

New Concept of Business Trusts in India



To attract more domestic and foreign investment in real estate and infrastructure sector, the Finance Bill, 2014 has introduced a new concept of “Business Trusts”. Regulations for these trusts will be governed by the SEBI. It is proposed to give these business trusts a formal recognition and confer benefits on them. Business trusts have been given pass through status and many tax benefits are available to the business trusts and also to the unit holders. It will be necessary to understand this concept from its origin to its tax implications. Read on...

Introduction

“Real Estate Investment Trusts (REITs) have been successfully used as instruments for pooling of investment in several countries. I intend to provide necessary incentives for REITs which will have pass through for the purpose of taxation. As an innovation, a modified REITs type structure for infrastructure projects is also being announced as Infrastructure Investment Trusts (InvITs), which would have a similar tax efficient pass through status, for PPP and other infrastructure projects. These structures would reduce the pressure on the banking system while also making available fresh equity. I am confident that

these two instruments would attract long term finance from foreign and domestic sources including the NRIs.” This statement was given by the Finance Minister Mr. Arun Jaitley while presenting the Finance Bill, 2014. With this statement, a new concept of business trust has been emerged in India.

Understanding Business Trusts

Chapter XII-FA has been inserted to the Income-tax Act with effect from 1st April 2015 which describes special provisions related to the business trusts. Definition of “Business Trusts” as given in the Finance Bill, 2014 by insertion of a new Clause 2(13) (A) to the Income-tax Act says “*business trust means a trust registered as an infrastructure investment trust or a real estate investment trust, the units of which are required to be listed on a recognised stock exchange, in accordance with the regulations made under the Securities Exchange Board of India Act, 1992 and notified by the Central Government in this behalf.*”



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As said by the Finance Minister, business trusts have been given the pass through status. These business trusts are not a separate legal entity, but a combination of elements of company and trust. It runs a business enterprise, invests in sectors and assets, but trustees are the legal owners of the trust's properties and they manage these assets for the benefit of the unit holders.

Such business trusts include new category of investment vehicles i.e. real estate investment trusts (REITs) and infrastructure investment trusts (InvITs). These investment vehicles should have certain prerequisites such as creation of trust, recognition from SEBI and compulsory listing on a recognised stock exchange in India. Moreover, these trusts have to follow certain conditions, such as these trusts will have to raise capital through issue of units or through debt and acquire a controlling stake in special purpose vehicles (SPVs) having income bearing assets, which mainly focus on infrastructure projects awarded through public private partnership (PPP) model. Special purpose vehicle (SPV) means an Indian company in which business trust holds controlling interest and any specific percentage of shareholding or interest, as may be required by regulations under which the trust is granted registration.

SEBI Rules For Real Estate Investment Trusts (REITs)

Recently, SEBI has approved basic rules for REITs called SEBI (Real Estate Investment Trusts) Regulations, 2014. These rules, in brief, are:

- a) REITs shall be set up as a trust and registered with SEBI. It shall have parties such as Trustee, Sponsor(s) and Manager.
 - b) The trustee of a REIT shall be a SEBI registered debenture trustee who is not an associate of the Sponsor/Manager.
 - c) REIT shall invest in commercial real estate assets, either directly or through SPVs. In such SPVs, the

REIT shall invest in commercial real estate assets, either directly or through SPVs. In such SPVs, the REIT shall hold or proposes to hold controlling interest and not less than 50 % of the equity share capital or interest. Further, such SPVs shall hold not less than 80 % of its assets directly in properties and shall not invest in other SPVs.
- d) Once registered, the REIT shall raise funds through an initial offer. Subsequent raising of funds may be made through follow-on offer, rights issue, qualified institutional placement, *etc.* The minimum subscription size for units of REIT shall be ₹2 lakh. The units offered to the public in initial offer shall not be less than 25 % of the number of units of the REIT on post-issue basis.
 - e) Units of REITs shall be mandatorily listed on a recognised stock exchange and REIT shall make continuous disclosures in terms of the listing agreement. Trading lot for such units shall be ₹1 lakh.
 - f) For coming out with an initial offer, the value of the assets owned/proposed to be owned by REIT shall be of value not less than ₹500 crore. Further, minimum issue size for initial offer shall be ₹250 crore.
 - g) The trustee shall generally have an overseeing role in the activity of the REIT. The manager shall assume operational responsibilities pertaining to the REIT. Responsibilities of the parties involved are enumerated in the Regulations.
 - h) An REIT may have multiple sponsors, not more than three, subject to each holding at least 5 % of the units of the REIT. Such sponsors shall collectively hold not less than 25 % of the units of the REIT for a period of not less than three years from the date of listing. After three years, the sponsors, collectively, shall hold minimum 15 % of the units of REIT, throughout the life of the REIT.
 - i) Not less than 80 % of the value of the REIT assets shall be in completed and revenue generating properties. Not more than 20 % of the value of REIT assets shall be invested in the following :
 - i. developmental properties,
 - ii. mortgage backed securities,
 - iii. listed/unlisted debt of companies/ body corporates in real estate sector,
 - iv. equity shares of companies listed on a recognised stock exchange in India which derive not less than 75 % of their operating income from real estate activity,
 - v. government securities,
 - vi. money market instruments or cash equivalents.

Industry Specific

The aggregate consolidated borrowings of the InvIT and the underlying SPVs shall never exceed 49 % of the value of InvIT assets. Further, for any borrowing exceeding 25 % of the value of InvIT assets, credit rating and unit holders' approval is required.

However, investments in developmental properties shall be restricted to 10 % of the value of the REIT assets.

- j) An REIT shall invest in at least two projects with not more than 60 % of value of assets invested in one project. Detailed investment conditions are provided in the Regulations.
- k) REIT shall distribute not less than 90 % of the net distributable cash flows, subject to the applicable laws, to its investors, atleast on a half yearly basis.
- l) REIT, through a valuer, shall undertake full valuation on a yearly basis and updation of the same on a half yearly basis and declare NAV within 15 days from the date of such valuation/ updation.
- m) The borrowings and deferred payments of the REIT at a consolidated level shall not exceed 49 % of the value of the REIT assets. In case such borrowings/deferred payments exceed 25 %, approval from unit holders and credit rating shall be required.
- n) Detailed provisions for related party transactions, valuation of assets, disclosure requirements, rights of unit holders, *etc.* are provided in the Regulations. However, for any issue requiring unit holders' approval, voting by a person who is a related party in such transaction as well as its associates shall not be considered.

SEBI Rules For Infrastructure Investment Trusts (InvITs)

SEBI has also approved rules for infrastructure investment trusts called the SEBI (Infrastructure Investment Trusts) Regulations, 2014. Salient features of the InvIT regulations, as approved by the SEBI, are as under:

- a) Infrastructure is as defined by the Ministry of Finance *vide* its notification dated 7th October 2013 and shall include any amendments/ additions made thereof. InvITs shall be set up as a trust and registered with SEBI.
- b) It shall have parties such as Trustee, Sponsor(s), Investment Manager and Project Manager.
- c) The trustee of an InvIT shall be a SEBI registered debenture trustee who is not an associate of the Sponsor/Manager.
- d) InvITs shall invest in infrastructure projects, either directly or through SPV. In case of PPP projects, such investments shall only be through SPV.
- e) An InvIT shall hold or propose to hold controlling interest and more than 50 % of the equity share capital or interest in the underlying SPV, except where the same is not possible because of a regulatory requirement/requirement emanating from the concession agreement. In such cases, sponsor shall enter into an agreement with the InvIT to ensure that no decision taken by the sponsor, including voting decisions with respect to the SPV, are against the interest of the InvIT/ its unit holders.
- f) Sponsor(s) of an InvIT shall, collectively, hold not less than 25 % of the total units of the InvIT on post issue basis for a period of at least 3 years, except for the cases where a regulatory requirement/concession agreement requires the sponsor to hold a certain minimum percent in the underlying SPV. In such cases, the consolidated value of such sponsor holding in the underlying SPV and in the InvIT shall not be less than the value of 25 % of the value of units of InvIT on post-issue basis.
- g) The proposed holding of an InvIT in the underlying assets shall be not less than ₹500 crore and the offer size of the InvIT shall not be less than ₹250 crore at the time of initial offer of units.
- h) The aggregate consolidated borrowings of the InvIT and the underlying SPVs shall never exceed 49 % of the value of InvIT assets. Further, for any borrowing exceeding 25 % of the value of InvIT assets, credit rating and unit holders' approval is required.
- i) An InvIT which proposes to invest at least 80 % of the value of the assets in the completed and revenue generating infrastructure assets, shall :
 - i. raise funds only through public issue of units,
 - ii. have a minimum 25 % public float and at least 20 investors,
 - iii. have minimum subscription size and trading lot of ₹ 10 lakh and ₹ 5 lakh, respectively,
 - iv. distribute not less than 90 % of the net

- distributable cash flows, subject to applicable laws, to the investors, atleast on a half yearly basis.
- v. through a valuer, undertake a full valuation on a yearly basis and updation of the same on a half yearly basis and declare NAV within 15 days from the date of such valuation/ updation,
 - j) A publicly offered InvIT may invest the remaining 20 % in under construction infrastructure projects and other permissible investments, as defined in the Regulations. However, the investments in under construction infrastructure projects shall not be more than 10 % of the value of the assets.
 - k) An InvIT which proposes to invest more than 10% of the value of their assets in under construction infrastructure projects shall :
 - i. raise funds only through private placement from qualified institutional buyers and body corporates,
 - ii. have minimum investment and trading lot of ₹1 crore.
 - iii. have minimum of five investors with each holding not more than 25 % of the units,
 - iv. distribute not less than 90 % of the net distributable cash flows, subject to applicable laws, to the investors, atleast on a yearly basis,
 - v. undertake full valuation on yearly basis and declare NAV within fifteen days from the date of such valuation.
 - l) Conditions for InvITs investing in under construction projects:
 - i. *For PPP project(s):*
 - a. has achieved completion of at least 50 % of the construction of the infrastructure project as certified by an independent engineer; or
 - b. has expended not less than 50 % of the total capital cost set forth in the financial package of the relevant project agreement.
 - ii. *For Non-PPP project(s),* the infrastructure project has received all the requisite approvals and certifications for commencing construction of the project.
 - m) Listing shall be mandatory for both publicly offered and privately placed InvITs and InvITs shall make continuous disclosures in terms of the listing agreement.
 - n) Detailed provisions for related party transactions, valuation of assets, disclosure requirements, rights of unit holders, *etc.* are provided in the Regulations. However, for any issue requiring unit holders' approval, the voting by any person who is a related party in such transaction as well as its associates shall not be considered.

Taxation Aspects of Business Trusts

Section 115UA has been inserted to determine tax on income of unit holders and business trust. Type of income is essential to determine taxability of income of unit holder and business trust. Let us see the taxability of income in the hands of business trusts and unit holders in detail.

Interest Income:

These business trusts have been given only the pass through status. So, if any interest income is paid by the special purpose vehicle (SPV) to the business trust, then such interest income is not taxable in the hands of the trust and there will be no withholding tax (WHT) by the SPV while making such interest payments. However, when the trust distributes such interest income to the unit holders then WHT at the rate of 5 % in case of non-resident payee and 10 % in case of resident payee will be applicable. So, interest distributed by business trust is taxable in the hands of unit holders.

Dividend:

SPV distributing dividend to business trusts is subject to dividend distribution tax (DDT). But dividend is exempt in the hands of business trusts. From 1st October, 2014, dividend distributed by business trusts is exempt in the hands of unit holders.

Capital Gains:

As per the SEBI Guidelines, units of business trusts must be listed in stock exchange, so there

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will be no long term capital gain (LTCG) on transfer of such units and short term capital gain (STCG) will be taxable at the rate of 15 %, provided STT is paid on transfer of such units. The capital gain component of distributed income is exempt in the hands of the unit holders. Moreover, exchange of shares of SPV for units of business trust will not be regarded as taxable transfer. But it will be taxable only on ultimate disposal of the units by sponsor at prevailing rate of capital gain. The sponsor will not enjoy concessional STT exemption benefit at the time of ultimate disposal of units and the acquisition cost of units to the sponsor will be deemed to be the acquisition costs of the shares in the SPV. The holding period of shares would also be included in reckoning the holding period of units. The Finance Bill, 2015 has excluded from chargeability to MAT any notional gain/loss resulting from transfer of shares of SPV to a business trust in exchange of units allotted by that trust. Moreover, notional gain/loss resulting from any change in carrying amount of said units and actual gain/loss from transfer of said units as recorded in profit and loss account are excluded from the chargeability of MAT. The amount of gain/loss from transfer of the said units shall be computed considering the cost of shares exchanged with units or the carrying amount of the shares at the time of exchange, where such shares are carried at a value other than the cost through profit and loss account. As per the Finance Bill, 2015, REIT is also exempt from long term capital gain when special purpose vehicles (SPVs) which hold rent yielding properties, exchange shares for units of REITs and a pass through of rental income to unit holders on assets held by REITs.

Total Income of the Business Trusts:

Total income of the business trusts will be taxable at the maximum marginal rate of 33.99 % except taxability of above income discussed above.

External Commercial Borrowings:

If the business trust borrows any external commercial borrowings from non-resident, lenders, interest payment by the trust will be subject to TDS at the rate of 5 % under Section 194LC, if the money is borrowed in foreign currency.

And of course, business trusts have to file income tax returns and periodic statements of income distributed to unit holders.

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Concept of Business Trusts in the World

It should be noted that above provisions are in line with REIT legislations in Singapore and Hongkong. The concept of business trusts is new to India, but not new to the world. India is not the first to implement the concept of business trusts. Singapore has enacted the Business Trusts Act in 2004. In Singapore, tax treatment of real estate investment trusts is different from registered business trusts. Here, business trusts are created using trust deed and run by a single responsible person called trustee-manager. Here, business trusts are treated as company for tax purposes and they are taxed at corporate tax rate, but distribution of income of business trusts in the hands of unit holders, beneficiaries and shareholders is wholly exempt. In the United States, business trusts made its first debut in Massachusetts in 1827. In the US also, the business trusts are subject to corporate tax rate. In Malaysia, business trusts are registered by the Capital Market and Services Act, 2007 and like Singapore and the US, they are treated like a company. In Malaysia, business trusts can distribute income to investors from cash flow subject to solvency requirement, distribution received by unit holders is exempt from income tax and also there is stamp duty exemption for transfer of business and assets to business trusts.

Conclusion

The government has implemented this concept of business trust for economical growth of India through public private partnership (PPP). Definitely, these business trusts will prove to be additional revenue earning instruments for government and will be helpful in the development of India.

References:

(1) Website Incometaxindia.gov.in ■