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InvIT & REIT Roundup: Overview of the Recent Taxation and Regulatory Changes

The regulatory regime governing InvITs and REITs is rapidly evolving and has undergone various changes in the last six months. 'InvIT & REIT Roundup: Overview of the Recent Taxation and Regulatory Changes' has been prepared by Shardul Amarchand Mangaldas & Co to bring to your attention (i) certain key amendments made to the Finance Bill, 2020, which have been incorporated in the Finance Act, 2020 (passed by the parliament and received Presidential assent on March 27, 2020) and (ii) certain new guidelines and notifications issued by the Securities and Exchange Board of India (the "SEBI") and certain amendments made to the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014 ("REIT Regulations") and the Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014 ("InvIT Regulations" and together with the REIT Regulations, the "SEBI Regulations").

Key Takeaways

Taxability of dividend income in the hands of unitholders

The Finance Bill, 2020 had originally proposed to tax dividend income in the hands of unitholders, which was previously exempt. The proposal to tax dividend income had cast a doubt over the viability of Infrastructure Investment Trusts ("InvITs") and Real Estate Investment Trusts ("REITs") structures in India. However, the Finance Act, 2020 (which incorporates certain amendments to the Finance Bill, 2020) has re-instated the exemption available to InvITs and REITs on the taxability of the dividend distribution tax in the hands of the unitholders. This is a welcome change and will hopefully provide a fresh impetus to InvITs and REITs. The Finance Act, 2020 provides that:

- Dividend received/receivable by the InvIT/REIT from its Project SPVs shall continue to be exempt in hands of the InvIT/REIT (in line with the existing provisions of the Income Tax Act, 1961 ("IT Act")).
- Taxation of dividend income shall be exempt in hands of unitholders of the InvIT/REIT provided the Project SPV from which dividend income is received, does not exercise the option of benefit of a lower tax rate under Section 115BAA of the IT Act.
- Additionally, 'withholding tax' obligation has been exempted in hands of the InvIT/REIT on dividend income paid to unitholders in cases where the underlying Project SPV does not exercise the option of benefit of a lower tax rate under Section 115BAA of the IT Act.

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The InvIT Regulations and REIT Regulations allow an InvIT and REIT to raise further capital (post the initial offer) by way of a further public issue, preferential allotment, qualified institutions placement, rights issue, bonus issue or an offer for sale. However, the InvIT Regulations and REIT Regulations, do not prescribe the operational framework for undertaking further raising of capital by listed InvITs/REITs. Since an InvIT/REIT is required to distribute 90% of the net distributable cash flows, the ability to raise further capital is critical for listed InvITs and REITs, especially at the stage of expanding the initial portfolio of assets and acquiring new assets. Therefore, in order to fill the regulatory gap in the SEBI Regulations, SEBI has notified the operational framework for undertaking further raising of capital by way of a preferential issue, institutional placement and rights issue, which has been modelled similar to the framework applicable to listed companies for undertaking preferential issue, qualified institutions placement and rights issue under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 (“SEBI ICDR Regulations”).

Preferential Issue Guidelines

SEBI has notified the Preferential Issue Guidelines on November 27, 2019, which were subsequently amended by way of a circular dated March 13, 2020. The Preferential Issue Guidelines provide a framework for listed InvITs/REITs for undertaking further raising of capital (after the initial offer), by way of (i) a preferential issue of units to select group of persons undertaken on a private placement basis (“**Preferential Issue**”) and (ii) further issue of units undertaken on a private placement basis only to institutional investors (“**Institutional Placement**”).

- **Key eligibility criteria** – in case of Preferential Issue, the units are required to be listed on a recognised stock exchange for at least six months preceding the date of issuance of notice to unitholders for a resolution authorising the Preferential Issue, whereas in case of Institutional Placement, the units are required to be listed on a recognised stock exchange for at least 12 months preceding the date of issuance of notice to unitholders for a resolution authorising the Institutional Placement.
- **Subsequent issue** – a listed InvIT/REIT is not permitted to undertake any subsequent Institutional Placement until the expiry of six months from the date of the prior Institutional Placement.
- **Restriction on allotment** – in the case of an Institutional Placement, no allotment can be made, directly or indirectly, to any ‘institutional investor’ who is a sponsor or investment manager, or is a person related to, or related party or associate of, the sponsor or the investment manager of the InvIT, or a sponsor or manager, or is a person related to, or related party or associate of, the sponsor or the manager of the REIT. However, it may be noted that this restriction is not applicable in case of a Preferential Issue.
- **Pricing** – for Preferential Issue and Institutional Placement by an InvIT/REIT, the price of the units to be allotted is linked to a formula calculated on the basis of average of the weekly high and low of the volume weighted average price of the units quoted on the stock exchange. The pricing methodology for Preferential Issue and Institutional Placement is similar to the pricing methodology provided under the SEBI ICDR Regulations for preferential issue and qualified institutions placement, respectively.
- **Discount** – in the case of an Institutional Placement, a listed InvIT/REIT is permitted to offer a discount of not more than 5% on the issue price, subject to approval of unitholders. However, there is no provision for discount being available to investors in the case of a Preferential Issue.

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Securities Law Update

- **Lock-in** – In relation to the units allotted to the sponsor(s) and their associates (for an InvIT) and those allotted to the sponsor(s) and sponsor group (for a REIT), the Preferential Issue Guidelines prescribe that units not more than 15%/25% of the total unit capital of the InvIT/REIT shall be locked-in for three years from the date of trading approval and units allotted in excess of the 15%/25% of the total unit capital of the InvIT/REIT shall be locked-in for one year from the date of trading approval.

Rights Issue Guidelines

SEBI notified the Rights Issue Guidelines on January 17, 2020, which were subsequently amended by way of a circular dated March 13, 2020. The Rights Issue Guidelines provide a framework for issue of units by a listed InvIT/REIT to its unitholders as on a record date finalised for this purpose. The Rights Issue Guidelines also provide a mechanism for undertaking fast track rights issues.

- **Key eligibility criteria** – the key eligibility criteria under the Rights Issue Guidelines are similar to the criteria applicable to a rights issue under the SEBI ICDR Regulations and require, among other things, parties to the InvIT/REIT to fulfil certain KYC related criteria, such as not being declared as a fugitive economic offender or being debarred from accessing capital markets.
- **Minimum subscription** – 90% of the issue size has to be subscribed to through the letter of offer.
- **Manner of issuance** – the rights entitlements includes a right exercisable by an eligible unitholder to renounce the units offered to such eligible unitholder in favour of any other person. Further, subject to minimum public unitholding requirements, the sponsor(s), and their associates who are unitholders as on the record date, may choose to subscribe to additional units subject to disclosure of such intent in the draft letter of offer and letter of offer.
- **Restriction on further issue** – no further issue of units, whether by way of public issue, rights issue, preferential issue, qualified institutions placement, institutional placement, issue of bonus shares or otherwise, shall be made, during the period between the date of filing the draft letter of offer with SEBI and the listing of the units offered through the letter of offer or refund of application monies.
- **Pricing** – the investment manager/ manager on behalf of the InvIT/REIT, in consultation with the lead merchant banker(s), is required to decide the issue price before determining the record date, which is to be announced to the stock exchange(s) at least three working days prior to the record date. The InvIT/REIT is not permitted to withdraw the rights issue after the announcement of the record date. However in the event the rights issue is withdrawn after such announcement, the InvIT/REIT shall not be eligible to make a listing application of any of its units for a period of 12 months from the record date.
- **Fast Track Rights Issue** – the Rights Issue Guidelines allow listed InvITs/REITs to undertake a fast track right issue. Pursuant to a fast track rights issue, an InvIT/REIT is not required to file the draft offer document with SEBI, subject to compliance with the certain key conditions, which, among others, include:
 - **Listing** – units have been listed on a stock exchange for a period of at least three years immediately preceding the record date;
 - **Market capitalisation** – average market capitalisation of public unitholding of the InvIT/REIT is at least INR 2,500 million;
 - **Legal proceedings** – no show-cause notices have been issued or prosecution proceedings have been initiated by the SEBI and are pending against the InvIT/REIT, parties to the InvIT/REIT or their respective promoters or partners or directors as on the record date;

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- **Securities law violation** – the InvIT/REIT, parties to the InvIT/REIT or their respective promoters or partners or directors has not settled any alleged violation of securities laws through the consent or settlement mechanism with SEBI during three years immediately preceding the record date;
- **Audit qualification** – there are no audit qualifications on the audited accounts of the InvIT/REIT in respect of those financial years for which such accounts are disclosed in the letter of offer;
- **Disclosures in letter of offer** – the letter of offer, though not required to be filed with SEBI, requires disclosures largely similar to disclosures to be made in case of a public issue under the respective SEBI Regulations; and
- **Sponsor subscription** – sponsor(s) and their associates (in case of InvITs) and the sponsor(s), their associates and members of the sponsor group (in case of REITs), who are unitholders as on the record date, are required to mandatorily subscribe to their rights entitlement and shall not renounce their rights, except for ensuring compliance with minimum public shareholding norms prescribed under the respective SEBI Regulations.

Guidelines for filing of placement memorandum by InvITs (“Guidelines for Filing PM”)

- SEBI has issued guidelines for filing of placement memorandum on December 24, 2019 for InvITs proposing to issue units by way of private placement. The Guidelines for Filing PM require that privately placed InvITs will, similar to publicly placed InvITs, be required to file a draft placement memorandum (“PM”) with SEBI and the stock exchange(s), not less than 30 days prior to opening of the issue. These guidelines are only applicable to initial offers on a private placement basis by InvITs whose units are proposed to be listed. However, these guidelines are not applicable to privately placed unlisted InvITs.
- Additionally, the merchant banker(s) will be required to submit a due diligence certificate as per Form A (to the extent applicable) of Annexure I of SEBI circular on the ‘Guidelines for public issue of units of InvITs’ dated May 11, 2016 (“**Public Issue Guidelines**”) along with the draft PM. The merchant banker(s) are also required to (i) ensure that all comments provided by SEBI are suitably incorporated in the draft PM prior to the filing of the PM and (ii) provide the due diligence certificate as per Form B of Annexure I of the Public Issue Guidelines.

It may be noted that there have been three privately placed InvIT issues till date, however, in all such issues, the draft PM was not filed with SEBI for comments, as there was no clarity provided under the InvIT Regulations prior to this circular. Typically, the privately placed InvIT was considered as a faster route to listing, since the requirement to file the draft preliminary placement memorandum with SEBI was not applicable. However, the new requirement to file the draft PM with SEBI is likely to have significant implications on the timelines for undertaking a private placement by InvITs. Further, prior to the circular there was no clarity under the InvIT Regulations on whether the merchant banker(s) were required to provide a due diligence certificate to SEBI, however, the circular provides the various stages at which such certificate is required to be provided.

Relaxation in the eligibility requirements for the investment manager of an InvIT

SEBI, by way of the notification dated March 2, 2020, has amended the InvIT Regulations and allowed for relaxation in the experience requirement for the investment managers. Prior to this amendment, an investment manager was required to have an experience of at least five

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years in fund management or advisory services or development in the infrastructure sector in order to qualify as an investment manager of an InvIT. However, the InvIT Regulations have been amended to allow the combined relevant experience of at least 30 years of directors, partners and employees of the investment manager (even if it is a newly created entity), in fund management or advisory services or development in the infrastructure sector, to be considered towards the experience requirements of the investment manager. However, in order to consider the combined experience, only those directors, partners, employees which have more than five years of experience would be considered.

Guidelines on creation of encumbrance (“Encumbrance Guidelines”)

The InvIT Regulations and the REIT Regulations do not provide for creation of encumbrance on locked-in units. In order to provide procedural guidelines for creating encumbrance on locked-in units, as provided for locked-in shares for listed companies under the SEBI ICDR Regulations, SEBI, by way of notification dated March 23, 2020, has permitted the sponsors (in case of InvITs) and the sponsors and sponsor group (in case of REITs) to create encumbrance by way of pledge, lien, negative lien, non-disposal undertaking etc. or any other covenant, transaction, condition or arrangement in the nature of encumbrance on such units constituting 25% of the total units of the REIT/15% of the total units of the InvIT, which are required to be locked-in for period of not less than three years from the date of listing of such units (“Mandatory Holding Period”). The sponsors (in case of InvITs) and the sponsors and sponsor group (in case of REITs) may create encumbrance during the Mandatory Holding Period, subject to the following conditions:

- Details of the encumbrance or any change thereto, in the format provided in the guidelines, are to be provided by the sponsor(s) to the investment manager/ manager and by the InvIT/ REIT to the stock exchange(s) within two working days from the date of such encumbrance.
- The conditions for creation and invocation of encumbrance are required to be included in the agreement executed for the purpose of creation of such encumbrance.
- In case of InvITs, the encumbrance shall not be permitted to be invoked during the Mandatory Holding Period. However, in case of REITs such encumbrance may be invoked if the person invoking the encumbrance shall get itself or its nominee to be re-designated as a sponsor of the REIT in accordance with the REIT Regulations.

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Please feel free to address any further questions or request for advice to:

Prashant Gupta

National Practice Head – Capital Markets
prashant.gupta@AMSShardul.com

Nikhil Naredi

Partner – Capital Markets
nikhil.naredi@AMSShardul.com

Shilpa Mankar Ahluwalia

Partner - Debt Capital Markets and Structured Finance

Jay Gandhi

Partner - General Corporate and Investment Funds

Monal Mukherjee

Partner – Capital Markets
monal.mukherjee@AMSShardul.com

Sayantana Dutta

Partner – Capital Markets
sayantan.dutta@AMSShardul.com

Manjari Tyagi

Partner – Capital Markets
manjari.tyagi@AMSShardul.com

Shubhangi Garg

Partner - Debt Capital Markets and Structured Finance

Abhinav Maker

Principal Associate - Capital Markets

Abhishek Parekh

Principal Associate - General Corporate

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