Practical issues relating to the taxation of Real Estate Investment Trusts (“REITs”) in South Africa

Minor dissertation submitted to the University of Cape Town in partial fulfilment of the requirements for the degree Master of Commerce (Taxation) in the Department of Accounting

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Abstract

Real Estate Investment Trusts provide several benefits when compared to direct investment opportunities. Therefore, many countries, worldwide, offer specific tax dispensations to Real Estate Investment Trusts to encourage broad investment into real estate, by natural persons as well as companies, without the need of extensive capital outlay for the individual investor.

Historically, Real Estate Investment Trusts were not catered for in the South African regulatory and tax environments. Property Unit Trusts and Property Loan Stock companies served as vehicles for investment into fixed property. The downside to this was that foreign investors were not familiar with such vehicles and, therefore, were reluctant to invest in these types of property investment vehicles, mainly because of the difference in legal form and governing regulatory legislation applicable to Property Unit Trusts and Property Loan Stock companies.

However, in 2013, a new system for the taxation of real estate investment vehicles was introduced in South Africa with the intention to create, in terms of a special tax dispensation for Real Estate Investment Trusts, a simplified and uniform system with only one level of tax, ie the intention is that investors in Real Estate Investment Trusts are taxed on income distributed by the relevant Real Estate Investment Trust and on the gain made from the disposal of the long term investment in the Real Estate Investment Trust.

In this dissertation, the author focuses on the practical tax issues relating to the recently adopted South African Real Estate Investment Trust tax dispensation, by discussing international principles of Real Estate Investment Trust taxation and two foreign regimes, ie the US and UK Real Estate Investment Trust regimes which, it is understood, were used as a basis for the South African legislation. In addition, the dissertation discusses the details of the South African property investment vehicles regime pre 1 April 2013, and the new Real Estate Investment Trust tax regime applicable from 1 April 2013. Furthermore, it looks at suggestions and possible improvement to the taxation of Real Estate Investment Trusts in South Africa and whether the proposed amendments released by National Treasury, on 4 July 2013, satisfactorily address the issues raised in this dissertation.
### Abbreviations and Glossary

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>Act, the</td>
<td>Income Tax Act No 58 of 1962, as amended</td>
</tr>
<tr>
<td>APC</td>
<td>Associated Property Company</td>
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<tr>
<td>CISCA</td>
<td>Collective Investment Schemes Control Act, 2002</td>
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<td>CISP</td>
<td>Collective Investment Schemes in Properties</td>
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<td>Companies Act, the</td>
<td>Companies Act 71 of 2008, as amended</td>
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<td>CPC</td>
<td>Controlled Property Company</td>
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<td>DTA</td>
<td>Double Tax Agreement</td>
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<td>DWT</td>
<td>Dividends withholding tax</td>
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<td>EPRA</td>
<td>European Public Real Estate Association</td>
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<tr>
<td>FSB</td>
<td>Financial Services Board</td>
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<tr>
<td>JSE</td>
<td>Johannesburg Stock Exchange Limited</td>
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<tr>
<td>NAREIT</td>
<td>National Association of Real Estate Investment Trusts</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>PLS</td>
<td>Property Loan Stock</td>
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<td>PUT</td>
<td>Property Unit Trust</td>
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<tr>
<td>REIT</td>
<td>Real Estate Investment Trust</td>
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<tr>
<td>Republic</td>
<td>Republic of South Africa</td>
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<tr>
<td>SARS</td>
<td>South African Revenue Service</td>
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<td>UK</td>
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1 INTRODUCTION AND OVERVIEW

1.1 Background

1.1.1 Real estate investment

Property investors can achieve rental income streams by investing directly in immovable property or indirectly through immovable property investment vehicles. Indirect investment through immovable property vehicles provides certain benefits when compared to direct investment, where the investor has the advantage of investing collectively, with other investors, in significant sized properties, while the investment is fully managed, and the investor is taxed in its own name as if ownership is direct.

Internationally, property investment vehicles are referred to as REITs. The concept of a REIT was created in 1960 in the US to enable the public to invest in large-scale, income-producing real estate (National Treasury, 2007:1).

The concept of REITs has since expanded internationally.

1.1.2 Benefits of REITs

REITs are known for the following benefits:

- Tax efficiency;
- Diversification;
- Liquidity;
- Accessibility;
- Provider of income; and
- Good governance (National Treasury, 2007:7-8).
1.1.3 Brief history of real estate investment vehicles in South Africa

Although some form of property investment vehicles did exist in South Africa, previously, REITs were not catered for in the South African regulatory and tax environments. However, a unified system for the taxation of real estate investment vehicles was first introduced in South Africa in 2013, in terms of the Taxation Laws Amendment Act No 22, 2012\(^1\).

Prior to this, the PUTs and PLS companies operated as immovable property investment vehicles in South Africa in a similar manner as the internationally known REITs. Even though both, PUTs and PLS companies (listed), are subject to JSE listing requirements and rules, different regulations are applicable to each of them in terms of legal form and governing regulatory legislation.

1.1.4 Reasons for change

From an international perspective, the PUTs and PLS companies are not generally recognised property investment vehicles and therefore not suitable to attract foreign investment. Foreign investors appear to be hesitant to invest in these property vehicles due to the inconsistent tax treatment between them (National Treasury, 2007:7). Some resources also state that PUTs and PLS companies “have not enjoyed the full confidence of offshore investors” and that “they have also been avoided by certain institutions and indices that are mandated to only consider formal REIT companies” (Cairns, 2012). This was mainly as a result of the difference in legal form between the PUT (a trust) and PLS (a company) and the difference in governing regulatory legislation (National Treasury, 2007:7). In addition, there was no certainty for the tax treatment of PLS companies.

Therefore, the need arose to introduce a well-known regulated and internationally accepted type of property investment vehicle for South Africa. The goal was that this property investment vehicle would attract and be suitable to facilitate foreign investment in immovable property into South Africa, and would also provide a consistent tax treatment.

National Treasury’s aim was to create a unified system to cater for both the existing PUT and PLS company regimes in the form of REIT legislation, in which local regulations are in line with international standards for REITs. National Treasury (2007:9) stated that it is therefore

\(^1\) Promulgated on 1 February 2013.
necessary to ensure “appropriate regulation to promote maximum protection to investors and to safeguard the industry reputation, whilst also allowing enough flexibility for REITs to provide maximum return for investors”.

From a tax point of view, it was Government’s intention to create, in terms of a special tax dispensation for REITs, a simplified and uniform system with only one level of tax, ie the investors in REITs are taxed on income distributed by the relevant REIT and on the gain made from the long term investment in the REIT (National Treasury, 2007:26).

### 1.1.5 REIT taxation in South Africa

A new section, section 25BB of the Act (“Taxation of REITs”) was introduced effective for years of assessment commencing on or after 1 April 2013. This brought about some very welcome changes to the taxation of property investment vehicles in a regulated environment, such as:

- Interest distributions by a REIT to resident investors are recharacterised as taxable dividends, whereas the dividend will remain exempt from income tax for foreign investors²;
- An income tax deduction in the hands of the REIT in respect of qualifying distributions, which in itself can create tax neutrality in the REIT³;
- Any allowances⁴ relating to immovable property are disallowed in the hands of the REIT⁵; and
- The REIT is exempt from capital gains tax in respect of the disposal of its immovable property, interests in other REITs or in its property subsidiaries⁶.

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² Section 25BB(6) and section 10(1)(k)(i)(aa) of the Act
³ Section 25BB(2)
⁴ These allowances include section 11(g) (leasehold improvements), section 13 (“Deductions in respect of buildings used in a process of manufacture”), section 13bis (“Deductions in respect of buildings used by hotel keepers”), section 13ter (“Deductions in respect of residential buildings”), section 13quat (“Deductions in respect of erection or improvement of buildings in urban development zones”), section 13quin (“Deduction in respect of commercial buildings”) and section 13sex (“Deduction in respect of certain residential units”) of the Act.
⁵ Section 25BB(4) of the Act
⁶ Section 25BB(5) of the Act
1.1.6 Practical considerations

There are, however, also practical issues to consider which have emerged from the current REIT legislation, eg difficulty in meeting the JSE listing requirements, which is a pre-requisite to qualify as a REIT for tax purposes. There are also various practical tax issues which a taxpayer may experience, ie implications that the REIT itself may experience or at investor level. The implications include:

- The income from APCs, as defined in section 25BB(1) of the Act, may be subject to double taxation, ie the APC may be subject to corporate income tax and, in addition, the resultant dividend may be recharacterised to be a taxable dividend in the hands of the property unit holder in the REIT. This, for the investor, undesired and detrimental treatment, may create the need to restructure APC investments out of the REIT environment, to ensure that returns for investors are not unfairly reduced and remain economically sensible;

- If the rental income of the REIT/CPC, as defined in section 25BB(1) of the Act, decreases below the required minimum to qualify for the qualifying distribution deduction, ie 75% threshold of gross income, an additional layer of tax may result in the hands of that REIT/CPC, which in turn could have an even greater negative impact on investors’ returns;

- Where a CPC of a REIT is in the process of being wound up, it may not be possible to wind up this company within the same year that it ceases to operate as a property company and to declare a liquidation dividend in this same year. A delay, which could result in a scenario where the liquidation dividend can only be paid out in subsequent years, could often occur due to the lengthy process involved for property companies to be wound up. This delay would often be the result of industry specific, practical problems, eg resolving municipal accounts. Therefore, the REIT may receive income in the form of a liquidation dividend from the company, which was previously a CPC, and, therefore, the dividend received will not constitute “rental income” in the hands of the REIT. If this dividend is significant in relation to the total income of the REIT, this may result in the REIT not meeting the 75% rental income threshold criteria stipulated to be eligible for the qualifying distribution deduction;

- No mention is made in the REIT legislation regarding the treatment, from a tax perspective, of potential recoupments of prior year’s capital allowances in respect of the disposal of immovable property or related assets or the treatment of pre-existing losses; and
In terms of PLS investments, foreign investors earned interest which could be repatriated tax-free. However, this will change when withholding tax on interest at 15% is introduced. In terms of the new REIT legislation, foreign investors will be subject to dividends tax in respect of dividends received by or accrued to on or after 1 January 2014. It is therefore necessary to determine whether DTA relief may be available in respect of a dividend receipt (ie as treated for tax purposes) or a receipt of interest (ie based on the legal nature of the PLS investment).

1.2 Research Problem

Given the practical tax issues identified above, this dissertation serves to focus on the practical issues relating to the taxation of REITs in South Africa.

1.3 Scope of this Dissertation

This dissertation will therefore review the tax legislation in respect of the special tax dispensation for REITs in South Africa which was proposed in 2012 and enacted in terms of the Taxation Laws Amendment Act No 22, 2012\(^7\), to expose the problem areas highlighted above.

This dissertation will briefly look at existing foreign REIT regimes from which the South African REIT tax legislation was potentially partly borrowed, or which appears to be very similar to the current South African REIT tax legislation.

Per discussion\(^8\) with a key industry role-player, Estienne de Klerk (SA REIT Association, REIT Committee Chairman, and Executive Director of Growthpoint Properties), there is reason to believe that Keith Engel (Chief Director of Legal Tax Design at National Treasury of South Africa, at the time of implementing the South African REIT tax legislation) was influenced by the US REIT tax dispensation. He was already familiar with the US REIT dispensation as he was a Technical Advisor at the US National Treasury and a Tax Professor at the Washington & Lee University School of Law.

Further, it appears that the South African REIT tax legislation may have potentially also been influenced by the UK REIT regime, as the names of Nicola Westbrooke (Tax Partner KPMG

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\(^7\) Promulgated on 1 February 2013.

\(^8\) Discussion on 3 July 2013
LLP, London) and representatives from the EPRA\textsuperscript{9} were listed and thanked for their contribution in the presentation at the launch of the SA REIT Association on 23 May 2013. Nicola Westbrooke was the internal secondee to the UK tax authority to assist them with the UK REIT regime in 2006. Per discussion\textsuperscript{10} with Nicola Westbrooke, she confirmed that she hosted Gareth Lewis (EPRA), Keith Engel and Estienne de Klerk during 2012 in the KPMG London office, before the South African REIT tax legislation was introduced, to discuss the UK REIT regime and its relevance to the potential South African REIT legislation.

This was further confirmed by Estienne de Klerk (n.d.) who stated on the SA REIT Association blog “over the years, our international counterparts like NAREIT\textsuperscript{11} and EPRA, and their advisors, have shared their experiences to help establish the SA REIT dispensation.”

Thus, this dissertation will look at the US and UK REIT regimes, internationally, as the REIT legislation has been effectively implemented for a number of years in these countries, and it appears that the South African REIT regime may have been influenced by these international REIT regimes.

The dissertation will specifically look at the practical tax issues which have been identified above, and it will attempt to suggest possible improvements to the legislation, when compared to National Treasury’s (2007:1-2, 7) main objective for this legislation (ie providing a regulated environment for property investment vehicles, to make them internationally competitive to attract foreign investment and give consistent tax treatment), by comparing it to the US/UK REIT tax regime to determine how (if applicable) similar practical issues were dealt with when these countries introduced the REIT tax legislation and whether the proposed amendments, released by National Treasury in the Draft Taxation Laws Amendment Bill 2013 on 4 July 2013, address the practical issues satisfactorily.

1.4 Limitations of this Dissertation

This dissertation will focus on the practical tax issues which a taxpayer may experience with section 25BB of the Act, ie the special tax dispensation for listed REITs and excludes practical

\textsuperscript{9} EPRA is a not-for-profit association which aims to “promote, develop and represent the European public real estate sector” (EPRA, n.d.b.).
\textsuperscript{10} Discussion on 23 July 2013
\textsuperscript{11} NAREIT is described as “the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets” (REIT.com, n.d.)
issues with regards to unlisted REITs, the JSE listing requirements or accounting treatment/disclosure requirements.

This dissertation will look at the existing legislation as at 13 September 2013 in terms of the Act. It will include a high-level overview of the proposed amendments, released by National Treasury in the Draft Taxation Laws Amendment Bill 2013 on 4 July 2013 and will not take into account further versions of the Draft Taxation Laws Amendment Bill 2013, released by National Treasury during the course of 2013.13

It will further only include a high-level overview of the US and UK REIT tax regimes and will not include a review of all the countries that implemented REIT tax legislation.

1.5 Research Methodology

This dissertation will involve a review of international and South African discussion papers, legislation, explanatory memoranda, literature and articles relating to the taxation of REITs, as well as the interpretation and discussion of practical implications thereof.

The newly introduced REIT legislation for South Africa will be compared to international regimes from where South Africa potentially “borrowed” the REIT legislation and National Treasury’s initial objective of implementing REIT legislation in South Africa to identify practical issues and possible solutions.

1.6 Structure

The dissertation will briefly deal with the international REIT regimes of the US and UK in Chapter 2, to gain an understanding of where the South African REIT tax legislation potentially originates from.

Chapter 3 will look at the South African REIT regime and will provide a brief overview of the property investment vehicle (ie PUT and PLS company) legislation prior to the REIT

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12 The Minister of Finance, Pravin Gordhan, proposed in the 2013 Budget Speech that the REIT regime be extended to unlisted entities as well. It was proposed that it be extended to wholly-owned entities of private and government pension funds, and long-term insurers. As at 19 July 2013, National Treasury has, however, not released any draft legislation in respect of unlisted entities as yet.

13 The author of this dissertation acknowledges that the Taxation Laws Amendment Bill No 39 of 2013 was released by National Treasury on 24 October 2013, but it does not, however, solve the issues raised in this dissertation.
legislation. It will further look at the intention of the South African REIT legislation and will analyse the new REIT legislation from a South African perspective.

Chapter 4 serves to analyse the practical issues/shortcomings that exist with the current wording of the South African REIT tax legislation.

Chapter 5 will consider suggestions for possible improvements. It will compare the issues that have been identified against the US/UK (if applicable) REIT legislation in an effort to understand how these countries have overcome similar issues and what lessons can be learnt from these countries. It will also analyse the proposed amendments, released by National Treasury in the Draft Taxation Laws Amendment Bill 2013 on 4 July 2013, to consider whether the proposed amendments address the practical issues with the current REIT tax legislation satisfactorily.

Chapter 6 provides the conclusion and recommendations from the dissertation and will set out areas of further research.
2 INTERNATIONAL PRINCIPLES OF REIT TAXATION

2.1 Introduction

The concept of a REIT offers various benefits such as giving the general public a mechanism to invest in a variety of large-scale, income-producing real estate opportunities (e.g., commercial, industrial, residential). Other benefits include investor protection in the form of good governance, regulation of the REITs, tax efficiency, with only one layer of tax (i.e., at investor level as if the investment was direct) (National Treasury, 2007:6-7), and providing tax transparency for the treatment of real estate investment vehicles (KPMG, 2010:1).

Since REITs were implemented for the first time in the US in 1960 (National Treasury, 2007:1), some other governments across the world have followed its lead. Globally, REIT-like regimes are in place in countries such as Australia, Belgium, Brazil, Bulgaria, Canada, Chile, Costa Rica, Dubai, Finland, France, Germany, Greece, Hong Kong, India, Israel, Italy, Lithuania, Luxembourg, Japan, Malaysia, Mexico, Netherlands, New Zealand, Pakistan, Philippines, Puerto Rico, Singapore, South Korea, South Africa, Spain, Taiwan, Thailand, Turkey, the UK, and US (EPRA, n.d.a.). These REIT-like regimes generally consist of a special tax dispensation for qualifying entities, if certain criteria are met, resulting in only one layer of tax for qualifying entities.

The REIT concept further provides a way for governments to boost the economy, by providing a friendly regime for the real estate investment market and attracting foreign investment, particularly from countries already familiar with REITs.

This chapter, firstly, considers the US and UK REIT regimes, on a high-level, to obtain a general understanding of the requirements and tax treatment of REITs in these countries. As mentioned above, it appears that National Treasury potentially “borrowed” from these countries, as National Treasury met with role-players from the US and UK before the South African REIT regime was enacted.

Thereafter it considers and addresses the OECD’s view on the taxation of REITs in terms of the OECD Model Tax Convention on Income and on Capital, since the REIT concept has expanded globally and the need arose to make specific provision for REITs.
2.2 US REIT Legislation

Below, some aspects pertaining to the REIT legislation applicable in the US are set out:

2.2.1 Background

As stated above, globally, many countries have introduced REIT legislation to address the need for a special dispensation for real estate investment vehicles providing an investment opportunity for a broad base of investors.

The so-called “father” of the REIT legislation, the US, was the first country in the world to enact a REIT regime, in 1960.

2.2.2 US REIT regime

2.2.2.1 Listing requirements

Different to the REIT rules existing in many other jurisdictions, including South Africa at the moment, in the US, it is not mandatory for a REIT to be listed on a stock exchange (KPMG, 2013b:3).

2.2.2.2 Legal form

The legal form of a REIT in terms of the US rules can be in the form of a corporation, a trust or an association taxable as a corporation, including a limited partnership or limited liability company (PWC, 2013:60).

2.2.2.3 Capital requirements

The US REIT legislation does not limit the amount of funds that a REIT may borrow (KPMG, 2013b:7). However, deductions claimed in respect of interest paid to related parties are subject to similar debt to equity and earnings stripping considerations as other corporations (PWC, 2013:60).
2.2.2.4 **Restrictions on investors**

It is a legal requirement that a US REIT must have a minimum of 100 shareholders (KPMG, 2013b:3). Further to this, not more than 50% of the value of the REIT’s shares may have been held directly or indirectly by five or fewer individuals during the last half of the REIT’s taxable year (KPMG, 2010:21). From a foreign investment perspective, the US REIT legislation does not impose any restrictions on share ownership by foreign investors (PWC, 2013:60).

2.2.2.5 **Asset/income/activity tests**

The legislation prescribes several requirements relating to a US REIT’s assets, income and activities. There are requirements that need to be complied with on an annual basis, some need to be complied with on a quarterly requirements basis, and there are “other” requirements. The fulfilment of these requirements needs to be demonstrated, and the various requirements are set out below:

**Annual requirements:**

- A minimum of 75% of the REIT’s gross income (ie the 75% gross income test) must consist of real estate related income (ie property rentals, interest on obligations secured by mortgages on property, gains on the sale of property and mortgage loans, and dividends and gains from other US REITs) (PWC, 2013:60); and
- A minimum of 95% of the REIT’s gross income (ie the 95% gross income test) must be from passive income, ie from the source mentioned above in the 75% gross income test (real estate related income), other interest and dividend income and gains on securities (KPMG, 2013b:5).

**Quarterly requirements:**

- A minimum of 75% of the REIT’s total assets must consist of real estate assets, cash and US government securities;
- A REIT is prohibited from owning more than 10% of the vote or value of the securities of another person. Furthermore, securities owned by a REIT may not constitute more than 5% of the value of the REIT’s total assets. It should be noted that shares in other REITs, wholly-
owned subsidiaries and securities of taxable REIT subsidiaries are not taken into account for the determination of this; and

- The total value of taxable REIT subsidiary securities owned by the REIT may not exceed 25% of the value of the REIT’s total assets (PWC, 2013:60).

**Other:**

- If a REIT holds certain properties to sell primarily to customers in the ordinary course of the REIT’s business, the REIT is subject to 100% tax on the gain made from the selling of such trading stock (KPMG, 2013b:5).

### 2.2.6 Restrictions on foreign assets

The legislation applicable to US REITs does not impose a limitation on REITs owning foreign assets (KPMG, 2013b:6).

### 2.2.7 Distribution requirements

A REIT, under US legislation, must distribute, annually, a minimum of 90% of its taxable income (other than the REIT’s net capital gain) to its shareholders (KPMG, 2013b:7).

### 2.2.8 Tax treatment at REIT level

A US REIT may claim a deduction for dividends paid to its shareholders and the undistributed amount (including its net capital gain) is subject to corporate tax (PWC, 2013:61).

The REIT is further subject to an excise tax of 4% if it fails to distribute the required distribution (KPMG, 2013b:8). The 4% non-deductible excise tax is calculated on the difference between the required distribution and the amount distributed for the tax year.

### 2.2.9 Withholding tax on distributions

Generally, withholding tax is not applicable to distributions to domestic shareholders (KPMG, 2013b:10). However, a withholding tax at a rate of 30% is imposed on the distribution of any ordinary dividends paid to foreign shareholders, and a withholding tax of 35% on capital gain
distributions by a REIT (ie a capital gain dividend) to foreign shareholders (KPMG, 2013b:10). If the REIT is not domestically, ie US, controlled or if a withholding tax certificate is not obtained from the authorities, an additional 10% withholding tax is imposed on return of capital distributions (PWC, 2013:61). Government entities may be exempt from withholding tax on distributions under certain circumstances (PWC, 2013:61).

*Treaty access*

Where there is a DTA in place, the withholding tax on ordinary dividends can be reduced, depending on circumstances such as investor type, country with which the DTA is in place and ownership percentage held by the shareholder in the REIT (PWC, 2013:61).

Where the REIT is not domestically controlled, the sales price of REIT shares will be subject to a withholding tax at a rate of 10%, unless the investor is in possession of a withholding tax certificate\(^\text{14}\) or if the investor owns less than 5% of the shares in the REIT (PWC, 2013:61).

**2.2.2.10 Tax treatment at investor level**

The tax treatment at investor level can be distinguished depending on whether the investor is a domestic investor, or a foreign investor:

*Domestic investors*

Domestic investors are taxed on distributions (ie from earnings and profits) received from a REIT as ordinary income at a rate of 39.6% (depending on the shareholder’s income level) (PWC, 2013:61). In addition, Medicare Contribution Tax\(^\text{15}\) is levied at 3.8% (KPMG, 2013b:14). Capital gain dividends are generally taxed at 20% (depending on the shareholder’s income level) and gains attributable to accumulated depreciation are taxed at 25% (PWC, 2013:61).

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\(^{14}\) In such instance, the foreign shareholder must apply to the Internal Revenue Service, prior to the distribution, for a withholding tax certificate to be exempt from withholding tax.

\(^{15}\) Medicare Contribution Tax is levied on a higher-income individual’s wage and investment income as well as on a self-employed individual’s business or farming income (About.com, 2012).
Foreign investors

Ordinary dividends are subject to 30% withholding tax (subject to DTA relief) (KPMG, 2013b:16). Legislation requires foreign shareholders to submit a US tax return if the foreign shareholder receives a taxable capital gain dividend or sells shares in a REIT (PWC, 2013:61). Capital gain dividends are generally subject to a 35% withholding tax (KPMG, 2013b:16).

2.3 UK REIT Legislation

Selected rules relating to the REIT regime as applicable in the UK are set out below:

2.3.1 Background

The UK REIT regime was enacted in terms of the Finance Act 2006 on 1 January 2007. The aim was to introduce a tax regime in terms of which investors are taxed as if the ownership in the underlying real estate was direct, with only one layer of tax payable (KPMG, 2013a:1). This differed from prior treatment, in terms of which a REIT was liable to pay corporate tax, and the shareholder had to pay tax on the dividends received (KPMG, 2013a:1).

2.3.2 UK REIT regime

2.3.2.1 Listing requirements

A UK REIT must be listed on a stock exchange recognised by the UK tax authorities, and includes a listing on the Alternative Investment Market (PWC, 2013:57). Furthermore, the legislation provides for a grace period of up to three years in respect of new REITs to list on the Alternative Investment Market. Thereafter, if the group/company is not listed, a deeming provision will apply as if the REIT left the REIT regime at the end of its second accounting period.

2.3.2.2 Legal form

A UK REIT may consist of either a group of listed companies, or a single listed company. The legislation requires that the ultimate parent company must be UK tax resident and may not be dual resident or an open-ended investment company (KPMG, 2010:2).
Additionally, the parent company must own at least 75% of the shares in a subsidiary (PWC, 2013:56).

The tax authority requires that the parent company files a notice with it, Her Majesty’s Revenue and Customs, which specifies the date from which the REIT rules will apply to the company (PWC, 2013:56). Once this notice is accepted by the tax authority, the company will receive UK REIT status.

The legislation further provides that a REIT may elect to include its share of another company/group’s income and gains into the REIT regime, if that other company/group owns investment property and the REIT owns 40% or more in that other company/group (PWC, 2013:56).

2.3.2.3 **Capital requirements**

Legislation does not prescribe specific capital requirements for a UK REIT (PWC, 2013:57). There are, however, certain limitations relating to the type of shares that may be issued by the parent company of a UK REIT. The type of shares is limited to ordinary shares, non-voting preference shares and convertible non-voting preference shares, with only one class of ordinary share capital permitted (PWC, 2013:57).

The financing requirements for a UK REIT are as follows:

- The profits must exceed the finance costs\(^\text{16}\) by at least 1.25 times. In certain circumstances an exemption to this rule will apply where the REIT experiences unforeseen financial difficulties; and
- Normal commercial terms must apply to a loan extended to a UK REIT and interest may not be excessive (PWC, 2013:57).

2.3.2.4 **Restrictions on investors**

The UK REIT regime imposes some restrictions on REIT investors, and these are set out below:

\(^{16}\) In terms of Finance Act 2012, “finance costs” only includes interest.
Minimum number of investors

A UK REIT may not be controlled by only a select number of investors (ie referred to as a “close company” where it is controlled by 5 or fewer persons) or a minimum of 35% of the REIT’s shares must be available for public up taking (PWC, 2013:57). Furthermore, a new REIT may only be close for its first three years of existence, thereafter the REIT must exit the REIT regime. Widely held shares include shares held by charities, registered providers of social housing, sovereign wealth funds, pension funds, managers/trustees of authorised unit trusts and Open Ended Investment Companies (ie OEICs) and investment partnerships (PWC, 2013:57).

Restrictions on non-resident investors

The legislation does not provide for restrictions relating to non-resident investors (PWC, 2013:57).

2.3.2.5 Asset/income/activity test

As for the US REIT regime (refer paragraph 2.2.2.5 above), the UK REIT legislation prescribes several requirements relating to a UK REIT’s assets, income and activities:

A minimum of 75% of profits and assets must be attributable to the real estate business (PWC, 2013:57). This 75% threshold is determined based on the consolidated annual financial statements of the company, prepared in accordance with International Financial Reporting Standards, with adjustments being made for non-recurring or distortive items (PWC, 2013:57). Furthermore, as a minimum, the REIT must have three rental producing properties and one property may not relate to more than 40% of the total asset value of the REIT.

2.3.2.6 Restrictions on foreign assets

The UK REIT legislation does not provide for any restrictions on foreign assets, ie a UK REIT may invest in, and own foreign property (PWC, 2013:57).

2.3.2.7 Distribution requirements

The UK REIT legislation contains a requirement in terms of which a REIT needs to distribute a certain amount of its profits. As a minimum, a UK REIT must distribute 90% of its rental
income (after finance costs, overheads and tax depreciation are deducted) as a dividend to its shareholders (PWC, 2013:58). However, it should be noted that the legislation does not prescribe that the REIT must distribute any capital gains (PWC, 2013:58).

2.3.2.8 Tax treatment at REIT level

As stated above, the primary reason for REIT taxation is to provide a mechanism for real estate investment vehicle investment to avoid taxation on more than one level, which would make the REIT commercially not viable. The UK REIT dispensation provides that certain types of income received by the REIT are not taxable in its hands, eg rental income earned and capital gains in respect of the REIT’s assets are not taxed in the hands of the REIT. However, other income and gains, ie not related to the real estate investment activity, are taxed at the corporate tax rate, in the hands of the REIT (PWC, 2013:58).

To demonstrate compliance with the above requirements and that the required conditions have been met to qualify for the REIT tax dispensation, a REIT is required to provide annual financial statements to Her Majesty’s Revenue and Customs (KPMG, 2013a:2).

2.3.2.9 Withholding tax on distributions

A withholding tax of 20% is generally applicable to dividend distributions by the REIT resulting from rental income and capital gains profits (ie income not subject to tax in the REIT)\(^\text{17}\). No actual withholding tax is, however, applicable to dividends declared out of taxed income, as such dividends are treated as ordinary dividends\(^\text{18}\).

Generally, subject to the below, where a UK REIT distributes a dividend to an investor who is a resident in a country with which the UK has a DTA, a reduced withholding tax rate of 15% in respect of distributions to non-residents may apply.

For distributions to local UK residents, different rules apply. A reduced withholding tax rate is not available to UK resident individual shareholders in the UK REIT (PWC, 2013:58). Further, a UK REIT is subject to a 10% penalty in instances where it pays a dividend to a corporate shareholder with a more than 10% shareholding/voting control/dividend rights in that UK REIT.

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\(^{17}\) Where the REIT makes a distribution to UK corporates/UK pension funds/UK charities, the legislation allows the payment to be made gross to such bodies.

\(^{18}\) UK resident individuals are subject to a deemed withholding credit of 10% on such ordinary dividends.
### 2.3.2.10 Tax treatment at investor level

Below, the tax treatment of income from a UK REIT for the investor is set out:

**UK resident investors – individual**

A dividend received from a UK REIT by a UK resident individual investor, where the dividend is from real estate type activities related profits (ie from the REIT’s tax exempt business) is subject to 20% withholding tax in the UK (PWC, 2013:58). In addition, the individual will be liable to pay capital gains tax at the individual’s marginal tax rate where it disposes of its share in a UK REIT. Furthermore, other income distributions by the REIT to the individual, such as interest, are taxed as ordinary dividend income in the hands of the individual.

**UK resident investor - corporate**

Where the UK resident investor in a UK REIT is a corporate, however, other rules apply. Rental income, capital gains (from rental property) distributions and the gain from the disposal of a share in a REIT is taxed at the corporate tax rate in the hands of that investor (PWC, 2013:58). Other income distributions are treated as normal distributions and generally not taxable in the hands of the corporate investor. The legislation allows the distribution payment by a REIT to a UK resident corporate investor to be gross, ie not subject to withholding tax (PWC, 2013:58).

**Non-resident investors**

Furthermore, some rules apply to non-resident investors. A withholding tax of 20% applies to rental income and capital gains (from rental property) distributions to a non-resident investor, which may be reduced in terms of DTAs entered into by the UK with other countries, if applicable (generally a reduced rate of 15%) (PWC, 2013:59). However, withholding tax is not applicable in respect of any other ordinary distributions received from a REIT (PWC, 2013:59). In addition, it should be noted that a non-resident is not subject to tax on any capital gains derived from the sale of a UK REIT share by that investor.
2.4 OECD View on the Taxation of REITs

2.4.1 Background

The South African National Treasury (2007:25) stated, in 2007, in its discussion paper, “Reforming the listed property investment sector in South Africa”, that DTAs did not particularly cater for tax specific needs of REITs and that the OECD was looking at incorporating a specific clause in its model tax treaty addressing double taxation relief for REITs.

On 30 October 2007, the OECD issued a public discussion draft document on “Tax treaty issues related to REITs”. The OECD (2007:3) stated that since the concept of a REIT was introduced in the US in 1960 for the first time, it has expanded throughout other jurisdictions in the rest of the world, which led the OECD to analyse the cross-border tax issues that may occur for REITs and the potential impact on tax treaties. This resulted in an update of the 2008 OECD Model Tax Convention on Income and on Capital catering for REIT specific requirements (Instituto de Estudios Fiscales, 2009:13).

The section below discusses the difficulties which the OECD faced when drafting a possible solution for the inclusion of relief provisions for REITs in the OECD Model Tax Convention on Income and on Capital to avoid double taxation.

2.4.2 OECD Model Tax Convention on Income and on Capital dealing with REITs

2.4.2.1 OECD definition of a REIT

The OECD describes a REIT as “a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property, distributes most of that income annually and does not pay income tax on the income related to immovable property that is so distributed” (OECD, 2010:201).

This is in line with the general principle behind the REIT regime of taxing the investor on such income, as if the investment was directly held by the investor in the relevant immovable property.
2.4.2.2 *Classification of the income of a REIT*

The income of a REIT may comprise rental income, income from the sale of immovable property, potentially triggering CGT, dividend or interest income. Accordingly, a REIT’s income may potentially qualify for double taxation relief, and be covered by the following articles of the OECD Model Tax Convention (OECD, 2007:4):

- Rental income – Article 6: Income from immovable property;
- Rental income earned through an investment in immovable property through another REIT – Article 7: Business profits;
- Dividends received – Article 10: Dividends;
- Interest earned – Article 11: Interest; and
- Capital gain from the selling of immovable property or shares – Article 13: Capital gains.

2.4.2.3 *Distributions by REITs to foreign investors*

*Income from immovable property vs income from investing in a security*

The OECD (2007:6) stated that the major concern was whether the distribution by a REIT to a foreign investor must be treated as income from immovable property (ie Article 6) or income from investing in a security (ie Article 10).

The OECD (2007:6) effectively acknowledged that there could potentially be two views on this matter:

(a) Generally, the most significant portion of a REIT’s income consists of rental income. The one view accepted by the OECD, therefore, suggests that the income of a REIT be attributed to each investor (based on the shareholding), as if the investment in immovable property was direct. Therefore, such income may be seen as income from immovable property in the hands of the foreign investor. The OECD (2007:6) further acknowledged that this might result in such income being taxed at a higher rate or place an additional administrative burden on the foreign investor in a REIT to complete a tax return in the country where the immovable property is located; or
(b) The foreign investor invests in the REIT’s immovable property indirectly, by acquiring a share in the REIT. This view of the OECD (2007:6) suggests that the investor invests in the REIT with the expectation of receiving a return on investment in the form of a dividend.

Another important point that the OECD (2007:6) raised in this regard is that one needs to distinguish between a dividend received from a REIT and other (ordinary) dividends, as the dividend received from a REIT is distributed from income that has not been subject to tax in the country where the REIT is a resident. Therefore, the OECD realised that careful consideration must be given to the treatment of REIT distributions in terms of the OECD Model Tax Convention, as “ordinary” dividends are generally declared from after-tax profits.

In terms of the REIT regime, a REIT is generally required to distribute a significant portion of its distributable profits to its shareholders in the form of a dividend. The OECD (2007:7) further acknowledged that a distribution from a REIT is more akin to a return on equity than a return on debt.

Commentary on Article 10 (Dividends) of the OECD Model Tax Convention

The OECD Model Tax Convention addresses the right to tax dividends in Article 10. A “dividend” is defined as “the distribution of profits to the shareholders by companies limited by shares, limited partnerships with share capital, limited liability companies or joint stock companies” (OECD, 2010:186).

Article 10 (paragraph 1) states that dividends paid by a company which is a resident of a Contracting State (eg a South African company, for illustrative purposes) to a resident of the other Contracting State (eg a UK resident, for illustrative purposes) may be taxed in that other State (ie the UK).

It further prescribes in Article 10 (paragraph 2) that the dividends may also be taxed in the country where the company is a resident, ie South Africa, being the source of the dividend. If, however, the beneficial owner of the dividends is a resident of the other Contracting State (ie the UK), the tax charged in respect of the dividends, is limited to:
“5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

15 per cent of the gross amount of the dividends in all other cases” (OECD, 2010:28).

The OECD commentary on Article 10 further states that one has to distinguish between:

- A “small” investor – such an investor is viewed as a “portfolio investor”, as the investor has no control over the immovable property of the REIT and has, therefore, not invested directly in the immovable property itself, but rather invested in the REIT (OECD, 2010:201); and

- A “larger” investor – in such instance, it can be said that the larger investor has substituted its direct investment in the immovable property of the REIT, by acquiring a large shareholding in the REIT (i.e., indirect investment in immovable property). Therefore, the OECD (2010:201) is of the view that such investors be subject to the full tax in the source state, as the REIT will not pay tax on the income which it distributes to such investors.

The OECD (2010:201-202), therefore, suggests that countries may wish to replace paragraph 2 of the article bilaterally, with the following wording:

“However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State (other than a beneficial owner of dividends paid by a company which is a REIT in which such person holds, directly or indirectly, capital that represents at least 10 per cent of the value of all the capital in that company), the tax so charged shall not exceed:

- 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds at least 25 per cent of the capital of the company paying the dividends (other than a paying company that is a REIT);

- 15 per cent of the gross amount of the dividends in all other cases.”

Therefore, in terms of the suggested “new” wording for paragraph 2 as per the update of the OECD Model Tax Convention, a person (i.e., a large investor) who owns (directly or indirectly) at least 10% of the capital value of a REIT, will not qualify for the reduced rate under a double tax
treaty. The OECD suggests that countries may agree bilaterally on the relevant threshold (ie 10%) to determine what will be deemed to be a “large” investor (OECD, 2010:202).

Capital gains distributions

Regarding the treatment of distributions by a REIT of capital gains in the hands of a foreign investor, the OECD (2007:10) states that distributions made by a REIT to a foreign investor should be treated in the same manner as distributions made from rental income earned by the REIT and states that this principle should be applied to other types of income earned by a REIT.

Capital gains on the disposal of an interest in a REIT

Where a foreign investor disposes of its shareholding in a REIT at a gain, Article 13 of the OECD Model Tax Convention, which deals with capital gains, may apply. Article 13 provides in paragraph 4 that “gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State” (OECD, 2010:31). Therefore, if for example a UK resident sells shares in a South African company and the only asset of that company is immovable property in South Africa, then the gains derived from the sale of the shares in the South African company may be taxed by South Africa.

Again, the OECD (2007:11) considered the effect of articles of the OECD Model Tax Convention on small and large investors in REITs, as Working Party members had conflicting views on this matter. Following deliberations, the OECD then suggested that the Commentary on Article 13 paragraph 4 be expanded and new paragraphs 28.9 to 28.11 of the Commentary were added.

Accordingly, the OECD Commentary (OECD, 2010:246) states that it may be appropriate to make provision for an exception for source taxation in respect of the disposal of a small investor’s interest in a REIT. Therefore the OECD Commentary (OECD, 2010:246) suggests that countries modify the wording of Article 13 paragraph 4 with words such as “may be taxed in that other state” or “except shares held by a person who holds, directly or indirectly, interest representing less than 10 per cent of all the interest in a company if that company is a REIT”.

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**OECD application to South Africa**

Olivier & Honiball (2011:311) states that, although South Africa is not a member of the OECD, the South African courts have acknowledged that the OECD Model Tax Convention Commentary may be used to interpret tax treaties entered into by South Africa. South Africa has about 72 bilateral treaties for the avoidance of double taxation in place, which are based on the OECD Model Tax Convention (Olivier & Honiball, 2011:291).

South Africa is listed as a non-OECD member country (OECD, 2010:427). It has also provided its digressing position on a number of articles of the OECD Model Tax Convention Commentary thereto. South Africa’s and other countries’ views, where different from the Commentary, are included in a separate section of the OECD Model titled “Non-OECD Economies’ Positions of the OECD Model Tax Convention”.

### 2.5 Conclusion

Internationally, REITs have come a long way since the concept was first introduced in the US in 1960. The OECD recognised the popularity of the REIT regime and, therefore, updated its Model Tax Convention in 2008, to address certain anomalies, and to provide rules for the treatment of REIT distributions between countries in an attempt to eliminate double taxation.

Based on the above, it is apparent that REIT structures, such as the US and UK, show certain similarities and differences. The table below briefly summarises the selected rules, as discussed above, relating to the US and UK REIT regimes:

*Table 1: Brief summary of selected rules of the US and UK REIT regimes*

<table>
<thead>
<tr>
<th></th>
<th>US REIT regime</th>
<th>UK REIT regime</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year enacted</strong></td>
<td>1960</td>
<td>2007</td>
</tr>
<tr>
<td><strong>Listing requirements</strong></td>
<td>Not mandatory to be listed on a stock exchange</td>
<td>Mandatory listing on a recognised stock exchange</td>
</tr>
<tr>
<td><strong>Legal form</strong></td>
<td>Corporation, trust or an association taxable as a</td>
<td>Consist of either a group of listed companies or a</td>
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<tr>
<td>Corporation, including a limited partnership or limited liability company</td>
<td>single listed company</td>
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<tr>
<td>• Ultimate parent company must be UK tax resident (not dual resident)</td>
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<tr>
<td>• Parent company must own at least 75% of the shares in a subsidiary</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Capital requirements</th>
<th>No limit on borrowings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of shares is limited to ordinary shares, non-voting preference shares and convertible non-voting preference shares, with only one class of ordinary share capital</td>
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<tr>
<td>Profits must exceed finance cost by at least 1.25 times</td>
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<tr>
<td>Normal commercial terms must apply to a loan extended to a UK REIT and interest may not be excessive</td>
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<table>
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<tr>
<th>Restriction on investors</th>
<th>Minimum of 100 shareholders</th>
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</thead>
<tbody>
<tr>
<td>• Minimum of 100 shareholders</td>
<td>May not be controlled by five or fewer persons</td>
</tr>
<tr>
<td>• Not more than 50% of shares held directly or indirectly by five or fewer individuals</td>
<td>Minimum of 35% of REIT’s shares must be available for public up taking</td>
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<td></td>
<td>United States</td>
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<tr>
<td><strong>Asset/income/activity test</strong></td>
<td>Minimum of 75% of REIT’s gross income must consist of real estate related income</td>
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<td></td>
<td>Minimum of 95% of REIT’s gross income must be from passive income</td>
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<tr>
<td></td>
<td>Minimum of 75% of REIT’s total assets must consist of real estate assets, cash and US government securities</td>
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<tr>
<td></td>
<td>Total value of taxable REIT subsidiary securities owned by REIT may not exceed 25% of value of REIT’s total assets</td>
</tr>
<tr>
<td><strong>Restrictions on foreign assets</strong></td>
<td>None</td>
</tr>
<tr>
<td><strong>Distribution requirements</strong></td>
<td>Annually</td>
</tr>
<tr>
<td></td>
<td>Minimum of 90% of taxable income (other than net capital gain)</td>
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<td></td>
<td>No minimum specified for</td>
</tr>
<tr>
<td>Tax treatment at REIT level</td>
<td>Withholding tax on distributions</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>1. Deduction claimed for dividends paid to shareholders</td>
<td>1. Not applicable to US domestic shareholders</td>
</tr>
<tr>
<td>2. Undistributed profits (including net capital gain) subject to corporate tax</td>
<td>2. 30% withholding tax on distribution of ordinary dividends paid to foreign shareholders</td>
</tr>
<tr>
<td>3. Additional 4% excise tax if it fails to distribute the required distribution</td>
<td>3. 35% withholding tax on capital gain dividends paid to foreign shareholders</td>
</tr>
<tr>
<td>4. Rental income and capital gains in respect of the REIT’s assets are not taxed in the hands of the REIT</td>
<td></td>
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<tr>
<td>5. Other income and gains are taxed at the corporate tax rate</td>
<td>4. 20% withholding tax on dividend distributions by a REIT from rental income and capital gain profits (ie from the tax exempt business)</td>
</tr>
<tr>
<td></td>
<td>5. No withholding tax on dividends declared out of taxed income (ie ordinary dividends)</td>
</tr>
</tbody>
</table>
3 THE SOUTH AFRICAN REIT REGIME

3.1 Pre 1 April 2013 Property Investment Vehicles

Prior to the introduction of the South African REIT regime with effect from years of assessment commencing on or after 1 April 2013, the South African property market made use of PUTs and PLS companies as property investment vehicles. As mentioned above, foreign investors appeared to be hesitant to invest in these types of property investment vehicles due to the inconsistent tax treatment between these vehicles. The reason for this was mainly the result of the difference in legal form and governing regulatory legislation applicable to the PUT and PLS company (National Treasury, 2007:2).

Below follows a brief description of the legal form and governing regulatory legislation of these property investment vehicles, as well as the income tax treatment prior to the introduction of REIT legislation in South Africa, to provide a better understanding of the tax treatment of each type and why the tax treatment of the PUT and PLS company compared to one another is, therefore, described by National Treasury (2007:2) as “inconsistent”.

3.1.1 The PUT

3.1.1.1 Legal form and governing regulatory legislation

A PUT is, as the name suggests, a trust that is further defined as “a collective investment scheme in property which invests in a portfolio of investment grade properties that is held for its rental income and capital appreciation” (The Association of Property Unit Trusts, n.d.).

Thus, a PUT is a CISP. A CISP is further defined in section 47(1) of CISCA as a scheme which consists of a portfolio of property shares, immovable property, assets determined by the registrar or investment in foreign immovable property, and property shares or participatory interests in a collective investment scheme in property in a foreign country, subject to the provisions of section 49 of CISCA.

Listed PUTs are listed on the “Real Estate” sector of the JSE and must comply with the JSE listing requirements. In addition to the applicable law, PUTs are further governed by the
relevant trust deed\textsuperscript{19} in terms of CISCA, under the supervision of the FSB (JSE, 2010). Furthermore, CISCA stipulates, \textit{inter alia}:

- Restrictions on administration of CISP;
- Foreign countries in which CISP may invest;
- Listing of participatory interest by exchanges; and
- Provisions in respect of manager of a CISP.

The trust (PUT) is administered by a manager\textsuperscript{20}, ie an “external company” (Brinker, 2012:1), who looks after the day-to-day operation of the properties, including the leases and the investment strategy designed for the trust with the fiduciary responsibility provided by the trustees (National Treasury, 2007:3). Where it is required that the external management of the PUT be changed, the trustees must request the FSB to assist.

An investor in a PUT holds units\textsuperscript{21} in this PUT, which is the equivalent to equity ownership in the PUT, but without voting rights. Investing in a PUT is an attractive form of investment for the investor, as the investor’s interest would increase in value as a result of the PUT earning rental income and the property portfolio increasing in value over time.

The FSB protects the investor in a PUT by stipulating that the PUT may only invest in the following categories of investments:

- Specified immovable property assets (these include buildings, land and leaseholds);
- Shares in property companies; and

Furthermore, clause 34 of the model trust deed provided by the FSB (n.d.:38) states that the “trustee shall pay to investors the amount available for distribution in respect of the said income distribution period in proportion to the number of participatory interests held by such investors.


\textsuperscript{20} Clause 35 of the model trust deed provided by the FSB states that a service charge is levied by the manager for the services provided to the investors of the PUT.

\textsuperscript{21} According to the Association for Savings & Investment SA these “units” represent a direct proportionate interest in every asset in the portfolio. The return on investment, in the investor’s hands, will depend on the amount invested and the ruling net asset value. Available: http://www.asisa.co.za/_docs/Chapter%201.pdf [Accessed on 20 July 2013].
on the relevant date”. Therefore, the investors have a vested right in the amount available for distribution, with the PUT acting as a vested trust.

3.1.1.2 Income tax treatment

Section 25B(1) of the Act (“Income of trusts and beneficiaries of trusts”) results in the PUT acting as a conduit, where the rental income earned from the underlying properties is taxed in the hands of the beneficiaries (ie the investors/participatory interest holders).

Although the PUT is a trust providing vested rights to its beneficiaries, the normal tax principles apply, ie the PUT is taxed at 40% on the remaining taxable income.

Where a CISP holds an interest in a fixed property company, the fixed property company may deduct the dividends distributed during the year of assessment from profits of a revenue nature in terms of section 11(s) of the Act, when determining the taxable income of the fixed property company. Section 11(s) of the Act is only applicable to “property shares”, as defined in section 47 of CISCA, which means “shares in and of a fixed property company or a holding company which has no subsidiaries other than fixed property companies which are wholly owned subsidiaries” of that holding company. Therefore, where the fixed property company distributes rental income earned by way of a dividend, to the PUT, the fixed property company may deduct such dividends in terms of section 11(s) of the Act, ie the same “conduit” principle applies to this extent.

Local dividends received by or accrued to any person are generally exempt from income tax in terms of section 10(1)(k) of the Act. However, proviso (aa) to section 10(1)(k)(i) of the Act provides that this exemption does not apply to dividends received from property shares (as defined in section 47 of CISCA), unless the fixed property company distributed these dividends out of profits of a capital nature.23

The SARS Comprehensive Guide to Capital Gains Tax (Issue 4) (SARS, 2012:421) states that the CISP trust (ie PUT) “itself is not liable to CGT, since the capital gains and losses arising on the transactions it carries out do not accrue to it, but rather to its beneficiaries. The conduit-pipe

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22 Section 11(s) of the Act was deleted with effect from 1 April 2013 and applicable in respect of years of assessment commencing on or after that date (ie from the date that the REIT legislation is introduced).
23 Proviso (aa) of section 10(1)(k)(i) was substituted by section 19(1)(f) of the Taxation Laws Amendment Act of 2012 with effect from 1 April 2013 and applicable in respect of dividends received on or after this date (ie from the date that the REIT legislation is introduced). This will be discussed in more detailed below.
principle is, however, overridden by para 67A of the Eighth Schedule to the Act which provides that the participatory interest holder of the PUT must determine a capital gain or capital loss in respect of any participatory interest in that portfolio only upon the disposal of that interest.

Due to the legal nature of the PUT, ie a trust, the reorganisation rollover provisions of the Act are not available to the PUT.

3.1.2 The PLS company

3.1.2.1 Legal form and governing regulatory legislation

A PLS company operates as a company which invests in rental income generating property and is managed internally. Listed PLS companies are regulated by the Companies Act and the JSE listing requirements.

An investor would invest in a PLS company by purchasing a linked unit (for example R100) in the PLS company which would consist of an equity share (for example R1) and a debenture (for example R99). Debentures are governed by a debentures trust deed, which addresses the terms and conditions attached to the debentures, the rate of interest payable and repayment dates (National Treasury, 2012:67). The investor (ie unit holder) earns interest at a variable rate on the debenture portion of the linked unit and the interest is paid out of profits earned by the PLS company in the form of rental income received, the sale of an asset that has increased in value, property management services income earned or other similar activities (National Treasury, 2007:3-4).

A PLS company typically pays out most of its annual income to unit holders.

3.1.2.2 Income tax treatment

A PLS company is taxed at the standard corporate income tax rate of 28% and it pays capital gains tax at the effective rate of 18.6%. As stated above, a PLS company may pay to its investors either interest from debentures, or dividends.

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24 Paragraph 67A of the Eight Schedule to the Act was repealed with effect from 1 April 2013 and applicable to years of assessment commencing on or after that date (ie from the date that the REIT legislation is introduced).
**Interest payments**

Generally, section 11(a) of the Act provides that, for the determination of the taxable income of a person from carrying on any trade, the expenditure and losses actually incurred in the production of the income of that person can be deducted, provided that they do not constitute expenditure and losses of a capital nature. The payment of interest by a PLS company to its unit holders in respect of the debenture constitutes such qualifying expenditure. Thus, a PLS company can claim its annual interest payments to unit holders as a deduction in terms of section 11(a) of the Act. In turn, the unit holders who receive the interest payments are taxed on the interest income received.

Therefore, as a result of the PLS company typically paying out most of its annual income to unit holders by way of interest earned on their debenture portion of the linked unit and claiming these distributions as interest deductions, the PLS company is usually left with little taxable income or an increase in the assessed loss carried forward.

National Treasury stated in the Explanatory Memorandum on the Taxation Laws Amendment Bill 2012 (National Treasury, 2012:68) that the tax deductibility of interest payments by PLS companies to the respective unit holders has been questioned by SARS, where the level of interest was considered to be excessive. According to Andrew Brooking (Director at Java Capital) “SARS believes the payout on the debenture to unit holders is more like a dividend than an interest payment, especially if is higher than a commercial interest rate, and the tax treatment should be the same as if it was a dividend” (Wilson, 2013a).

**Dividend payments**

A PLS company may also pay out dividends to unit holders on the equity portion of the linked unit. These dividends are not tax deductible for the PLS company and are subject, where applicable, to DWT.\(^{25}\)

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\(^{25}\) Dividends distributed by South African resident companies are subject to a DWT of 15%, provided such dividend is not exempt from DWT in terms of section 64E, read with section 64F and 64FA of the Act.
3.1.3 Comparison of the PUT and PLS

It is clear that different legislation regulates the treatment of the PUT and PLS company, ie the PUT is governed by the FSB (CISCA) and the PLS company by the Companies Act. However, JSE listing requirements apply to both types of the listed property investment vehicles.

In addition to this, from an income tax perspective, various different sections of the Act apply to these property investment vehicles. On the one hand, as stated above, the rental income of the PUT is basically a flow through (refer the discussion to the “conduit principle” set out above), and beneficiaries of the trust, who have a vested right to the income of the trust, are taxed on the rental income received by it. In addition, the trust is taxed at 40% on any remaining taxable income. On the other hand, the PLS company is treated as a normal company for tax purposes and taxed at a rate of 28%, where unit holders earns interest on the debenture portion and dividends on the equity portion of the linked unit.

The above discussion demonstrates why National Treasury considers the difference in tax treatment regarding these two property investment vehicles to be “inconsistent” (National Treasury, 2007:2).

Furthermore, regarding the question relating to the tax treatment, by SARS, of the excessive portion of interest deductions claimed by PLS companies, it should be noted that this was of significant concern for foreign investors. Previously foreign investors were “reluctant to invest into our listed property sector simply because they were concerned that at some point the South African Revenue Service (SARS) would close the variable PLS (property loan stock) loophole, which they are now going to do” (Hedley, 2013a). It, therefore, appears that SARS has, in an attempt to overcome this concern, changed the contentious tax legislation dealing with that type of property investment vehicle issues, by introducing South African REIT tax legislation.

Below follows a review of the South African REIT tax legislation.26

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26 This dissertation excludes an analysis of the tax legislation pertaining to PUTs and PLS companies after the introduction of the South African REIT legislation.
3.2 South African REIT regime

3.2.1 Background to the introduction of the South African REIT regime

More than six years ago, in 2006, it became apparent that the members of the listed property sector had one common goal in mind: “to achieve tax certainty, simplicity, transparency, good governance and flexibility for the new SA REIT dispensation” (Estienne de Klerk, n.d.).

Following this realisation, the Property Loan Stock Association called for the members of the sector to get together and consulted with the Association of Property Unit Trusts, sector companies and their advisors to pursue the goal of introducing REIT legislation in South Africa (Estienne de Klerk, n.d.).

Key industry role-player, Estienne de Klerk, advised that the Property Loan Stock Association and the Association of Property Unit Trusts, at the time, combined forces, representing the listed property industry, to approach National Treasury in this regard to discuss the importance of having the same tax treatment for property investment vehicles in South Africa.

The associations further consulted with international associations like NAREIT and EPRA to gain knowledge and to share experience regarding establishing a REIT tax dispensation for South Africa.

3.2.2 Intention of the South African REIT Legislation

National Treasury issued a discussion paper on 3 December 2007, “Reforming the listed property investment sector in South Africa”, which stated that there were two main drivers for reviewing the way in which the property investment sector is regulated, ie:

- The property investment sector at the time was fragmented, not regulated consistently and not competitive with international REIT regimes; and

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28 SA REIT Association REIT Committee Chairman and Executive Director of Growthpoint Properties
29 Discussion with Estienne de Klerk on 3 July 2013
The tax treatment of PUTs and PLS companies appeared to be inconsistent, and thus not suitable, for the property investment sector (National Treasury, 2007:1-2).

Accordingly, National Treasury (2007:26) suggested a “uniform tax dispensation” for the property investment sector, to align PUTs and PLS companies with internationally recognised REIT regimes.

National Treasury (2007:8) envisaged that the conversion of PUTs/PLS companies to the new REIT regime would be fairly smooth, as the PUTs and PLS companies already had certain similarities when compared to most international REIT structures, such as:

- Investment returns resulting from the REIT is taxed in the hands of the investor only (almost all income of PUTs/PLS companies is paid out to the respective investors, who are then taxed on this);
- A REIT invests in immovable property (PUTs and PLS companies invest in rental earning property); and
- It is required that a REIT is listed on a licensed exchange (listed PUTs and PLS companies are listed on the JSE).

National Treasury’s aim was, therefore, to align the PUTs and PLS companies with the internationally recognised REIT system to attract and be suitable to facilitate foreign investment in immovable property into South Africa, and this would also provide a consistent tax treatment (National Treasury, 2007). It was further important for National Treasury to ensure that appropriate regulations are in place to promote maximum protection for investors and to safeguard the South African property investment sector’s reputation, and to allow the REIT to provide maximum returns for its investors (National Treasury, 2007:9).

Therefore, REIT tax legislation was introduced into the South African Income Tax Act in 2012 (in terms of the Taxation Laws Amendment Act No 22, 2012 promulgated on 1 February 2013), for years of assessment commencing on or after 1 April 2013, in order to create a unified system for both the listed PUT and PLS company regimes.

3.2.3 A Review of the South African REIT Legislation

The South African REIT tax legislation is contained in section 25BB of the Act. The law effectively constitutes a tax dispensation which aims to provide clarity for the taxation of
qualifying South African property investment vehicles. It formally brings the South African REIT regime in line with international norms and attempts to achieve the taxation of the income from immovable property at the level of the investor in a manner similar to the investor having invested in the relevant immovable property directly.

### 3.2.3.1 Qualifying criteria

To qualify for the REIT\(^{30}\) dispensation, a company\(^{31}\) must be tax resident\(^{32}\) in South Africa and its shares must be listed as shares in a REIT in terms of the JSE listing requirements\(^{33}\). Below, the relevant terms are discussed in more detail:

**A company**

The definition of the term “company” is contained in section 1 of the Act, and the meaning of the term is generally intended to be broad. The definition was amended\(^{34}\) to specifically include a “portfolio of a collective investment scheme in property” for tax purposes. A “portfolio of a collective investment scheme in property”\(^{35}\) refers to “any portfolio comprised in any collective investment scheme in property contemplated in Part V of the Collective Investments Schemes Control Act, 2002 (Act No. 45 of 2002), managed or carried on by any company registered as a manager under section 51 of that Act for purposes of that Part”.

**Resident**

The term “resident” relating to a person other than a natural person is defined in section 1 of the Act as a “person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic, but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation”.

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\(^{30}\) “REIT” defined in section 1 of the Act

\(^{31}\) “Company” defined in section 1 of the Act

\(^{32}\) “Resident” defined in section 1 of the Act


\(^{34}\) In terms of the Taxation Laws Amendment Act No 22, 2012 promulgated on 1 February 2013), for years of assessment commencing on or after 1 April 2013.

\(^{35}\) Defined in section 1 of the Act
It should be noted that the definition of a “person” was amended to include “any portfolio of a collective investment scheme”, which is defined in section 1 of the Act as “any portfolio of a collective investment scheme in participation bonds, portfolio of a collective investment scheme in property, portfolio of a collective investment scheme in securities or portfolio of a declared collective investment scheme”. Both the abovementioned amendments were with effect from 1 April 2013 and applicable in respect of years of assessment commencing on or after this date.

Therefore, for South African income tax purposes, a PUT is now included in the definition of a company.

**Listed**

The definition of a REIT in section 1 of the Act requires that the shares must be “listed on an exchange (as defined in section 1 of the Securities Services Act, 2004 (Act No. 36 of 2004), and licensed under section 10 of that Act”. “Exchange” is defined as “a person who constitutes, maintains and provides an infrastructure transferred by or on behalf of a seller for bringing together buyers and sellers of securities, for matching the orders for securities of multiple buyers and sellers, and whereby a matched order for securities constitutes a transaction”\(^{36}\).

**As shares in a REIT in terms of the JSE listing requirements**

The law requires that, for a company to qualify as a South African REIT, the shares in that company must be listed “as shares in a REIT as defined in the JSE Limited Listing Requirements”\(^{37}\). This has made it necessary to adapt the listing requirements, and the JSE has accordingly amended its listing requirements to facilitate the South African REIT tax legislation. Therefore, the definition of the term “REIT” and various other definitions were added to the rules pertaining to the JSE listing requirements. Thus, the updated JSE listing requirements now define a REIT “as an applicant issuer which receives a REIT status in terms of the Listing Requirements” (JSE, 2013). Accordingly, in order for a REIT to obtain REIT status for income tax purposes, it also needs to meet REIT status according to the JSE listing requirements.


\(^{37}\) Subparagraph (b)(ii) of the “REIT” definition in section 1 of the Act
The REIT status listing criteria are divided into two categories: CISPs and property entities other than CISPs. Therefore, a new definition clarifying the meaning of the term “property entity” was inserted in the JSE listing requirements to accommodate such entities. The new definition refers to “a company or CISP which is primarily engaged, directly or indirectly, in property activities including the holding of properties and development of properties for letting and retention as investments or the purchase of land for development of properties for retention as investments” (JSE, 2013).

More specifically, a company that seeks to be listed as a REIT, therefore, must meet the following main criteria to obtain REIT status:

- Gross assets of R300 million as a minimum;
- The company must be a property entity as defined;
- At least 75% of its revenue must be from rental income (ie derived from owing immovable property, leasing immovable property which is let or sub-let to tenants and dividends received from another REIT);
- The company must qualify for a listing on the Main Board or Alt of the JSE;
- Total consolidated liabilities must not exceed 60% of the total consolidated assets; and
- The company must distribute 75% of its total distributable profits as a distribution to the shareholders (JSE, 2013).

### 3.2.3.2 Entities covered

The South African tax legislation applicable to REITs covers only the JSE listed property investment sector, ie the dispensation is, currently, not available to non-listed entities. In addition, the legislation applies to a CPC in relation to a company which is classified by the JSE as a REIT.

A CPC refers to a company that is a subsidiary of a REIT, as defined in International Financial Reporting Standard 10, which means an entity that is controlled by another entity.\(^{38}\)

The term “control” is an International Financial Reporting Standard concept and generally requires practical control with a more than 50% voting right (National Treasury, 2012:70).

\(^{38}\)“CPC” defined in section 25BB(1) of the Act
International Financial Reporting Standard 10 defines control where a controlling entity (ie a REIT) has power over the investment decisions made by the entity (ie a CPC), the REIT must have exposure or rights to variable returns from its involvement in the investment decisions of the CPC and the REIT must be able to use its power over the investments which the CPC makes to obtain its return on investment (KPMG, 2011:2).

An APC refers to a company in which the REIT or CPC holds 20% or more of the equity shares or linked units (alone or together with any other company forming part of the same group of companies as that REIT or CPC). 39

The term “group of companies” is defined in section 1 of the Act and means that two or more companies qualify as a group of companies where “two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other company (hereinafter referred to as the “controlled group company”), to the extent that at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof and the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company”. Thus, if company A owns at least 70% of the equity shares in company B, then companies A and B form a group of companies, with company A being the controlling group company.

3.2.3.3 Terminology

The terms “declared” in respect of a dividend, and “property linked unit” are specifically relevant to the South African REIT regime, and these are accordingly addressed below:

Section 25BB clarifies that a dividend is “declared” when it is approved by the directors of a company or by some other person with comparable authority. 40

A “property linked unit” is defined as a unit comprising a share and a debenture in a company that are linked together and cannot be disposed of independently. 41

39 “APC” defined in section 25BB(1) of the Act
40 “Declared” defined in section 25BB(1) of the Act
41 “Property linked unit” defined in section 25BB(1) of the Act
3.2.3.4 *The tax treatment*

Below, some aspects of the income tax treatment of REITs, from a South African perspective, are discussed:

**Taxation of a distribution in the hands of the REIT or CPC**

For purposes of determining its own taxable income, a REIT or resident CPC may deduct from its gross income an amount which represents a “qualifying distribution” declared or incurred during a year of assessment. This rule constitutes one of the main benefits applicable to South African REITs and CPCs, as a REIT or CPC may deduct the distributions paid to investors for South African income tax purposes, if certain criteria are met. This is further discussed below:

A qualifying distribution consists of certain dividends declared or interest incurred (in respect of a debenture forming part of a property linked unit) by a REIT during a year of assessment, if more than 75% of the REIT/CPC/APC’s gross income in the preceding year of assessment consisted of rental income. Thus, reference is therefore made to the year prior to the declaration or incurral of the distribution (National Treasury, 2012:68). However, where the current year of assessment is the REIT/CPC/APC’s first year of assessment (ie the REIT/CPC/APC was incorporated, formed or established during that year of assessment), the rental portion of the gross income is to be evaluated (ie the 75% requirement) during the current year of assessment in which the distribution was declared or incurred.

Section 25BB(2) of the Act specifically excludes a dividend contemplated in paragraph (b) of the “dividend” definition in section 1 of the Act, ie share buy-backs do not apply.

The term “rental income” is specifically defined and refers to the following amounts received or accrued:

- in respect of the use of immovable property, including a penalty or interest in respect of late payment of any such amount;
- as a dividend (other than a dividend as a result of a share buy-back) received from a REIT;
- as a qualifying distribution from a CPC; or

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42 Section 25BB(2) of the Act
43 Paragraph (b) of the “qualifying distribution” definition defined in section 25BB(1) of the Act
44 Paragraph (a) of the “qualifying distribution” definition defined in section 25BB(1) of the Act
45 Dividend contemplated in paragraph (b) of the “dividend” definition in section 1 of the Act
• as a qualifying distribution by or from an APC. ⁴⁶

However, the aggregate amount of these deductions may not exceed the taxable income of that REIT or CPC for that year of assessment, before taking into account the amount of taxable capital gain included in taxable income ⁴⁷. Therefore, a REIT or CPC may not create an assessed loss from the deduction of the qualifying distribution and deductible distributions cannot be fully derived from capital gains (National Treasury, 2012:69).

For a REIT, it is therefore important to monitor its income “mix” throughout the year, in order to ensure that it will meet the requirement for the qualifying distribution deduction.

Below follows an illustrative example of the different scenarios that a REIT may experience in determining whether it, and to what extent, may claim the distribution deduction.

**Illustrative example 1**

During the first year of assessment, REIT A’s gross income is R100 million, of which R78 million relates to rental income earned by REIT A. The taxable income for the year is R80 million, before taking into account the distribution deduction and any taxable capital gain. REIT A declares a dividend of R80 million to its shareholders at year end.

As this is the first year of assessment (refer the special rule applicable where the REIT is in its first trading year, which is explained above) for REIT A, it will look at the rental income earned during its first year in relation to its total gross income for the year, ie 78% of its gross income consists of rental income and it, therefore, meets the 75% test. Further, REIT A may claim the R80 million distribution deduction in full, as it meets the 75% test and the taxable income for the year is R80 million, before taking into account the distribution deduction and any taxable capital gain.

**Illustrative example 2**

The same facts apply as per illustrative example 1. However, in its second year of assessment, REIT A’s gross income is R125 million, of which R77 million of this amount relates to rental income earned by REIT A. The taxable income for the year is R90 million, before taking into account the distribution deduction and any taxable capital gain. REIT A declares a dividend of R100 million to its shareholders at year end.

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⁴⁶ Section 25BB(1) of the Act
⁴⁷ In terms of section 26A of the Act
As this is the second year of assessment for REIT A, it will look at the rental income earned in relation to its total gross income during the preceding year, ie 78% of its gross income consisted of rental income in its first year of assessment and, therefore, it meets the 75% test. However, REIT A may not claim the R100 million distribution deduction in full, as the deduction is capped at the taxable income for the year, which is R90 million, before taking into account the distribution deduction and any taxable capital gain. Therefore, REIT A may only claim R90 million as a distribution deduction and the R10 million is not available for set off against REIT A’s taxable income in terms of section 25BB(2)(b) of the Act.

Illustrative example 3

The same facts apply as per illustrative example 1 and 2. However, in its third year of assessment, REIT A’s gross income is R100 million, of which R80 million relates to rental income earned by REIT A. The taxable income for the year is R90 million, before taking into account the distribution deduction and any taxable capital gain. REIT A declares a dividend of R90 million to its shareholders at year end.

As this is the third year of assessment for REIT A, it will look at the rental income earned in relation to its total gross income during the preceding year, ie 62% of its gross income consisted of rental income in its second year of assessment and, therefore, it does not meet the 75% test. REIT A may, thus, not claim the R90 million distribution deduction, as the 75% test was not met in relation to the prior year.

Financial instruments

Any amount received by or accrued to a REIT or CPC during a year of assessment in respect of a financial instrument will be deemed to be not of a capital nature and must be included in the income of that REIT or CPC for that year of assessment. However, a share in a REIT, a CPC or an APC is regarded to be of a capital nature in the hands of the REIT or CPC.

Therefore, if a REIT, for example holds shares in a mining company (ie a “share” is included in the definition of a “financial instrument” as defined in section 1 of the Act), the dividends which it receives from this investment will be income in the hands of the REIT and therefore taxed as

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48 Defined in section 1 of the Act
49 Section 25BB(3) of the Act
ordinary revenue\textsuperscript{50}. In addition, if the REIT disposes of its investment in the mining company, it will be subject to normal tax on the disposal of its investment in the mining company (and not subject to CGT), as the disposal of this financial instrument is deemed to be not of a capital nature.

This treatment is part of National Treasury’s (2012:71) aim to discourage a REIT to hold other forms of investments, such as portfolio shares and “thereby coming into conflict with the mandate of a collective investment in securities”.

\textit{Building allowances}

The law provides that REITs are not entitled to claim certain capital allowances otherwise available in terms of the Act. For example, a REIT or a CPC may not claim capital allowances on the cost of the immovable property it holds, for purposes of determining its own taxable income. The allowances which are specifically not available to a REIT or a CPC are:

- An allowances in terms of section 11(g) of the Act where the REIT or CPC actually incurs expenditure in terms of an obligation to effect improvements on land or to buildings, incurred under a lease agreement;
- Deductions in respect of buildings used for manufacturing in terms of section 13 of the Act where the taxpayer may deduct an allowance of 5\% of the cost incurred\textsuperscript{51};
- Deductions in respect of buildings used by hotel keepers in terms of section 13\textit{bis} of the Act where a taxpayer may deduct an allowance of 5\% of the cost incurred\textsuperscript{52};
- Deductions in respect of residential buildings in terms of section 13\textit{ter} of the Act where a taxpayer may deduct from its income an allowance of 2\% of the cost to the taxpayer of any residential unit erected by the taxpayer under a housing project of the taxpayer.\textsuperscript{53} A “residential unit” is defined as any self-contained residential accommodation consisting of more than one room (excluding any hostel, hotel or similar accommodation), the erection of which was commenced by the taxpayer on or after 1 April 1982 and before 21 October 2008 and which was erected under a housing project of the taxpayer in order to be let to a tenant.

\textsuperscript{50} There is also no exclusion available in terms of section 10(1)(k)(i) of the Act.
\textsuperscript{51} Section 13(1) of the Act
\textsuperscript{52} Section 13\textit{bis}(1) of the Act
\textsuperscript{53} Section 13\textit{ter}(2) of the Act
for the purpose of deriving a profit for the taxpayer or in order to be occupied by a \textit{bona fide} full-time employee of the taxpayer (ie in the case of pre-2008 projects).\footnote{Section 13\textit{ter}(1) of the Act} A “housing project” is defined as any project for the erection of a building or buildings in the Republic consisting of or including at least five residential units;\footnote{Section 13\textit{ter}(1) of the Act}

- Deductions in respect of the erection or improvement of buildings in an urban development zone, which refers to a specific area demarcated\footnote{Section 13\textit{quat}(6) of the Act} by a municipality in terms of section 13\textit{quat} of the Act\footnote{Section 13\textit{quat}(2) of the Act};

- A deduction in respect of commercial buildings in terms of section 13\textit{quin} of the Act where the taxpayer is allowed to deduct an allowance of 5\% of the cost to the taxpayer of any new and unused building owned by the taxpayer, or any new and unused improvement to any building owned by the taxpayer, if that building or improvement is wholly or mainly used by the taxpayer during the year of assessment for purposes of producing income in the course of the taxpayer’s trade, other than the provision of residential accommodation; and

- A deduction in terms of section 13\textit{sex} of the Act where the taxpayer may deduct an allowance of 5\% of the cost to the taxpayer of any new and unused residential unit, or any new and unused improvements to a residential unit, owned by the taxpayer if that unit or improvement is used by the taxpayer solely for the purpose of a trade carried on by the taxpayer, that unit is situated within the Republic and the taxpayer owns at least five residential units within the Republic, which are used by the taxpayer for the purpose of a trade carried on by the taxpayer.\footnote{Section 13\textit{sex}(1) of the Act}

It follows that where the REIT or CPC did not claim any allowances on its immovable property, there will be no recoupment included in the REIT or CPC’s income.

\textit{CGT exemption}

A REIT or a CPC is exempt from CGT in respect of the disposal of its immovable property, shares in another REIT or shares in a CPC. This exemption does not apply to the disposal of shares in an APC or other shares.
Therefore, the holder of the REIT share will only pay CGT in terms of the Eight Schedule to the Act when the investor sells a share in the REIT. Previously, paragraph 67A of the Eight Schedule to the Act provided that a holder of a participatory interest in a portfolio of a CISP must determine a capital gain or capital loss in respect of any participatory interest in that portfolio only when the participatory interest holder disposes of that interest. However, this paragraph was repealed in terms of the Taxation Laws Amendment Act of 2012, with effect from 1 April 2013 and applicable in respect of years of assessment commencing on or after that date. Thus, as a result of the conversion of CISPs to REITs, this rule has fallen away.  

Recharacterisation of interest distributions

Resident shareholders

As stated above, interest distributions by a REIT (or a CPC) payable to South African resident investors (ie a company, trust or natural person) are recharacterised as taxable dividends. Therefore, the normal tax exemption for dividends in terms of section 10(1)(k)(i) of the Act does not apply, as proviso (aa) to section 10(1)(k)(i) of the Act stipulates that a dividend distributed by a REIT or CPC to a resident is not an exempt dividend for South African income tax purposes.

However, DWT will not apply to resident shareholders as section 64F(l) provides that any dividend is exempt from DWT to the extent that the dividend received by a person who is a beneficial owner does not consist of a dividend in specie and to the extent that the dividend constitutes income in the hands of that person.

This is regardless of whether the REIT makes qualifying distributions during the year of assessment.

Foreign shareholders

Where the recipient of the interest distributions by a REIT is a non-resident person, the interest is also recharacterised as a dividend in the hands of the foreign investor. Proviso (aa) to section 10(1)(k)(i) of the Act provides that dividends distributed by a REIT or a CPC to a person that is not a resident will be exempt from income tax in South Africa.

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59 The fact that the legislation has been repealed may be a problem where the entity does not meet the requirements to qualify as a REIT, as the change only gives clarity to the tax treatment in respect of REITs.
Any dividend paid by a REIT or a CPC received or accrued before 1 January 2014 is exempt from DWT in terms of section 64F(2) of the Act to the extent that the dividend does not constitute a dividend in specie.

However, from 1 January 2014, foreign investors in a South African REIT will be subject to DWT, as the dividend received is not ordinary revenue in the hands of the foreign investor (subject to any DTA reductions, if applicable) and section 64F(2) of the Act will no longer apply. The reason for delaying this treatment until 1 January 2014 is to allow the various parties concerned such as regulated intermediaries (ie central securities depository participants) to adjust their systems to withhold DWT on such dividends paid to foreign shareholders of a REIT (National Treasury, 2012:70).

Furthermore, any amount of interest paid in respect of a property linked unit in a REIT or a CPC must be deemed to be a dividend paid by that REIT or CPC for purposes of DWT and is not an amount of interest paid by that REIT or CPC for purposes of the withholding tax on interest. Therefore, foreign investors will not be subject to withholding tax on interest on the amounts received from a REIT or CPC.60

**Securities Transfer Tax exemption**

Securities Transfer Tax is levied at a rate of 0.25% of the taxable amount on every transfer of a security (ie a share in a company) in terms of the Securities Transfer Act No 25 of 2007. However, where a person acquires a share in a REIT, it will not be liable for securities transfer tax, as Section 8(1)(t) of the Securities Transfer Act No 25 of 2007 specifically excludes a security that constitutes a share in a REIT as defined in section 1 of the Act.

It recognises that transfer duty or VAT would have been paid in respect of the acquisition of the underlying properties. This exclusion brings the REIT in line with the exclusion available where a person acquires securities in a collective investment in securities (National Treasury, 2012:72).

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60 Section 25BB(6)(b) of the Act
3.2.4 Transition rules

A REIT will not be subject to paying an entry charge type of tax when that entity becomes a REIT.

3.2.4.1 Roll-over relief

The property linked unit of a PLS company that obtains REIT status, consists of a share and debenture portion. As section 25BB(6) of the Act deems the interest paid in respect of that property linked unit in a REIT or CPC as a dividend for tax purposes, it seems that, going forward, it would not be necessary for companies who received REIT status to have property linked units on which it pays dividends (share portion) and interest (debenture portion) to its shareholders.

The company can therefore convert the debenture portion of the property linked unit to shares in the REIT. Corporate roll-over relief, which enables this to be effected tax free, is available in such circumstances in terms of section 43 of the Act which deals with “substitutive share-for-share transactions”.

A substitutive share-for-share transaction deals with:

- transactions between a person and a company;
- where that person disposes of an equity share interest in that company and acquires another equity share interest in that company; and
- where the “new” equity share interest is acquired by the person as a capital asset or as trading stock where the equity share interest disposed of is disposed of as a capital asset or as trading stock where the equity share interest disposed of is disposed of as trading stock.

Section 43(1) of the Act defines an “equity share” to include a “property linked unit” which refers to “a unit comprising a share and a debenture in a REIT or a controlled property company as defined in section 25BB, where that share and that debenture are linked together and cannot be disposed of independently of each other”\(^{61}\).

Therefore, in terms of section 43 of the Act, which determines the tax treatment, the debenture portion held by investors of the PLS company, can be converted into shares in the REIT once

\(^{61}\) Section 43(1) of the Act
the company has obtained REIT status (ie it still remains an investment in the same company). The section further provides that this conversion process happens tax-free in the investor’s hands. In essence, the investor will be deemed to have disposed of and acquired the equity share interest for an amount equal to the expenditure incurred and it further deems the new share to be acquired on the same day that the debenture was acquired initially.

Therefore, this results in no CGT payable on such a conversion of the debenture portion to shares in the REIT or CPC.

3.3 Conclusion

The above discussion demonstrates some of the tax technical aspects players in the South African property investment industry have been facing when making use of property investment vehicles, under the old regime, the new (REIT) regime and when converting from the old to the new regime.

From a South African income tax perspective, however, the tax on the net income of the REIT is ultimately borne by the investor, which is in line with the flow through principle. However, the applicable legislation has proven to be rather difficult to apply, and technical anomalies created issues. Hence, a number of technical issues have been identified which will be discussed further in Chapter 4 below.
4 PRACTICAL TAX ISSUES RELATING TO THE TAXATION OF REITS IN SOUTH AFRICA

4.1 Introduction

The introduction of REIT legislation to South Africa was long awaited and a welcome change to bring certainty to the taxation of immovable property investment vehicles, making such investment internationally competitive and attracting foreign investment in South African listed real estate.

As discussed in Chapter 1 above, it appears that National Treasury has been influenced by the US and the UK REIT regimes when drafting the South African legislation, which is now in effect. Chapter 2 explored the international REIT regimes and specifically focused on the US and the UK REIT regimes.

The South African REIT regime shows similarities to the US REIT regime in respect of the requirement that 75% of the revenue must be attributable to rental income, distributions must be made to shareholders annually, the REIT may claim a deduction for dividends paid to shareholders, the REIT is taxed on the remaining income (after such distributions are made to shareholders), and the investors are taxed on distributions received from the REIT.

Further, the South African REIT regime also reflects elements similar to the UK REIT regime in respect of the requirement that the REIT must be a listed company, distributions must be made to shareholders annually (which is also a requirement for US REITs) and the flow through principle applies, ie investors are taxed on distributions made by the REIT, and not the REIT itself (single layer of tax).

Therefore, it appears that National Treasury has carefully considered international REIT regimes to implement a local REIT regime which is a good fit for the South African listed property industry, and, therefore, described by some as a “best-of-breast practices” system (Estienne de Klerk, n.d.).

There are, however, some practical tax issues which have emerged from the current, very recently introduced, REIT legislation both at REIT and at investor level. This chapter explores these practical tax issues in more detail and Chapter 5 looks at possible solutions and whether
the proposed amendments, published by National Treasury on 4 July 2013, satisfactorily address these issues.

4.2 Practical Tax Issues Identified with the Current REIT Tax Legislation

4.2.1 Listing requirement

Currently, the Act requires that a company that wishes to qualify for the REIT dispensation in South Africa must be listed on an exchange and the shares must be listed on the JSE as shares in a REIT. As discussed in more detail in Chapter 3 above, there are specific requirements, in terms of the JSE listing requirements, which have to be met before a company can obtain such listing.

While the listing requirement is in line with other regimes and can be seen to serve as a mechanism to ensure that appropriate measures have been taken to comply with legal requirements (to provide investor protection), this “listing” requirement appears to be very narrow and administratively burdensome. Additionally, under the current law, unlisted REITs are not able to benefit from, and are therefore missing out on the favourable REIT dispensation. Furthermore, international recognition from foreign investors is not given to unlisted REITs.

4.2.2 Potential double taxation of income from APCs

The income from APCs, as defined in section 25BB(1) of the Act, may be subject to double taxation, i.e. the APC may be subject to corporate income tax and, in addition, the resultant dividend payable by the APC may be recharacterised to be a taxable dividend in the hands of the property unit holder in the REIT. This, for the investor, undesired and detrimental treatment, may create the need to restructure APC investments out of the REIT environment, to ensure that returns for investors are not unfairly reduced and are commercially and economically viable.

4.2.3 A REIT not meeting the 75% rental income threshold

As stated above, one of the qualifying criteria for a REIT is to achieve a minimum rental income of 75% of gross income during each year of assessment. However, if the rental income of a REIT does not meet the required minimum threshold, it may not be eligible for the qualifying
distribution deduction in the following year. This would then result in an additional layer of tax being created in the hands of that REIT, which could have a negative impact on investors’ returns.

This scenario can be illustrated by the example below, which demonstrates the effect of the additional layer of tax in the hands of the REIT, and which decreases the return (ie the dividend) to be received by investors.

4.2.3.1 **Illustrative example**

*First year of operations*

During the first year of operations, the APC and the CPC’s income stream consists of rental income.

The tax treatment in respect of each taxpayer is set out below.
Tax treatment in the hands of the APC

The R13 888 889 rental income will be taxable income in the hands of the APC, resulting in current tax (at 28%) of R3 888 889. Therefore, the APC has R10 000 000 available for distribution.

Upon distribution, the REIT, which holds a 20% shareholding in the APC, will receive a dividend of R2 000 000 (ie R10 000 000 x 20%). DWT is not applicable on the dividend distribution in terms of section 64F(1)(a) of the Act, as the beneficial owner (ie the REIT) is a resident company. The REIT must submit a declaration to the APC regarding this exemption by a date determined by the APC or the date on which the dividend is paid, and a written undertaking to forthwith inform the APC in writing should the circumstances regarding the REIT’s exemption from DWT change or the REIT ceases to be the beneficial owner.62

Tax treatment in the hands of the CPC

The CPC earned rental income of R5 000 000 during the first year of operations, which will be included as gross income in determining the taxable income of the CPC. The CPC declares an annual distribution, ie a dividend, to the REIT who holds a 100% shareholding in the CPC.

DWT is not applicable on the dividend distribution in terms of section 64F(1)(a) of the Act, as the beneficial owner (ie the REIT) is a resident company and the dividend is subject to income tax in terms of section 10(1)(k)(i)(aa) of the Act.63

However, the CPC may, in terms of section 25BB(2) of the Act, deduct the R5 000 000 distribution to the REIT, as 100% of the CPC’s gross income consisted of rental income during the first year of operations and meets the criteria as set out in section 25BB(1) of the Act of a qualifying distribution.

Therefore, the CPC will have no taxable income (ie R5 000 000 gross income less R5 000 000 qualifying distribution) for the first year of assessment.

Tax treatment in the hands of the REIT

The dividends received from the APC (R2 000 000) and the CPC (R5 000 000), totalling R7 000 000, will be gross income in the hands of the REIT. The dividend received from the APC will be exempt income in terms of section 10(1)(k)(i) of the Act.

62 Documentary requirements in terms of section 64G(2) of the Act
63 Subject to the documentary requirements specified in section 64G(2) of the Act
During the first year of operations, the REIT makes an annual distribution to its shareholders of R7 000 000. Rental income, as defined, includes a qualifying distribution received from an APC and a CPC. Therefore, the R7 000 000 dividend declared to its shareholders meets the criteria of a qualifying distribution, as more than 75% of the REIT’s gross income consists of rental income (ie the APC and the CPC only earned rental income and this was distributed to the REIT by way of a dividend).

However, the qualifying distribution of R7 000 000 which may be deducted, is limited to the taxable income before the qualifying distribution is taken into account, ie R5 000 000 (R7 000 000 gross income less R2 000 000 exempt dividend). Therefore, the qualifying distribution deduction is limited to R5 000 000, leaving the REIT with zero taxable income for the first year of assessment.

**Tax treatment in the hands of the individual shareholder**

The individual shareholder receives a dividend of R1 750 000 from the REIT, which is a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act and, therefore, the dividend is not subject to DWT in terms of section 64F(1)(l) of the Act. The individual shareholder will be taxed at the marginal tax rate. Assuming a marginal rate of 40%, tax will amount to R700 000 for the year of assessment.

**Tax treatment in the hands of the company shareholder**

The company shareholder receives a dividend of R3 500 000 from the REIT, which is a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act and, therefore, the dividend is not subject to DWT in terms of section 64F(1)(l) of the Act. The company shareholder will be taxed at the corporate tax rate (28%), with tax amounting to R980 000 for the year of assessment.

**Tax treatment in the hands of the foreign shareholder**

The foreign shareholder receives a dividend of R1 750 000 from the REIT, which is an exempt dividend in terms of section 10(1)(k)(i)(aa) of the Act. Section 64F(2) of the Act provides that the dividend will be exempt from DWT where the dividend is received from a REIT prior to 1 January 2014. Where the dividend is received by or accrues to the foreign shareholder on/after 1

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64 Subject to the documentary requirements specified in section 64G(2) of the Act
65 Subject to the documentary requirements specified in section 64G(2) of the Act
January 2014, DWT (at 15%) of R262 500 will be levied, subject to DTA relief (if applicable) (see below).

Second year of operations

Continuing the example, during the REIT’s second year of operation, the rental generating properties of the APC underwent major renovations and resulted in the APC not earning any rental income. The APC did, however, manage to earn other business income of R13 888 889 and the CPC’s income stream consists only of rental income.

The tax treatment in respect of each taxpayer is set out below.

Tax treatment in the hands of the APC

The R13 888 889 business income will be taxable income in the hands of the APC, resulting in current tax (at 28%) of R3 888 889. Therefore, the APC has R10 000 000 available for distribution.
Upon distribution, the REIT, which holds a 20% shareholding in the APC, will receive a dividend of R2 000 000 (ie R10 000 000 x 20%). DWT is not applicable on the dividend distribution in terms of section 64F(1)(a) of the Act, as the beneficial owner (ie the REIT) is a resident company.\textsuperscript{66}

**Tax treatment in the hands of the CPC**

The CPC earned rental income of R5 000 000 during the second year of operations, which will be included as gross income in determining the taxable income of the CPC. The CPC declares an annual distribution, ie a dividend, to the REIT which holds a 100% shareholding in the CPC.

DWT is not applicable on the dividend distribution in terms of section 64F(1)(a) of the Act, as the beneficial owner (ie the REIT) is a resident company and the dividend is subject to income tax in terms of section 10(1)(k)(i)(aa) of the Act.\textsuperscript{67}

However, the CPC may, in terms of section 25BB(2) of the Act, deduct the R5 000 000 distribution to the REIT, as 100% of the CPC’s gross income consisted of rental income during the first year of operations (ie one has to look at the preceding year of assessment, as the CPC was established in the prior year and this is the second year of operations) and meets the criteria as set out in section 25BB(1) of the Act of a qualifying distribution.

Therefore, the CPC will have zero taxable income (ie R5 000 000 gross income less R5 000 000 qualifying distribution) for the second year of assessment.

**Tax treatment in the hands of the REIT**

The dividends received from the APC (R2 000 000) and the CPC (R5 000 000), totalling R7 000 000, will be gross income in the hands of the REIT. The dividend received from the APC will, however, be exempt income in terms of section 10(1)(k)(i) of the Act.

During the second year of operations, the REIT makes an annual distribution to its shareholders of R7 000 000. Rental income, as defined, includes a qualifying distribution received from an APC and a CPC. Therefore, the R7 000 000 dividend declared to its shareholders meets the criteria of a qualifying distribution, as more than 75% of the REIT’s gross income consists of rental income in the preceding year of assessment (ie the APC and the CPC only earned rental

\textsuperscript{66} Subject to the documentary requirements specified in section 64G(2) of the Act
\textsuperscript{67} Subject to the documentary requirements specified in section 64G(2) of the Act
income in the preceding year of assessment, the first year of operations, which was distributed to the REIT by way of a dividend).

However, the qualifying distribution of R7 000 000 which may be deducted, is limited to the taxable income before the qualifying distribution is taken into account, ie R5 000 000 (R7 000 000 gross income less R2 000 000 exempt dividend). Therefore, the qualifying distribution deduction is limited to R5 000 000, leaving the REIT with zero taxable income for the second year of assessment.

**Tax treatment in the hands of the individual shareholder**

The individual shareholder receives a dividend of R1 750 000 from the REIT, which is a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act and, therefore, the dividend is not subject to DWT in terms of section 64F(1)(l) of the Act.\(^{68}\)

The individual shareholder will be taxed at the marginal tax rate (40%), with tax amounting to R700 000 for the year of assessment.

**Tax treatment in the hands of the company shareholder**

The company shareholder receives a dividend of R3 500 000 from the REIT, which is a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act and, therefore, the dividend is not subject to DWT in terms of section 64F(1)(l) of the Act.\(^{69}\)

The company shareholder will be taxed at the corporate tax rate (28%), with tax amounting to R980 000 for the year of assessment.

**Tax treatment in the hands of the foreign shareholder**

The foreign shareholder receives a dividend of R1 750 000 from the REIT, which is an exempt dividend in terms of section 10(1)(k)(i)(aa) of the Act. Section 64F(2) of the Act provides that the dividend will be exempt from DWT where the dividend is received from a REIT prior to 1 January 2014. Where the dividend is received by or accrues to the foreign shareholder on/after 1 January 2014, DWT (at 15%) of R262 500 will be levied, subject to DTA relief (if applicable) (see below).

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\(^{68}\) Subject to the documentary requirements specified in section 64G(2) of the Act

\(^{69}\) Subject to the documentary requirements specified in section 64G(2) of the Act
Third year of operations

Continuing the example, during the third year of operations, the APC and the CPC’s income streams consist again only of rental income.

The tax treatment in respect of each taxpayer is set out below.

Tax treatment in the hands of the APC

The R13 888 889 rental income will be taxable income in the hands of the APC, resulting in current tax (at 28%) of R3 888 889. Therefore, the APC has R10 000 000 available for distribution.

Upon distribution, the REIT, which holds a 20% shareholding in the APC, will receive a dividend of R2 000 000 (ie R10 000 000 x 20%). DWT is not applicable on the dividend.
distribution in terms of section 64F(1)(a) of the Act, as the beneficial owner (i.e., the REIT) is a resident company.\textsuperscript{70}

Tax treatment in the hands of the CPC

The CPC earned rental income of R5 000 000 during the third year of operations, which will be included as gross income in determining the taxable income of the CPC. The CPC declares an annual distribution, i.e., a dividend, to the REIT who holds a 100% shareholding in the CPC.

DWT is not applicable on the dividend distribution in terms of section 64F(1)(a) of the Act, as the beneficial owner (i.e., the REIT) is a resident company and the dividend is subject to income tax in terms of section 10(1)(k)(i)(aa) of the Act.\textsuperscript{71}

However, the CPC may, in terms of section 25BB(2) of the Act, deduct the R5 000 000 distribution to the REIT, as 100% of the CPC’s gross income consisted of rental income during the preceding year of assessment (i.e., second year of operations) and meets the criteria as set out in section 25BB(1) of the Act of a qualifying distribution.

Therefore, the CPC will have zero taxable income (i.e., R5 000 000 gross income less R5 000 000 qualifying distribution) for the third year of assessment.

Tax treatment in the hands of the REIT

The dividends received from the APC (R2 000 000) and the CPC (R5 000 000), totalling R7 000 000, will be gross income in the hands of the REIT. The dividend received from the APC will, however, be exempt income in terms of section 10(1)(k)(i) of the Act.

During the third year of operations, the REIT makes an annual distribution to its shareholders of R7 000 000. Rental income, as defined, includes a qualifying distribution received from an APC and a CPC. However, the R7 000 000 dividend declared to its shareholders does not meet the criteria of a qualifying distribution, as only 71% (i.e., R5 000 000 / R7 000 000) of the REIT’s gross income consists of rental income (i.e., the APC did not meet the “qualifying distribution” criteria as it did not earn rental income in the preceding year of assessment and, therefore, only R5 000 000 of the R7 000 000 consists of rental income received by the REIT in the preceding year of assessment).

\textsuperscript{70} Subject to the documentary requirements specified in section 64G(2) of the Act

\textsuperscript{71} Subject to the documentary requirements specified in section 64G(2) of the Act
Therefore, the REIT does not qualify for the qualifying distribution deduction in this year of assessment. The taxable income in the hands of the REIT of R5 000 000 is taxed at 28% (ie tax of R1 400 000), resulting in only R5 600 000 (R7 000 000 less R1 400 000) available for distribution to the REIT’s shareholders.

**Tax treatment in the hands of the individual shareholder**

The individual shareholder receives a dividend of R1 400 000 from the REIT, which is a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act and, therefore, the dividend is not subject to DWT in terms of section 64(1)(l) of the Act.\(^{72}\)

The individual shareholder will be taxed at the marginal tax rate (40%), with tax amounting to R560 000 for the year of assessment.

**Tax treatment in the hands of the company shareholder**

The company shareholder receives a dividend of R2 800 000 from the REIT, which is a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act and, therefore, the dividend is not subject to DWT.\(^{73}\)

The company shareholder will be taxed at the corporate tax rate (28%), with tax amounting to R784 000 for the year of assessment.

**Tax treatment in the hands of the foreign shareholder**

The foreign shareholder receives a dividend of R1 400 000 from the REIT, which is an exempt dividend in terms of section 10(1)(k)(i)(aa) of the Act. Section 64F(2) of the Act provides that the dividend will be exempt from DWT where the dividend is received from a REIT prior to 1 January 2014. Where the dividend is received by or accrues to the foreign shareholder on/after 1 January 2014, DWT (at 15%) of R210 000 will be levied, subject to DTA relief (if applicable) (see below).

**Summary**

The tax effect in respect of each taxpayer is set out below in Table 2.

\(^{72}\) Subject to the documentary requirements specified in section 64G(2) of the Act

\(^{73}\) Subject to the documentary requirements specified in section 64G(2) of the Act
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<thead>
<tr>
<th></th>
<th>APC</th>
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<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
<td>Year 3</td>
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<tr>
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<td>13 888 889</td>
<td>13 888 889</td>
<td>13 888 889</td>
</tr>
<tr>
<td>Tax (at 28%)</td>
<td>3 888 889</td>
<td>3 888 889</td>
<td>3 888 889</td>
</tr>
<tr>
<td>Available for distribution</td>
<td>10 000 000</td>
<td>10 000 000</td>
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<thead>
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<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
<td>Year 3</td>
</tr>
<tr>
<td>Gross income (rental income)</td>
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<td>5 000 000</td>
<td>5 000 000</td>
</tr>
<tr>
<td>Less: qualifying distribution</td>
<td>(5 000 000)</td>
<td>(5 000 000)</td>
<td>(5 000 000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Tax (at 28%)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Available for distribution</td>
<td>5 000 000</td>
<td>5 000 000</td>
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<thead>
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<td>Year 3</td>
</tr>
<tr>
<td>Gross income</td>
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<td>7 000 000</td>
<td>7 000 000</td>
</tr>
<tr>
<td>Less: exempt income</td>
<td>(2 000 000)</td>
<td>(2 000 000)</td>
<td>(2 000 000)</td>
</tr>
<tr>
<td>Less: qualifying distribution</td>
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<tr>
<td>Taxable income</td>
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<td>-</td>
<td>5 000 000</td>
</tr>
<tr>
<td>Tax (at 28%)</td>
<td>-</td>
<td>-</td>
<td>1 400 000</td>
</tr>
<tr>
<td>Available for distribution</td>
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<td>7 000 000</td>
<td>5 600 000</td>
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<thead>
<tr>
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<th>Individual shareholder</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
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<tr>
<td>Taxable income</td>
<td>1 750 000</td>
<td>1 750 000</td>
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<tr>
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<td>Year 1</td>
<td>Year 2</td>
<td>Year 3</td>
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<td><strong>Company shareholder</strong></td>
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<tr>
<td>Tax (at 40%)</td>
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<td>700 000</td>
<td>560 000</td>
<td></td>
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<td></td>
</tr>
<tr>
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<td>-</td>
<td>-</td>
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</tr>
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<td>DWT on/after 1 January 2013</td>
<td>262 500</td>
<td>262 500</td>
<td>210 000</td>
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</tr>
</tbody>
</table>

Therefore, based on the above illustrated example, it is apparent that where the REIT does not meet the requirements for the qualifying distribution, it will result in an additional layer of tax in the hands of the REIT, which reduces the investors’ returns.

### 4.2.4 Receipt of a liquidation dividend

The question arises what impact the receipt of a liquidation dividend by a REIT will have on the tax position of the REIT, particularly considering the 75% threshold referred to above.

Where a CPC of a REIT is in the process of being wound up, it may not be possible to wind up this company within the same year that it ceases to operate as a property company and to declare a liquidation dividend in this same year. A delay, which could result in a scenario where the liquidation dividend can only be paid out in a subsequent year after the company has, for example, ceased trading for more than three years ago, could often occur due to the lengthy process involved for property companies to be wound up. This delay would often be the result of industry specific, practical problems, eg resolving municipal accounts.

Therefore, the REIT may receive income in the form of a liquidation dividend from the company, which was previously a CPC, and, therefore, the dividend received will not constitute “rental income” in the hands of the REIT, as it does not constitute a qualifying distribution.
received from a CPC (ie, in this example, the CPC ceased trading more than three years ago and it can therefore not meet the requirement that more than 75% of its gross income consists of rental income in the preceding year of assessment).

If this dividend is significant in relation to the total income of the REIT, this may result in the REIT not meeting the 75% rental income threshold criteria stipulated to be eligible for the qualifying distribution deduction, with the resultant problem set out above in the example.

4.2.5 Potential recoupment and treatment of pre-existing losses

Recoupments and/or pre-existing losses, ie carried forward from previous tax period, may also impact on the income tax position of a REIT, and again, they may negatively impact the tax treatment considering the 75% minimum threshold (refer below).

However, no mention is made in the current REIT legislation regarding the treatment, from a South African income tax perspective, of potential recoupments of prior year’s capital allowances in respect of the disposal of immovable property or related assets or the treatment of pre-existing losses.

4.2.5.1 Recoupments

The Act provides that a REIT or a CPC may not claim allowances in respect of immovable property. However, there may be immovable property assets on which the company did claim capital allowances, before the company obtained REIT status.

Therefore, once those assets, on which capital allowances were claimed up to the point when the company obtained REIT status, are disposed of, one would expect that the general recoupment provisions in terms of section 8(4)(a) of the Act would apply. Hence, the recoupment would be included in the REIT’s income for the year of assessment in which the asset is disposed of.

Further, a recoupment of a capital allowance previously claimed (ie a section 8(4) recoupment), is included in “gross income” in terms of paragraph (n) of the gross income definition74. Therefore, the recoupment will be included in the REIT’s gross income, but will not form part of the REIT’s “rental income” when determining the 75% threshold, potentially, with the consequent results as set out above.

74 Section 1 of the Act
The current REIT legislation is, however, silent regarding this.

4.2.5.2 Pre-existing losses

Furthermore, the REIT legislation does not provide any guidance on how a REIT must treat pre-existing losses, and whether any accumulated assessed losses from a prior year may be carried forward once the company has obtained REIT status to be offset against non-distributed income or if the REIT fails to achieve REIT tax status in any year.

4.2.6 Potential double taxation of an amount received in respect of a financial instrument

As discussed in 3.2.3.4 above, any amount received or accrued to a REIT or CPC during a year of assessment in respect of a financial instrument will be deemed to be not of a capital nature and must be included in the income of that REIT or CPC for that year of assessment. However, a share in a REIT, a CPC or an APC is regarded to be of a capital nature in the hands of the REIT or CPC.

Therefore, if for example a REIT receives a dividend from its investment in a mining company, the dividend will be income in the hands of the REIT in terms of section 25BB(3)(b) of the Act, irrespective of the section 10(1)(k)(i) dividend exemption. The dividend is, therefore, taxed as ordinary revenue in the hands of the REIT.

Furthermore, when the REIT declares such dividend to its resident shareholders, the dividend will be a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act, resulting in double taxation of the dividend originally received by the REIT from its investment in the mining company.

4.2.7 Tax treatment of distributions from a REIT in the hands of foreign investors

In terms of the new REIT legislation, foreign investors will be subject to DWT in respect of dividends received by or accrued to on or after 1 January 2014.

In terms of the South African income tax legislation, section 25BB(6) of the Act prescribes that interest in respect of the debenture portion of a property linked unit which is received by or accrues to the investor during the year of assessment, must be deemed to be a dividend. In
addition, any amount of interest paid by the REIT in respect of a property linked unit in a REIT or a CPC must be deemed to be a dividend and not be regarded as an amount of interest paid for purposes of withholding tax on interest.

It is therefore necessary to determine whether DTA relief is available to foreign investors in respect of a South African dividend receipt (ie as treated for tax purposes) or a receipt of interest (ie based on the legal nature of the PLS investment).

4.3 Conclusion

The introduction of REIT legislation was a welcome change, giving certainty to the tax treatment at REIT and at investor level.

Although there are currently practical tax issues that a taxpayer may encounter, at REIT and at investor level as set out above, one should consider how these practical issues may be overcome. Chapter 5 attempts to point out possible improvements to the practical issues encountered as set out above. In addition, it discusses whether National Treasury’s proposed amendments may potentially resolve some issues which occurred since the introduction of the REIT legislation in South Africa.
5 SUGGESTIONS FOR POSSIBLE IMPROVEMENTS

5.1 Introduction

As discussed in Chapter 4, there are practical tax issues which have emerged from the current REIT legislation, at REIT and at investor level, since the introduction of the REIT regime in the Act.

On 4 July 2013, National Treasury released the Draft Taxation Laws Amendment Bill 2013, which proposes several technical corrections and amendments to the current South African REIT legislation.\(^{75}\) It has been proposed that these corrections be applied retrospectively, ie as if they existed in the legislation introduced earlier this year.

The analysis below explores possible solutions/improvements to the practical issues set out in Chapter 4, and it also discusses whether the proposed amendments address any of the issues identified, and if so, whether or not they are sufficient.

5.2 Areas for Possible Improvement and Suggested Solutions

5.2.1 Listing requirement

As stated above, one of the requirements for a company to qualify for the South African REIT dispensation is that the relevant entity must be listed on the JSE as a REIT. However, the US REIT regime also applies to unlisted companies. Accordingly, consideration should be given to expand the REIT dispensation to qualifying unlisted companies. This is in line with Finance Minister Pravin Gordhan’s proposal in the 2013 Budget Speech that the REIT regime be extended to unlisted entities as well. This proposal included that the regime be extended to wholly-owned entities of private and government pension funds, as well as long-term insurers. However, to date, National Treasury has not yet released draft legislation that would provide for an extension of the South African REIT regime to unlisted companies.

\(^{75}\) The author of this dissertation acknowledges that the Taxation Laws Amendment Bill No 39 of 2013 was released by National Treasury on 24 October 2013, but it does not, however, solve the issues raised in this dissertation, and is therefore not considered further.
In addition, consideration needs to be given to, eventually, extending the REIT legislation beyond unlisted entities such as wholly-owned entities of private and government pension funds, and long-term insurers, to private companies with significant sized property portfolios.

A possible reason for the “delay” in introducing proposed legislation catering for unlisted REITs may be the difficulty associated with regulating these types of entities, and to ensure that all requirements for an unlisted company to qualify as a REIT are met on an annual basis. This would be important to ensure compliance, so only qualifying companies can benefit from the REIT dispensation. Currently, listed REITs are governed by the strict JSE listing requirements, which need to be complied with on an ongoing basis. Therefore, more certainty exists where a body such as the JSE reviews whether a company complies with regulating requirements imposed, and enforced accordingly, if required.

National Treasury (2013a:56) has also stated that consideration must be given to legislation dealing specifically with property syndication, in an attempt to “protect investors from Ponzi schemes”. A Ponzi scheme is typically described as a fraudulent investment scheme where existing investors receive returns from the money received from new investors who invest in the scheme (and not from a profit generated by the scheme), and who are lured by the promise of high returns with minimal risk associated with the investment, and where the investors’ money are used to fund personal expenses of the founder(s) of the scheme (US Securities and Exchange Commission, n.d.).

Therefore, it is clear that, if there are no proper regulations in place (for example not an actual investment in property to generate rental income), the REIT regime may be “abused” by the unlisted REIT sector, which may leave investors vulnerable.

At this stage it is not clear what body would be suitable to be used for governing or regulating unlisted REIT companies.

However, as discussed above, the US permits listed and unlisted REITs to participate in the REIT regimes. Unlisted US REITs are required, as are listed REITs, to be registered with the Securities and Exchange Commission and comply with disclosure requirements, including providing the Securities and Exchange Commission with quarterly and annual reports and filing a prospectus and these documents are available to the public on the Securities and Exchange Commission’s database (FINRA, n.d.).
Therefore, National Treasury may wish to follow such a route and require unlisted REITs to be registered with the JSE, from a compliance point of view, in an attempt to regulate unlisted REITs in the same manner as listed REITs and to protect investors from fraudulent schemes.

5.2.2 Potential double taxation of income from APCs

It appears that, currently, the income from APC’s may be subject to double taxation. This is as a result of an APC not being able to qualify for the qualifying distribution deduction which is only available to a REIT or a CPC in terms of section 25BB(2) of the Act. Therefore, the APC is taxed on its taxable income at the corporate tax rate of 28% and the resultant dividend may be recharacterised to be a taxable dividend in the hands of the property unit holder in the REIT.

This, in effect reduces the return on investment for the investor in the REIT which earns income from an APC and accordingly, this would not to be a very desirable investment from an investor’s perspective.

Therefore, it appears that it would be more economical to restructure APC investments out of the REIT environment, to ensure that returns for investors are not unfairly reduced and commercially and economically viable.

National Treasury has proposed in terms of the 2013 draft amendments\(^{76}\) that the definition and all references to an APC be deleted from the Act. Thus far, National Treasury has not included any commentary on the reason for this removal in the Explanatory Memorandum or the Clause by Clause Explanation of the Draft Taxation Laws Amendment Bill 2013\(^{77}\).

This removal would, however, not be a sufficient improvement to the REIT legislation, as it does not address the problem of double taxation, unless the APC is sold.\(^{78}\)

5.2.3 A REIT not meeting the 75% rental income threshold

The illustrative example in Chapter 4 above indicates that, where the rental income of a REIT decreases below the required minimum threshold for it to meet the criteria for the qualifying distribution deduction, ie a minimum of 75% of gross income, an additional layer of tax may

\(^{76}\) Issued on 4 July 2013
\(^{77}\) Issued on 4 July 2013
\(^{78}\) It is noted in the Taxation Laws Amendment Bill No 39 of 2013 that the current definition of an APC is in included as part of the new definition of a “property company” (refer 5.3.1).
arise as a result of this in the hands of that REIT. Thus, this would reduce the return (ie dividend) received by the investors on their investment.

It is therefore important that management of a REIT constantly monitors the 75% threshold criteria to ensure that 75% of its gross income constitutes rental income in respect of each relevant year of assessment, as defined. This would be important to ensure that investors are getting the “full” return on investment, without losing revenue through the imposition of an additional layer of tax in the hands of the REIT.

It is submitted that this additional layer of tax may be deliberate as it is not only applicable to REITs in terms of the South African REIT tax legislation. For example, where a UK REIT does not meet the requirement that 75% of its total profits constitute income received from the property letting business, the property letting income will not qualify for the exemption and will be taxed at the corporate tax rate.

From a practical point of view, in terms of the current rules, there is confusion regarding the timing of the qualifying distribution. The proposed amendments\(^\text{79}\) provide for a clarification and it has been proposed that the determination regarding whether the 75% rental income threshold has been achieved will be based on the distribution amount taken into account for financial reporting purposes in respect of the relevant year of assessment. National Treasury (2013b) explains that, if a distribution is actually paid in 2016, but is taken into account for financial reporting purposes in 2015, the qualifying distribution is based on rental income for 2015\(^\text{80}\), and not 2016. This clarification is helpful, by giving more certainty regarding which year’s rental income must be used in determining whether the REIT may qualify for the qualifying distribution deduction, by referring to a distribution taken into account for financial reporting purposes.

Furthermore, it has been proposed\(^\text{81}\) (by inserting a proviso to the qualifying distribution definition) that a dividend received or accrued to a REIT from any company that is not a REIT or a controlled company at the time must not be taken into account in the qualifying distribution.

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\(^{79}\) Draft Taxation Laws Amendment Bill 2013, issued on 4 July 2013

\(^{80}\) However, in terms of the wording of the Act, the author of this dissertation is of the view that the example should refer to rental income earned during the 2014 year of assessment where the distribution is taken into account for financial reporting purposes in 2015.

\(^{81}\) Draft Taxation Laws Amendment Bill 2013, issued on 4 July 2013
However, the wording of the proposed amendment is unclear, in that it states that “Provided that a dividend received or accrued from any company that is not a REIT or controlled company at the time of that disposal must not be taken into account” (National Treasury, 2013c:91). It appears that the word “disposal” is misplaced in the context and would need to be replaced with “Provided that a dividend received or accrued from any company that is not a REIT or controlled company at the time that the dividend is received or accrues to the REIT”, to refer to the fact that a dividend that is received or accrues from any company that is not a REIT or a controlled company at the time of that distribution, will not be taken into account by the REIT, when determining the qualifying distribution deduction.

Currently, a REIT that meets the 75% rental income threshold is able to deduct any dividend paid/payable to its shareholders as part of the qualifying distribution. However, it appears that the proposed amendment will limit this deduction, by excluding a dividend received/accrued from any company that is not a REIT or controlled company at the time that the dividend is received/accrues by/to the REIT.

As at 4 October 2013 the proposed changes have not been enacted and it is unclear at this stage whether this is an intentional change proposed by National Treasury. However, it appears to be to the disadvantage of the REIT, as it would have previously been able to deduct a bigger qualifying distribution.

### 5.2.4 Receipt of a liquidation dividend

As discussed on Chapter 4, where a CPC of a REIT is in the process of being wound up, it may not be possible to wind up this company within the same year that it ceases to operate as a property company and to declare a liquidation dividend in this same year. A deferral, which could result in a scenario where the liquidation dividend can only be paid out in subsequent years, could often occur due to the lengthy process involved for property companies to be wound up. The delay would often be the result of industry specific, practical problems, eg resolving municipal accounts, which is common for property companies.

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82 It is noted that the proviso to the qualifying distribution definition has been amended in the Taxation Laws Amendment Bill No 39 of 2013, but it does not satisfactory address the problem discussed in 5.2.4 above.
Therefore, the REIT may receive income in the form of a liquidation dividend from the company, which was previously a CPC, and, therefore, the dividend received would not constitute “rental income” in the hands of the REIT.

The problem with such scenario is that if this dividend is significant in relation to the total income of the REIT, this may result in the REIT not meeting the 75% rental income threshold criteria for it to be eligible for the qualifying distribution deduction. This, in turn, would cause an additional layer of tax to arise in the hands of the REIT and a reduction in the return for investors (as demonstrated in the illustrative example in 4.2.3.1 above).

However, the proposed amendments\(^{83}\) clarify that a dividend from a REIT or a qualifying distribution from a controlled company will only be taken into account as rental income if the distributing company qualifies as a REIT or controlled company at the point in time when it made the distribution.

Therefore, if the proposal is enacted, it is necessary that the company making the dividend distribution be a REIT/controlled company at the time of the distribution, in order to include the dividend received in the “rental income” of the REIT that receives such dividend. Further, as mentioned above, the proposed amendments also consider limiting the qualifying distribution to dividends received/accrued from a REIT/controlled company at the time that the dividend is received/accrued by/to the REIT.

### 5.2.5 Potential recoupment and treatment of pre-existing losses

The South African REIT legislation does not address the treatment, from a tax perspective, of potential recoupments of prior year’s capital allowances in respect of the disposal of immovable property or related assets, or the treatment of pre-existing losses. This is discussed in more detail below:

#### 5.2.5.1 Recoupments

Although the South African REIT legislation does not contain specific REIT related recoupment rules, ie the REIT legislation does not address specifically whether a REIT is required to include in its income the recoupment of capital allowances previously claimed in respect of immovable

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\(^{83}\) Draft Taxation Laws Amendment Bill 2013, issued on 4 July 2013
property before that company obtained REIT status, consideration must be given to the normal tax principles applicable to recoupments.

Section 8(4)(a) of the Act requires that a taxpayer must include in its taxable income all amounts which were previously claimed as an allowance when the amounts are recovered or recouped when an asset is disposed of during a year of assessment.

Therefore, although the REIT legislation in section 25BB of the Act does not contain specific provisions dealing with the recoupment of an allowance asset, the normal tax principles of section 8(4)(a) apply in these circumstances and a REIT would be required to include in its income any capital allowances previously claimed as a recoupment when it disposes of such an immovable asset.

Furthermore, in terms of the proposed amendments, the current rule that a REIT or controlled company may not claim any capital (depreciation) allowances in respect of immovable property has been clarified in that the rule will only apply if the company qualifies as a REIT/controlled company on the last day of the relevant year of assessment.84

5.2.5.2 Pre-existing losses

Another area that has not yet been specifically addressed in the South African REIT legislation relates to the treatment of pre-existing losses by a REIT, and whether an assessed loss accumulated during the prior year may be carried forward once the company has obtained REIT status to be set off against non-distributed income or if REIT status is lost.

However, the set-off of assessed losses is generally dealt with in section 20 of the Act. The section provides that in order to determine the taxable income generated from a taxpayer’s trade, the taxpayer may set-off against its income the balance of an assessed loss brought forward from the previous year of assessment and any assessed loss incurred in carrying on any other trade.

Therefore, applying the general rule to REITs, in terms of section 20(1) of the Act, a REIT would be able to carry forward pre-existing losses which resulted from its trade, before the company obtained REIT status. This can, therefore, potentially be set-off against income received from financial instruments which is considered to be income in the hands of the REIT

84 It is noted that this proposal remains unchanged in the Taxation Laws Amendment Bill No 39 of 2013.
in terms of section 25BB(3) of the Act. However, it may be worth considering introducing a specific sub-section in section 25BB of the Act to explicitly explain the tax treatment of pre-existing losses for REITs.  

5.2.6 Potential double taxation of an amount received in respect of a financial instrument

Any amount received or accrued to a REIT or CPC during a year of assessment in respect of a financial instrument will be deemed to be not of a capital nature and must be included in the income of that REIT or CPC for that year of assessment. However, a share in a REIT, a CPC or an APC is regarded to be of a capital nature in the hands of the REIT or CPC.

In the example discussed in 4.2.6 it is noted that where a REIT receives a dividend from its investment in a mining company, the dividend will be income in the hands of the REIT, irrespective of the section 10(1)(k)(i) dividend exemption. The dividend is, therefore, taxed as ordinary revenue in the hands of the REIT. Furthermore, when the REIT declares such dividend to its resident shareholders, the dividend will be a taxable dividend in terms of section 10(1)(k)(i)(aa) of the Act, resulting in double taxation of the dividend originally received by the REIT from its investment in the mining company.

Although this effect of double taxation is detrimental for investors’ returns, it appears from the Explanatory Memorandum (National Treasury, 2012:71) that it was National Treasury’s aim when drafting the REIT legislation “to deter REITs from holding other forms of investments”.

5.2.7 Tax treatment of distributions from a REIT in the hands of foreign investors

In terms of the South African income tax legislation, section 25BB(6) of the Act prescribes that interest in respect of the debenture portion of a property linked unit which is received by or accrues to an investor during the year of assessment, must be deemed to be a dividend. In addition to this, any amount of interest paid by the REIT in respect of a property linked unit in a REIT or a CPC is deemed to be a dividend and is not to be regarded as an amount of interest paid for purposes of withholding tax on interest.

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85 It is noted that the Taxation Laws Amendment Bill No 39 of 2013 makes a brief reference to an assessed loss brought forward in that it states that a qualifying distribution deduction may not increase the assessed loss brought forward.
In terms of section 64F(2) of the Act, foreign investors will be subject to DWT (at 15%) in respect of dividends received by or accrued to them on or after 1 January 2014.

It is pointed out in 2.4.2.3 above that a dividend paid by a REIT (ie an investor only holds shares in the REIT and, if the company was previously a PLS company, has fully converted the debenture portion of the linked units to shares) will be considered under article 10 of the OECD Model Tax Convention as a dividend and not be regarded as income from immovable property (ie Article 6 of the OECD Model Tax Convention). Therefore, DTA relief should be available in terms of the DTA between South Africa and the country where the foreign investor is tax resident, in terms of the DTA article dealing with dividends.

When making a decision whether to invest in a South African REIT, it is therefore important for a non-resident to determine whether DTA relief is available in respect of a distribution made by a PLS company, which has obtained REIT status, where the investor owns a property linked unit in a REIT where the debenture portion of that linked unit has not been converted to a share in the REIT.

In such instance, the question arises whether the distribution by the REIT to the foreign investor will be considered to be a dividend receipt (ie as treated for tax purposes) or a receipt of interest (ie based on the legal nature of the PLS investment) in terms of the applicable DTA.

Consideration must be given to the specific DTA entered into between South Africa and the country where the foreign investor is tax resident, to determine whether such distribution will constitute a dividend in terms of the relevant DTA, or as interest. In addition, it is important to determine whether the foreign investor will qualify for DTA relief in respect of the 15% DWT payable on a distribution received from the REIT which is deemed to be a dividend for South African tax purposes versus interest (legal nature).\(^{86}\)

Therefore, it may be in the foreign investors’ best interest (from a tax point of view), that the REIT’s linked units are converted to shares, or alternatively, the legislation needs to clarify the nature for purposes of DTA interpretation.

\(^{86}\) For the purpose of this dissertation it does not discuss whether the deemed dividend (for South African tax purposes in terms of section 25BB(6) of the Act) would qualify as a dividend for DTA relief.
5.3 Other Proposed Amendments in Terms of the Draft Taxation Laws Amendment Bill 2013

As mentioned above, National Treasury released the Draft Taxation Laws Amendment Bill on 4 July 2013, and this included various proposed technical corrections to the current REIT tax legislation. Some amendments that have not yet been addressed above include the following:

5.3.1 Terminology and definitions

A number of refinements to the definitions contained in section 25BB of the Act have been proposed. For example, it has been proposed that the definition of a CPC be amended to rather refer to a “controlled company”, as the definition itself does not require a property element in the name.

Furthermore, it is proposed\(^{87}\) that a definition of the term “property company” be introduced in the section. The proposal clarifies that a property company means a company where 80% or more of the market value of all the assets of that company are directly or indirectly attributable to immovable property and a REIT or a controlled company holds at least 10% of the equity shares in that company.\(^{88}\)

5.3.2 Profit on the disposal of a financial instrument - timing

Under the current REIT legislation, the profit on the disposal of a financial instrument, except the disposal of an interest in a REIT/CPC, is considered to constitute ordinary revenue in the hands of the REIT.

It is proposed\(^{89}\) that, concerning timing, this rule should only apply to the disposal of a financial instrument by a company that qualifies as a REIT or a controlled company at the end of the relevant year of assessment. This is in line with the legislation’s intention to encourage REITs to invest only in rental earning property (for the ultimate benefit of the investors) with little other investments and to discourage REITs to invest largely in financial instruments such as derivatives.

\(^{87}\)Draft Taxation Laws Amendment Bill 2013, issued on 4 July 2013
\(^{88}\)It is noted that the Taxation Laws Amendment Bill No 39 of 2013 deleted the reference to the 10 holding and incorporates the definition of an APC.
\(^{89}\)Draft Taxation Laws Amendment Bill 2013, issued on 4 July 2013
This timing clarification will ensure that the tax treatment does not apply just because a company qualifies as a REIT for a moment during the year of assessment.

Additionally, an exception exists to the rule relating to the determination of a REIT’s income where the disposal relates to an interest in a REIT/CPC, the profit on the disposal is not considered to be ordinary revenue. In this regard it has been proposed\(^\text{90}\) that this exception shall apply only if the company in which the interest is disposed of is a REIT or a controlled company at the time of the disposal. Thus, where for example a REIT (company A) disposes of an interest in a controlled company (company B) the profit on the disposal would not be considered to be revenue in the hands of company A if company A still qualifies as a REIT at the end of the relevant year of assessment and company B was a controlled company at the time of disposal.

### 5.3.3 Capital gains exemption – immovable property

Another proposed amendment\(^\text{91}\) seeks to clarify that the capital gains exemption will apply to a REIT or a controlled company, if that company qualifies as a REIT or a controlled company on the last day of the company’s year of assessment. This capital gains exemption applies in respect of the disposal of immovable property owned, or a share in a REIT or property company at the time the share was disposed of.

This timing clarification will ensure that the tax treatment does not apply just because a company qualifies as a REIT for a moment during the year of assessment.

### 5.3.4 Tax implications of ceasing to be a REIT

The Act does not currently mention the impact on a company where this company ceases to be a REIT/CPC.

The related proposal\(^\text{92}\) suggests a rule which provides that the REIT or controlled company’s year of assessment will end on the day that the company ceases to be a REIT or controlled company where, for example, the REIT no longer adheres to the JSE rules. Therefore, the then following year of assessment will commence on the day immediately after that company ceases...
to be a REIT or a controlled company. Accordingly, for this new year of assessment, the REIT dispensation will not be available to the company.

5.3.5 Cancellation of debentures

The current legislation also does not provide a rule regarding the treatment, for income tax purposes, of a cancellation of the debenture part of a linked unit by a REIT/CPC without compensation. Accordingly, in terms of the Draft Taxation Laws Amendment Bill 2013\textsuperscript{93}, the REIT or controlled company is considered to have capitalised the face value of the debenture to stated capital for accounting purposes (ie the debentures is converted into shares as part of the conversion process from a PLS to a REIT). The proposed amendment\textsuperscript{94} to section 25BB in this regard specifically provides that the REIT or controlled company will not be taxed in the case of such cancellation of a debenture.

Thus, in terms of the proposal\textsuperscript{95}, the cancellation would not have any income tax or capital gains tax effect in terms of the rules relating to the reduction or cancellation of debt. It has further been proposed that the cancellation of the debenture be disregarded by the debenture holder and that the expenditure incurred by the shareholder of the REIT in respect of the acquisition of the shares be equal to the amount of the expenditure incurred in respect of the acquisition of the linked unit. Therefore, the base cost of the shares in the REIT or controlled company held by the investor (shareholder of the REIT), will, in terms of the proposal, remain unchanged for purposes of the conversion process. This is a welcome clarification, as previously there was uncertainty as to how the REIT and investor should account for this from an income tax point of view.

5.4 Conclusion

It is clear that the South African REIT regime still has room for improvement on the practical issues which a REIT or the investor in a REIT may encounter.

Going forward, consideration must be given to the following areas of the REIT legislation:

\textsuperscript{93} Issued on 4 July 2013
\textsuperscript{94} Draft Taxation Laws Amendment Bill 2013, issued on 4 July 2013
\textsuperscript{95} Draft Taxation Laws Amendment Bill 2013, issued on 4 July 2013
• Potentially extend the REIT dispensation to include unlisted entities, such as private companies with significant sized property portfolios;

• Foreign investors will require clarity on the (deemed) dividend received on the debenture portion of the linked unit in a REIT for purposes of DTA interpretation, to determine whether the receipt is interest (legal nature) or a dividend (for South African tax purposes); and

• Based on current legislation, it is also important that the REIT, at all times, carefully monitors the 75% rental income threshold, to be eligible for the qualifying distribution, to ensure that investors’ returns are not (negatively) impacted by an additional layer of tax in the hands of the REIT.

It should be noted, however, that the changes proposed by National Treasury following the very recent introduction of REIT legislation to South Africa show good commitment from National Treasury in ensuring the tax dispensation for South African REITs is suitable for its intended purpose.
6 CONCLUSION

6.1 Practical Issues Relating to the Taxation of REITs in South Africa

In 2007, National Treasury (2007:5) described the South African property investment sector as “fragmented, only partly regulated and the regulatory framework is too restrictive and not internationally competitive”. At the time, the South African tax legislation did not cater for the internationally known REIT regime. This appeared to be to the disadvantage of the South African property investment sector, as the PUT and PLS company were not generally recognised property investment vehicles, from an international perspective, and therefore these property investment vehicles were not suitable to attract foreign investment.

As a consequence, the need arose to bring the South African tax legislation in line with internationally accepted REIT systems.

During the process of drafting the South African REIT tax legislation, National Treasury held discussions with members of the South African listed property sector, as well as international associations like NAREIT and EPRA. It appears that National Treasury consulted with experts familiar with the US and UK REIT regimes, to gain knowledge and to share experience from theses well established REIT regimes, regarding establishing a REIT tax dispensation for South Africa.

South Africa (finally) introduced REIT tax legislation for years of assessment commencing on or after 1 April 2013, to align itself with the international recognised system.

This was a welcome change to the previously existing regime and shows that National Treasury was serious about implementing changes to overcome the tax inconsistencies which existed between the PUTs and PLS companies in an attempt to make eligible property investment companies internationally competitive and to attract foreign investment.

However, a review of the new South African REIT dispensation, which is discussed above in Chapters 3 and 4, reveals that although the REIT legislation is designed to give certainty to the tax treatment at REIT and at investor level, there are currently some practical tax issues that may be encountered both at REIT and at investor level.
Chapter 5 seeks to provide some suggestions and possible solutions for these issues and it is clear that the South African REIT regime still has room for improvement on these practical tax issues. On 4 July 2013, National Treasury released the Draft Taxation Laws Amendment Bill 2013, with a number of technical corrections to the current REIT tax legislation. As at 4 October 2013, these amendments were not yet finalised, but they indicate that National Treasury is showing commitment and works with industry role-players to improve the current REIT tax regime. This will assist South Africa to create a world-class REIT tax dispensation, which will also support the South African listed property investment sector. Regarding one of the industry’s major role players, ie Growthpoint, it has already been reported that (Hedley, 2013b) “the recently introduced real estate investment trust (REIT) legislation in SA strengthened Growthpoint’s investment case to foreign investors.”

Further to this, it was said (Cairns, 2012) in December 2012 that “if all the property companies currently listed on the JSE adopt the REIT structure, South Africa will boast the eighth largest REIT market in the world. The biggest counter, Growthpoint, could become the largest emerging market REIT and the 40th largest overall”. Whether this will become true in the near future remains to be seen, but the introduction of the South African REIT tax dispensation is definitely a step in the right direction to assist the South African listed property investment sector in doing so.

6.2 Recommendations

Based on the analysis of the South African REIT tax dispensation performed in this dissertation, the following recommendations are proposed regarding some of the points identified:

- Consideration needs to be given to extend the REIT tax legislation to unlisted entities (such as private companies with significant sized property portfolios) to ensure that unlisted real estate investment vehicles do not receive detrimental tax treatment compared to the listed equivalents. At this stage it is not clear what body would be suitable to be used for governing or regulating unlisted real estate investment vehicles. However, as discussed in 5.2.1, National Treasury may wish to follow the same route as the US REIT regime and require unlisted real estate investment vehicles to be registered with the JSE, from a compliance point of view, in an attempt to regulate unlisted real estate investment vehicles.
in the same manner as listed REITs and to protect investors from fraudulent investment schemes.

- As discussed in 5.2.5.2, it is recommended that consideration be given to introducing specific rules concerning pre-existing losses for REITs to clarify whether these can be carried forward by the REIT once it has obtained REIT status.

- In addition, as set out in 5.2.7 above, it may be in the foreign investor’s best interest (from a tax point of view), that all REITs are required to have a share capital structure only (ie linked units must be converted to shares) in order for these dividends to be treated in terms of Article 10 of the OECD Model Tax Convention, to avoid the issue of double taxation. Alternatively, where these linked units are not converted to a simple share capital structure, the legislation needs to clarify the nature of the dividend distribution received from the REIT as either interest (legal nature) or a dividend (for South African tax purposes).

### 6.3 Areas of further research

Areas for further research, some of which may already be being looked into by National Treasury, may provide a basis to improve the current REIT tax dispensation even further, in order to streamline it and to adapt it to continuously changing economic and commercial requirements. Below, some potential areas for further research relating to the South African REIT tax regime are set out:

- Performing a review of the nature of the dividends received by foreign investors from a REIT which has not yet converted its linked units to a simple share capital structure, in terms of the OECD Model Tax Convention, to give clarify for purposes of DTA interpretation. The review could also include an analysis of the DTAs entered into by South Africa to identify areas of improvement to specifically cater for REITs.

- Significant research would be required to develop a tax dispensation system for unlisted real estate investment property vehicles in South Africa. As stated above, it is recommended that National Treasury considers the relevant provisions contained in the US REIT legislation. However, there is a need for research into the suitability of this for the South African environment, both from a legal and from a commercial/practical perspective. Particularly
the regulatory aspect, ie which body could assist with governing unlisted real estate investment vehicles in South Africa needs special consideration.
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