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

Policy Address Team
Chief Executive's Policy Unit
26/F, West Wing
Central Government Offices
2 Tim Mei Avenue
Tamar
Hong Kong

Attention: The Honourable John K C Lee, GBM, SBS, PDSM, PMSM

Dear Chief Executive,

HKREITA's Submission to 2024 Policy Address Public Consultation

On behalf of the Hong Kong REITS Association (HKREITA), its members and the H-REIT industry, we are pleased to offer our recommendations on the Government's upcoming Policy Address.

As global investors explore various avenues to diversify their portfolios and secure consistent income, REITs have become an increasingly attractive option. To capture this opportunity, Hong Kong rolled out its REIT regime in 2003. However, the growth of H-REIT market has not kept pace with regional counterparts like Singapore and Japan, particularly in terms of market diversity and the number of listed REITs.

Leveraging its status as a global financial hub and its proximity to Mainland China, Hong Kong is well-positioned to harness the opportunities to elevate its position as the largest REIT market in the Asia Pacific region. The time is ripe for the Government to adopt a more dynamic stance to unlock the vast potential of the H-REIT market. Please see attached our views on the measures the Government could consider fostering the H-REIT market.

Should you have any questions, please do not hesitate to reach out to myself or Kenneth Wong, Secretary General of HKREITA, at secretariat@hkreita.com or 2175 1882.

Yours sincerely,

George Kwok Lung HONGCHOY
Honorary Founding President & Chairman
Hong Kong REITS Association Limited

Encl.

c.c. LEUNG Fung Yee, Julia, SBS, JP,
Chief Executive Officer, The Securities and Futures Commission
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Executive Director, The Securities and Futures Commission

HKREITA's Submission to 2024 Policy Address Public Consultation

HKREITA supports and appreciates effort made by the Government to foster the development of the H-REIT market. To further enhance the regulatory and tax framework for H-REITs to create a level of commerciality on par with or exceeding that of our regional competitors, we set out below five key policy recommendations:

1. Relaxation of the Code on Real Estate Investment Trusts (the "REIT Code")

The market's vibrant growth hinges on a regulatory environment that fosters innovation and allows for the exploration of new investment opportunities. However, certain stringent aspects of the REIT Code are perceived as hindering this growth and have raised concerns among market participants. A careful review and potential relaxation of the following specific restrictions within the REIT Code could unlock a more dynamic and robust market, benefiting both investors and the broader Hong Kong economy:

(i) <u>Relaxation on the minimum of two-year holding period for the properties of H-REITs</u>

Hong Kong authorities should consider certain flexibility to the two-year holding restriction regarding the disposition of properties. Currently, H-REITs must hold its interest in the properties for a period of at least two years, unless the unitholders have given their consent to such disposal by way of a special resolution at a general meeting. Such two-year rule hinders H-REITs' ability to adapt to changing market conditions, seize opportunities and manage risk effectively.

Owing to the evolving property market and the need for immediate adjustment to be made to the property portfolio of H-REITs, flexibility and agility to maximise value for its unitholders in a timely manner shall be required. We consider that the feature of H-REITs would not be affected following the proposed relaxation with regards to the other key principles under the REIT Code, e.g., at least 75% of the gross asset value of H-REITs shall be invested in real estate that generates recurrent rental income at all times, at least 90% of its audited annual net income after tax shall be distributed to unitholders as dividends each year, etc.

More importantly, there is no such similar two-year holding restriction for REITs in comparable foreign jurisdictions such as Singapore, Japan, Australia, UK and US. Removing this arbitrary two-year rule would align Hong Kong's regulatory landscape with international best practices and foster a more competitive and attractive environment for H-REITs, which could further create synergy to the financial market.

(ii) <u>Relaxation on prohibition of financial assistance provided by H-REITs</u>

Hong Kong authorities should consider relaxing the current restrictions on financial assistance under the REIT Code. It is common practice in the market to acquire distressed properties through secured loan arrangements; however, the existing ban limits H-REITs' ability to acquire such properties, potentially impacting unitholders' interests. Allowing loans to joint venture entities, loans to senior management for fund subscriptions or loans to third parties secured by real estate could enhance H-REITs' ability to pursue strategic opportunities.

The existing prohibition also restricts H-REITs from pursuing acquisitions, development projects or capital-raising efforts where financial assistance to related parties would be beneficial, e.g., loans to a joint venture partner to finance the development or asset enhancement of the joint venture properties as a whole. Concerns regarding the risks of financial assistance can be effectively mitigated through prudent safeguards and oversight. The management company of a H-REIT is entrusted with fiduciary responsibilities to act in the best interests of the unitholders. This includes conducting comprehensive risk assessments, establishing robust controls and formulating detailed mitigation plans to safeguard the unitholders' interests particularly when providing financial assistance secured by properties or other kind of assets. Generally, REITs in comparable jurisdictions such as Japan, Australia, UK and US allow provision of financial assistance under certain circumstances.

By easing the prohibition on financial assistance while implementing these safeguards, H-REITs could unlock strategic opportunities, enhance investment flexibility and foster a more dynamic H-REIT market.

2. 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 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. Stamp duty here is effectively 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 properties from existing holding structures to that of a H-REIT or lowering the stamp duty rate for the direct transfer of properties by H-REITs to 0.26%, aligning with that of the stamp duty levied on property transaction through the transfer of SPVs.

3. Tax transparency

REITs are supposed to be stable retail investments so the focus should be on retail investor's tax positions and the need for transparency to ensure they are not disadvantaged. Tax transparency should be improved such 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 has several implications. First, it 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.

Furthermore, the above property and profits 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. Overseas investors potentially suffer from double taxation as a result of the current arrangement.

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.

Another recommendation would be to introduce a withholding tax rate which would allow the tax position to be tailored to different investors. Tax transparency, therefore, does not necessarily result in lower overall tax; instead, tax revenue from such investment stream would depend on the overall design of the system.

Last but not the least, the Government is committed to implementing global minimum tax and minimum top-up tax in Hong Kong under Pillar Two of the Base Erosion Profit Shifting (BEPS) framework drawn up by the Organisation for Economic Co-operation and Development (OECD). The OECD's rules contain provisions for most REITs to be treated as an excluded entity; however, because the taxation of H-REITs differ from global norms, it is not clear whether H-REITs would fall within the definition. This could put H-REITs in a less competitive position if REITs in other jurisdictions ended up paying less tax and being exempted from global minimum tax in contrast to H-REITs. It would be a good opportunity for the Government to review the tax system by either confirming that H-REITs meet the global definitions (noting that such a confirmation would not be binding on other jurisdictions) or to amend H-REIT's taxation provisions so that they align with global standards.

4. Inclusion of REITs into the HKD-RMB Dual Counter Model

HKREITA welcomes the inclusion of REITs in the Stock Connect regime announced by the China Securities Regulatory Commission and Hong Kong market regulators on 19 April 2024. This measure is part of the initiatives aimed at further expanding mutual market access between the Mainland and Hong Kong. The inclusion of REITs will increase investment alternatives and diversify stable income options for Mainland China and Hong Kong investors, while attracting more capital to the Hong Kong market. HKREITA will work closely with relevant parties in both markets to foster market development and education to encourage wider participation in the Stock Connect regime.

Furthermore, we recommend including H-REITs as eligible securities under the HKD-RMB Dual Counter Model to support the Renminbi development in the Hong Kong securities market, so that investors have a choice of trading H-REIT units in either Hong Kong Dollar or Renminbi. This would provide consistent liquidity in the Renminbi counter, minimise price discrepancies between the counters and further enhance liquidity of the stock market. Coupled with the inclusion of H-REITs into the Stock Connect regime, it will be even more attractive for Mainland investors to trade Renminbi denominated H-REIT units via southbound trading.

5. Diversification of the legal structure of H-REITs

We note that in other comparable jurisdictions, 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 to choose their legal structure.

Currently, 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.

The inability to structure a H-REIT as a corporate may serve as a severe deterrent for real estate companies that 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. Approximately 97% of total market capitalisation of currently listed H-REITs are affected. 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.

Therefore, introducing greater flexibility to the legal structure would improve investors' coverage, allowing investors with various mandates to participate in H-REIT investments. 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. Hong Kong could eventually compete more robustly in the global arena as the domicile of choice for REIT managers and sponsors.

Hong Kong REITS Association Limited
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