

# Real Estate Investment Trust: A Legal and Regulatory Analysis\*

## I. INTRODUCTION

With the end view of democratizing wealth by allowing Filipinos from all walks of life to invest and participate in the ownership of income-generating real estate in the Philippines, Republic Act (RA) No. 9856 or the “Real Estate Investment Trust Law” (“REIT Law”) was passed by the Philippine legislature in 2009. Still, no Philippine REIT has been incorporated or established despite the fact that almost a decade has passed since the REIT Law lapsed into law. To this effect, market players have claimed that legal and administrative requirements have made investment in the Philippine REIT market difficult, let alone infeasible.

This paper intends to analyze the legal and regulatory requirements that allegedly hamper the full implementation of the REIT Law and discuss possible solutions to these challenges.

## II. REIT IN THE PHILIPPINES

The REIT Law sets the legal framework for Philippine REITs. According to the law, Philippine REITs are stock corporations incorporated to own income-generating real estate assets.<sup>1</sup> Specifically, they are listed companies that own and operate income-producing real estate such as condominiums, shopping centers, office spaces, hotels, and resorts and hospitals. They can also own and operate infrastructure facilities such as tollways, airports, and highways. Inspired by the promising growth of international and Asian REIT markets, then House Representative (now Senator) Juan Edgardo “Sonny” M. Angara and former Senator Edgardo J. Angara championed the passage of the bill which later became the REIT Law. As of 2016, the global market capitalization for REIT stood at approximately US\$1.7 trillion, up from US\$734 billion.<sup>2</sup> In Asia and the Pacific, the four largest REIT Markets

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<sup>1</sup> Senate Journal 1432, 27 January 2009.

<sup>2</sup> Ernst & Young Global Perspectives: 2016 REIT Report, available at [http://www.ey.com/Publication/vwLUAssets/global-perspectives-2016-reit-report-ey/\\$File/ey-global-perspectives-2016-reit-report.pdf](http://www.ey.com/Publication/vwLUAssets/global-perspectives-2016-reit-report-ey/$File/ey-global-perspectives-2016-reit-report.pdf), accessed on 30 September 2017

(Japan, Australia, Singapore, and Hong Kong) have combined market capitalization of US\$295 billion.<sup>3</sup> The REIT Law intends to tap into this enormous market to provide further economic growth in the country.

In order to attract potential investors and foster the intended economic growth from the Philippine REIT market, the REIT Law provides for specific tax and other fiscal treatments/incentives to qualified registrants in the Philippine REIT system:

- a. A Philippine REIT is subject to regular income tax, but it can claim as deduction from its taxable net income any dividend distributed out of its distributable income.<sup>4</sup> In this regard, a Philippine REIT is required to distribute annually at least ninety percent (90%) of its distributable income as dividends to its shareholders not later than the last day of the fifth (5<sup>th</sup>) month following the close of its fiscal year.<sup>5</sup> Further, a Philippine REIT is not subject to the minimum corporate income tax.<sup>6</sup> However, a REIT shall be subject to income tax on its taxable net income as defined in the National Internal Revenue Code of 1997 (“NIRC”), as amended, instead of the provisions of the REIT Law in case of the following:
  - i. Failure to maintain its status as a public company as defined in the REIT Law (please see discussion below);
  - ii. Failure to maintain its listed status of the investor securities on the Philippine Stock Exchange (“PSE”) and the registration of the investor securities by the Securities and Exchange Commission (“SEC”); and/or
  - iii. Failure to distribute at least ninety percent (90%) of its distributable income required under the law.<sup>7</sup>
- b. Income payments to a Philippine REIT shall be subject to a lower creditable withholding tax of one percent (1%).<sup>8</sup>
- c. Sale or transfer of real property to a Philippine REIT, including any and all security interest in the real property, shall be subject to fifty percent (50%) of the applicable documentary stamp tax (“DST”) imposed under the NIRC, as amended. In addition, all applicable registration and annotation fees related or incidental to the transfer of the particular asset, or any related security interest,

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<sup>3</sup> *Id.*

<sup>4</sup> Section 3(mm), Republic Act No. 9856 (“REIT Law”).

<sup>5</sup> Section 7, REIT Law.

<sup>6</sup> Section 10, REIT Law.

<sup>7</sup> Section 10, REIT Law.

<sup>8</sup> Section 11, REIT Law.

shall be fifty (50%) of the applicable registration and annotation fees. These incentives can be availed of by any unlisted Philippine REIT as long as it becomes listed in the PSE within two (2) years from the date it started availing of the incentives. However, the other fifty percent (50%) of the DST that should have been paid by the Philippine REIT shall be collected, including applicable surcharge, penalty, and interest reckoned from the date it should have been paid, in case of the same instances as mentioned above in letter (a) or in case it fails to list in the PSE within two (2) years.<sup>9</sup>

- d. The original issuance of investor securities shall be subject to the applicable DST under the NIRC, as amended. Further, any sale, barter, exchange or other disposition of listed investor securities through the PSE shall be subject to the stock transaction tax under the same Tax Code but shall be exempt from payment of the DST. In addition, any initial public offering and secondary offering of investor securities shall be exempt from other percentage taxes under the Tax Code.<sup>10</sup>
- e. Cash or property dividend paid by a Philippine REIT shall be subject to the regular final withholding tax of ten percent (10%), except in the following cases:
  - i. Dividends received by nonresident alien individuals or nonresident foreign corporations are subject to the preferential withholding tax rate of less than ten percent (10%) pursuant to an applicable tax treaty;
  - ii. Dividends received by domestic corporations or resident foreign corporations are exempt from income tax or withholding tax; and
  - iii. Dividends received by overseas Filipino investors are exempt from income tax for seven (7) years from the effectivity of RR No. 13-2011.<sup>11</sup>
- f. Lastly, a Philippine REIT is subject to value-added tax (“VAT”) on its gross sales from disposal of real property or on its gross receipts from rental of real property, but it shall not be considered as a dealer in securities and shall not be subject to VAT on its sale, exchange, or transfer of securities that form part of its real-estate related assets.<sup>12</sup>

However, for a Philippine REIT to qualify for the abovementioned tax and fiscal incentives/treatments provided under the REIT Law, it must meet the following requirements:

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<sup>9</sup> Section 12, REIT Law.

<sup>10</sup> Section 13, REIT Law.

<sup>11</sup> Section 14, REIT Law. RR 13-2011 became effective on 11 August 2011. Hence, the dividend exemption given to overseas Filipino investors shall lapse on 10 August 2018.

<sup>12</sup> Section 15, REIT Law.

- a. It must be a public company, i.e. it must maintain its status as a listed company in the PSE, and, upon and after listing, have at least one thousand (1,000) public shareholders who each own at least fifty (50) shares of any class of shares, and comprise at least one-third (1/3) of the outstanding capital stock of the corporation (please see discussion below).<sup>13</sup>
- b. It must distribute at least ninety percent (90%) of its annual net income as discussed above.<sup>14</sup>
- c. It must have a minimum paid-up capital of P300,000,000.00.<sup>15</sup> At least seventy five percent (75%) of its assets must be invested in, or must consist of, income-generating real estate.<sup>16</sup> Upon the authority of the SEC, it may invest in income-generating real estate outside the Philippines, as long as such foreign investment does not exceed forty (40%) of its total assets.<sup>17</sup>
- d. Upon the authority of the appropriate regulatory agency, it can invest up to a maximum of five (5%) percent of its investible funds in synthetic investment products such as credit default swaps, credit linked notes, collateralized debt obligations, total return swaps, credit spread options, and credit default options.<sup>18</sup>
- e. Unless it intends to hold the developed property up to completion, it may not undertake property development activities or invest in unlisted property development activities. Further, its exposure in these activities or investments must not exceed ten percent (10%) of its total assets.<sup>19</sup>
- f. It may not invest more than fifteen percent (15%) of its investible funds in any one issuer's securities or managed fund, except in government securities where the limit is twenty five percent (25%).<sup>20</sup>
- g. When investing in real estate as a joint owner, it should acquire shares or interests in an unlisted special purpose vehicle ("SPV") constituted to hold or own the real estate, and it must have the freedom to dispose of such investment. Further, the joint venture agreement must provide for a minimum percentage of distributable

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<sup>13</sup> Section 8.1, REIT Law.

<sup>14</sup> Section 7, REIT Law.

<sup>15</sup> Section 8.2, REIT Law.

<sup>16</sup> Section 8.5, REIT Law.

<sup>17</sup> Section 8.3, REIT Law.

<sup>18</sup> Section 8.4, REIT Law.

<sup>19</sup> Section 8.6, REIT Law.

<sup>20</sup> Section 8.7, REIT Law.

profits and must grant the Philippine REIT veto rights over key operational issues.<sup>21</sup>

- h. Its total borrowings and deferred payments must not exceed thirty five percent (35%) of its assets, except if it has a publicly disclosed investment grade credit rating by a duly accredited or internationally recognized rating agency, in which case this limit may increase up to seventy percent (70%) of its assets.<sup>22</sup>
- i. It must have its assets valued at least once a year by an independent appraisal company duly accredited by the SEC.<sup>23</sup>
- j. It must have an independent fund manager and an independent property manager.<sup>24</sup> Their fees must not exceed one percent (1%) of the net asset value of the assets under management.<sup>25</sup>
- k. At least one-third (1/3) of its board of directors must be independent directors.<sup>26</sup>
- l. The total annual compensation of all its executive officers must not exceed the percentage of net income before regular corporate income tax during the immediately preceding taxable year as provided by the SEC.<sup>27</sup>
- m. Finally, aside from being subject to the reportorial and disclosure requirements prescribed by the Corporation Code,<sup>28</sup> the Securities Regulation Code,<sup>29</sup> and the SEC,<sup>30</sup> it is also subject to special quarterly and annual reports to be submitted to the SEC.<sup>31</sup>

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<sup>21</sup> Section 8.9, REIT Law.

<sup>22</sup> Section 8.10, REIT Law.

<sup>23</sup> Section 8.12, REIT Law.

<sup>24</sup> Sections 8.12 and 8.13, REIT Law.

<sup>25</sup> Section 8.18, REIT Law.

<sup>26</sup> Section 8.15, REIT Law.

<sup>27</sup> Section 8.17, REIT Law. Under Rule IV, Section 5.2 of the REIT Law's Implementing Rules and Regulations, this is set at ten percent (10%).

<sup>28</sup> Batas Pambansa Bilang 68, as amended.

<sup>29</sup> Republic Act No. 8799.

<sup>30</sup> Section 9.1, REIT Law.

<sup>31</sup> Section 9.2, REIT Law. 9.2 Special Quarterly and Annual Reports — In addition to the quarterly and annual reportorial and disclosure requirements prescribed for public and listed companies, the REIT shall make a report on and disclose the following to the Commission and the Exchange:

- i. Summary of all real estate transactions entered into during the period, including the identity of the parties, the contract price, and their valuations, including the methods used to value the assets;

### III. COMPETITIVENESS OF THE PHILIPPINE REIT – ISSUES AFFECTING IMPLEMENTATION

Of the several requirements provided in the REIT Law, according to market players, there are three (3) requirements that delay the full implementation of the REIT Law. According to them, these issues do not pertain to the REIT Law, but emanate from the administrative regulations, resulting in stringent and onerous implementation of the requirements that do not appear to have any basis in the REIT Law.<sup>32</sup> However, a review of the REIT Law and other relevant laws show that either the administrative regulations are not overreaching or that the implementation is prescribed by other relevant laws.

#### A. Minimum Public Ownership Requirement

In order to facilitate public participation in the Philippine REIT market, one of the requirements provided under the REIT Law that Philippine REITs must comply with at all times is the minimum public ownership. Section 8 of the law provides:

SECTION 8. Requirements. — Unless the [Securities and Exchange] Commission provides otherwise and after public hearing, taking into account public interest, the need to protect investors and develop the country's real estate investment industry to make it globally competitive, the following requirements shall apply:

8.1 Minimum Public Ownership — A REIT must be a public company and to be considered as such, a REIT must: (a) maintain its status as a listed company; and (b) upon and after listing, have at least one thousand (1,000) public shareholders each owning at least fifty (50) shares of any class of shares who in the aggregate own at least one-third (1/3) of the outstanding capital stock of the REIT.

x    x    x

Pursuant to Section 22 of the REIT Law, the SEC issued the law's Implementing Rules and Regulations ("REIT IRR") which prescribes the MPO requirement, among others. The SEC initially followed the REIT Law's MPO requirement:

#### RULE 4

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- ii. Summary of all the REIT's real estate assets, including the location of such assets, their purchase prices and the latest valuations, rentals received and occupancy rates, and/or the remaining terms of the REIT's leasehold properties;
  - iii. Comparative summary of the financial performance of the REIT covering various time periods (e.g., quarterly, one (1)-year, three (3)-year, five (5)-year or (10)-year).

<sup>32</sup> Letters dated 13 June 2011 and 27 September 2016 from Mr. Hans B. Sicat, President and Chief Executive Officer, Philippine Stock Exchange.

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SECTION 5. Requirements. — The REIT shall comply with the following requirements:

### 5.1 Body Corporate.

a. Minimum Public Ownership. A REIT shall be a public company and to be considered as such, a REIT shall: (a) maintain its status as a listed company; and (b) upon and after listing, have at least one thousand (1,000) Public Shareholders each owning at least fifty (50) shares of any class of shares, and who, in the aggregate, own at least one-third (1/3) of the outstanding capital stock of the REIT.

However, the SEC eventually amended the REIT IRR and increased this MPO requirement:

Section 5.1 (a), Rule 4:

Minimum Public Ownership. A REIT shall be a public company and to be considered as such, a REIT shall: (a) maintain its status as a listed company; and (b) upon and after listing, have at least one thousand (1,000) Public shareholders each owning at least fifty (50) shares, and who, in the aggregate, own at least forty percent (40%) of the outstanding capital stock of the REIT at the initial year; provided, that the minimum ownership shall be increased to sixty seven percent (67%) within three (3) years from its listing.<sup>33</sup>

x      x      x

Because of this higher MPO requirement in the REIT IRR, Revenue Regulations (“RR”) No. 13-2011 which implements the law’s tax provisions imposed the same MPO requirement:

SECTION 11. General Conditions for the Availment of Tax Incentives. — In order to qualify for the tax incentives under Sections 5 and 10 of these Regulations, a REIT must:

1. Be a public company and maintain its status as a public company as defined herein;

x      x      x

SECTION 3. Definition of Terms. — For purposes of these Regulations, the term:

x      x      x

<sup>33</sup> SEC Memorandum Circular No. 02-2011 dated April 27, 2011.

(s) "Public Company" means a company listed with the Exchange which has, upon and after listing, at least one thousand (1,000) public shareholders each owning at least fifty (50) shares of any class and who in the aggregate own at least forty percent (40%) of the outstanding capital stock of the REIT at the initial year; provided, that the minimum ownership shall be increased to sixty seven percent (67%) within three (3) years from its listing.

Notably, the MPO requirement for Philippine REITs is significantly higher than the MPO requirement for publicly listed companies which is currently at 10%.<sup>34</sup> In his sponsorship speech, Senator Edgardo J. Angara said that the reason for this requirement is that a REIT must be a widely public held corporation.<sup>35</sup> In fact, the increase in the MPO requirement from at least one-third (1/3) of the outstanding capital stock ("original MPO") to at least forty percent (40%) at the initial year with a requirement of increasing it to sixty seven percent (67%) within three (3) years from its listing ("increased MPO") was due to the request of former BIR Commissioner Kim S. Jacinto-Henares, upon the instructions of former Finance Secretary Cesar V. Purisima to be "consistent with the avowed policy of the [REIT L]aw to make the REIT a public company."<sup>36</sup>

However, this increased MPO, and even the original MPO, is not a hard-and-fast rule. The REIT Law provides that the SEC may "after public hearing, taking into account public interest, the need to protect investors and develop the country's real estate investment industry to make it globally competitive," provide for a different requirement, even lower than the original MPO requirement set by the REIT Law.<sup>37</sup> Hence, the PSE has continuously urged the SEC to reconsider its increased MPO requirement. The PSE claims that the original MPO is already difficult to achieve and that the increased MPO requirement makes the Philippine REIT regulatory regime the "most aggressive in the region" making it the "least conducive for investments and cross-border listings."<sup>38</sup> A review of the REITs in the Asia Pacific Region including the United Kingdom and the United States by the European Public Real Estate in its *Global REIT Survey 2017*<sup>39</sup> shows that the Philippines' current MPO requirement, in fact, is the strictest in the region, and is even stricter compared to the United Kingdom and the United States.

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<sup>34</sup> The SEC has increased the MPO requirement for applicants for initial public offerings to 20%.

<sup>35</sup> Senate Journal 1573, 10 February 2009

<sup>36</sup> SEC Notice, available at <http://www.sec.gov.ph/wp-content/uploads/2015/11/notice-reit-amendment.pdf> accessed on 30 September 2017

<sup>37</sup> Section 8, REIT Law.

<sup>38</sup> *Supra*, Note 32.

<sup>39</sup> Dated 01 September 2017, available at [http://prodapp.epra.com/media/Global-REIT-Survey-complete\\_1508858723450.pdf](http://prodapp.epra.com/media/Global-REIT-Survey-complete_1508858723450.pdf), accessed on 30 September 2017



**Table 1: COMPARATIVE MPO AND LISTING REQUIREMENTS IN DIFERRENT JURISDICTIONS**

|   | <b>Country</b> | <b>MPO Requirement</b>  | <b>Listing Requirement</b>  |
|---|----------------|---|---|
| 1 | Philippines    | There must be at least 1,000 shareholders with at least 50 shares each (who in aggregate own at least 40% of share capital in the year of listing and should be increased to 67% within 3 years of listing).  | Listing is mandatory.   |
| 2 | Australia      | No MPO requirement to incorporate.  | Listing is not mandatory.   |
| 3 | Hong Kong      | No MPO requirement to incorporate. However, both the Main Board and the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited require 25% minimum public float. <sup>40</sup>   | Listing is mandatory.   |
| 4 | Indonesia      | There must be at least 100 shareholders. The number of participation units owned by the largest unitholder must not be more than 75% of the total participation units.  | Listing is not mandatory.   |
| 5 | Malaysia       | No MPO requirement to incorporate.  | Listing is not mandatory. For listing, the REIT must have at least 25% of the total number of units held by at least 1,000 public unit holders holding at least 100 units each.   |
| 6 | New Zealand    | No MPO requirement to incorporate.  | Listing is not mandatory.   |
| 7 | Singapore      | For Singapore Dollar-denominated REITs listed on the Singapore Exchange, at least 25% of its capital must be held by at least 500 public unit holders. In the case of foreign currency-denominated REITs listed on the Singapore Exchange, a spread of holders necessary for an orderly market is required. | Singaporean REITs need not be listed, but only a REIT that is listed on the Singapore Exchange is eligible for tax concessions. A REIT listed on a foreign exchange will not be eligible for the various tax concessions.   |
| 8 | South Korea    | At least 30% of the shares must be offered to the public within 18 months from of official permission.  | The South Korean REIT must list its stocks on the securities market of the Korea Stock Exchange or register them with the Korea Securities Dealers Association and make them traded either in the securities market of the Korea Stock Exchange or in the association brokerage market of the Korea Securities Dealers Association. |

<sup>40</sup> Available at [http://sc.hkex.com.hk/gb/ips1.hkex/eng/listing/listreq\\_pro/listreq/equities.htm](http://sc.hkex.com.hk/gb/ips1.hkex/eng/listing/listreq_pro/listreq/equities.htm), accessed on 30 September 2017

|    | <b>Country</b> | <b>MPO Requirement</b>  | <b>Listing Requirement</b>   |
|----|----------------|---|--|
| 9  | Thailand       | The minimum number of unit holders is 250 for an initial public offering and 35 after listing in the stock exchange. Former property owners and related persons shall not acquire more than 50% of total units sold of each tranche (if any). At least 15 % of the unit must be held by public investors in each tranche. | Listing is mandatory.  |
| 10 | Japan          | There are no shareholder requirements. However, in order to benefit from the privilege of deducting distributed dividends for tax purposes, specific shareholder conditions must be met.  | Listing is not mandatory. For listing, the following are the minimum free-float requirements (at the time of the initial listing):<br>a. The number of outstanding shares should be 4,000 shares or more;<br>b. The total number of shares held by the 10 largest Japanese REIT shareholders should be 75% or less of the total outstanding shares; and<br>c. The number of shareholders other than the 10 largest Japanese REIT shareholders should be 1,000 or more. |
| 11 | United Kingdom | A UK REIT cannot be controlled by five or fewer shareholders. A listed company will not be close if at least 35% of the shares are owned by shareholders owning less than 5% and pension funds (who do not provide pensions for the employees of that REIT) but excludes non-close companies.                             | Listing is mandatory. The UK REIT must be admitted to trading on a recognized stock exchange and either listed on the London Stock Exchange (or foreign equivalent main market exchange) or traded on any Stock Exchange recognized by the UK tax authorities (within three years).  |
| 12 | United States  | US REIT shares must be transferable. Beginning with the US REIT's second taxable year, the US REIT is required to have a minimum of 100 shareholders. Also, no more than 50% of its shares may be held by five or fewer individuals or private foundations during the last half of the taxable year.                      | Listing is not mandatory.  |

This strict increased MPO requirement, according to PSE, has resulted to the Philippines remaining behind its peers in the Association of South East Asian Nation (“ASEAN”) region, most of which have long had robust and thriving REIT markets.

## B. Imposition of VAT

Another issue that concerns the REIT Law implementation is the imposition of VAT on the initial transfer of property from the initial owner of the real property (“source”) to the Philippine REIT in exchange for the latter’s shares of stocks.

In order to qualify for the incentives provided in the REIT Law, a Philippine REIT must have a minimum paid-up capital of P300,000,000.00 at the time of incorporation either in cash and/or property.<sup>41</sup> In addition, at least seventy-five percent of its assets must consist of, or must be invested in, income-generating real property.<sup>42</sup> Hence, the tax efficient method to comply to these requirements is to transfer high-valued real property to the Philippine REIT in exchange for corporate control. However, since the REIT Law does not provide for the tax treatment of this initial transfer of property from the source to the Philippine REIT in exchange for the latter’s shares of stocks is not provided by the REIT Law, Section 16 of the same law provides that the general provisions of the NIRC, as amended, apply.<sup>43</sup> Specifically, Section 40(C)(2) of the Tax Code provides:

### C) Exchange of Property. —

(1) General Rule. — Except as herein provided, upon the sale or exchange of property, the entire amount of the gain or loss, as the case may be, shall be recognized.

(2) Exception. — No gain or loss shall be recognized if in pursuance of a plan of merger or consolidation —

x      x      x

No gain or loss shall also be recognized if property is transferred to a corporation by a person in exchange for stock or unit of participation in such a corporation of which as a result of such exchange said person, alone or together with others, not exceeding four (4) persons, gains control of said corporation: Provided, that stocks issued for services shall not be considered as issued in return for property.

x      x      x

Based on this tax deferral arrangement provided in the Tax Code, any resulting gain or loss resulting from the initial transfer of property to the Philippine REIT will not be recognized as long as the source gains control of the Philippine REIT. This initial transfer of property in exchange for corporate control in the Philippine REIT may be subject to VAT,

<sup>41</sup> Section 8.2, REIT Law.

<sup>42</sup> Section 8.5, REIT Law.

<sup>43</sup> Section 15, Revenue Regulations No. 13-2011.

depending on whether the property is treated by the sponsor as a capital asset or an ordinary asset. RR No. 10-2011, which amended RR Nos. 16-2005 and 4-2007, provides:

SEC. 4.106-8. Change or Cessation of Status as VAT-Registered Person. —

x            x            x

(b) Not subject to output tax. —

The VAT shall not apply to goods or properties which are originally intended for sale or for use in the course of business existing as of the occurrence of the following:

(1) Change of control of a corporation by acquisition of the controlling interest of such corporation by another stockholder (individual or corporate) or group of stockholders. The goods or properties used in business (including those held for lease) or those comprising the stock in trade of the corporation having a change in corporate control will not be considered sold, bartered, or exchanged despite the change in the ownership interest in the said corporation.

*However, the exchange of goods or properties including the real estate properties used in business or held for sale or for lease by the transferor, for shares of stocks, whether resulting in corporate control or not, is subject to VAT. (emphasis supplied)*

x            x            x

If the sponsor treats the transferred property as a capital asset, it will not be subject to VAT on the initial transfer in exchange for shares of stock. However, if the transferred property is an ordinary asset, i.e. the sponsor either used the property in business or is held for sale or for lease, then the initial transfer will be subject to VAT.

Again, the PSE disagreed to this VAT imposition:

A sale, barter or exchange involves the absolute conveyance of ownership over the property transferred and the corresponding loss of the transferor's control over said property. In the case of a transfer of property from the sponsor to the REIT company in exchange for the latter's shares whereby the sponsor will acquire control of the REIT company, which is essentially a Section 40(C)(2) transfer, the sponsor does not divest himself absolutely of control over the property.<sup>44</sup>

Further, it opined that the BIR will be in a better revenue position in the long run if the VAT is not imposed on this initial transfer. It opined that if the initial transfer of property from the sponsor to the REIT will not be subject to VAT, the REIT will not be able to credit

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<sup>44</sup> *Supra*, Note 32.

input tax against the VAT on its sales and rental income. Hence, the REIT will have excess output VAT and the government will be able to collect more revenues in the long run.<sup>45</sup>

Finally, the PSE said that this VAT imposition will significantly increase the sponsor's cost of investment in REITs, and hence will discourage their establishment. Consequently, additional investments and new employment opportunities that could have been generated by the creation of a new REIT company will be lost.

### C. Escrow Requirement

The last issue that concerns potential Philippine REIT entrants is the escrow requirement on income tax collectible from the company. Section 10 of RR No. 13-2011 provides:

SECTION 10. Income Taxation of REIT. —                   x           x           x

For purposes of this section, the dividends allowed as deductions during the taxable year shall pertain to dividends actually distributed out of the REITs's distributable income at any time after the close of but not later than the last day of the fifth (5th) month from the close of the taxable year. Any dividends distributed within this prescribed period shall be considered as paid on the last day of REIT's taxable year.

*Provided however, the REIT shall place in escrow in favor of the Bureau with an Authorized Agent Bank acceptable to the Bureau the income tax collectible from the REIT on the dividend it declared and deducted from its taxable income for the first and second year of the REIT prior to its attaining the minimum ownership of sixty seven percent (67%) had it been disallowed. The escrowed income tax amount shall be released to the REIT only upon showing of proof of compliance to the increase of minimum ownership to sixty seven percent (67%) within three (3) years from its listing, otherwise, it shall be released in favor of the government in accordance with Section 16 of these Revenue Regulations.*

By the end of the third year from its listing, at the latest and thereafter, the REIT shall maintain the minimum public ownership of sixty seven percent (67%). Otherwise, dividend payment shall not be allowed as a deduction from its taxable income.

A REIT is required to submit to LTRAD 3 quarterly a sworn statement containing the list of its shareholders, their Tax Identification Number, their shareholdings, and the percentage that their shareholding represents. Prior to any declaration of any dividends, and for said dividends to be deducted from its income for tax purposes, the REIT shall in addition submit a sworn statement that the minimum ownership requirements for the relevant years — forty percent (40%) for the first two (2) years and sixty seven percent (67%)

<sup>45</sup> *Supra*, Note 32.

on or before the end of the third year and thereafter — were maintained at all times. (emphasis supplied)

This escrow requirement intends to secure the income which the Government would otherwise have collected if not for the advantage of the incentives under the REIT Law. In effect, this only ensures that the proper income tax that should be collected will in fact be collected by the government.

Escrow requirements imposed by the BIR are not new. The BIR has previously required taxpayers availing of certain incentives to deposit the supposed taxes in order to protect the interest of the Government.<sup>46</sup> Still, market players are concerned with the application of this escrow requirement in connection with the increased MPO requirement set forth in the REIT IRR and in RR No. 13-2011, i.e. considering the increased MPO requirement will be very difficult to comply, this will result to the escrowed income tax being almost automatically forfeited by the Government. However, since the escrow requirement under RR No. 13-2011 merely ensures compliance with the requirements set forth by the REIT Law and only protects the interest of the Government in the income tax that are supposedly due from Philippine REITs, it does not defeat the purposes of the REIT Law.

#### IV. CONCLUSION

Of the three (3) issues discussed that allegedly confront the full implementation of the REIT Law, the first two (2) concerns pose considerable attention: the increased MPO requirement and the VAT imposition on the initial transfer of real property to the Philippine REIT.

With regard to the increased MPO requirement, the Department of Finance (“DOF”) has continuously posited that this should be set back to the original MPO requirement to open the market to possible investors that can further stir up the real estate and capital markets. Still, the DOF is cognizant of the SEC’s concern of protecting the investing public through ensuring that public participation through wide public float is maintained. Further, the SEC’s imposition of the increased MPO requirement is pursuant to its validly delegated power under the REIT Law. Fortunately however, the SEC has previously maintained that they are amenable to reviewing the increased MPO requirement if the VAT imposition on initial transfer of real property is also reviewed.<sup>47</sup>

With regard to the second concern, it is true that the imposition of VAT on the transfer of real property from the source to the REIT results to significant additional investment from possible market entrants. In effect, if an investor intends to incorporate a Philippine REIT and comply with its minimum investment requirement by transferring its

<sup>46</sup> Revenue Regulations No. 13-1999, as amended, pertaining to capital gains tax due from sale of principal residences by a natural person and Revenue Regulations No. 3-2005, as amended, pertaining to taxpayers who have pending tax deficiency assessments applying for Tax Clearance Certificates.

<sup>47</sup> Public Hearing of the House Committee on Economic Affairs, 16 November 2016.

ordinary asset in exchange for corporate control (P300,000,000.00 minimum paid-up capital with 75% of the assets invested in income-generating real property), this will require an additional P27,000,000.00 in the form VAT by the Philippine REIT.<sup>48</sup> Notably, this VAT payment is considered a deferred tax asset in the form of input tax which can be used by the Philippine REIT to offset its future output tax liabilities from operations. Still, the PSE in its previously mentioned letters<sup>49</sup> raised concerns that this additional required investment will discourage possible entrants in the Philippine REIT market.

The Department of Finance (“DOF”) has continuously supported the growth of the Philippine REIT market, it has also continuously maintained that since the REIT Law does not provide specific rules on the taxability of the initial transfer from the source to the Philippine REIT in exchange for corporate control, the general provisions of Tax Code apply pursuant to Section 16 of the REIT Law. Hence, since real estate companies (who are usually the source in the initial transfer of real property to the Philippine REIT) deal with real estate, all properties held by them would fall as ordinary assets and, therefore, transfer of these properties are subject to VAT. Nevertheless, the DOF has been considering carving out transactions resulting from Section 40(C)(2) of the Tax Code from the VAT system since these transfers do not result to change in beneficial ownership of the asset. In fact, the DOF has included this exemption in Package 1 of its proposed comprehensive tax reform program.

**Update: With the support of the DOF, transfer of property pursuant to Section 40(C)(2) of the NIRC, as amended, is now exempt from VAT pursuant to the amendments in the Tax Code provided under RA No. 10963, otherwise known as the Tax Reform for Acceleration and Inclusion Law. With this welcome development, the DOF is confident that the SEC will revisit its increased MPO requirement that will eventually lead to possible investors in the Philippine REIT market.**



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<sup>48</sup> P300,000,000.00 minimum paid-up capital multiplied by the 75% asset requirement multiplied by 12% VAT rate.

<sup>49</sup> *Supra*, Note 32.