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Budget 2023: Impact on InvITs

Key Takeaways

- Distributions out of repayment of debt principal could now be taxed as ‘other income’ – at odds with global standards
- Distributions out of debt repayments through redemption of units not treated as ‘income’, but reduce cost of acquisition - InvIT / REIT Regulations do not permit redemption of units
- Major impact on IRRs as distribution structure of most InvITs factored in distributions through debt repayments
- Changes and policy ambiguity could thwart the growth of REITs / InvITs, which were just about seen as ‘bond proxies’

Introduction

Enough has been written about the impact of Budget 2023 on REITs and InvITs. Through this piece, we aim to succinctly capture the what, why and what next of the proposed changes – keeping it germane mainly to global financial investors.

1. What is the change?

If a business trust (i.e. InvIT/ REIT) receives monies from the underlying SPVs as 'repayment of debt', then, any distribution of such monies to its unitholders should be taxed as 'income from other sources'. This could be as high as 40% for non-resident unitholders – including for sovereign wealth funds and pension funds which are otherwise exempt from tax in respect of their InvIT investments. Till date, such distributions were received 'tax free' by the unitholders.

2. What was the background?

Business trusts house real assets such as roads, telecom towers, school lands etc. which are highly capital intensive. So, most business trusts typically infuse a significant portion of capital as debt into the underlying project SPVs (***sub-debt***) – to enable tax-optimal upstreaming of cash. This sub-debt is serviced with an appropriate coupon by the SPVs. However, there could still be a sizeable cash trap in the SPVs (especially in the initial years) post coupon payment due to accounting losses (eg: depreciation, carry forward of past losses etc.). Dividend payment is also not possible during these years until accounting profits can be demonstrated. Therefore, SPVs repaid the sub-debt (in part of full) from time to time which was in-turn distributed to the unitholders. No tax was paid by the InvIT or the unitholders in respect of such repayment. The tax department assumed this to be a case of dual non-taxation since income was received by the unitholder and it was neither taxed at his hand nor did his cost of acquisition reduce (even though underlying value was shaved off in making the distributions).

3. Have any existing REITs or InvITs distributed monies to unitholders as 'repayment of debt'?

Yes. A few REITs/ InvITs have used this route for unitholder distribution. Some empirical data for the last financial year is provided below:

Sl. No	Name of the Business Trust	Total distribution per unit in FY 2021-22 (INR)	Distribution per unit paid via repayment/ amortization of debt (INR)	% of distribution paid via repayment of debt (tax free for unitholders)
1	Embassy REIT	21.76	8.06	37.04%
2	Brookfield REIT	22.1	6.72	30.40%
3	IndiGrid InvIT	12.75	2.43	19.10%

4. What was the need for taxing debt repayment? Was there case of dual-non taxation in the first place?

The answer (partly) lies in understanding the evolution of business trusts in India. In the early-mid 2000s, Indian real asset companies were finding it difficult to attract institutional capital. Some companies in fact flipped their assets to offshore REIT/ holding company structures to rope in global investors. In order to prevent further offshoring of domestic capital markets, SEBI after significant deliberations enacted the REIT regime in 2014. The InvIT regime followed in 2016.

Recognizing the key role of REITs and InvITs in developing real assets, the government in 2014 introduced a special tax regime for business trusts – where the returns were effectively taxed on a pass-through basis. This meant that any 'interest' or 'dividend' income upstreamed by the underlying SPVs to a business trust was directly taxed in the hands of unitholders. The objective was naturally to avoid double taxation – i.e. at the level of business trust (InvIT/ REIT) and the unitholders.

'Repayment of debt' was not taxed at any level as it was seen as principal repayment and not 'income'. Hence, neither business trusts nor unitholders were taxed. It may not be entirely accurate to say that a loophole was being exploited since repayment of debt never qualified as income on first principles of law.

The Finance Act 2023 now proposes to (a) qualify such principal distributions as ‚income' and tax these distributions as 'income from other sources' where the units of the business trust are not redeemed, and (b) reduce the cost of acquisition to the extent of the sum received, where the units are redeemed. Interestingly, units of a REIT or an InvIT cannot even be redeemed, except in case of delisting or buy-back for which the operational framework is not yet in place. Hence, 'redemption' of units in context of business trusts needs to be redefined, but the reference naturally is to repayment of debt.

5. What next?

Units of a REIT/ InvIT cannot be redeemed in the first place due to restrictions in the SEBI regulations. To that extent, distributions are necessarily required to be made without redemption – and taxing such distributions as income appears unfair, and at odds with global practices as well.

In any event, the changes cannot be such that the special tax regime provided to business trusts is entirely compromised, making REITs and InvITs unattractive. So, to find a balanced solution, distributions as 'repayment of debt' should effectively be treated as part redemption, and first result in reduction of 'cost of acquisition' of units after considering indexation benefits. Once the cost of acquisition is fully exhausted, further distributions and any gains earned on transfer should be taxed as 'long term

capital gains' as long as the unitholder in question has been holding the units for more than 1 year. And finally, no withholding provisions should apply, and each unitholder should determine taxability based on their respective residential status and holding period.

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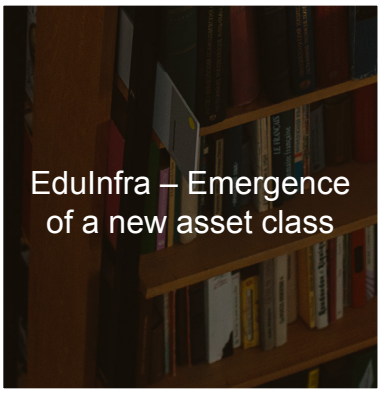

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