HKREITA
香港房託基金協會有限公司
Hong Kong REITS Association Limited

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BY POST and EMAIL

Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue
Tamar
Hong Kong

Attention: Mr Christopher Hui, Secretary for Financial Services and the Treasury

Dear Mr Hui,

Policy recommendations on promoting the growth of the H-REIT industry

Introduction

On behalf of the Hong Kong REITS Association (HKREITA), its members and the H-REIT industry, we are writing to provide our views on the next steps the Government may consider in its continued endeavours to foster the vibrancy and growth of the H-REIT industry.

By way of introduction, HKREITA is an industry association of REITs in Hong Kong, with Link REIT, SF REIT and Yuexiu REIT as our co-founding corporate members. HKREITA represents the local REIT market, with a shared aim of driving the H-REIT industry to greater prominence in global capital markets.

As investors worldwide seek options to diversify their investment portfolios and achieve stable income returns, REITs have grown significantly in scale and influence as an asset class. To capture this opportunity, Hong Kong rolled out its REIT regime in 2003. However, the development of the H-REIT industry has lagged behind that of its regional peers, such as Singapore and Japan, both in terms of diversity and the number of REITs in the market.

Hong Kong should seize the opportunities at hand to strengthen its role and status in the global REIT market. Given its strength as an international financial centre and proximity to Mainland China, Hong Kong is in a unique position to become the largest REIT market in the Asia Pacific region. It is now time for the Government to take a more proactive approach to fully capitalise on the significant growth potential of the H-REIT market.

Policy Recommendations

HKREITA supports and appreciates every effort made by the Government and the SFC to foster the development of the H-REIT market. But unfortunately, while some progress has been made, H-REITs have faced several constraints, notably the lack of tax incentives and the relative restrictiveness of the REIT Code.

The Government should take swift and bold action to enhance the regulatory framework for H-REITs to create a level of commerciality on par with or exceeding that of our regional competitors. Accordingly, we have identified five key policy recommendations, which we set out below.

(i) Stamp duty exemption for the transfer of properties into H-REITs

The stamp duty rate in Hong Kong is unduly onerous for potential sponsors wishing to inject their properties into new H-REITs or for H-REITs to grow by acquiring newly built properties, especially when the properties are held directly by the property owner. The sale and transfer of non-residential properties in Hong Kong is subject to stamp duty of up to 4.25%. A stamp duty rate of 4.25% is even higher than one year's net property income of certain properties. However, overseas REITs in competitor markets, such as Japan and Singapore, enjoy lower stamp duty rates of up to 1.6% and 3%, respectively.

Where a property owner holds properties via a special purpose vehicle (SPV), the transfer of that property would typically take the form of the sale and purchase of the shares of the relevant SPV, which is subject to a stamp duty rate of 0.26%. The above differential stamp duty treatment puts those landlords who do not hold their properties in separate SPVs in a highly disadvantaged position.

The unfavourable stamp duty regime in Hong Kong has severely limited the growth of the H-REIT sector. Stamp duty here represents a significant cost for property owners and H-REITs, substantially diminishing any incentive to deploy a H-REIT structure or spin off assets into a H-REIT.

To facilitate growth from asset injection and to encourage the establishment of H-REITs, the Government should consider exempting H-REITs from stamp duty on the sale and transfer of property from existing holding structures to that of a H-REIT or lowering the stamp duty rate for the direct transfer of properties into H-REITs to 0.26%, aligning with that of the stamp duty levied on property transaction through the transfer of SPVs.

(ii) Stamp duty exemption for the trading of H-REITs

To further support the H-REIT market, the Government may consider the provision of stamp duty concessions on trading H-REIT units. Trading of H-REIT units is currently subject to a stamp duty rate of 0.26%. We note that the Government has extended the stamp duty exemption to the transfer of certain SFC-authorised collective investment schemes, such as exchange-traded funds and leveraged and inverse products. We believe the same arrangements should be extended to H-REITs. Reducing the transaction costs associated with trading H-REITs would encourage more H-REIT listings in Hong Kong and drive the depth and liquidity of our securities market.

(iii) Tax transparency

Tax transparency means that a REIT will not be subject to income tax at the trust level if it meets certain requirements in distributing income to unitholders. Rather, tax is payable at the investor level, at their respective marginal rates.

Hong Kong adopts a simple and low tax regime. No tax is levied on capital gains or dividend income from investing in H-REITs.

Nonetheless, Hong Kong stands alone amongst mature REIT markets in not providing tax transparency. When a H-REIT directly holds properties in Hong Kong and derives rental income thereon, such rental income will be subject to a property tax of 15%. When a H-REIT indirectly holds properties in Hong Kong via SPVs, such SPVs will be subject to profits tax at 16.5% (in respect of the profits derived from those properties).

The absence of tax transparency fosters the impression that H-REITs are subject to highly disadvantageous tax treatment and produce lower yields than available in other markets, disincentivising potential REITs from listing in Hong Kong and existing H-REITs from acquiring properties.

We also note that the above property and profit tax treatment for H-REITs will disadvantage small investors in the lower tax bracket and disincentivise them from buying H-REIT units. Those investors will be subject to a higher tax rate than in cases where rental income from properties is charged at their individual tax rate.

Hong Kong should consider following the successful path of other mature REIT markets in adopting tax transparency. Appropriate tax structures have repeatedly been proven as key tenets in growing and sustaining an attractive REIT market.

While removing profit and property tax at the trust level could lead to H-REITs becoming fully tax-exempt, we consider that a partial concession might represent an attractive economic incentive for new REITs to launch in Hong Kong and more properties to be acquired by H-REITs, aiding H-REITs in approaching parity with regional peers. For instance, Mainland China's tax authority has allowed certain tax benefits for setting up C-REITs. It includes the income tax waiver during the restructuring of C-REITs' underlying assets and income tax deferral ahead of a C-REIT IPO. A lack of special tax treatment will affect the issuers to consider putting their assets into a REIT structure. We believe that special tax treatment shall be provided to H-REITs, which could further stimulate H-REIT development.

(iv) Diversify the legal structure of H-REITs

H-REITs must be established as unit trusts under the REIT Code. The rationale is to ensure a clear segregation of assets. However, a clear segregation of assets can also be achieved via a corporate structure by appointing an independent custodian with the equivalent supervisory and oversight responsibilities as a trustee.

We note that in other mature REIT markets, such as the United States, Australia and Japan, REITs are given broad discretion to choose the legal structure that best suits their business needs and are permitted to adopt corporate structures. We believe H-REITs should be given the same level of flexibility and freedom to choose their legal structure.

The inability to structure a H-REIT as a corporate may serve as a severe deterrent for real estate companies which may otherwise develop REITs in Hong Kong. For example, from an accounting perspective, a H-REIT (being a trust with a limited lifespan) cannot be treated as equity on a sponsor's balance sheet nor consolidated by the said sponsor. As sponsors may only treat H-REITs as liabilities on the balance sheet, the whole concept of forming and listing of H-REITs is rendered unattractive.

In addition, existing H-REITs are subject to the rule of perpetuity which limits the duration of trusts constituted before 1 December 2013, under the laws of Hong Kong to 80 years. The rule against perpetuity, which requires trusts in Hong Kong to run for no more than 80 years, was abolished in the amended Perpetuities and Accumulations Ordinance (2013). However, this abolition applies only to trusts created on or after 1 December 2013. The restriction in the perpetuity period limits the financing options for existing H-REITs when compared with corporates that can issue perpetual bonds (which can be treated as the sponsor's equity given their perpetual nature) to raise funds.

Furthermore, there is no statutory compulsory acquisition and scheme of arrangement mechanism in the H-REIT regime equivalent to that of the Companies Ordinance. Mergers and acquisitions are apparent means by which REITs may grow their businesses and improve liquidity, but the lack of squeeze-out and scheme of arrangement provisions would render a complete takeover or privatisation virtually impossible in practice. No mechanism is provided in the REIT Code for the offeror to exclude uncooperative minority unitholders and those unitholders who cannot be reached or even lost, no matter how small their holding is. The provisions of the REIT Code that require the deployment of trust structures are therefore a significant impediment for those H-REITs seeking inorganic growth.

We believe that being able to choose a corporate form will provide greater operational and structural flexibility for H-REITs. Some investment funds or institutions have certain restrictions on investment in trusts/funds, or rules against becoming a fund of funds, thus preventing them from investing in REITs in a trust form. Such technical investment hurdles could be surmounted if H-REITs were permitted to be structured as corporates. Introducing greater flexibility would improve investors' coverage, allowing investors with various mandates to participate in H-REIT investments. This will eventually help Hong Kong to compete more robustly in the global arena against other international financial centres as the domicile of choice for REIT managers and sponsors.

Additionally, the definition of H-REITs could be further expanded to cover other similar securities such as business trusts that invest primarily in real estate with the aim of providing returns to investors derived from the rental income of the real estate. It would help to expand the size and universe of the H-REIT market in Hong Kong.

(v) Inclusion of REITs into the Stock Connect regime

Hong Kong has long played the role of a global investment connector between the Mainland and the rest of the world. The launch of Stock Connect further strengthened Hong Kong's position as a destination for Mainland investors and opened the door for Mainland and international investors to trade in each other's markets.

Trading in Stock Connect has been active since its launch. According to data published by the Stock Exchange of Hong Kong, the average daily combined volume of North and Southbound trading reached RMB101.08 billion and HKD30.5 billion, respectively, in 2022. To diversify its product offering, the Stock Connect regime was, in July 2022, extended to cover ETFs. Further, the SFC recently announced the inclusion of foreign companies which are constituents of Hang Seng Composite Indices and meet the relevant criteria of the Stock Connect regime. Nonetheless, H-REITs cannot benefit from these existing interconnection mechanisms as they are excluded from the list of eligible securities under the Stock Connect regime.

In this regard, we propose to include H-REITs as eligible securities under the Stock Connect regime. This development would allow global investors to benefit from a broader exposure to Mainland assets, particularly in infrastructure sectors. Further, Mainland investors could leverage these platforms to invest in overseas real estate assets through H-REITs and diversify their investment portfolios. The investor bases of the two markets would thus be expanded, which would further enhance liquidity provision and price discovery in each market.

In short, the inclusion of H-REITs under the Stock Connect regime would provide both global and Mainland investors with diversified investment opportunities and promote the effective matching of real estate assets with international capital. This, in turn, would help establish Hong Kong as a REIT investment hub rivalling that of other markets and contribute to the continued economic transformation and expansion of Hong Kong.

Conclusion

As the home of many leading real estate developers and an international financial centre, Hong Kong has all the necessary tools to develop a REIT market of global standing. Hong Kong must however grasp those tools, or face being left behind by dynamic regional and global competitors who proactively anticipate and exploit the changing market landscape, meeting investors' expectations and benefiting their local markets.

HKREITA is committed to cooperating with regulators to formulate plans to foster the development of the H-REIT industry. We believe that implementing these recommendations will help provide a substantively more attractive market for investors. A vibrant REIT market will bring additional liquidity to real estate companies and the stock market, drive activity in the real estate and financial services sectors and buoy Hong Kong employment. This would undoubtedly enhance Hong Kong's competitiveness and strengthen its status as a premier asset management and capital formation centre.

Should you have any questions, please contact our Mr. George Hongchoy, Honorary Founding President & Chairman of HKREITA, at george.hongchoy@hkreita.com, or our Mr. Kenneth Wong, Secretary General of HKREITA, at kenneth.wong@hkreita.com. We would also be glad to have a meeting with you for further discussion.

Yours sincerely,

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