How is income from Reits and InvIT taxed?

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The hurdle for small investors is the higher min amount that a person has to invest

Recent weeks have seen a rights issue by an infrastructure investment trust (InvIT) as well as an IPO by another. As more and more real estate investment trusts (Reits) and InvITs are getting listed, and as understanding of these instruments grows, investment in such instruments is gaining popularity, mainly on account of the post-tax yields offered by them. The icing on the cake is that while such trusts are mandatorily required to pay out 90% of their distributable cash flows, and such distributions are mandatorily required to be made every half year, some of them make such payouts every quarter.

Reits invest in the acquisition of immovable property, which yields rentals. Normally, such investments are not made directly by the trusts, but through special purpose vehicles (SPVs). The Reit invests in these SPVs through shares, interest-bearing loans or debt instruments. The SPVs earn rental income, pay the outgoings of the properties, pay taxes on their incomes and pay interest and dividends to the Reit. The SPV may also earn capital gains on sale of a property. Any cash surplus is used to repay the loans or debt instruments. The Reit earns mainly dividends, interest and has an additional cash flow in terms of loan/debt repayment received from the

SPVs. If the Reit owns an immovable property, it would also have rental income and capital gains, and in addition, cash flows to the extent of depreciation of the property. InvITs also invest through SPVs in infrastructure assets—the assets may be power grids or toll roads. The SPVs earn transmission income or toll, and in turn pay interest, dividends and repayment of debt to the InvIT. On sale of an infra asset, the SPV may also earn capital gains. The InvIT also earns dividends and interest, and has further cash flows on repayment of debt by the SPVs.

The SPVs pay tax on their respective taxable income, which is computed after deducting all allowable expenses (including interest paid to the Reit/InvIT) from the gross income earned by way of rent, transmission fees or toll and investment income such as bank interest or mutual fund income. For companies, such tax may be the normal rate of 25% plus surcharge and cess, or the concessional rate of 22% plus surcharge and cess.

The interest and dividends received by the Reit/InvIT from the SPVs is exempt from tax. The Reit is also exempt from tax on its rental income, which it may have earned if it owned a property directly. A Reit/InvIT would pay tax only on its capital gains and other interest and investment income, other than income earned from the SPVs. Debt repayment by the SPVs to the Reit/InvIT would not be an income of the Reit/InvIT at all, being a repayment of the principal amount of the debt advanced by the latter.

The investor is subjected to tax only on respect of that portion of the cash flow distribution, which represents interest income of the Reit/InvIT from the SPVs (and which was exempt in the hands of the SPVs) and on rental income of the Reit (which was exempt in the hands of the Reit). Further, if the SPVs have opted for the concessional rate of tax on their incomes, the investor would also be taxed on that portion of the cash flow distribution attributable to such dividend. All other cash flows received by the investor would be exempt from tax. In any case, the cash flow attributable to the debt repayment by the SPV represents return of capital of the investor, and would not be taxable.

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 Reit/InvIT 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 Reit/InvIT, 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 Reit/InvIT 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 Reit/InvIT can, therefore, effectively give investors a higher post-tax return, as compared to a normal company structure.

Of course, the main disadvantage of a Reit/InvIT for small investors is the higher minimum amount that an investor has to invest— ₹50,000 for Reits and ₹1 lakh for InvITs in an IPO, and 200 units for trading on stock exchanges.

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