Update

Budget proposes tax transparent treatment to Real estate investment trusts: Commercial real estate to get a push

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Among other proposals, the Budget 2014-15 proposes a tax transparent treatment to real estate investment trusts and infrastructure investment trusts.

Meaning and advent of REITs

REITs were introduced in 1960 in the USA by granting a pass-through or tax transparent status. Real estate investment trusts are collective investment devices that invest in income producing real estate, mostly rental properties such as offices, shopping malls, health care units, warehouses and so on. Most of the REITs in the USA are what is known as "equity REITs", that is, those that invest in ownership of the commercial property, rather than "mortgage REITs", that is, those that lend against such properties.

REITs are mostly closed-end unit trusts or companies. That is, their shares or units have a set termination date and do not allow further investors after the initiation of the fund. Such funds buy and hold the real estate portfolio for the life of the fund and do not make reinvestments even if sales occur. Since introduction in the USA, REITs have been introduced in several countries which includes France, Netherlands, Australia, The U.K, Singapore and more. The genesis of REITs was to shift the regime from a tax opaque structure to a "*tax transparent structures*". REITs came into existence somewhere around 1960s in the U.S. The intent was to create a vehicle which would be tax transparent or tax neutral and to examine new facilities for owning real estate. Hence REITs were formulated with the condition that the fund will distribute atleast 90% of its income to the investors. To the extent vehicle distributes the income, the income will be deducted from the taxable income of the REITs and taxed in the hands of the investors, making the REIT tax neutral as substantially all of its income is distributed. The structure of a vehicle pooling and distributing income was more tax transparent as opposed to pooling and not paying. With this condition REITs have been doing well in most parts of the world, incentivizing investors to make investments in such vehicles.

Introduction of REITs in India:

Discussions on introduction of REITs in India have been going on in India. In India investment in property is permissible under the SEBI (Collective Investment Schemes), Regulations, 1999. Considering the importance REITs play globally on providing retail investors an option to have exposure in the sector, REITs regulations were proposed in 2008[1] which did not take effect as regulations.

The regulations on REITs are being re-considered and SEBI has issued draft regulations on REITs -- (SEBI (Real Estate Investment Trusts) Regulations, 2013) [2] on 10th October, 2013.

The draft regulations state that the REITs are to be formed as a trust. REITs would raise money from the investors and in turn shall make investment in real estate projects. The

[1] http://www.sebi.gov.in/commreport/RealEstateReg.pdf
[2] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1381398382013.pdf

investors will be holding units which would represent the beneficial interest in the property held by the REITs and these units will be mandatorily listed.

The REITs could invest either directly into income generating properties or through an SPV which shall hold not less than 90% of their shares directly in such properties. The REITs need to distribute 90% of the net distributable income **after tax** of the REIT shall be distributed to the investors.

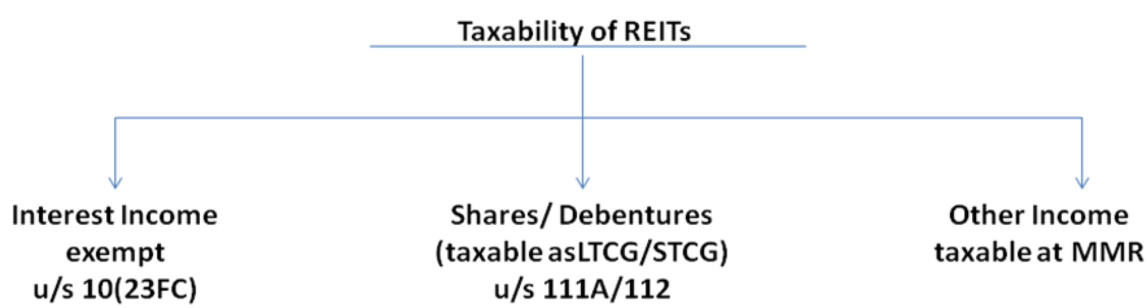
Budget proposals on REITs:

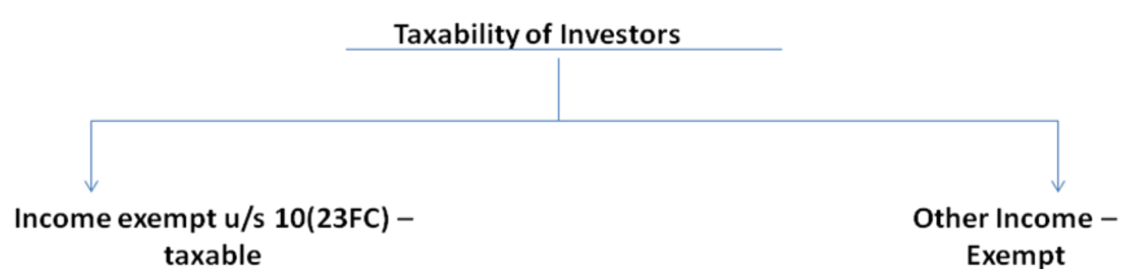
The Budget introduces sections 2 (13A), 10 (23FC), 10 (23FD) and 115UA pertaining to exemption to REITs.

Sec 115UA is the main section pertaining to "business trusts", which term includes REITs too. The REITs would be controlling interest in an SPV which in turn will have exposure in income generating assets. A special purpose vehicle is defined in explanation to Section 10 (23FC) as –

> *Explanation*.—For the purposes of this clause, the expression "special purpose vehicle" means an Indian company in which the business trust holds controlling interest and any specific percentage of shareholding or interest, as may be required by the regulations under which such trust is granted registration;

The tax structure of the REITs as explained in the Finance Act, 2014 is as follows:





Any interest income received or receivable by the business trust from the special purpose vehicle is exempt from the total income of the business trust u/s 10 (23FC) as inserted by the Finance Act, 2014. This income exempt in the hands of the business trust is taxable in the hands of the unit holders as per Section 115UA (3) of the newly inserted Chapter XII FA as newly inserted by the Finance Act, 2014.

> *(3) If in any previous year, the distributed income or any part thereof, received by a unit holder from the business trust is of the nature as referred to in clause (23FC) of section 10, then, such distributed income or part thereof shall be deemed to be income of such unit holder and shall be charged to tax as income of the previous year.*

Any other income received by the unit holder from the business trust is exempt in the hands of the unit holder as per Section 10 (23FD) introduced by the Finance Act, 2014 and is reproduced below –

There will be no capital gains applicable on the shares allotted by a special purpose vehicle to a business trust in exchange of units allotted by that trust to the transferor u/s 47 (xvii) inserted by the Finance Act, 2014. In case the business trust sells the shares of the special purpose vehicle, the income arising from the sale of shares will be subject to long term capital gains or short term capital gains u/s 111A or 112 as amended by the Finance Act, 2014.

Any other income of the business trust subject to the provisions of Section 111A and 112 shall be taxable on maximum marginal rate.

Further income distributed by the business trust to its investors u/s 115UA which is exempt in the hands of the business trust u/s 10 (23FC), such income will be distributed by the business trust after deduction of income-tax at the rate of 10% in case of resident unit holder and at the rate of 5% in case of non-resident holder u/s 194LBA (1) and (2) newly inserted by Finance Act, 2014 respectively.

These amendments will take effect from 1st April, 2015 and will become applicable in relation to assessment year 2015-16 and subsequent years.

Typically REITs globally, distribute substantial income of the REITs amongst its unit holders in the form of dividend and such distribution would act as a deduction from the taxable income of the REITs. Once a company qualifies as a REIT, all income distributed as dividend is allowed as a deduction from taxable income. The dividend so distributed is taxable in the hands of the investors. Further the tax rate on the dividend from REITs is lower than the tax rate on corporate dividends. This is other incentive for the investors to invest in REITs.

In a complex mesh of amendments/ insertions introduced by the Finance Act, 2014 the essence of the tax regime is what is taxable in the hands of the business trust will be exempt in the hands of the unit holders and vice-a-versa. In the mature markets like The U.S.A the tax regime may be far simpler. Having said this, the Finance Act, 2014 has surely given impetus to investment in real estate industry and has ushered the new era of REITs in India.

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