Taxation of INVITs, REITs and their Unit-holders

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1. Background:

1.1 Before the emergence of the Venture Fund industry in India, entrepreneurs largely depended on private & family sources, public issues and lending by financial institutions for raising capital. However, these were not optimal means of raising funds. The economic liberalization of the economy from the 1990s led to the awareness and introduction of international practices of Venture Capital and Private Equity funds as an attractive source of capital.

1.2 Following the introduction of the Securities and Exchange Board of India (Venture Capital Funds) Regulations ("VCF Regulations") in 1996 and the SEBI (Foreign Venture Capital Investors) Regulations in 2000, ("FVCI Regulations"), the Venture Fund industry got a formal structure and recognition which enabled it to successfully fill the gap between capital requirements of fast-growing companies and funding available from traditional sources such as banks, IPOs, etc.

1.3 Subsequently, in 2012, SEBI took steps to completely overhaul the regulatory framework for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations"). Among the main reasons cited by SEBI to highlight its rationale behind introducing the AIF Regulations are to recognize AIFs as a distinct asset class; promote start-ups and early stage companies; to permit fund investment strategies in the secondary markets; and to tie concessions and incentives to investment restrictions.

1.4 <u>Different kinds of Alternate Investment Funds</u>:

SEBI has classified AIF into the following broad categories into which investors, both domestic and foreign, may invest:

1.4.1 Category I AIF: Funds which invest in start-ups, early stage ventures, social ventures, infrastructure or other sectors which the government or regulators consider as socially or economically desirable will qualify as Category I AIFs.(Priority of the Regulator)

1.4.2 Category II AIF: Private Equity Funds or Debt Funds for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category II AIF classification. These are Funds which cannot be categorized as Category I or Category III AIF. These funds do not undertake leverage or borrowing other than to meet the permitted day to day operational requirements.(Tax neutral)

1.4.3 Category III AIF: Funds that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives are included in this category. Hedge Funds or funds which trade with a view to make short-term returns are included in the Category III AIF classification.(Low Priority)

1.5 <u>Other Special-purpose pooled investment structures</u>:

1.5.1 Infrastructure Investment Trusts (‘InvITs’): InvIT means a trust registered under the SEBI (InvIT) Regulations, 2014 which may raise capital through units issued inter alia under private placement and / or initial / follow on offer. The InvIT shall invest in infrastructure projects, either directly or through a Special Purpose Vehicle (SPV), in accordance with stipulated conditions in the said SEBI Regulations.

1.5.2 Real Estate Investment Trust (‘REIT’): REIT means a trust registered under the SEBI (REIT) Regulations, 2014 which owns and manages income generating developed properties and offers its unit to public investors. REITs typically offer regular yields coupled with capital appreciation and cater to retail investors. The REIT shall invest in Real Estate assets in accordance with stipulated conditions in the said SEBI Regulations.

These fund can invest only in the ready infrastructure only under the Regulations.

2. Taxation of InvITs and REITs:

2.1 The Income-tax Act provides in relation to the taxability of infrastructure investment trusts (“**InvITs**”) and real estate investment trusts (“**REITs**”), both together referred to as “**business trusts**” which are registered with the Securities and Exchange Board of India under the Securities Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014 (“**InvIT Regulations**”) or the Securities Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014 (“**REIT Regulations**”), respectively.

2.2 InvITs and REITs i.e. Business trusts as defined in Section 2(13A) of the Income-Tax Act, have been given a pass-through status under Section 10(23FC) with respect to interest and dividend received or receivable from an SPV. The expression “SPV” (Special Purpose Vehicle) means an Indian Company in which business trust holds controlling interest or such percentage holding under the InvIT Regulations or REIT Regulations as may be prescribed.

The total income of a business trust may include interest and dividend income from SPVs, Rental income if it holds rent generating assets, investment income from funds/fixed deposits where surplus money is parked, capital gains under section 111A and 112.

Any income of a business trust being a REIT by way of renting or leasing of any real estate asset directly owned by the trust does not form part of total income under Section 10(23FCA).

Subject to the provisions of section 111A and 112, the total income of a business trust shall be charged to tax at maximum marginal rate (30 % + applicable surcharge and cess).
Thus income of the Business Trust is exempt from Tax if it is in the nature of Interest or Dividend or the Rent. Capital gains will be taxed u/s 111 A or u/s 112 as the case may be. Any other Income /Business Income in it’s case will be taxed at MMR.
The following are the provisions in relation to taxability and exemptions available to business trusts in India, as amended recently by the Finance Act, 2020 and Finance Act, 2021:

2.2.1 Change in the definition of ‘business trusts’:

A `business trust’ was defined under Section 2(13A) of the Income-tax Act to mean a trust registered as an InvIT under the InvIT Regulations or a REIT under the REIT Regulations, units of which, are required to be listed on a recognised stock exchange in accordance with the InvIT Regulations or REIT Regulations, as the case may be.

The Finance Act, 2020 has amended w.e.f. April 1, 2020 the definition of `business trusts’ which earlier recognised only listed InvITs and REITs registered with SEBI to now include unlisted InvITs and REITs registered with SEBI as well.

Thus now Business Trust will include both listed as well as unlisted units.

Accordingly, capital gains realised on the transfer of units of unlisted private InvITs shall be taxable at the rate of 10% (plus applicable surcharge and cess) in hands of a non-resident unit-holder and 20% (plus applicable surcharge and cess) for resident unit-holder, provided the units have been held for more than 36 months. The short term capital gains (where units have been held for less than or equal to 36 months) will be taxed at the rate of 30% (plus applicable surcharge and cess) for residents and 40% (plus applicable surcharge and cess) for non-resident corporates. Non-resident unit-holders may claim the beneficial provision available under the applicable double tax avoidance agreement ("**DTAA**"), if any.

Long term capital gains arising from market sale of listed units, both in the hands of residents and non-residents, are taxed at the rate of 10% (plus applicable surcharge and cess) on gains exceeding Rs. 1 lakh while short-term capital gains will be taxed at the rate of 15% (plus applicable surcharge and cess).

2.2.2 Dividend Distribution Tax replaced with Dividend Withholding Tax:

Under the erstwhile Section 115-O of the Income-tax Act, dividend distributed by a domestic company was subject to dividend distribution tax ("**DDT**"), in the hands of the company, at an effective rate of 20.56% (including surcharge and cess). Such dividends were exempt from tax in India in the hands of the unit-holders including non-resident unit-holders though they may have been taxable in the home jurisdiction of a non-resident unit-holder.

Further, as per erstwhile Section 115-O sub-section (7) of the Income-tax Act, dividend distributed by a special purpose vehicle ("**SPV**"), in which a business trust held the entire share capital other than as required to be held by the Government or any regulatory authority, was exempt from DDT. The dividend received by business trusts from their SPVs was then distributed to the unit-holders without any further tax being levied on it.

The Finance Act. 2020 has abolished the DDT regime as applicable to companies and has shifted the incidence of taxation of dividend on the shareholder or unit-holders. Accordingly, as per the amended provisions, (i) dividend income would be subject to tax in the hands of the shareholders, at the applicable rate; and (ii) the SPV would be required to withhold tax on the same. However, the business trust will continue to be exempt from tax on dividend income from an SPV. Since no mechanism for an SPV was provided by Finance Act, 2020 to not withhold tax from dividends when distributing to business trust, the business trust was required to provide a nil withholding tax certificate to the SPV to ensure that no tax is withheld by the SPV while distributing dividend to the business trust. Therefore, the Finance Act, 2021 has rectified this hardship by introducing an exemption from tax deduction at source on dividend income earned by business trust from specified investee companies (being SPVs who pay taxes under the normal regime and not concessional regime). This amendment takes effect retrospectively from 1 April 2020.

Further, the business trust as per the amendment of Finance Act, 2020 is now required to withhold tax on the distribution where the income being distributed is in the nature of dividend income received from the SPV, as described below:

a. Taxation of dividends at the Business Trust Level:

The erstwhile Section 10(23FC) of the Income-tax Act exempted certain income of business trust being, (i) interest income received from an SPV, where the business trust held controlling interest and such percentage holding prescribed under the InvIT Regulations or REIT Regulations; and (ii) dividend income from an SPV in which the business trust held the entire share capital other than as required to be held by the Government or any regulatory authority.

The Finance Act, 2020 has made no changes in respect of the taxation of interest income of a business trust. However, the amended Section 10(23FC) has exempted the dividend income received by a business trust from an SPV, in which the business trust holds controlling interest or such percentage holding under the InvIT Regulations or REIT Regulations as may be prescribed.

Subject to any capital gains tax that may be applicable, the total income of a business trust (other than interest and dividend) shall continue to be charged to tax at the maximum marginal rate of 42.7%.

b. Taxation of dividends at the Unit-holder level:

Erstwhile Section 10(23FD) of the Income-tax Act provided that any distributed income, received by a unit-holder from the business trust, other than interest income or rental income (i.e. rental income earned directly by a REIT) would be exempt from the total income of the unit-holder. As per the amendment by Finance Act, 2020, in addition to interest income and rental income, dividend income distributed by the business trust to the unit-holders would also be subject to taxation in the hands of the unit-holders with effect from April 1, 2020. Accordingly, interest and dividend income distributed to unit-holders are now taxable at the tax rates applicable to each of the unit-holders.

This tax on dividend in hands of unit-holders is seen to be as a less favourable tax treatment under the new tax regime for dividend, as compared to the DDT regime. Hence, the Finance Act, 2020 has provided some concessions. Accordingly, as per amendment of Section 10(23FD), dividend distributed by a business trust is exempt in the hands of the unit-holders, provided the SPV distributing the dividends has not exercised the option to pay corporate tax under the 22% corporate tax regime available in terms of, and subject to compliance with, Section 115BAA of the Income-tax Act.

Further, as per the amendment, dividend income received by residents and non-resident unit-holders would be subject to withholding tax at the rate of 10%. However, in case of non-residents, any lower rate as may be provided in the DTAA between India and the country of residence of the non-resident unit-holder may be applicable, provided such non-resident is eligible for the benefits available in the DTAA provisions.

2.2.3 Taxation of interest and rental income on unit holders of a business trust:

In terms of Section 194(LBA)(1) of the Income-tax Act, any distributable income in the nature of interest income and rental income in the hands of a resident investor is subject to deduction of tax at the rate of 10%. Similarly in terms of Section 194(LBA)(2) of the Income-tax Act, any distributable income in the nature of interest income and rental income in the hands of a non-resident is subject to deduction of tax at the rate of 5%. No change was made by the Finance Act, 2020 in respect of taxation of unitholders on interest and rental income received from the business trust.

2.2.4 Applicability of DDT in a multi-level business trust structure:

In terms of the InvIT Regulations and the REIT Regulations, an InvIT or a REIT is permitted to have a multi-level holding structure, being one where the business trust holds shares in the SPV through a holding company. It would be relevant to note that the erstwhile Section 115-O of the Income-tax Act did not exempt such a multi-level structure of holding shares through a holding company from the applicability of DDT. Accordingly, dividend paid by an SPV to its holding company was subject to DDT at an effective rate of 20.56% (inclusive of surcharge and cess). The Finance Act, 2020 which has abolished Section 115-O of the Income-tax Act has reintroduced Section 80-M in the Income-tax Act. This section provides for a deduction for dividends received by one domestic company from another domestic company, limited to the amount of dividend received from the investee company if the shareholder company pays dividend before the specified due date. Thus, under the amended provisions, the holding company would be able to claim deduction for the dividends received from the SPV, resulting in avoidance of double tax on dividends. The Finance Act, 2020 in addition to confirming the aforementioned proposals, has further extended the deduction under Section 80-M of the Income-tax Act to dividends received from business trusts and foreign companies. Accordingly, as per the new provisions, a unit-holder of the business trust which is a domestic company, may claim a deduction for the dividends received by it from a business trust, subject to conditions provided under Section 80-M of the Income-tax Act.

2.3 The following example of taxation of the income stream from the underlying SPV in the hands of an investor in a business trust would be helpful in understanding the provisions:

		Rs.
A	Income of SPV	100.00
B	Interest paid by SPV to Business Trust	50.00

C	Taxable Income of SPV (A – B)	50.00
D	Tax payable by SPV (30% of C)	15.00
E	Dividend paid by SPV (C – D)	35.00
F	Tax withheld by SPV of Interest & Dividend paid by SPV to Business Trust	0.00
G	Cash received by Business Trust (B + E)	85.00
H	Interest distributed by Business Trust (B less withholding tax of 10% of B)	45.00
I	Dividend distributed by Business Trust (E less withholding tax of 10% of E)	31.50
J	Total distribution received by Unit-holder net of withholding taxes (H + I)	76.50

If one examines the various streams of income, interest paid by the SPVs is an allowable tax deduction for the SPV, not taxable in the hands of the business trust but taxable in the hands of the investor. The dividend paid by the SPVs out of tax paid profits are not taxed in the hands of the business trust, but are taxed in the hands of the investor only if the SPV has opted to pay the concessional rate of tax on its profits. Rental income of the REIT is exempt in its hands, but taxable in the hands of the investors. Effectively, there is only a single level of taxation for most streams of income, except cases where the SPVs have paid concessional rates of tax on their profits, in which case the dividend is taxed again in the hands of investors, though the SPV has paid tax on its profits.

This is a significant advantage of a business trust as compared to a normal company structure, where the company pays tax on its profits, and the shareholders are subjected to tax on the dividends, irrespective of the rate of tax paid by the company. A business trust can, therefore, effectively give investors a higher post-tax return, as compared to a normal company structure.

3. Taxation of AIFs:

3.1 There have been no changes in the taxation of Investment Funds (i.e. Category I & II AIFs as per clause (a) of Explanation 1 to Section 115UB) and their unit-holders except the implications relating to abolition of DDT by the Finance Act, 2020 and the consequent taxation of dividends in the hands of the unit-holders.

3.2 The tax provisions relating to AIFs – Category I & II are summarized as under:

Nature	Tax implication for AIF	Tax implication for Investor in AIF
Income of the Investment Fund, other than income from profits and gains of business	Exempt from tax in the hands of the Investment Fund, as per section 10(23FBA). As per Notification No. 51 dated 24th June, 2015, the income (other than business income) received by the Investment Fund would be exempt from TDS requirement.	As per section 115UB(1), such income (including dividends after the amendment by Finance Act, 2020) would be taxable in the hands of the investors on a pass through basis. Such income will be taxable in the same manner as if it were the income accruing or arising to, or received by, such investor had the investments, made by the Investment Fund, been made directly by such investor. Further, income taxable in investors' hands shall be deemed to be of the same nature and proportion as in the hands of the Investment Fund as per section 115UB(3)
Income in the nature of profits and gains of business or profession	Taxable in the hands of Investment Fund at the maximum marginal rate as per section 115UB(4)	As per section 10(23FBB), the investors shall be exempt from tax on such income
TDS on income credited or paid to investor	Where any income other than income from profits and gains of business, is credited or paid to an Investor by the Investment Fund, the Investment Fund shall deduct income-tax at the rate of ten per cent as per section 194LBB.	-

Deemed credit to investors	If income accruing to or received by the Investment Fund is not paid or credited to the investors, such income shall be deemed to have been credited to the investors on the last day of the previous year in the same proportion in which investors would have been entitled to receive the income had it been paid during the year as per section 115UB(6)	Deemed income of the investor with tax credit of tax deducted at source by investment fund.
Loss at investment fund level	If in any year there is a loss at the investment fund level either current loss or the loss which remained to be set off, the loss shall not be allowed to be passed through to the investors but would be carried over at the investment fund level to be set off against income of the next year in accordance with the provisions of the Act as per section 115UB(2)	-

3.3 Taxation of AIF - Category III:

As tax pass through status has not been accorded to Category III AIFs, the taxability of Category III AIFs will be governed by the general principal of taxation (depending on the form in which Category III AIF is set up i.e Trust or LLP or company).

4. Conclusion: It is interesting to note that in addition to the issues which are sought to be

addressed through a pass through structure to avoid multilayer taxation ,due to policy change in tax structure of dividend additional complexities have been found in the taxation of the business trust and one has to look at the main provisions, exemptions and the TDS provisions to grasp the scheme of taxation.