

**ISLAMIC FINANCIAL
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AND SPECIALISED WORKSHOPS**

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TOPIC: ISLAMIC REITs –

Legal & Legislative Issues in I-REITs

By

**MOHAMED ISMAIL MOHAMED SHARIFF
LL.B. (HONS.), (S'PORE), LL.M. (LOND), FCIArb, FMIArb,
OF LINCOLN'S INN, BARRISTER AT LAW
ADVOCATE AND SOLICITOR OF
THE HIGH COURT OF MALAYA &
THE SUPREME COURT OF THE REPUBLIC OF SINGAPORE**

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Mohamed Ismail Shariff

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REITs

- REITs are Real Estate Investment Trusts. As the name suggests, they are *trusts* which provide investors with an *investment vehicle* in *landed properties*.
- A REIT has been defined as “a vehicle which mobilises funds from the unit holders comprising individuals and companies for investment in real estate”.

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REITs (ctd)

- As is the case with other investment instruments there are no laws that are universally applicable to REITs across various jurisdictions.
- However the law relating to **trusts**, **investments** and **real estate** are generally well established in almost all jurisdictions, subject to particular features in the law peculiar to each jurisdiction.

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ISLAMIC REITS

- Given the apparently rather simple structure of a REIT, how different can an Islamic REIT be?
- The answer is, it can be, and has to be, rather different.
- But first, what is an Islamic REIT?

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ISLAMIC REITS (ctd)

- There can be as many definitions as there are jurisdictions. There is no universal definition though all definitions have to comply with the requirements of the Shariah.

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ISLAMIC REITS (ctd)

- For the purposes of this discussion we'll consider the position in Malaysia.
- Malaysia is given credit as “the first jurisdiction in the global Islamic sector to have issued Guidelines for Islamic Real Estate Investment Trusts and setting a global benchmark for the development of Islamic REITS”.

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ISLAMIC REITS (ctd)

- On 21 November 2005 the Securities Commission of Malaysia issued Guidelines for Islamic REITs called *Guidelines for Islamic Real Estate Islamic Trusts* (the Guidelines). It defines an Islamic Reit as follows:
- **“An Islamic REIT is a collective investment scheme in real estate, in which the tenants operate permissible activities according to the Shariah”.**

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ISLAMIC REITS (ctd)

- Certain issues arise from this definition:
 - a. what activities are permissible?
 - b. what is the position where mixed activities (permissible and non-permissible) are carried on in the premises? In other words, what is the criteria to be used in deciding whether an Islamic REIT may purchase a property where mixed activities are operated?

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ISLAMIC REITS (ctd)

- Regarding the 1st issue, the Guidelines adopts the elimination method of definition, i.e. it sets out what are non-permissible activities. The implication is that all other activities are *prima facie* permissible.
- The list of non-permissible activities is as follows:
 1. Financial services based on *riba* (interest);
 2. Gambling/gaming;

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ISLAMIC REITS (ctd)

3. Manufacture or sale of non-*halal* products or related products;
4. Conventional insurance;
5. Entertainment activities that are non-permissible according to the Shariah;
6. Manufacture or sale of tobacco-based products and related products;
7. Stock broking or share trading in Shariah non-compliant securities; and
8. Hotels and resorts.

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ISLAMIC REITS (ctd)

- As regards the second issue, the Guidelines says that where mixed activities are carried on the Islamic REIT manager must conduct additional compliance assessments. This involves:
 - Aggregating the rental from all non-permissible activities in the property in question; and next

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ISLAMIC REITS (ctd)

- Ascertaining the proportion the aggregate rental so determined bears to the total turnover of the Islamic REIT.
- If the percentage of the non-permissible rental exceeds 20% of the total turnover the fund manager cannot invest in that real estate.

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ISLAMIC REITS (ctd)

- This is the benchmark, the 20% benchmark, set by the Shariah Advisory Council of the Securities Commission, Malaysia as the threshold on rental from non-permissible activities that is allowed in an Islamic REIT.
- There is also a rider to this.

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ISLAMIC REITS (ctd)

- An Islamic REIT is not allowed to own real estate in which all the tenants operate non-permissible activities even if the percentage of the rental from that property to the total turnover of the Islamic REIT is less than 20%, i.e. below the benchmark.
- The fund manager is also advised not to accept a new tenant whose activities are wholly non-permissible.

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ISLAMIC REITS (ctd)

- The Guidelines also provides a formula for calculating the proportion of rental paid for non-permissible activities over the total rental paid by a tenant operating mixed activities.
- The formula is based on the area occupied for non-permissible activities to the total area occupied.

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ISLAMIC REITS (ctd)

- For activities that do not involve usage of space, such as service-based activities, the calculation is left to be determined by *ijtihad* by the Shariah committee or Shariah advisor of the Islamic REIT.

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INVESTMENT, DEPOSITS AND FINANCING

- It is stipulated that all forms of investment, deposit and financing instruments for Islamic REITs must comply with Shariah principles.

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INSURANCE

- Islamic REITs are required to use *Takaful* schemes to insure its real estate.
- However where the *Takaful* scheme is unable to provide the required coverage, Islamic REITs are allowed to use conventional insurance schemes.

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RISK MANAGEMENT

- Islamic REITs are allowed to deal in forward sales and purchases of currency as a risk management tool.
- In so doing, they are encouraged to deal with Islamic financial institutions, in which case the principle of *wa'ad* (unilateral promise) will apply. This means that only the party that initiates the promise is obligated to fulfill it.

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RISK MANAGEMENT (ctd)

- Where Islamic REITs deal with conventional financial institutions, they are allowed to conduct forward sales and purchases in the conventional way.

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OBJECTIVES

- The Guidelines:
 - “are designed to facilitate further development of new Islamic capital market products and to further promote and accelerate the growth of a competitive Islamic capital market in Malaysia;
 - “aim to provide a new investment opportunity for those who wish to invest in real estate through Shariah compliant capital market instruments;

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OBJECTIVES (ctd)

- “facilitate the creation of a new asset class for investors;
- “allow fund managers to further diversify their investment sources and portfolios; and
- “provide international investors seeking Shariah compliant instruments an opportunity to invest in Malaysian real property without the need for direct ownership of such assets.”

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TAX INCENTIVES FOR REITs

- (i) Gains arising from disposal of real property is subject to real property gains tax but such gains on disposal to REITs are exempted;
- (ii) Stamp duty is payable on transfers of real property but such transfers to REITs are exempted;
- (iii) Income of REITs distributed to unit holders are exempt from income tax;

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TAX INCENTIVES FOR REITs (ctd)

- (iv) Income tax on income distributed by REITs for resident units holders will be at their respective rates and for non-residents at 28%;
- (v) Tax credit is given to units holders on accumulated income of REITs which was subjected to tax and subsequently distributed;
- (vi) Expenditure on setting up of REITs (e.g. consultancy, legal, valuation fees,

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SOME PROPOSED CHANGES IN TAX TREATMENT OF REITs

- (i) Non-corporate REIT investors will be subject to 15% withholding tax for 5 years on distributions by REITs;
- (ii) Foreign institutional investors will be subject to 20% withholding tax for 5 years on distributions by REITs;
- (iii) REITs will be exempt from income tax if at least 90% of their total income is distributed to investors.

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MILESTONES IN ISLAMIC REITs

- One Islamic REIT (the *Al-Aqar KPJ Healthcare REIT*) (hospitals) was issued and listed on the stock exchange in Malaysia in 2006. It is trading above the issue price whilst a few other non-Islamic REITs, also listed in 2006, are trading below the issue prices.
- Another Islamic REIT (the *Al-Hadharah Boustead REIT*) (plantations) is due to be issued and listed in February 2007.

24 January 2007 A few other Islamic REITs are in the pipeline

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MOVING FORWARD

- The issuance of Islamic REITs has once again demonstrated the innate adaptability of Islamic finance principles to meet modern day market requirements.
- A degree of innovation and ingenuity is what is required to devise new Islamic products.

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MOVING FORWARD (ctd)

- These products may not at once be 100% Shariah compliant but a start must be made at some time and then improvements can be made along the way to attain the desired level.

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MOVING FORWARD (ctd)

- In this instance Malaysia has made the start. It is hoped other countries will follow and help produce a more refined and wholly Shariah-compliant product.

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END

- **Wallahu A'lam.**
- **Thank you. Wassalam.**
- **Contact details:**
 - **Mohamed Ismail Md Shariff**
 - **Tel: +603-2070 8786;**
 - **Fax: +603-2070 8787.**
 - **Email: ismail@milaw.com.my**

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