AN ANALYSIS OF THE SEBI (REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014

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I. INTRODUCTION

A Real Estate Investment Trust ("REIT") is basically a company or an organization which owns, and in most cases operates income-producing real estate assets. The concept of REITs was first introduced in America in the year 1960, when President D. Eisenhower signed the legislation governing the REITs, combining the benefits of the real estate and stock-exchange income generating systems.

It is a company that owns or finances income-producing real estate.[328] Regulation 2(zm) of the SEBI (Real Estate Investment Trusts) Regulations, 2014 ("Regulations") defines REIT as a registered trust, in accordance with the provisions of the Indian Trusts Act, 1882 and the trust deed has to be duly registered as per the provisions of Registration Act, 1908[329]

Investment in a listed REIT is similar to investing in a mutual fund of the stock market, as the Regulations provide that the REIT has to list their units on the national and recognized stock exchanges, which would then be open for the public. The units would be listed according to the listing agreement entered into by the REIT and the particular stock exchange. The money in REITs is raised by collecting the money from the public, and the same is used to buy and rent the income generating assets in real estate.

The taxable income which is generated would be distributed in the form of dividends to the shareholders and in turn, shareholders pay the income tax on those dividends. The Trusts have proven to be a successful model in the economies all over the world and generally provide for stable income streams, diversification and long-term capital appreciation to its investors. Thus,

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[327] Student, School of Law, Christ University
[328] http://www.reit.com/investing/reit-basics/what-reit
[329] Megha Kapoor and Harsimran Singh, **Framework Of REITs In India, (**October 20, 2014) (http://www.mondaq.com/india/x/348000/Fund+Management+REITs/Framework+Of+REITS+In+India)

REITs reliably facilitate investors to acquire a diverse portfolio of real estate assets, or easy liquidity for their completed real estate projects, in a rather tax-efficient way.[330]

The two main types of REITs are:-

1) Equity REITs - Equity REITs generate income through the collection of rent on, and from sales of, the properties they own for the long-term.

2) Mortgage REITs - Mortgage REITs invest in mortgages or mortgage securities tied to commercial and/or residential properties.

Today, REITs are tied to several aspects of the economy, including apartments, hospitals, hotels, industrial facilities, infrastructure, nursing homes, offices, shopping malls, storage centers, student housing, and timberlands. REIT owned properties are located in every state and support one million U.S. jobs annually. U.S. REITs have become a model for REITs around the world, and now more than 30 countries around the world have adopted REIT legislation.[331]

II. INDIAN PERSPECTIVE

SEBI REGULATIONS, 2014

The Securities & Exchange Board of India ("**Board**") formally introduced the REITs in 2007 as draft REIT Regulations. Thereafter, SEBI released a revised set of draft REIT Regulations on October 10, 2013 through the consultative paper placed on SEBI website along with the draft REIT Regulations, 2013. The draft was placed on SEBI website for public comments on October 10, 2013 till October 31, 2013; and comments were received from 65 entities.

Based on the comments received on the draft regulations and the Budget announcement of 2014-15, appropriate changes were made to the draft Regulations of 2013 and pursuant thereto, the

[330] Sandhya Aggarwal, **REITs To Boost Growth And Transparency In Indian Real Estate Sector!**(August 28 2014)(http://www.mondaq.com/india/x/336834/Fund+Management+REITs/REITs+To+Boost+Growth+And+Transparency+In+Indian+Real+Estate+Sector)

[331] http://www.reit.com/investing/reit-basics/what-reit

Board issued a memorandum proposing the draft SEBI (Real Estate Investment Trusts) Regulations, 2014 (hereinafter referred as "Draft REIT Regulations"), and sought consideration and approval for the same.

The Board on August 10, 2014 approved the SEBI (Real Estate Investment Trusts) Regulations, 2014 and the same was notified on September 26, 2014, hence formally laying down a framework for REITs in India and registration and regulation thereof.[332]

a) FORMATION OF REIT

The REITs have to be registered with Board in order to operate in India and they have to obtain the certificate of registration by the Board to carry on business in the field. In order for them to obtain the certificate they have to fulfill certain eligibility criteria and an application has to be filed with the Board alongwith the prescribed fee. If the Board finds that the trust has complied with all the requirements prescribed then a certificate of registration is granted to them.[333] The Eligibility criteria have to be fulfilled by persons before they could act as the key personnels of the REIT, namely the manager, sponsors and the trustee.

The certificate which is granted to the REIT would be subject to certain conditions. The conditions are, the REIT has to comply with these regulations at all points of time, disclosure of any misleading information or material change in the documents has to be made to the Board in writing. They also have to ensure that the proper code of conduct is observed, which is laid down in Schedule VI is also complied with at all times by the Trust. [334]

The general affairs of the REIT would be conducted in the interest of the shareholders, and in compliance with the objectives which are laid down in the Offer document. Any material information and relevant documents would be disclosed to the unit holders and the investors, and any fee chargeable from them should be a fair and reasonable amount. Schedule VI also makes the

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[332] Kapoor, *supra* note 2.
[333] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 6.
[334] SECURITIES AND EXCHANGE BOARD OF INDIA (REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014,Regulation 7.

REIT and the related parties accountable to the investors for any conduct or negligence on their part.[335]

b) INVESTING IN THE REIT

After a certificate of registration is granted to the REIT, the next step would involve raising funds to invest into the real estate assets and projects. The Regulations have prescribed that the initial offer of the units for the investors has to be made by the means of public issue only. The minimum value of the assets which are owned by the REIT should not be less than five hundred crores, and the minimum value of the units which are offered could not be less than two hundred and fifty crores. Further, the portion which is listed should not be less than twenty five percent of the total value of the REIT's assets. After the initial offer is made, the subsequent issue of units could be through other mechanisms as agreed upon by the Board. The units before they are offered for sale to public, has to be held for a period of one year by any existing holder, who is not a sponsor.[336]

c) LISTING OF UNITS

After the REIT is formed and the initial offer is made to the public, the units have to be listed in the stock exchange market. The units have to be listed in a recognized stock exchange after the initial offer is made to the public within a period of twelve days. The REIT also has to ensure that the share of public holding of the units should always be more than twenty five percent and the number of unit holders is more than two hundred.

If the same is not maintained, an action may be taken by the Board against the REIT. There are certain conditions which are laid down, which would lead to the delisting of units of REIT from a particular stock exchange or any other action might be taken by the Board in case if there is a violation of certain conditions.[337] The conditions are if the public holding falls below the specified limit of twenty five percent or if the number of unit holders would fall below two hundred. Apart

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[335] SECURITIES AND EXCHANGE BOARD OF INDIA (REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Schedule VI.
[336] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014,Regulation 16
[337] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 10

from that, if the REIT has no projects or assets remaining with them, and they are not planning to invest in any other ventures, it would also lead to the delisting of units. The unit holders can also apply for the delisting of units, if such delisting would be in their interest. [338]

The final decision regarding the delisting of units would lie in the hands of the Board, and they may take any other action against the REIT other than Delisting of their units, under these Regulations.

d) RIGHTS OF THE UNIT HOLDERS

The general rights of the unit holders and the duties of the manager towards the unit holders have also been prescribed. The regulations provide that the approval of the unit holders would be taken by the REIT in the matters requiring their approval. An annual meeting would be held at least once in a financial year, in which the important information would be disclosed to the unit holders including the accounts and the performance of the Company, appointments and removals of the Key personnels, borrowings, matters relating to issuing of units and any other relevant issues which might affect the interest of the shareholders, whether directly or indirectly. [339] One such important right is the removal of the Key personnel like the Manager, Trustee or the sponsors through the process of voting, if they feel that the Key personnels are acting detrimental to the interest of the REIT.

Duties of the Manager and Trustee

As the unit holders have a right to know, the manager is under an obligation to maintain the records regarding the general activities of the REIT. It would include the decisions related to the investments and the divestments, agreements which are entered into by the REIT, insurance policies for the assets of REIT, valuation methods and estimates, books of accounts and financial statements, audit reports, report of activities and grievances of units holders, distribution of dividends made to the unit holders and any other material documents which are supposed to be

[338] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 22.
[339] *Id.*

maintained by the Manager.[340] The regulations provides that the trustee also has to maintain such relevant records as provided under this sub-section, and these documents could be called for inspection by the Board whenever they think it is necessary.

Borrowings

To avert excessive leverage, it is prescribed that the borrowings and deferred payments of a REIT at a consolidated level must not exceed 49% of the value of the REIT assets. In the event of its borrowings or deferred payments go beyond 25% of the value of REIT assets, then the approval from the unit holders has to be obtained. This would ensure that the REIT would not be highly indebted, further the requirement of approval from the unit holders would ensure that they would be made aware of the condition of the REIT in terms of borrowing and pending debts.[341]

e) INSPECTION

The Board has also reserved certain powers relating to the overall supervision and inspection of the REITS. The powers of the Board have been laid down with regard to the inspection of the documents, books, records of any REIT. The same could be done either *suo motu* by the Board, or after receiving a complaint or query from any other person or body.

A notice for the enquiry has to be provided to the REIT[342] and all the parties and associated members of the REIT have a duty under these Regulations to extend full cooperation in the matters of enquiry which would include providing relevant documents and records for the inspection, furnishing statements and any other relevant information that the Board requires.[343]

A reasonable opportunity would be given to the parties to present themselves in front of the Board and on the basis of the findings of the inspections and enquiries and after hearing all the sides, the

[340] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 26.
[341]SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 20.
[342] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation28.
[343] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 29.

Board would take the necessary action in the form of issuing of directions which have to be complied with by the REIT.

If the Board finds that there has been any contravention of these regulations or any other laws, by laws, circulars relating to these Trusts or otherwise, the Board may issue directions and require the contravening REIT to delist its units from the designated stock exchange, sell their assets, or take any such action which would be in the favor of the investors.[344]

III. BRIEF ANALYSIS OF THE REGULATIONS

The Regulations which have been laid down by the Board provide for a stringent and exhaustive mechanism for the establishment and functioning of REITs in India. It ensures that the developers can raise money for the investment in the complete, rent and income generating real estate assets and provide a stable income in the form of dividends to the investors. But a careful reading of the Regulations would yield that a number of provisions have been laid down in these Regulations to ensure that these REITs would function in an efficient, fair and reasonable manner, and the rights and interests of the investors would be protected. It also tries to ensure that the REITs would adhere to their laid down objectives and would prioritize the growth of REIT. The key personnels who are involved in the overall functioning of the REIT have to follow and observe all the norms laid down under these regulations, and the investors have to be informed about all the relevant activities of the REIT, so that they do not indulge into any activities which might be prejudicial to the interests of the investors. The Board along with the Stock exchange authorities would also exercise overall control and supervision over these REITs and they have reserved the powers to inspect, enquire and penalize these REITs in case of default or contravention.

IV. ADVANTAGES OF REITs

Diversification: Over the long term, Equity shares have been stable and are not susceptible to the changes like the other shares in the stock market. It would also enable small investors to now

[344] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 30.

diversify their portfolios by investing in this new asset class, which otherwise would be hard, as the capital required to invest in the Real Estate is relatively high.

Dividends: The listed REITS have also been successful in providing a stable amount of income in the form of dividends to the investors, ninety percent of the income which is received by the REIT has to be distributed amongst its investors[345] and such a distribution has to be made at least once in six months. Once the dividend is declared for distribution, it has to be made to the investors within fifteen days of such a declaration.

Liquidity: Stock exchange-listed REIT shares can be easily bought and sold. Unlike the general practice of owning a real estate asset or property, the investor is then concerned with the rent generating potential of the property, rather than thinking of the price of the value of the property in the market. REITs would provide that advantage, as the easy liquidity of the same would allow investors to sell the shares fairly quickly to raise cash or to take the advantage of the market.

Transparency: There have been stringent rules which have been laid down by Board, regarding the disclosures and records that have to be maintained by the Trusts and the rules that they have to follow. The offer document which would be issued by the REIT will make all the material disclosures in a correct and truthful manner[346], which would enable the investors to make an informed choice about the investment in a particular REIT. [347]

It also provides that the document would not contain anything extraneous to the contents, and the information which is provided should not mislead the investors. Further, it will also contain the risk factors which might be attached with the investments in the trust. In order to ensure further transparency, there is a duty which is cast upon the manager to submit yearly and half yearly reports to the investors and to the stock exchanges regarding the ventures of the REIT and any such information which would have a bearing on the performance and functioning of the REIT.

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[345] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 18.

[346] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 15.

[347] http://www.reit.com/investing/reit-basics/what-reit

Fair valuation of assets: The Board has also tried to ensure that the valuation of the assets which has to be carried out should be done in an impartial and fair manner. The provisions[348] of the Regulations ensures that the Valuer carries out the valuation of the assets of the REIT in a fair and impartial manner and that he/she is equipped with the adequate financial and other resources to carry out the same. The duties as a valuer would be discharged in a competent and skillful manner and there would be no false or misleading claims made by him/her. In order to ensure that, the Regulations have specified that the valuer would be an independent body and would not hold any interest in the property being valued.

Competence of Key personnels: At least eighty percent of the of the investments of the REITs would be in completed and rent generating properties, which would ensure that the flow of income to the investors would be immediate and there wouldn't be any delay in the payment of dividends to them. All the Key personnels of the trust including the Sponsors, managers and Trustee would be professionals who would be competent and well versed with the matters of Real estate and related businesses. The regulations clearly provide that all the personnels mentioned above should have the experience in the Real Estate industry for a period of not less than five years. [349]

V. PROBLEMS

TAX HURDLES

There are a number of issues which are related to the taxation of these REITs, which would make it an unattractive option, both for the Sponsors as well as the investors. The first problem would be related to the taxation of the entity at the time of its startup, as the tax bill for starting a REIT would be high.

For the sponsors, there is no tax benefit but a mere deferral benefit as they would be taxed once the share units would be listed with the stock exchange and would be made available to the public.

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[348] SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 12,Regulation 21.

[349]SECURITIES AND EXCHANGE BOARD OF INDIA(REAL ESTATE INVESTMENT TRUSTS) REGULATIONS, 2014, Regulation 4

Secondly, there would be tax exemption only in the cases where the shares which are held by a Special purpose vehicle (SPV) are transferred to the REIT. It means that in the cases where the real estate assets are directly transferred to the REIT, they would still be taxable.[350] Further, the dividend distribution tax would be applicable, once the dividends would be obtained from SPV, and since the regulations have mandated that ninety percent of the income has to be divided amongst the investors, this tax would be applicable to them. [351]

The investors too, would have to bear the taxation problems as the units ultimately in the hands of the investors, would be taxed for a mean that it would not provide better returns. Further, they would be exempted from tax only if the share units are held by them for a period of three years, compared to other "listed units" under stocks, which would be exempted from tax only after the holding for one year. If all the taxes are included, then the share of investors will ultimately entail 42-43% tax, which is very high. The sponsors at the same time, will be taxed at the time of listing these shares in the first instance when they would be open to public. [352]

NON TAX HURDLES

The stock market, in general is a volatile place and there might be fluctuations in the prices of the shares once they are listed with a recognized stock exchange. The general nature of the stocks and the risk involved with the fluctuation in the market might further discourage the prospective investors to go for REIT.

The minimum subscription amount which is prescribed under the rules is also high. It has to be a minimum of two lakh rupees, as prescribed under the Regulations, which says that the REIT shall not accept subscription of an amount less than two lakh rupees from an applicant. Requiring high

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[350] Sriram Govind & Ruchir Sinha, **REITS: TAX ISSUES AND BEYOND, (**October 27, 2014) (http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/rd eits-tax-issues-and-beyond-1.html)
[351] *Id.*
[352]Nischal Joshipura, **Opaque taxations may kill REIT appetite**, (Aug 10, 2014) (http://www.nishithdesai.com/fileadmin/user_upload/pdfs/NDA%20In%20The%20Media/Quotes/Opaque_taxations_may_kill_REIT_appetite.pdf)

amounts of initial investment may also make it unattractive for a lot of potential investors.[353]

The requirement for a sponsor to have a real estate track record is likely to rule out a substantial portion of yield generating assets. As already mentioned the Board already provides the relevant provisions in the Regulations about the eligibility criteria of the various Key personnel of the Trust. This to a great extent eliminates the possibility of non-real estate players such as hotels, hospitals, banks and others (such as Air India) becoming sponsors of REITs.[354]

Another problem which is associated with REITS in India is the marketability and the yields of Indian REITs compared with other fixed-income products. The expected yield on REITs may not exceed 5-6% compared to an 8% yield offered by government securities[355]

VI. POTENTIAL PROSPECTS IN INDIA

There are several problems and constrains which are present in the Real Estate market related to adequate and structured financing options. The creation of REITs and increasing the amount of investment in such ventures would provide the industry with better growth prospects and make it competitive in the Global market[356]

Not only that it will also help in the creation of a more flexible and transparent market, which would be now accessible to a greater number of investors rather than being confined in the hands of few. It will also ensure that people, who were not able to participate in the Real Estate market, would now be able to do so.

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[353] Anto Antony, **REIT $20bn spending in India delayed by tax rules**, (14 Oct 2014) (http://www.livemint.com/Money/bCVHQjpRtrFQe0Fp5DTrDO/20-billion-REITs-in-India-delayed-by-tax-rules.html)

[354]Govind, *supra* note 8.

[355]*Id.*

[356] Navin Kumar, **REIT : A solution to many problems in Indian Real Estate**, (March 3, 2014) (http://www.livemint.com/Money/p7QyTErJ0uxzW1DQcSiATN/Reits-A-solution-to-many-problems-in-Indian-real-estate.html)

For e.g.:- Small investors and institutions would now have an opportunity to invest in large scale commercial real estate, which would have otherwise been only possible for HNIs and wealthy individuals.[357]

The other prospects that it would have would be, REITs are likely to offer monetization opportunities to private equity funds and developers, which have till now been unable to find institutional buyers for completed real estate assets. As the appetite for developmental projects has reduced, REITs will offer opportunities to foreign investors to invest in rent generating assets, an asset class otherwise prohibited for foreign investments.[358]

For developers, it would "improve property market transparency, smoothen volatile property cycles, and potentially lower the cost of capital." [359]There have also been issues related to the existence of high debt levels, and REITs can also provide some relief in that regard to the developers. REITs could prove to be an extremely efficient exit vehicle, which would offer an extremely attractive capitalization rate to them.[360]

According to a study conducted by Cushman and Wakefield, REITs in India has the potential to emerge as one of the top five markets in Asia, the real estate assets which could be brought under the REIT scheme in India would reach the level of $20 billion by the year 2020. [361]

VII. CONCLUSION

The new regulations which have been laid down by Board would serve as an important step for the growth of the real estate business in India, and would help in attracting foreign as well as domestic investments in the Indian real estate industry. The regulations would ensure that the global concept of the REITs is incorporated in India and raising money for the investment in the

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[357]Moneycontrol.com, **How REITs will be a game-changer for Indian real estate**, (September 4, 2014) (http://www.moneycontrol.com/news/business/how-reits-will-begame-changer-for-indian-real-estate_1170812.html?utm_source=ref_article)
[358] Govind, *supra* note 8.
[359] Moneycontrol.com, *supra* note 15.
[360] Gaurav Pandey, **REIT is an opportunity for India**, (September 8, 2014) (http://www.livemint.com/Money/FV6chrB0CzXpogaom9RrNM/REIT-is-an-opportunity-for-India.html)
[361] Antony, *supra* note 11.

real estate would ultimately benefit the investors and the developers in the longer run.[362]The various benefits that it would provide amongst others are easy and secure investments in the real estate sector, convenient diversification of investments, exit avenues to the cash-starved property developers, better liquidity situation in the real estate industry, increased accountability and reliability in this sector, and greater FDI in the real estate sector of India.[363]

362 Kapoor, *supra* note 2.
363Aggarwal, *supra* note 3.