



URGENT BY FAX AND BY HAND
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11 June 2003

Investment Products Department,
Securities & Futures Commission,
12/F., Edinburgh Tower,
The Landmark,
15 Queen's Road Central,
Hong Kong.

Dear Sirs,

SFC Consultation Paper on the Draft Code on Real Estate Investment Trusts (REITs)

Further to our emails of 29 May 2003 and 6 June 2003 requesting for an extension of time for submitting our comments on the captioned Consultation Paper (CP), we have pleasure in submitting our comments on the CP. We should be grateful if you would give due consideration to our comments in finalizing the proposed Code even though they are late.

Part A - Reporting requirements for auditors

1. **Reporting framework and auditors' opinion**

Appendix B of the CP sets out the proposed reporting requirements by auditors of REITs. We note that the CP seeks to require auditors to report on the truth and fairness of the disposition of a REIT at the end of the period and of the transactions of a REIT for the period then ended, and on a REIT's compliance with certain requirements of the Trust Deed and the proposed Code.

We would like to take this opportunity to explain below the reporting frameworks that will govern the reporting engagements by auditors of REITs and the type of audit reports that will be issued by them.

In line with international professional development, the HKSA has issued the Standards on Assurance Engagements (SAEs) Framework, which is adopted from the International Standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants, in addition to the Statements of Auditing Standards (SASs) Framework. The SASs Framework primarily governs the audit of annual financial statements whereas the SAEs Framework primarily governs compliance reporting by auditors. As a result of the above latest professional development, auditors are now required to issue separate auditors' reports for engagements performed under the SASs and SAEs Frameworks.

The proposed requirements for the contents of the auditors' report for a REIT in the CP has not taken into account the above latest professional development in Hong Kong. Accordingly, it should be revised by requiring the preparation of two separate auditors' reports, one reporting on the truth and fairness of the financial statements of a REIT (governed by the SASs Framework) and another on the compliance reporting (governed by the SAEs Framework).

A suggested revised “Contents of the Auditors’ Report” in Appendix B-6 is set out in the Appendix to this letter for your consideration.

We would be happy to explain further to the Commission details of the latest professional development and to work with the Commission in developing example auditors’ reports that would meet the requirements of the Commission.

For your information, in recent years, the HKSA has helped the regulators to determine the scope of reporting duties by the auditors under the SASs Framework and the SAEs Framework in the regulators’ making of the relevant legislation and subsidiary legislation. These include:

- a. the Securities and Futures Commission in respect of reporting on licensed corporations and associated entities of intermediaries under the Securities and Futures (Accounts and Audit) Rules; and
- b. the Mandatory Provident Fund Schemes Authority in respect of reporting on Mandatory Provident Fund Schemes and Occupational Retirement Schemes under the Mandatory Provident Fund Schemes Ordinance and the Occupational Retirement Schemes Ordinance respectively.

2. Liquidation of a REIT or merger of REITs

Paragraph 11.9(e) requires the report on the liquidation of a REIT or merger of REITs to contain a statement by the auditors that the final accounts have been properly prepared for the purpose of the winding up or the merger.

We are unclear as to the objectives that the Commission is intending to achieve and suggest that the Commission and the HKSA should discuss and agree on the appropriate reporting framework and the type of audit report that can be provided by auditors for such engagement so that they meet the requirements of the Commission.

Part B - Taxation considerations

1. Profits tax

The proposal in the CP to exempt REITs from profits tax is consistent with the tax exemption under either section 14, 26 or 26A of the Inland Revenue Ordinance (Cap.112)(“IRO”) provided to any investment funds authorised by the Commission.

Under the proposal, however, the REITs will be subject to property tax in respect of the rental income. This proposed tax treatment may place potential REITs investors in a less favourable tax position than direct property owners.

Under the property tax regime, in general, the REITs can deduct against their rental income only (i) rates paid in respect of their properties; and (ii) 20% of the rental income as allowance for repairs and outgoings.

However, a corporation deriving rental income from properties in Hong Kong will be subject to profits tax. Under the profits tax regime, the corporation can deduct all related operating expenses such as property rates, management fees and mortgage loan

interest expenses to arrive at the net taxable income, which is subject to profits tax.

An individual deriving rental income from properties in Hong Kong can elect to be assessed under Personal Assessment if certain conditions are met. Under Personal Assessment, he can enjoy the deduction of mortgage loan interest in addition to the property rates and the 20% deduction for repairs and outgoings under property tax. In addition, he can deduct personal allowances and enjoy the progressive tax rates available under Personal Assessment.

Where the expenditure (e.g. financing costs) incurred by REITs exceeds 20% of their rental income, this may place them at a disadvantageous position when compared to individual and corporate property investors.

If the aim is to encourage the development of REITs in Hong Kong then one option would be to make them tax exempt for a fixed period or indefinitely. Alternatively, they could be placed in the same tax position as if they were holding the real estate directly. There are various options each with its own advantages and disadvantages:

- a. Allowing REITs to deduct their actual interest expenses in addition to the 20% deduction for repairs and outgoings under property tax. However, this alternative would require a significant change in the law governing property tax.
- b. Allowing REITs the option to subject themselves to profits tax instead of property tax such that REITs could elect to have their actual expenses deducted for tax purposes and claim depreciation allowances under the profits tax regime. Legislative amendments would be required to allow REITs to elect to subject themselves to profits tax rather than property tax, as well as to make it clear that, where REITs have so elected, the tax exemption under section 26A of the IRO would not apply.
- c. Confirming that REITs are, prima facie, subject to profits tax as a business, which would ensure a high degree of certainty. However, this would also require some change in the law to exclude authorised REITs from the effect of section 26A.
- d. Introducing tax transparency arrangements for REITs, i.e. tax is not paid at the REIT level but instead passed through to investors who pay tax at their marginal rates. Tax transparency is a common feature for REITs in jurisdictions such as the United States and Australia. However, while it may be possible to achieve transparency under the existing law, it could be administratively onerous to implement. If the REIT was taxed as agent for individual investors, on the other hand, it might also require changes in the law as this cannot readily be done at present if the investors are Hong Kong residents. In addition mechanisms might need to be in place for the REIT to track the tax paid in respect of individual investors, so that investors would be in a position to claim credits if necessary.

2. Stamp duty

As stamp duty is chargeable at 0.2% on the purchase and sale of stock, investments in unit trusts will enjoy a comparative advantage over investments in REITs which will be subject to the much higher rates of stamp duty on property transactions. Therefore, as a further measure to encourage the initial development of the market for REITs,

consideration could be given to providing some form of stamp duty concession for a certain period. However, any legislative amendments introduced to provide for a stamp duty concession should contain adequate safeguards against possible abuses by large property owners.

Generally, therefore, it would seem that there are potential complications in relation to the taxation aspects of the proposals and we would suggest that more thought needs to be given to the possible implications. This matter should be considered in the light of the overall objectives of the proposals and the potential impact on the tax system, bearing in mind that the relative simplicity of Hong Kong's system of taxation and our low tax rates constitute important elements in Hong Kong's attraction internationally as a place of business and investment.

Part C - Other comments

1. General obligations of a management company

We consider that paragraph 5.2(c) should be amended to set out the responsibility of a management company in respect of record keeping and preparation of financial statements as follows:

- “(c) maintain or cause to be maintained proper books and records of the scheme in Hong Kong and prepare the scheme's financial statements which are in agreement with the scheme's books and records and in accordance with the relevant provisions of the Trust Deed and this Code, and give a true and fair view of the disposition of the scheme at the end of the financial period and of the financial transactions of the scheme for the financial period then ended;
- (d) prepare and publish reports. At least two reports shall be published in respect of each financial year. These reports shall be sent to all registered holders and filed with the Commission within the time frame specified in 10.7; and”

In addition, the definition of “proper books and records” has not been made in the CP. We therefore suggest that such a definition should be made in the CP. In this regard, a useful reference is contained in section 121 of the Companies Ordinance which sets out the requirements for companies incorporated under the Companies Ordinance.

2. Appointment of the auditor

We consider that paragraph 5.18 should be amended, for the purpose of clarification, as follows:

“The management company shall cause the scheme's financial statements to be audited by the auditor, and the contents of such auditors' report shall contain the information in Appendix B.”

3. Dividend policy

Paragraph 7.9 proposes that a REIT shall distribute as dividend 100% of its net after tax income each year. As financial statements are generally prepared on an accruals basis, the availability of positive net after tax income does not necessarily match the

availability of cash and therefore the proposed dividend policy may result in potential cash flow problems for REITs.

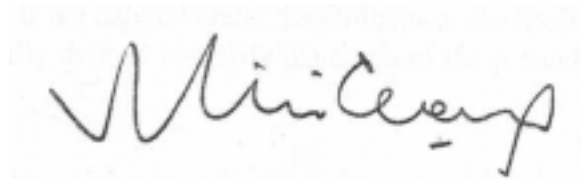
4. Formation costs

Appendix B requires disclosures of “formation costs” in the balance sheet and “amortization of formation costs” in the income statement. Formation costs which are incurred prior to the commencement of operations would typically fall within the scope of HKSA Statement of Standard Accounting Practice (SSAP) 29 “Intangible assets” and would typically fail the capitalization criteria applying in that SSAP. Such costs would typically be reported in the entity’s first income statement as expenses.

We therefore suggest that, in accordance with the requirements of SSAP 29, “formation costs” should be deleted from the disclosure requirements for balance sheet, and “amortization of formation costs” should be changed to “formation costs” in the disclosure requirements for income statement.

We trust that you will find our comments helpful. If you have any questions on our above comments or wish to discuss them further with us, please do not hesitate to contact Stephen Chan, the Society’s Deputy Director (Ethics & Assurance), in the first instance.

Yours faithfully,



WINNIE C. W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL AND TECHNICAL DEVELOPMENT
HONG KONG SOCIETY OF ACCOUNTANTS

WCC/SSLC/cy

**HKSA's proposed revised wording for
"Contents of the Auditors' Report (Appendix B-6)"**

- "A. Two auditors' reports are required in respect of a financial period, representing:
1. an auditors' report on the financial statements in which the auditors express an opinion as to whether the financial statements give a true and fair view of the disposition of the scheme at the end of the financial period and of the financial transactions of the scheme for the financial period then ended; and
 2. an auditors' report on the compliance with the regulatory requirements in which the auditors express an opinion as to whether the financial statements for the financial period have been properly prepared in accordance with the relevant provisions of the Trust Deed and the Code.
- B. If the auditors are of the opinion that proper books and records have not been kept by the scheme and/or the financial statements prepared are not in agreement with the scheme's books and records, that fact should be stated in the auditors' report(s) in (A) above.
- C. If the auditors have failed to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of the audit, that fact should be stated in the auditors' report(s) in (A) above."