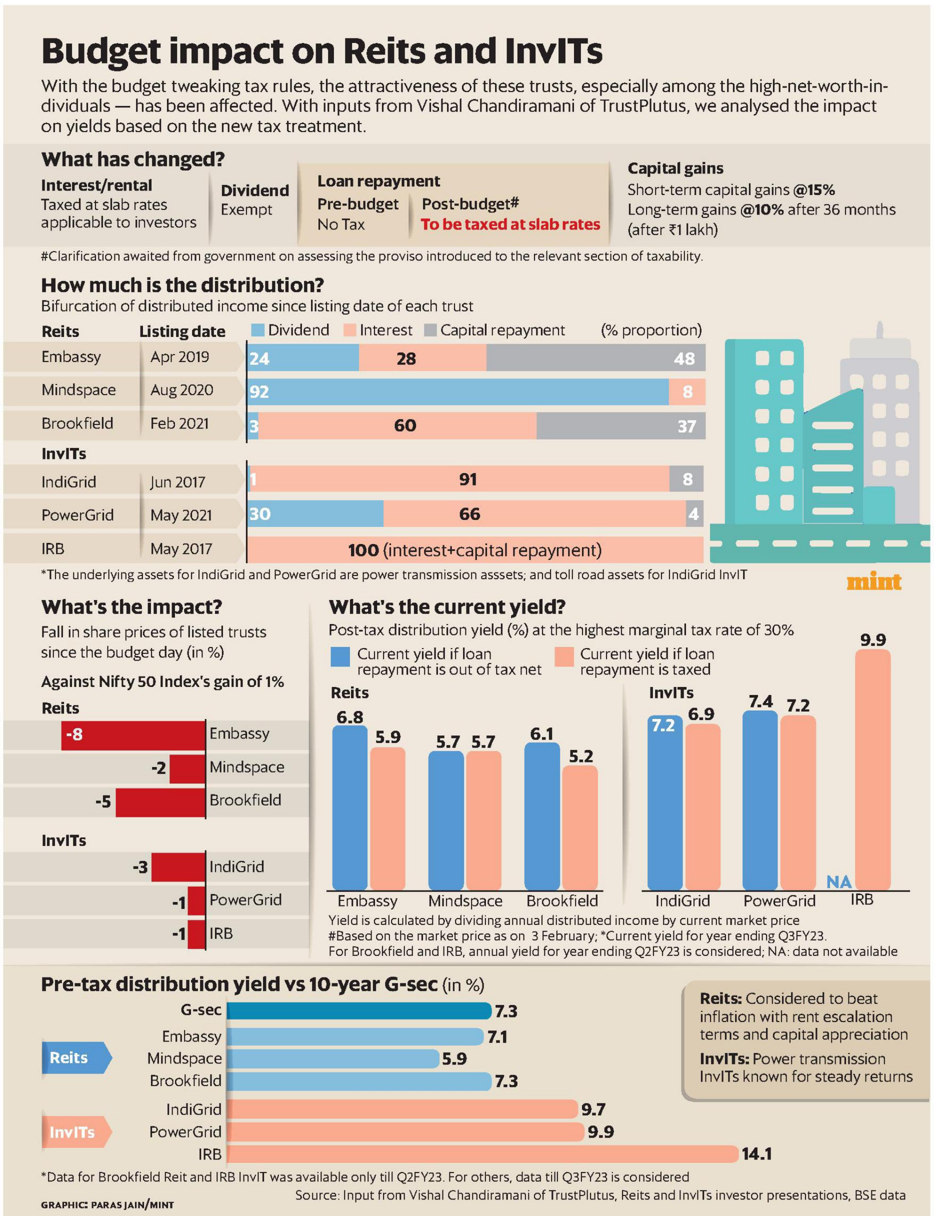
Tue, 07 Feb-23; Mint - Delhi; Size : 921 sq.cm.; Circulation:21050; Page : 13

New tax on distribution income, a budget dampener for Reits, InvITs

Budget proposal makes amortization of debt taxable in hands of unitholders under 'income from other sources'

Satya Sontanam
satya.sontanam@livemint.com



They were considered a good investment avenue till now—one that made sense to be in your portfolio. But that was before the finance minister presented the budget on 1 February. Post-budget, investors seem to be shunning publicly listed real estate investment trusts (Reits) and infrastructure investment trusts (InvITs). Their stock prices have fallen 1-8% against the broader market index's (Nifty 50) gain of 1% till date.

Blame it on a budget proposal that sought to bring one of the income components of these trusts—the repayment of loan—into the tax net. Finance minister Nirmala Sitharaman announced that the 'repayment of loan'—or 'amortization of debt'—should be taxable in the hands of unitholders under the head 'income from other sources' at the slab rates of an investor.

Reits and InvITs, which invest in income generating commercial real estate properties and infrastructure assets, respectively, are mandated by market regulator Sebi to distribute at least 90% of the cash available to unitholders. Thus, distribution income—which comes in the form of a dividend, interest, rental income or loan repayment to unitholders—forms a significant share of the return from these trusts. If the budget proposal becomes effective, the post-tax distribution yield from these trusts will come down by 100 basis points. One basis point is one-hundredth of a percentage point.

The distribution yield, which is calculated by dividing the annual distributed income by the current market price, gives a fair picture of the returns one can expect from their investments. Currently, the distribution yield of these trusts has been in the range of 6-7.5%.

What has happened now?

Reits and InvITs invest in special purpose vehicles (SPV) through equity or debt instruments. Any income distributed by these trusts to its unit holders must be in the same nature and in the same proportion as distributed by the SPV to the business trust.

That is, if the SPV pays interest amount to the trust for the debt taken, that amount has to be given by the trust to the unitholders in the form of interest income only. Since the trusts are given a pass-through structure, such income is taxable in the hands of the unit holders.

Dividend income is exempt in the hands of unitholders, in most cases. However, if the SPV opted for a lower tax regime, dividends along with interest will be taxable at slab rates, while the interest/rental income is taxed at the slab rates applicable to an investor.

The 'loan repayment' component of the distributed income was hitherto not attracting any tax both in the hands of business trusts as well as in the hands of unitholders.

The finance minister plugged this loophole by proposing that such income has to be taxed as part of 'income from other sources' of unitholders that attracts tax at slab rates of an individual. With this, the attractiveness of these trusts—which had gained traction in the last few years, especially among the high-net-worth-individuals —as a yield product has been affected.

India has three listed Reits—Brookfield India Real Estate Trust (Brookfield Reit), Embassy Office Parks REIT (Embassy Reit), and Mindspace Business Parks REIT (Mindspace Reit).

The post-tax distribution yield from these trusts will come down by 100 basis points if the tax is made effective

The loan repayment component forms a significant share of distributions made by Embassy and Brookfield. Post-budget, the taxable (at slab rate) component of distributions of these companies would stand at 76% and 97%, respectively.

Mindspace, which has almost nil allocation to loan repayment in its distributions, looks attractive among the three REITs from a tax perspective.

Embassy witnessed the highest price fall of 8% post-budget. Having said that, with the fall in share price, Embassy Reit's distribution yield has begun to look attractive even after the tax (*see graphic*), said Vishal Chandiramani, chief operating officer at TrustPlutus. As the price falls, yield goes up.

There are about 18 Sebi-registered InvITs. Of these, only three are public and listed on the stock exchange: IndiGrid InvIT and PowerGrid InvIT invest in power transmission assets, while IRB InvIT invests in a portfolio of road assets to collect tolls throughout the concession period.

InvITs are generally highly leveraged companies compared to Reits and thus the 'loan repayment' component is higher in its distributions. Post-budget, both IndiGrid and IRB trusts could have almost 100% of distributions taxable at the individual's slab rates.

Industry experts believe that 'loan repayment' amount must be treated as capital gain that attracts 10% tax if held for the long term (36 months) and not as 'other income' that attracts tax at slab rates. "It is not fair to treat an income in the form of capital gains as 'other income' that attracts taxation at slab rate, as high as 39% (including surcharge and cess under new tax regime) for high-net-worth individuals. This proposal would trigger investors to shy away from investing in Indian infrastructure assets," said Nitan Chhatwal; managing director-investment manager, Shrem InvIT

Note that these tax rules are also applicable to unlisted Reits and InvITs.

Watch out for a clarification

The budget proposal has been worded in the Finance Bill, 2023, in such a way that it calls for clarification from the government, say experts.

Apart from highlighting that the 'loan repayment' would be charged under 'income from other sources', it also added a proviso (a condition) to the relevant section in the Income Tax Act—if the amount received by unitholder under 'loan repayment' represents a redemption of unit, then the sum received must be reduced by the cost of acquisition, which is nothing but capital gains tax treatment.

Industry experts are unsure of how to interpret this proviso. Also, tax experts and the trusts are trying to understand the definition of redemption in the current context. They also want to know whether the income will be treated as capital gains in the year of receipt or in the year of eventual sale of units and how to determine the cost of acquisition.

Embassy, in a recent press release, stated that "the announcement impacts around 40% of our current distributions. Plus, REITs are a total return product combining steady distributions, with upside on account of capital appreciation driven by growth levers. We, along with other industry participants, are currently evaluating next steps, including suitable representations given the to-date attractiveness and success of the product, especially to retail investors."

Nevertheless, with this proposal, the trusts have to disclose information in a much more detailed manner to its unitholders about the distributions, said Chandiramani.

What should investors do?

Those who would like to have better predictability of the post-tax yield on their investments in these trusts can wait till a clarification is issued.

Apart from taxation, the rationale for investing in Reits and InvITs and the quality of the underlying assets remain intact.

Vishal Dhawan, founder & CEO of Plan Ahead Wealth Advisors, believes that investors should not be changing their investment strategy in any form, because of the taxation that will be introduced on the principal repayment component.

"The underlying hypothesis and value of getting access to commercial real estate (in case of Reit) and the pool of assets continues to be as relevant as it was even before the budget. The benefit of using a Reit as an investment vehicle as a substitute to having and managing physical commercial real estate and having to find high quality tenants still remain intact," he added.

Reits currently do not offer any significant premium compared to the yield from a 10-year G-Sec instrument, for which the risk of default is practically nil. Having said that, experts say that the actual yield in the hands of investors from Reits may go up in future years if the renewal of leases happens at a higher rate due to inflation than the current rate. Another important component of return from Reits is the capital appreciation of the investment value if the stock price does not fall.