Taxation on REITs

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"The best investment on earth in Earth"

\- Louis Glickman

Meet the REITs – What they are

REITs are pooled investment vehicles that own, manage and finance in a range of property sectors through direct or indirect holding in Special purpose Vehicles (SPV). It was also called "Cigar Excise Tax Extension". REITs are a liquid assets.

REITs is a three-tier structure being registered under the SEBI (REITs) Regulations, 2014. It is mandatory for all the units of REITs to be listed on a recognised stock exchange having nation-wide trading terminals, whether publicly issued or privately placed. Globally, REITs are available in as many as 37 countries and have surpassed $1.7 trillion in market capitalization.

History - Origin

Structure/Value Chain Stakeholders

- Unit holders or Sponsors to set up REIT and appoint trustee.
- Trustee to hold assets on behalf of and for the benefit of Investors.
- Managers to assume operational responsibility of REIT.
- Valuer to ensure fair and transparent valuation
  - In respect of financial valuation
  - In respect of technical valuation
- REIT to hold specific assets:
  - Directly or through SPV holding real estate assets; or
  - Invest in SPV which has investments in other SPVs which subsequently hold real estate assets (Holding Co. structure)

What are the Tax Implications?

The Government started putting in place a framework for taxation of business trusts even before the regulations governing Real Estate Investment Trusts (REITs) were notified by SEBI. This was not without reason – progressive regulations and tax reforms have influenced the progress of REITs globally, with REITs market witnessing sudden growth spurts in countries such as Singapore and Hong Kong almost immediately following tax amendments. Now let's discuss the tax implications at each stage:

A. For Sponsors

- At the pre-listing stage,
  - In case of transfer of shares of SPV in exchange of units of REITs, it shall not be considered as "transfer" and hence no tax liability at the time of exchange as well as for MAT.
  - In case of transfer of assets to REIT, it shall be taxable in the hands of sponsor on regular as well as MAT basis.
- In case of sale of units of REIT, the STCG would be taxed at 15% and LTCG exceeding ₹ 1,00,000/- would be taxed at 10% without applying indexation. In case of non-resident sponsors, rates would be applicable as per DTAA. In such a case, the cost of acquisition and the period of holding shall be of the shares of SPV.

B. For Unit Holders

Particulars	Tax Rates applicable	Tax Deducted at source
Interest Income	• Taxed at normal rates to resident unit holders • Taxed at 5% for non-resident unitholders	Under section 194LBA, • For other than non-resident unit holders- 10% • For non-resident unit holders- 5%
Rental Income	Taxable at normal rates	Under section 194LBA, • For other than non-resident unit holders- 10% • For non-resident unit holders- At the rate in force
Any other income (other than dividend income)	Exempt u/s 10(23FD)	—

On the contrary, as per Amendment in Finance Act, 2020, the "Rationalisation of the Dividend Tax" pulled the trigger at the unit holder level. Now the dividend would also be subject to taxation in the hands of unit holders with effect from 1 April, 2020. It is subject to TDS @10%. However, some concessions are summarized below:

- If the SPV has exercised option to pay corporate tax @22% as per the section 115BBA, then 10% withholding tax applies on income in the nature of dividend distributed by the trust to unit holders and such dividend shall be taxable.
- If the SPV has not exercised option to pay tax under the new regime, then no withholding tax applies in the nature of dividend distributed and such dividend shall be exempt under section 10(23FD).

The foundation of the abolishment of the DDT regime is based on the awaiting demand of the foreign investors based on the non-availability of the credit of the DDT in their home country. This switch shall help as various tax treaties shall grant the benefit of lower withholding tax resulting in plummeting the cost of doing business.

C. For Business Trusts

- The interest income referred to in section 10(23FC) and rental income on own property referred in section 10(23FCA) shall be exempt in the hands of REIT as it is having a pass-through status through which tax liability is transferred to unit holders.
- Income from directly held assets shall also be exempt in the hands of REIT.
- While distributing the interest and income held as assets among the unitholders, it shall deduct tax at source u/s 194LBA @10% in case of resident unit holder and @5% in case of non-resident unit holders.
- In case of Dividend income received from SPVs, it shall be exempt u/s 10(34) in the hands of REIT.
- Capital gain on sale of assets/shares of SPVs shall be taxed at applicable rates and any other income shall be taxed at Maximum marginal rate.

D. For SPV/Holding Co.

Particulars	Taxability
Income derived from assets	Taxed as Business/HP Income
Gain on sale of assets	Taxable as Capital Gain
Interest paid on loans availed from REIT	Deduction granted as per the provisions of Income Tax Act applicable
Distribution on dividends	Deduction granted as per the provisions of applicable rates (DDT abolished)

Some Extracts:

- All the above rates are excluding the applicable surcharge and cess.
- No relief on stamp duty shall be allowed in case of transfer of assets.
- As per section 115UA(1), any income distributed by the business trust to the unit holders shall be deemed to be of same nature and proportion in the hands of unit holders as it had been received by, or accrued to the business trust.
- It shall be mandatory for the Business Trust to file return under section 139(4E) of the Income Tax Act, 1961 irrespective of whether the total income has exceeded the basic exemption limit.
- It shall be mandatory to provide information of all type of business that REIT is conducting to the Income Tax Officer and the unit holders by 30th June of the relevant Assessment year.
- The business trust is required to issue a nil withholding tax certificate to SPV for the purpose of ensuring that while distributing dividend income, no tax is withheld by the SPV to the trust.

Conclusion

REITs are easy to buy and sell, as most are traded on public exchanges. Performance-wise, REITs offer attractive risk-adjusted returns and stable cash flows. Also, a real estate presence can be good for a portfolio because it broadly diversifies the risk. Diversification in real estate area will lead to lower correlation and thus, smooth increase in portfolio values over time, with much less volatility from year to year or even quarter to quarter.

On the taxation front, any distributed income, received by a unit holder from a business trust, other than interest, dividend and rental income (i.e rental income earned directly by a REIT) would be exempt from the total income of unit holder (as it would be taxed in the hands of the REIT itself).

Furthermore, In India, though the number of tax payers has increased significantly in the past decade, our tax to GDP ratio continues to be range bound. As was recognised by the Kelkar Task force, economies have increased their tax revenue-to-GDP ratio not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration. Thus, the Union Budget 2022-23 may reduce the holding period for investors in real estate investment trusts (REITs) to enjoy the lower capital gain tax.

More contributors getting enticed and encouraged by lower tax rates lead to higher collection!

REITs concur with the traditional approach of investment in real estate which offers a steady cash flow and value appreciation and at the same time, at an affordable sum especially for small retail investors. Consequently, broader participation of people in REIT will increase the flow of money in the market.