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Budget tax proposal may hit investor returns in REITs

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The government said that distribution of debt repayment is not taxable for REITs and InvITs as well as the unit holder and hence, it results in dual non-taxation.

Investor returns in real estate investment trusts (REITs) could be hit after the Budget proposed to tax the repayment of debt in the hands of unit holders of REITs and InvITs as income from other sources, tax experts have said.The government said that distribution of debt repayment is not taxable for REITs and InvITs as well as the unit holder and hence, it results in dual non-taxation.

Kalpesh Maroo, partner, KPMG, said the proposed amendment will have a huge negative impact on REITs and investor returns, considering that some of the REITs are distributing a large proportion of their net distributable cash flows as repayment of shareholder loan or amortisation of SPV debt, on which neither the REIT nor the unit holders are subjected to tax based on the current regulations.

"The proposed taxation as 'other income' on such distributions is particularly problematic as it could potentially take the tax rates as high as 40% (plus surcharge and cess) on such distributions for foreign institutional investors and reopen a debate on classification of income under the domestic laws versus the treaties," Maroo said.Pulkit Poddar, associate partner, Economic Laws Practice, a law firm, said that as the (Budget) proposal reduces the attractiveness of debt repayment, the REITs may reorganise their capital structure to increase the dividend component.

"As far as debt repayment is concerned, a special purpose vehicle (SPV) does not get any deduction for debt repayment and repays such debt out of surplus cash flows which may have already been taxed, Poddar said. He added: "Accordingly, there is a possibility that an SPV may have paid income-tax on debt repayment and now the unit holders will have to again pay taxes on the same income." Ratnadeep Roychowdhury, co-head, private equity practice at Nishith Desai Associates, said that the government has introduced a residuary provision which is looking to tax distributions to unit holders, not sourced from the distributions received from underlying SPVs."Since this has been categorised as "other income", it is likely to be an unwelcome and material development for the universe of investors investing in InvITs and REITs," Roychowdhury said.

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Ashish Sodhani, co-head, international tax practice at Nishith Desai Associates, believes that the intent of the government to bring the proposed amendment seems to be have been double non-taxation but the taxation of repayment of debt in the hands of the unit holder seems to be "an unintended and unthought consequence"."If we think from a sovereign wealth fund (SWF) perspective, the proposed provisions results in the SWF becoming taxable on income which is perhaps not taxable due its very nature. The benefit of passthrough which has been accorded to business trusts will no longer be available to such stream of payment. In order for investment to come through business trusts, it is important to keep it lucrative and competitive," Sodhani said.

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When contacted, an Embassy REIT spokesperson said: "We're currently reviewing this proposed amendment and its implications."A Mindspace Business Parks REIT spokesperson did not offer any comment on the subject. Mail sent to Brookfield India REIT did not get any response.SR Patnaik, partner & head – taxation, Cyril Amarchand Mangaldas, said that the Budget provides that in case of redemption of units, the unit holder shall be allowed to claim its cost as a deduction while calculating its income.

However, for repayment of loan, there is no specific proposal to reduce the original loan being allowed as a deduction. "Thus, there is a risk that the total amount received by the unit holder shall be subject to tax without allowing deduction of the amount towards principal," Patnaik said.

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