real estate similar to investment in stocks as provided by mutual funds, wherein the entity invests in revenue-generating properties and sells 'units' upon listing on stock exchanges. Those who own these 'units' receive distributions from the rent generated, which can be considered similar to the dividends received on stock. This structure has evolved over the years in USA, functioning in varied and complex ways, yet *the original legislative intent of making large-scale, income-producing commercial real estate investment available to all types of investors remains at the core.*⁵ (emphasis supplied) The structure of REIT was introduced in Australia in 1971 and in a number of Asian countries in the late 1990s and early 2000s. Almost 30 countries have operating REIT markets; a further 12 have REIT-type legislations in place, while other countries have such legislation under active consideration.⁶

² See Consultation paper on the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013.

³ 'SEBI Relaxes Rules for REITs, Offshore Fund Managers' *The Economic Times* (Mumbai India 18 June 2016), available at http://economictimes.indiatimes.com/markets/stocks/policy/sebi-relaxes-rules-for-reitsoffshore-fund-managers/articleshow/52798985.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst (last visited 17 January 2017).

⁴ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 14 of regulation 14.

⁵ Debbie Stabenow, Junior United States Senator from Michigan, while addressing the Congress stated the above lines on the occasion of the 50th Anniversary of REITs in USA. These lines reiterate the five decade intent that has guided the functioning of REITs in USA, ie, '*investors from all walks of life to benefit from the income generation and diversification advantages of commercial real estate investments*'. *Congressional Record* Volume 156, Number 123 (14 September 2010), available at <http://www.gpo.gov/fdsys/pkg/CREC-2010-09-14/html/CREC-2010-09-14-pt1-PgS7081.htm> (last visited 17 January 2017).

⁶ Bobby Parikh, 'The right way to tax REITs', *India Forbes* (16 February 2016), available at <http://forbesindia.com/article/special/the-right-way-to-tax-reits/39627/1?utm=slidebox> (last visited 17 January 2017).

The Securities and Exchange Board of India (SEBI) introduced the *Securities and Exchange Board of India (Real Estate Investment Trust) Regulations, 2014, as amended* (REIT Regulations) with the intent to include rent generating properties within the REIT asset profile for enabling a framework for setting up of, operating and listing of Indian REITs (I-REITs), which were notified on 26 September 2014. Besides the commercial real estate space, the REIT Regulations go further and allow investment in certain infrastructural projects limited to hotels, hospitals, convention centres and common infrastructure for composite real estate projects.⁷

Although the REIT Regulations were notified in September 2014, in a span of two years SEBI has made approximately 190 amendments to remove ambiguities and to provide certain clarifications in the REIT Regulations. These amendments were notified with effect from 30 November 2016. In light of this background, the article explains the concepts, methods and principles adopted in REIT Regulations. Part II of this article carries a detailed analysis of REIT Regulations pertaining to the structure and framework of I-REIT, while noting its various facets and peculiarities *vis-à-vis* the frameworks in various international jurisdictions. Part III puts forth the regulatory and practical concerns related to the manner and nature of investment in property. Part IV deals with the proposed tax regime and studies the best tax practices existing across jurisdictions to ascertain a suitable structure for I-REITs.

II. STRUCTURE AND FRAMEWORK OF I-REIT

The REIT Regulations set forth strict requirements for an I-REIT structure, the nature of its assets and its sources of income. They provide, *inter alia*, for an organisational and functional structure of an I-REIT, roles, rights and responsibilities of the parties involved, compliance procedures for issue and listing of I-REIT units, procedures and disclosures concerning related party transactions.

⁷ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1(zi) of regulation 2.

The REIT Regulations require every I-REIT to be mandatorily registered with SEBI.⁸ Pursuant to such norms for mandatory registration with SEBI, certain specific eligibility criteria are required to be fulfilled by the parties involved,⁹ being, the sponsor and sponsor group, manager and trustee. The primary criterion stipulates that an I-REIT should be a trust, with the trust deed registered in India under the provisions of the *Registration Act, 1908*.¹⁰ The trust deed must have its main objective as undertaking the activity of an I-REIT in accordance with the REIT Regulations. It must also include the responsibilities of the trustee as laid down under Regulation 9 of the REIT Regulations including overseeing the activities of the manager in the interest of the unitholders.¹¹ Further, the parties are separate, non-connected entities¹² and include sponsors, sponsor groups, managers and trustees, and exclude the principal valuer.¹³ The concept of a sponsor group has been recognised in the REIT Regulations unlike the *Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014*, which lays down *inter alia*, the framework for infrastructure investment trusts. These parties manage, regulate and supervise the I-REIT, its investments as well as the issuance of the units. Each of the parties has distinctive criteria and responsibilities ranging from setting up the I-REIT to managing the I-REIT. However, the manager has certain distinct responsibilities which are subject to supervision of the trustee. The role and liability of the trustee may be limited to the extent of delegation of certain responsibilities that is permitted to managers. However, this delegation of responsibilities cannot supersede the primary fiduciary responsibilities that the trustee is required to fulfil under the *Indian Trusts Act, 1882*.

⁸ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1 of regulation 3.

⁹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1(zc) of regulation 2.

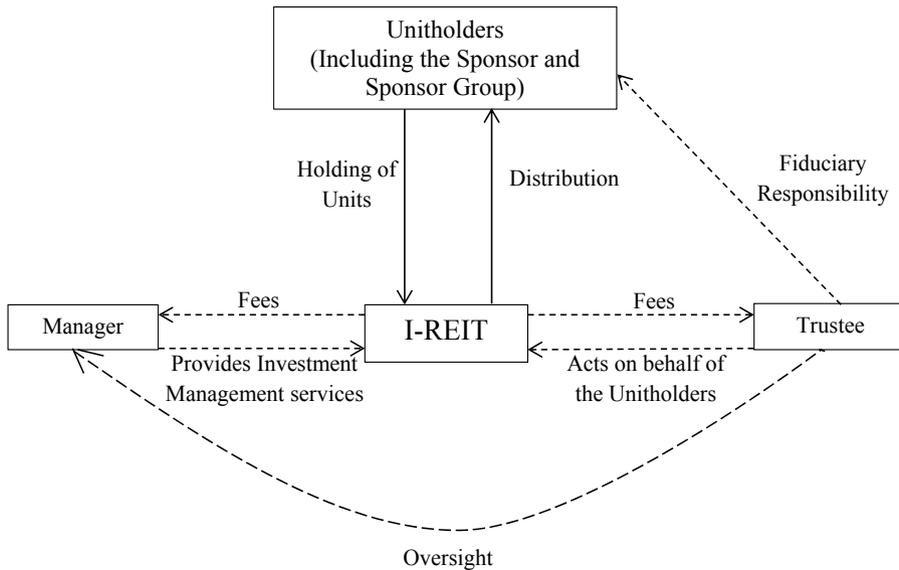
¹⁰ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(a) of regulation 4.

¹¹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(b) of regulation 4.

¹² *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(c) of regulation 4.

¹³ *Contra* draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013, sub-regulation 1(c) of regulation 2.

The pictorial representation below provides an overview of the structure envisaged under the REIT Regulations:



A. *Sponsor and sponsor group*

The sponsor and sponsor group set up an I-REIT.¹⁴ When the I-REIT is created, the sponsor and sponsor group would inject their properties into the initial portfolio of the I-REIT. The sponsor and sponsor group, collectively, will also retain majority of the ownership when the I-REIT is created. The sponsor could be a real estate developer like a builder, or a private equity fund investing in real estate.¹⁵ All sponsors in an I-REIT must collectively have a minimum net worth of 100 crore rupees,¹⁶ with each individual sponsor having a net worth of not less

¹⁴ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1 of regulation 11.

¹⁵ See Consultation paper on the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013.

¹⁶ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(d)(ii) of regulation 4.

than 20 crore rupees.¹⁷ Such a moderately high bar is beneficial as it ensures the support of a strong sponsor which strengthens the financial stability of an I-REIT.

It is essential that such ‘strong’ sponsors back an I-REIT; especially in light of the performance of the Singaporean REITs during the global financial crisis of 2007-2008. During this period, some of the Singaporean REITs faced delinquency risks as they were unable to refinance the loans with banks, and their sponsors lacked the capacity to support them with loans or equity injection. However, Singaporean REITs which had strong sponsor-backing were able to sail through liquidity crunches by short term injection of funds by such sponsors.¹⁸

The sponsor or its associates must also have a minimum of five years’ experience¹⁹ as a real estate developer, or in fund management²⁰ in the real estate industry. While there is no additional qualification for a real estate fund manager acting as a sponsor, the sponsor, if a developer, must have at least two of its projects completed.²¹ The concern with this stipulation is that the REIT Regulations do not provide any clarification or explanation regarding the nature of such projects. The nature of these projects seems relevant, especially if the sponsor has had experience and success in developing residential real estate and is foraying into commercial real estate through the REIT set-up. For instance, a developer that invests in residential real estate can also qualify as a sponsor for an I-REIT that may engage in commercial real estate. This may not be an ideal situation.

¹⁷ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, proviso to sub-regulation 2(d)(ii) of regulation 4.

¹⁸ Seek Ngee Huat et al (eds), *Singapore’s Real Estate: 50 Years of Transformation* (World Scientific), 184.

¹⁹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(d)(iii) of regulation 4.

²⁰ Funds management is the management of the cash flow of a financial institution. The funds’ manager ensures that the maturity schedules of the deposits coincide with the demand for loans, ‘Fund Management’ *Investopedia*, at <http://www.investopedia.com/terms/f/fundsmanagement.asp> (last visited 17 January 2017). Thus a fund management in real estate industry would involve the channelising of the pooled funds in real estate assets or projects.

²¹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, proviso to sub-regulation 2(d)(iii) of regulation 4.

Regulation 11 of the REIT Regulations charts out the responsibilities of a sponsor and sponsor group. In addition to establishing an I-REIT, the sponsor and sponsor group have been conferred upon the task of appointing the trustee. It also stipulates that the sponsor and sponsor group shall transfer or undertake to transfer their entire ownership of real estate assets to an I-REIT, prior to allotment of the I-REIT units. Commercially, there would be an agreement between the I-REIT and its sponsor and/or sponsor group in relation to the right of first refusal agreement. In a situation where the sponsor and/or the sponsor group wants to sell its property asset, the I-REIT will be offered the right to purchase the asset first before it is being offered to the market. They may also transfer their interest in a Special Purpose Vehicle (SPV) that owns real estate. Since the REIT Regulations have charted out the work of an independent valuer who must carry out a detailed valuation of the assets including physical inspection, so that any risk that may lie in transferring of property by them to the I-REIT, either in terms of fair pricing or quality of buildings, is averted.²²

The REIT Regulations do not have any restriction on the number of sponsors.²³ After the initial offer of the units, the sponsor and sponsor group must have a minimum holding of 25 per cent of the I-REIT units for at least three years from the date of listing of such units. Any holding in excess of the above limit must be held for at least one year.²⁴ At all times, the sponsor must individually hold at least five per cent²⁵ of the I-REIT units and collectively,²⁶ all sponsors and sponsor groups must hold at least 15 per cent of the I-REIT units.

Upon the lapse of the compulsory holding periods, the sponsors may sell their units, subscribing to permanent holding limits, specified

²² *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, regulation 21.

²³ Prior to the *Securities and Exchange Board of India (Real Estate Investment Trusts) (Amendment) Regulations, 2016*, the number of sponsors was limited to three.

²⁴ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 3(a) of regulation 11.

²⁵ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 3(c) of regulation 11.

²⁶ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*. sub-regulation 3(b) of regulation 11.

above.²⁷ However, if the sale is below such limits (5 per cent individually and 15 per cent collectively), it must arrange, prior to such a sale, for another person to step in as the re-designated sponsor. Such a re-designated sponsor shall comply with all the qualifications applicable to a sponsor under the REIT Regulations and is required to obtain the approval of the unitholders, thereby placing a sound check on such a process. Once the I-REIT is listed, the sponsor's role would be reduced to that of a shareholder and like all other shareholders, it would receive income in the form of dividends.

While adhering to due process, promoters of companies are in a position to not only do away with their entire shareholding. In contrast, the sponsors and sponsor groups are obliged to maintain their stake and office in the I-REIT to ensure their 'skin in the game' at all times.²⁸

B. Manager

A manager of an I-REIT will be at the helm of all operations right from appointments²⁹ to asset management, and from arranging for listing to ensuring accounting, and supervising the auditing of the I-REIT. Such a manager can be a company or limited liability partnership (LLP) or a body corporate, qualified with a condition that it should be incorporated in India.³⁰ To qualify as a manager backed with financial competence, the REIT Regulations require a company or body corporate to have a net worth of at least 10 crore rupees, or an LLP to have at least 10 crore rupees worth of net-tangible assets.³¹ In addition, the manager or its associate must have at least five years of experience in fund management or advisory services or property management in the real estate industry or in development of real estate.³² An 'associate'

²⁷ *Supra* n. 25 and 26.

²⁸ Consultation paper on the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013.

²⁹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulations 5 and 6 of regulation 10.

³⁰ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1(w) of regulation 2.

³¹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(e)(i) of regulation 4.

³² *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(e)(ii) of regulation 4.

has been defined under the REIT Regulations to mean any person who has been as defined under the *Companies Act, 2013* or under the applicable accounting standards and shall also include the following (i) any person controlled, directly or indirectly, by the said person; (ii) any person who controls, directly or indirectly, the said person; (iii) where the said person is a company or a body corporate, any person(s) who is designated as promoter(s) of the company or body corporate and any other company or body corporate with the same promoter(s); (iv) where the said person is an individual, any relative of the individual.³³ The REIT Regulations impose immense responsibilities on the manager including the responsibility to make investment decisions with regard to the I-REIT assets. Accordingly, if a manager does not have the requisite experience, it may also avail the benefit of using the experience of one of its associates to fulfil this eligibility requirement. This stipulation seeks to ensure a certain degree of proficiency and expertise in the management of an I-REIT and also provides for a range of experienced players with varied real estate experience. To further augment the competency of the manager, at least two of its key personnel must have at least five years, each, of experience in fund management or allied services or advisory services or property management in the real estate industry or in development of real estate.³⁴ However, there is no clarity whether the experience in real estate is specific to commercial real estate or residential real estate. While this distinction may not be entirely relevant for the sponsor, it does raise a concern in the case of a manager who is in complete charge of the operations of an I-REIT and its properties.

The REIT Regulations envisage the involvement of professional managers with diverse skill bases in property development, redevelopment, acquisitions, leasing and management in I-REITs.³⁵ The scope of the professional managers includes making decisions on the purchase and financing of properties for an I-REIT. The question

³³ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1(b) of regulation 2.

³⁴ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(e)(iii) of regulation 4.

³⁵ See Consultation paper on the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013.

of appointment of an external-advisor and external management requirement arose when the USA REIT envisioned a passive investment vehicle, like the mutual funds, which were not intended to engage in the operating activities of a traditional company. Since a manager is entrusted with decision making powers, the interests of unitholders including sponsors may be subject to its vagaries.³⁶

If the manager is a company, then not less than half of its directors should be independent and should not be directors on the board of another I-REIT, and if it is an LLP, then not less than half of the members of its governing board should be independent and should not be members of the governing board of another I-REIT.³⁷ While this is deemed to dissuade any form of unscrupulous activity and ensure objectivity in the management of the I-REIT, explicit liabilities and responsibilities of independent directors or members of such entities have not been envisaged under the REIT Regulations. Despite, the trust nature of an I-REIT, inference may be drawn from the *Companies Act, 2013*³⁸ to determine the eligibility, responsibility, accountability, and remuneration³⁹ of independent directors.

³⁶ Broad experiences concerning REIT managers, both external and internal, which have existed in jurisdictions across the world, include issues of reorganisation of the assets, high management fees, etc. *See generally*, Barry Critchley, 'Externally Managed REITs Generate Their Own Set of Issues' *Financial Post* (10 April 2015), at <http://business.financialpost.com/news/fp-street/externally-managed-reits-generate-theirown-set-of-issues> (last visited 17 January 2017), Goh Eng Yeow, 'Check out REIT Manager's Fee, Not Just Dividend', *Straits Times* (11 July 2015), at <http://www.straitstimes.com/business/check-out-reit-managers-fee-not-just-dividend> (last visited 17 January 2017), Tien Foo, 'Challenges Ahead for Singapore Real Estate Investment Trusts' Department of Real Estate, *National University of Singapore*, at <http://www.rst.nus.edu.sg/staff/singtienfoo/Challenges%20Ahead%20for%20Singapore%20REITs.pdf> (last visited 17 January 2017), and Su Han *et al*, *Real Estate Investment Trusts - Structure, Performance, and Investment Opportunities* (Oxford University Press 2003), available at <https://goo.gl/os9Vl8> (last visited 17 January 2017).

³⁷ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(e)(iv) of regulation 4.

³⁸ *The Companies Act, 2013*, section 149.

³⁹ *The Companies Act, 2013*, sub-section 7 of section 197.

The provisions regarding the manager are largely inspired by those under Singapore's *Code of Collective Investment Schemes*⁴⁰ which are now being proposed to be included in the Draft Guidelines⁴¹ to Singapore REIT managers. For instance, the Singapore norms require explicitly that the manager be a Singapore-incorporated body with physical office in Singapore.⁴² Similarly, the REIT Regulations define the term 'manager' with a qualification of being incorporated in India. In doing so the regulator has consciously intended to read down the definition of the term 'body corporate' which has been defined under the *Companies Act, 2013* to include 'a company incorporated outside India'. The definition requires that the manager should be an entity incorporated in India thereby stipulating an incorporation test. Further, the ownership test, with respect to foreign ownership and control for a manager that is incorporated as a body corporate, shall be determined by SEBI in terms of *Foreign Exchange Management Act, 1999* and rules and regulations prescribed thereunder.⁴³

C. Trustee

A trustee is meant to be a person who holds the I-REIT assets in trust for the *benefit* of the unitholders, as per the REIT Regulations.⁴⁴ (emphasis supplied) The trustee must be registered with SEBI under the *Securities and Exchange Board of India (Debenture Trustees) Regulations,*

⁴⁰ Monetary Authority of Singapore, *Code on Collective Investment Schemes*, paras 2.1 - 2.6, available at http://www.mas.gov.sg/~media/resource/legislation_guidelines/securities_futures/sub_legislation/revisedcode30sep2011final.pdf (last visited 17 January 2017).

⁴¹ Monetary Authority of Singapore, 'Draft Guidelines to All Holders of a Capital Markets Services Licence for Real Estate Investment Trust Management', available at <http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Consultation%20Papers/Appendix%204%20Draft%20Guidelines%20to%20all%20holders%20of%20a%20Capital%20Markets%20Services%20Licence%20for%20REIT%20Management.pdf> (last visited 17 January 2017).

⁴² Draft Guidelines to All Holders of a Capital Markets Services Licence for Real Estate Investment Trust Management, Monetary Authority of Singapore, sub-clause 1 of clause 2.

⁴³ Reserve Bank of India, FEMA. 355/2015-RB (16 November 2015), available at <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT35545E09E76D76D41CB9C096814B9C87E6A.PDF> (last visited 17 January 2017).

⁴⁴ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1(zv) of regulation 2.

1993 (Debenture Trustees Regulations). The trustee must have such wherewithal with respect to infrastructure and personnel to the satisfaction of SEBI and in accordance with circulars or guidelines as may be issued by SEBI from time to time.

While the sponsor appoints the trustee, it is the trustee who enters into an investment management agreement, on behalf of the I-REIT, with the manager.⁴⁵ The trustee must not be an associate of the sponsor or the manager.⁴⁶ Further, elaborate monitoring and reviewing powers⁴⁷ have been granted to the trustees under the REIT Regulations that ensure scrupulous functioning of the I-REIT. These stipulations ensure independence of the trustee and foster unitholders' confidence in the I-REIT as the trustee is required to hold its assets in trust for the benefit of the unitholders in accordance with the trust deed and REIT Regulations.

The trustee is compliant under the Debenture Trustees Regulations,⁴⁸ and assumes certain fiduciary responsibilities under the *Indian Trusts Act, 1882*. In terms of the *Indian Trusts Act, 1882*, the trustee assumes the role of being the owner of the I-REIT assets and must manage the I-REIT assets which is beneficial and in the best interests of the I-REIT and the unitholders.⁴⁹ However, the REIT Regulations allow the trustee to delegate the primary responsibility of managing the activities of the I-REIT to the manager with supervisory roles, thereby limiting the liability of the trustee in relation to the activities of managing the I-REIT assets. However, this cannot be the means for the trustee to abstain from fulfilling its primary responsibilities under the *Indian Trusts Act, 1882*.

The REIT Regulations set out the statutory requirements for, among

⁴⁵ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2 of regulation 9.

⁴⁶ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2(f)(i) of regulation 4.

⁴⁷ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, regulation 9.

⁴⁸ *Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993*, sub-regulation 1 of regulation 3.

⁴⁹ See Justice Subhro Kamal Mukherjee and S.P. Sen Gupta, *Indian Trusts Act, 1882* (Kamal Law House 2015).

other things, the board composition of a manager. However, SEBI has not clearly stipulated requirements and obligations in respect of corporate governance mechanism for the manager to ensure that there is no conflict in the interest of sponsor and other unitholders. Given that the unitholders will benefit from strong corporate governance requirements of the manager, SEBI may consider setting out requirements for, among other things, board composition, audit committee composition and independence of directors of the manager. For instance, the *Business Trusts Regulations, 2005* under the laws of Singapore place strong emphasis on strong corporate governance of the manager by stipulating *inter alia*, the criteria for determining the independence of the board of the manager of the business trust, whether or not the director is acting on behalf the business trust, from management and business relationships with the manager and matters pertaining to other professional associations of the directors of the manager.⁵⁰ These provisions ensure that the responsibility of the director of a manager does not interfere with the exercise of the director's independent judgment with regard to the interests of all the unitholders of the business trust as a whole.

III. INVESTMENT IN PROPERTY

The REIT Regulations also lay out stipulations with regards to channelising the investments of an I-REIT. These are mostly in sync with the practices, with regards to REIT investment, prevalent in the world, particularly Far-East and South-East Asia.⁵¹ The REIT Regulations stipulate that investment can also be made in a holding company (holdco) and/or SPVs or transferrable development rights (TDRs) in India only.⁵² I-REIT is permitted to invest in a property⁵³ either

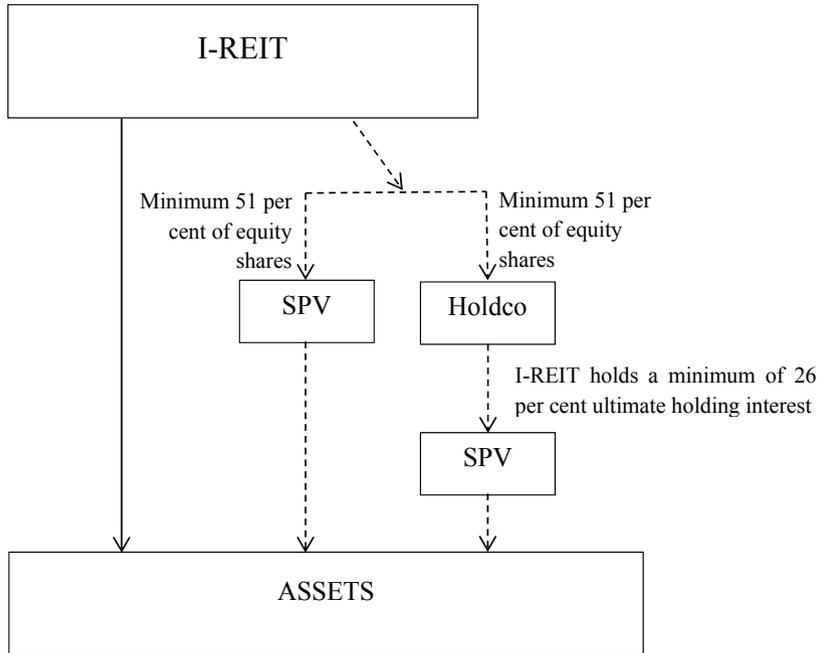
⁵⁰ See *Business Trusts Regulations 2005*, regulations 3 and 4.

⁵¹ See 'Destination India – Are we ready for REITs?' KPMG (September 2014), available at <https://assets.kpmg.com/content/dam/kpmg/pdf/2014/09/Real-Estate-Investment-Report.pdf> (last visited 17 January 2017).

⁵² *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1 of regulation 18.

⁵³ Regulation 2(1)(zi) of *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014* states that 'a property means land and any permanently attached improvements to it, whether leasehold or freehold and includes buildings, sheds, garages, fences, fittings, fixtures, warehouses, car parks, etc. and any other assets incidental to the ownership of real estate but does not include mortgage.'

directly or through a holdco or an SPV. The following diagram may be observed to understand the means available to an I-REIT to invest.



However, the REIT Regulations are characteristically restrictive. They stipulate certain qualifications for a holdco and an SPV. Firstly, a holdco or an SPV can be a company or an LLP. If an I-REIT is investing through a holdco, then it is required to have ultimate holding interest of not less than 26 per cent⁵⁴ in the underlying SPV, besides holding a minimum of 51 per cent of the equity shares of the holdco.⁵⁵ If an I-REIT is investing through an SPV, then it must have at least 51 per cent of the equity shares of the SPV. Further, an SPV, in either set-up,

⁵⁴ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 3A of regulation 18.

⁵⁵ Regulation 2(1)(zs) of *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014* defines an SPV, to mean 'any company or LLP, (i) in which the REIT holds or proposes to hold controlling interest and not less than fifty per cent of the equity share capital or interest; (ii) which holds not less than eighty per cent. of its assets directly in properties and does not invest in other special purpose vehicles; (iii) which is not engaged in any activity other than holding and developing property and any other activity incidental to such holding or development'.

is required to hold the properties directly and not invest in other SPVs. The REIT Regulations stipulate a layered investment through a holdco that holds properties through other SPVs. Such a holdco is meant to maintain a holding in SPVs alone and engage in activities incidental to such properties and no other activity.⁵⁶ SEBI treats this set up as a 'two level investment structure through a holding company'.⁵⁷ In the Hong Kong Regulations, two-layer investment is differently arranged where it is allowed through SPVs, where a top-layer SPV is solely formed for holding interests in one or more SPVs.⁵⁸ Further, under limited circumstances and upon reasonable demonstration, the regulatory authority in Hong Kong can permit multi-layer investment.⁵⁹

The REIT Regulations do not recognise other forms of control as it specifically mandates an I-REIT to hold at least 51 per cent of equity capital or interest of the SPV. This specific exclusion of other forms of control which may include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of management rights or shareholders agreements or voting agreements,⁶⁰ is without any justification.

The manner of investment requires atleast 80 per cent of the value of the I-REIT assets to be invested in completed and rent generating properties.⁶¹ Whilst the Draft Regulations had stipulated for 90 per cent of investment in real estate, the REIT Regulations has limited the investment figure to 80 per cent⁶² so that I-REITs can avail the benefit

⁵⁶ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1(qa) of regulation 2.

⁵⁷ Securities and Exchange Board of India, Press Release 139/2016 (23 September 2016).

⁵⁸ *Code on Real Estate Investment Trusts*, Hong Kong, sub-regulation 5(c)(ii) of regulation 7.

⁵⁹ *Code on Real Estate Investment Trusts*, Hong Kong, note to sub-regulation 5(d) of regulation 7.

⁶⁰ Section 2(27) of the *Companies Act, 2013* defines 'control' to include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

⁶¹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 4 of regulation 18.

⁶² *Ibid.*

of a diversified portfolio. This kind of a severe norm and its subsequent amendment has been observed in the Hong Kong experience,⁶³ where the limit was reduced to 75 per cent owing to the difficulties⁶⁴ arising out of the stifling nature of the norms.

Prior to the amendment, in the remaining 20 per cent of the total I-REIT asset value, upto 10 per cent could be invested in under-construction properties or completed but not rent generating and the remaining in a range of avenues.⁶⁵

This capping overlooked the concerns of a cash-strapped market for under-construction properties.⁶⁶ With the objectives of providing greater flexibility and aligning the framework with international REIT markets which either do not cap the level of investment in under-construction assets or permit a higher level of investment in under-construction real estate assets, SEBI brought about an amendment that has removed this capping. Thus, now the 20 per cent can be invested in under-construction properties along with the original options that include listed or unlisted debt of real estate companies, mortgage backed securities,

⁶³ Section 7.1 of *Code on Real Estate Investment Trusts* until 2014, stipulated that 100 per cent (generally) of the total asset value of the REIT must be invested in real estate while upto 10 per cent of the total net asset value can be invested in uncompleted and non-income generating real estate, at http://enrules.sfc.hk/en/display/display_main.html?rbid=3527&record_id=3397 (last visited 17 January 2017) and *see generally* Hong Kong Financial Services Development Council, 'Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts', Figure 5, available at <http://www.fsd.org.hk/sites/default/files/04%28Eng%29-Developing%20HK%20as%20a%20Capital%20Formation%20Centre%20for%20REITs.pdf> (last visited 17 January 2017).

⁶⁴ Hong Kong Securities and Futures Commission, 'Consultation Conclusions on Amendments to the Code on Real Estate Investment Trusts' (July 2014), available at <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=14CP2> (last visited 17 January 2017), 'Consultation Paper on Amendments to the Code on Real Estate Investment Trusts' (January 2014), available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=14CP2> (last visited 17 January 2017), and Hong Kong Financial Services Development Council, 'Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts', Figure 5, 27, available at <http://www.fsd.org.hk/sites/default/files/04%28Eng%29-Developing%20HK%20as%20a%20Capital%20Formation%20Centre%20for%20REITs.pdf> (last visited 17 January 2017).

⁶⁵ *Infra* n. 67.

⁶⁶ Consultation paper for amendments to the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014.

equity shares of companies listed on a recognised stock exchange in India which derive not less than 75 per cent of their operating income from real estate activity, government securities, money market instruments or cash equivalents.⁶⁷ This appears to be an exhaustive list which provides for reasonable diversification of investment.

The Draft Regulations ran the risk of allowing 100 per cent of the REIT asset to be invested in a project worth not less than 1000 crore rupees. However, in REIT Regulations, a more flexible investment opportunity has been provided wherein, the I-REIT can hold at least two projects with not more than 60 per cent of the value of its assets in one project.⁶⁸ With the Hong Kong Regulations including development projects with the 2014 amendment, the Asian REIT regime now shows sufficient leeway for development projects. Such a provision in the REIT Regulations is a welcome and sound inclusion.

It is required that on making an investment in a property, both completed and under-construction,⁶⁹ the I-REIT or SPV must hold it for a period of at least three years. Such a requirement shall ensure greater degree of financial stability of the I-REIT, without hampering liquidity and opportunities for diversification. It also prevents a situation in which an I-REIT maybe involved in constant purchase and investment in property.

Several restrictions have been imposed on the I-REIT with respect to its investment strategy. It is not allowed to invest in vacant land, agricultural land or debt securities.⁷⁰ It has been prohibited from launching schemes⁷¹ or from undertaking lending activities⁷².

⁶⁷ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 5 of regulation 18.

⁶⁸ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 8 of regulation 18.

⁶⁹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 10 of regulation 18.

⁷⁰ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 2 of regulation 18.

⁷¹ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 17 of regulation 18.

⁷² *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 13 of regulation 18.

It is expressly barred from investing in another I-REIT as well. This express exclusion seems to be peculiar to the REIT Regulations *vis-à-vis* the UK REIT, with respect to which the *Finance Act, 2013* in UK introduced changes to make the tax regime conducive to such an investment with the aim of further investment diversification, cash management flexibility and tax simplification.⁷³

It would have been interesting if the REIT Regulations and the corresponding tax regime could have been drafted in a manner to encourage investment in sustainable and environment-friendly ventures. This would have given scope for development of Green-REITs or Eco-REITs, thereby not only establishing a transparent but also a responsible and conscionable market.

IV. TAX IMPLICATIONS OF THE I-REIT STRUCTURE

The REIT Regulations came out in light of the *Finance Act, 2014*, by way of an amendment to the *Income-Tax Act, 1961*. The provisions in the *Finance Act, 2014* came into effect to provide for a special treatment regime governing taxability of the income earned through an I-REIT structure. These provisions have been incorporated depending on the stream of income that the I-REIT is earning and distributing. A discussion on this regime becomes relevant in light of the revenue estimations being touted in the market. An infusion of as much as USD 20 billion is expected to be facilitated in the real estate sector from the effective implementation of the REIT Regulations.⁷⁴

In terms of the *Finance Act, 2015*, the sponsor can avail of concessional tax scheme when it goes for initial listing of the I-REIT units on a recognised stock exchange. This would mean that upon payment of securities transaction tax (STT), long-term capital gains tax will be exempt and short-term capital gains tax will be taxed at 15 per cent on transfer of units. Given that the applicable tax treatment to both, a

⁷³ *The Finance Act, 2013*, United Kingdom, schedule 19.

⁷⁴ 'SEBI Issues Guidelines for Investment in INVITs, REITs' *The Economic Times* (New Delhi India 11 2011), available at http://articles.economictimes.indiatimes.com/2014-08-11/news/52687478_1_infrastructure-investment-trusts-invits-reits (last visited 17 January 2017).

sponsor of an I-REIT and a promoter of a company, is similar in terms of public listing, some additional tax benefits to a sponsor may make it lucrative for sponsors to opt for I-REIT. The high costs of setting up I-REITs could be taken into consideration in levying a concessional tax treatment on the sponsor at the time of initial listing of I-REIT units which may go a long way in making I-REITs a more attractive avenue. Pertinently, even the unitholders have been doled out a similar tax treatment. If the unitholders sell the units of the I-REIT on the stock exchange after holding it for more than 36 months, the capital gain arising on sale of such units of I-REIT will be exempt from tax. However, transfers within the 36 month period will attract short-term capital gains tax. Such sale of units on the stock exchange shall be subject to STT on transaction value.

It is significant to note that the concessional tax scheme has not been extended to direct transfer of real estate assets to an I-REIT and to transfer of interest in an LLP. By doing so, there is an avoidable additional corporate layer imposed between the I-REIT and the real estate asset, which could result in an additional tax outflow.⁷⁵ In order to avoid this tax leakage, a pass-through mechanism whereby the investors do not have to worry about any additional tax imbedded in the structure will serve as a positive step towards making the I-REIT structure lucrative for investors.⁷⁶ In Asia, Singapore has been the most generous with its tax incentives for REITs. For instance, REITs in Singapore and even those in Hong Kong are exempt from the payment of corporate tax. Further, no capital gains tax is levied on the investors investing in REITs in Singapore. Japan permits deduction of distributions, resulting in almost zero corporate tax on REITs, and imposes only capital gains tax at 10 per cent on individuals. This should further encourage the Indian authorities to reconcile with the Asian experience.

⁷⁵ Sriram Govind and Ruchir Sinha, 'REITs: Tax Issues and Beyond' (27 October 2014) *Lexology*, available at <http://www.lexology.com/library/detail.aspx?g=12d558bc-c506-4592-a2c6-dc5e90316391> (last visited 17 January 2017).

⁷⁶ Lisa Pallavi Barbora, 'No DDT for real estate investment trusts' (2 March 2016) *Live Mint*, available at <http://www.livemint.com/Money/rHPH1vB9dJtkAjtGrYbtuN/No-DDT-for-realestate-investment-trusts.html> (last visited 17 January 2017).

In case the SPV through which the I-REITs invest is in the nature of a company, it has to adhere to the provisions of the *Companies Act, 2013*. A company paying dividend would attract dividend distribution tax (DDT) at the applicable tax rate. The dividend paid by the SPV to I-REIT would have therefore, ordinarily attracted DDT. The Finance Minister of India in his speech on the budget for financial year 2016-2017 proposed that any distribution made out of income of SPVs to the I-REITs and investment trusts having specified shareholding will not be subjected to DDT at the hands of I-REIT and the unitholders of the I-REIT.⁷⁷ This proposal has found its place in the *Finance Act, 2016* to stimulate housing activity by facilitating investments in I-REITs and to augment registrations of I-REITs. This will not only spur a movement in the registrations of I-REIT, but will also bring the tax regime at par with the systems in Hong Kong, where no tax is payable on dividends paid to investors, and in Singapore, where all resident individual investors are exempt from payment of tax on dividends.

India's real estate sector is particularly hampered by wearisome and lengthy registration processes, and burdensome stamp duties varying across states which could be in the range of four per cent to 14 per cent. In this regard, India can take a cue from Singapore, which has waived the stamp duty on property transactions for five years from 2005, so as to make it cheaper for I-REITs to buy buildings.⁷⁸

It is important that the taxation rules applicable to I-REITs should be made consistent with the broader policy rationale underpinning the development of the I-REIT market. It is ideal to create and thereafter maintain the demand from real estate capital users to access public capital markets, and the demand on the part of investors, both large and small. Hence, I-REITs should be characterised by the absence of double-taxation of income. For the survival of I-REITs in changing markets, their organisational characteristics, ownership structures, and investment strategies are likely to continue evolving.⁷⁹ Since it may be argued that

⁷⁷ 'Speech of Arun Jaitley', Minister of Finance, Budget 2016-2017 (29 February 2016) available at <http://indiabudget.nic.in/ub2016-17/bs/bs.pdf> (last visited 17 January 2017).

⁷⁸ Goh Eng Yeow, 'REITS: Time to end tax breaks?', *Straits Times* (5 February 2015), available at <http://www.straitstimes.com/opinion/reits-time-to-end-tax-breaks> (last visited 17 January 2017).

⁷⁹ Su Han *et al*, *Real Estate Investment Trusts - Structure, Performance, and Investment Opportunities* (Oxford University Press 2003).

tax efficiency is critical to the success of I-REITs, the tax laws governing them must be driven by foresight and dynamism to reconcile with the changes.

V. CONCLUSION

I-REIT is a welcome move which will help bring in liquidity, transparency, better governance and more importantly an organised ecosystem which is professionally managed and protects investors. However, the I-REIT regime has not received the much anticipated enthusiasm from the market as yet. The Indian capital markets have not witnessed a single I-REIT registration or any of the properties being converted into an I-REIT status.⁸⁰ For instance, barring a few categories of investors who are expressly permitted by the RBI to invest in units,⁸¹ it is unclear whether certain categories of investors that are currently permitted to invest in equity shares⁸² offered by Indian companies, including venture capital funds and insurance companies, may also invest in the units in an offer of units by an I-REIT. This may be considered as a contributing factor to the absence of I-REIT registration in the last two years, despite the promulgation of the REIT Regulations in 2014. The quality and effectiveness of the REIT Regulations and the approach to tax and tax efficiency of I-REITs

⁸⁰ *Supra* n. 6.

⁸¹ Consultation paper on the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013; *Infra* n. 83.

⁸² Regulation 2(1)(zd) of the *Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009* defines qualified institutional buyer(s), to mean '(i) a mutual fund, venture capital fund, alternative investment fund and foreign venture capital investor registered with the Board; (ii) a foreign portfolio investor other than Category III foreign portfolio investor, registered with the Board; (iii) a public financial institution as defined in section 4A of the Companies Act, 1956; (iv) a scheduled commercial bank; (v) a multilateral and bilateral development financial institution; (vi) a state industrial development corporation; (vii) an insurance company registered with the Insurance Regulatory and Development Authority; (viii) a provident fund with minimum corpus of twenty five crore rupees; (ix) a pension fund with minimum corpus of twenty five crore rupees; (x) National Investment Fund set up by resolution no. F. No. 2/3/2005-DDII dated November 23, 2005 of the Government of India published in the Gazette of India; (xi) insurance funds set up and managed by army, navy or air force of the Union of India; (xii) insurance funds set up and managed by the Department of Posts, India.'

are factors in investment decision making. It is important to note that the makers of these decisions are circumscribed to the category of high net-worth individuals.⁸³ However, SEBI has been forthcoming in addressing the concerns of the stakeholders to facilitate the growth of I-REIT in India. It has permitted investment by mutual funds in units of an I-REIT and an infrastructure investment trust with certain investment restrictions.⁸⁴ The Indian government has also displayed its responsiveness and willingness to address the concerns of the industry and stakeholders, when it brought out the *Finance Act, 2016* which recommended certain proposals to facilitate investments in I-REITs. This willingness was translated into real action by the Reserve Bank of India (RBI) when it allowed persons resident outside India including a Registered Foreign Portfolio Investor and or a non-resident Indian (NRI) to acquire, purchase, hold, sell or transfer units of an investment vehicle⁸⁵, subject to certain terms and conditions.⁸⁶ Pursuant to the RBI notification, SEBI through a circular dated 15 March 2016 permitted Foreign Portfolio Investors to invest in units of I-REITs, Investment trusts and Category III Alternative Investment Funds (AIFs) in terms of the *Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014*, subject to such other terms and conditions as may be prescribed by SEBI from time to time.

Notwithstanding the fact that this is a welcome provision as it allows greater and freer participation in the regime as well as enables fresh

⁸³ Consultation paper on the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013.

⁸⁴ Securities and Exchange Board of India, Board Meeting PR No. 5/2017 (14 January 2017), available at http://www.sebi.gov.in/cms/sebi_data/pdffiles/35602_t.pdf (last visited 17 January 2017).

⁸⁵ Regulation 2(ii)(g) of the *Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000* defines an “Investment Vehicle” to mean an entity registered and regulated under relevant regulations framed by SEBI or any other authority designated for the purpose and shall include Real Estate Investment Trusts (REITs) governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts (InvITs) governed by the SEBI (InvITs) Regulations, 2014 and Alternative Investment Funds (AIFs) governed by the SEBI (AIFs) Regulations, 2012.’

⁸⁶ Reserve Bank of India through a notification dated 16 November 2015 amended the *Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000*, available at <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=10130&Mode=0> (last visited 17 January 2017).

equity in the market, it is also important that the changes must begin with a more internalised focus where it is required, than simply being aspirational. For instance, the REIT Regulations define 'units' to mean 'beneficial interest of the I-REIT'⁸⁷. The nature of these 'units' may be characterised from the definition provided under the Consolidated FDI Policy issued by the Department of Industrial Policy and Promotion which defines a 'unit' to mean 'beneficial interest of an investor in the Investment Vehicle and shall include shares or partnership interests'.⁸⁸ However, these units may not be classified as securities under the *Securities Contract Regulation Act, 1956*, since real estate investment trusts are not companies or bodies corporate. Accordingly, the applicability of several regulations (including regulations relating to intermediaries, underwriters, merchant bankers, takeover, insider trading and fraudulent and unfair trade practices) to the I-REIT is still unclear and untested.

While SEBI has addressed most of the concerns of the stakeholders through the amendment notification dated 30 November 2016 to the REIT Regulations, with certain appropriate regulatory measures and tweaking of the tax provisions, combined with better clarity to the stakeholders and investors, I-REITs may be seen in the global map for its performance in the Indian capital markets in the years to come.

⁸⁷ *Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014*, sub-regulation 1(zx) of regulation 2.

⁸⁸ Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, 'Consolidated FDI Policy' (7 June 2016), available at http://dipp.nic.in/English/policies/FDI_Circular_2016.pdf (last visited 17 January 2017).