TRILEGAL

UPDATES

Budget 2021 - Implications for InvITs and REITs (Part 1)

04 March 2021

This update covers:

The Finance Minister introduced the Finance Bill, 2021 (**Bill**) on 1 February 2021 with a slew of measures to boost the Indian infrastructure sector. The Bill proposes some key amendments that impact infrastructure investment trusts (**InvITs**) and real estate investment trusts (**REITs**). Some of these amendments include changes in the definition of securities, enabling a secured creditor to initiate actions against a 'pooled investment vehicle' that defaults in the repayment of principal or interest to its lenders, reducing the compliance burden of withholding tax and widening the base for eligible sovereign wealth funds (**SWFs)** and Pension Funds (**PFs**) by doing away with some of the conditions which were difficult to comply with.

The Finance Bill, 2021 proposes several measures to boost the infrastructure sector in the country. In this update, we analyse some of the key amendments impacting InvITs and REITs.

1 Amendments to the Securities Contracts (Regulation) Act, 1956

The Bill proposes certain amendments to the Securities Contracts (Regulation) Act, 1956 (**SCRA**), effective from 1 April 2021. One such amendment is the introduction of the concept of '*pooled investment vehicle*'. The proposed term defines pooled investment vehicle to mean a fund established in India, in the form of a trust or otherwise, which would include mutual funds, alternative investment funds (**AIFs**), collective investment schemes or business trusts (as defined in the Income-Tax Act, 1961 (**IT Act**) and registered with the Securities and Exchange Board of India (**SEBI**)), or such other funds, which raise or collect money from investors and invest such funds in accordance with SEBI regulations. It is pertinent to note that the IT Act defines business trusts as trusts registered with SEBI as an InvIT or a REIT.

Additionally, the Bill proposes that units or any other instruments issued by 'pooled investment vehicles' will be recognised as 'securities' under the SCRA.

Further, a new provision under the SCRA allowing pooled investment vehicles to (i) borrow and issue debt securities in accordance with regulations framed by SEBI; and (ii) provide security interest to lenders in terms of the facility documents entered into by such pooled investment vehicles, is proposed to be inserted.

The amendments proposed to SCRA may have different tax consequences for different investors. Earlier there was little clarity on the availability of concessional long-term capital gains tax rate for non – residents on the transfer of unlisted units of InvITs and REITs. Through this amendment, the Government has offered certainty on the availability of such concessional tax rate. However, as a consequence of the amendment, since these units are now within the ambit of 'securities', grant of these units would be subject to deemed gift tax provisions under the IT Act. This may have an adverse consequence on new investors / limited partners (**LPs**) investing into an AIF after the first close of the AIF and buying units of the AIF at the same price as the previous LPs. To elaborate, since the AIF would have made investments after the first close, there may have been an appreciation in the net asset value (**NAV**) of such AIF. However, given than the new LPs would be buying the units at the same price as the previous LPs, there may be a risk that this difference in price between the issue price of AIF units and the NAV can incur a tax liability for the incoming LPs under the deemed gift tax provision going forward. Thus, consequence of deemed gift tax provisions on compensating contribution would merit consideration on a case by case basis.

2 Borrowings by InvITs and REITs liberalised

The Finance Minister mentioned in her speech that to enable debt financing to InvITs and REITs by foreign institutional investors (**FIIs**) amendments are being proposed to relevant legislations. This may potentially open up a large source of fresh funding for these entities.FIIs are already provided a beneficial tax treatment on short term capital gains and it is felt that further enabling debt financing may increase the flow of foreign investments in infrastructure projects in India, not only from private players but also from Sovereign Wealth Funds (**SWFs**).

Further, to incentivise SWFs to invest in Indian infrastructure, the Bill proposes to relax some of the conditions for availing 100% tax exemption, as discussed below.

Conditions for notifying SWFs and PFs relaxed

The Finance Act, 2020 introduced an exemption from tax on dividends, interest and long-term capital gains income to notified SWFs and PFs, subject to complying with specified conditions. To rationalise these conditions, remove difficulties, and widen the base of eligible SWFs and PFs, the following amendments are proposed in the Bill:

- Investment in Category I and II AIFs will be eligible for the exemption if they, in turn, invest a minimum of 50% (reduced from 100%) in eligible infrastructure activities.
- Investment in Indian holding company registered after 1 April 2021 will be eligible for the exemption if such company, in turn, invests minimum 75% in one or more infrastructure companies.
- Investment in Non-banking finance company registered as Infrastructure debt fund/Infrastructure finance company will also be eligible for the exemption, if they, in turn, lend a minimum of 90% to one or more infrastructure entities.
- Exemption under this clause will be calculated proportionately if the aggregate investment of AIF in infrastructure company or companies or InvITs is less than 100%. Central Government to prescribe the method of calculation and rules thereon.

- SWF/PFs that have loans or borrowings (as defined), directly or indirectly for making investments in India will not be eligible for the exemption. The Bill also proposes to do away with certain conditions (such as, income earned by SWF should not benefit any private person and assets of the SWF should go to the Government to the extent of any loan taken or monies borrowed from the creditor).
- Relaxation is provided to pension funds from taxation if they are liable to pay tax in their home country initially and given exemption from taxation for all its income subsequently.
- Presently, SWF/PFs are not allowed to undertake any commercial activity. It is proposed that this condition be removed and replaced with a condition that SWF/PFs will not participate in day to day operation of the investee (as defined). It is also clarified that appointing director and executive director for monitoring the investment would not amount to participation in day to day operation.

These amendments will take effect from 1 April 2021 and are a welcome move for SWFs and PFs who have recently made representations before the Government regarding the hardships faced while trying to comply with the conditions set out in the ITA for availing exemptions.

3 Introduction of enforcement provisions under the SARFAESI Act

The Bill provides for the insertion of a new provision under the SCRA, that in the event of default by a pooled investment vehicle, lenders can recover the defaulted amount against the assets of the trust, by initiating proceedings against the trustee (acting on behalf of the pooled investment vehicle), and any remainder of the trust assets after paying the lenders, can be remitted to the unit holders on a proportionate basis.

As a consequence of the proposed amendments to the SCRA permitting a 'pooled investment vehicle' to issue debt securities and lenders to take enforcement action against such 'pooled investment vehicle' in the event of default, the Bill seeks to amend the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (**SARFAESI Act**) (effective from 1 April 2021), to include a 'pooled investment vehicle' within the ambit of 'borrower' as defined in the SARFAESI Act. Further, it proposes to expand the definition of 'secured creditor' to include debenture trustee appointed by a pooled investment vehicle, by removing the limitation of appointment of a debenture trustee by a company.

With the change in the definition of borrower, a secured creditor will now be able to initiate action in accordance with the provisions of the SARFAESI Act against a 'pooled investment vehicle' that defaults in the repayment of principal amount or payment of interest due to it.

4 Dividend income received by business trust exempt from TDS under the tax law

The last budget witnessed the abolition of dividend distribution tax and introduction of withholding on dividend. However, there were no carve outs for dividends paid by Indian investee companies (not paying taxes under concessional regime) to tax pass-through entities such as business trust. Given that distribution of dividend is not subject to tax to begin with, requiring such investee companies to withhold tax and eventually claim a refund or obtain a nil withholding tax certificate was onerous and resulted in cash flow issues for foreign investors.

The Bill rectifies this hardship by introducing an exemption from tax deduction at source on dividend income earned by REITs and InvITs from specified investee companies (being SPVs who pay taxes under the normal regime and not concessional regime). This amendment is proposed to take effect retrospectively from 1 April 2020.

5 Applicability of DTAA rate for withholding of taxes on income earned by Financial Institutional Investors

Currently, based on the provisions of the IT Act and a judicial precedent rendered by the Supreme Court of India, taxes are withheld at the rate of 20% (plus applicable surcharge and cess) on dividend income earned by FIIs.

With a view to enable FIIs to avail the beneficial rates under the relevant tax treaty on withholding of taxes on dividend/interest pay-outs to FIIs , the Bill proposes to amend the existing provisions under the ITA to provide for the withholding of taxes at the rate of 20% or 5% (in case specific conditions regarding interest rate cap are fulfilled) or the rates provided in the relevant tax treaty, whichever is lower.

The availability of the beneficial rate under the tax treaty will be subject to furnishing of a valid tax residency certificate by the FIIs and availability of benefits under the relevant tax treaty. Whilst this is a clarificatory amendment by the Government, it is one step closer towards acknowledging the need for reduction in income-tax litigation and gaining trust of offshore investors in the economy.

Our detailed updates on key tax proposals across different areas can be accessed through the links below:

1 Implications for InvITs and REITs

2 Rationalisation of Equalisation Levy provisions

3 Impact on mergers and acquisitions

4 Tax incentives for International Financial Services Centre

5 Key tax proposals for housing sector

6 Key tax proposals for employees

7 Other key proposals

8 Key indirect tax proposals