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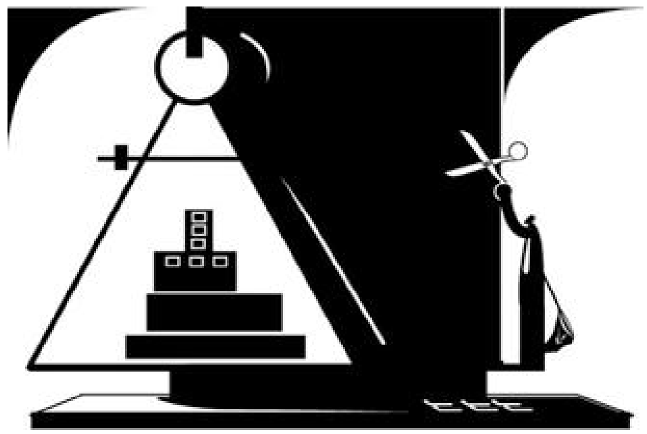
REITs: Tax issues and beyond

Apart from the tax challenges, there are non-tax issues also that make the Indian REIT unattractive



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The Securities and Exchange Board of India (Sebi) recently introduced the final regulations for real estate investment trusts (REITs) and infrastructure investment trusts (InvITs). These regulations come on the back of recent tax initiatives introduced in the budget this year. While the initiative is indeed a positive step, the tax measures governing REITs or business trusts (as they are referred to in the Income-tax Act) do not offer much encouragement, neither to the sponsor nor the unit holders.

From a sponsor's perspective, capital gains tax benefit has been given only in cases where shares of the special purpose vehicle (SPV) holding the real estate are transferred to a REIT against units of a REIT, and not when real estate is directly transferred to a REIT. By doing so, there is an unnecessary corporate layer imposed between the REIT and the real estate asset, which could result in a tax leakage of about 45% (corporate taxes of 30% at the SPV level and distribution tax of 15% on dividends, exclusive of surcharge and cess). To the sponsor, there is no tax benefit (but mere deferral) because she gets taxed when the REIT units are ultimately sold on the floor at a much more appreciated value, even though the units of a REIT would be listed and exempt from capital gains tax if held by other unit holders for more than three years.

While capital gains tax incidence may still be avoided by relying on principles of trust taxation, there will still be no respite from minimum alternate tax (MAT), which could become applicable on transfer of shares to the REIT. Considering that sponsors would like to transfer the shares at higher than book value to ensure commensurate fund raising for the REIT, the issue of MAT seems to be most critical.

From a REIT taxation perspective, although a pass-through of tax liability to investors for REIT income was promised, since the SPV is required to pay full corporate and dividend distribution taxes, where is the pass-through? What is even worse is that no foreign tax credit may be available for such taxes paid in India.

The only way to achieve tax optimization seems to be by way of infusion of debt into the SPV by a REIT. In such a situation, interest from the SPV to the REIT will be a deductible for the SPV, thus allaying both distribution taxes and corporate taxes. Interest from the SPV would be tax exempt at the REIT level and only a 5% withholding will be applicable on distributions by the REITs to the foreign unit-holders. This should help neutralize REIT taxation at India level, considering that the 5% withholding tax paid in India should also be creditable offshore.

The critical question that would then come up is how the SPV would use this debt. The debt can either be used to retire existing debt, or be structured to retire promoter equity in the SPV. If the debt is used for retiring equity, the risk of 'deemed dividend' characterization would need to be carefully considered. Though other creative structures may be devised to minimize tax exposure for the sponsor, it will be critical to 'dress up' the SPV appropriately with the right amount of debt and equity, before the SPV is transferred to the REIT.

Apart from the tax challenges set out above, there are also several non-tax issues that make the Indian REIT story unattractive. The requirement for a sponsor to have a real estate track record is likely to rule out a substantial portion of yield generating assets. This eliminates the possibility of non-real estate players such as hotels, hospitals, banks and others (such as Air India) becoming sponsors of REITs.

Most importantly, the marketability of Indian REITs compared with other fixed-income products remains weak since the expected yield on REITs may not exceed 5-6% compared with an around-8% yield offered by government securities. Though REITs may offer a higher return considering the capital appreciation, offshore investors seem reluctant to buy the 'cap rate story' attached to a REIT.

Having said that, REITs are likely to offer monetization opportunities to private equity funds and developers, which have till now been unable to find institutional buyers for completed real estate assets. As the appetite for developmental projects has reduced, REITs will offer opportunities to foreign investors to invest in rent generating assets, an asset class otherwise prohibited for foreign investments. It, however, remains to be seen how the Indian REIT story matches up to the Singapore REIT structure for Indian assets, or the more trending lease-rental-discounting structure, or the even more innovative commercial mortgage-backed security structure, which seem to be more appealing to potential sponsors.

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