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TAX & EXCHANGE CONTROL **ALERT**

IN THIS **ISSUE**

New legislation to be introduced to address the mismatch in respect of the taxation of foreign dividends received by REITs: A disincentive for REITs to invest offshore?

In essence, real estate investment trusts (REITs) are treated as conduits through which the income they derive, flows to their shareholders. The main advantage of a REIT is therefore that a deduction of the distribution made by the REIT to its shareholders may be claimed against its income provided that it is a qualifying distribution. By nature, REITs distribute most of their income to their shareholders and will usually pay little or no income tax on the distributions, instead shareholders will be liable to pay income tax on the distributions received from REITs. REITs are, however, taxed on the taxable income they retain at the standard corporate tax rate.

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New legislation to be introduced to address the mismatch in respect of the taxation of foreign dividends received by REITs: A disincentive for REITs to invest offshore?

The 2020 Budget Speech, delivered by the Minister of Finance, contained various tax policy proposals including those aimed at refining the REITs tax regime.

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The 2020 Budget Speech, (Budget) delivered by the Minister of Finance, (Minister) contained various tax policy proposals including those aimed at refining the REITs tax regime. These proposals include clarifying the definition of REITs and clarifying the meaning of a share in the definition of REITs. For a discussion of these proposals see our Special Edition Budget Speech Alert 2020 of 26 February 2020. The Budget also proposed amending the provisions regarding the taxation of foreign dividends received by REITs and this article unpacks this proposal in a little more detail.

Legislative framework and key definitions

In terms of the Income Tax Act 58 of 1962 (Act), a REIT is defined as a company that is a resident, the shares of which are listed on an exchange as defined in section 1 of the Financial Markets Act 19 of 2012 (Financial Markets Act) and are listed as shares in a REIT as defined in the listing requirements of an exchange approved in consultation with the Minister. Section 25BB(2)(a) of the Act, provides that there must be deducted from the income (for a year of assessment of a REIT or controlled company that is resident), the amount of any "*qualifying distribution*" made by that REIT or "*controlled company*" (being a subsidiary of a REIT for IFRS purposes) during that year of assessment.

A "*qualifying distribution*" in respect of a year of assessment for a company that is a REIT (as at the end of the year of assessment), means any dividend paid or payable or interest incurred in respect of a debenture forming part of a linked unit in that company. Importantly, the dividend paid, or interest incurred in respect of a debenture must be determined with reference to the financial results of that company as reflected in the financial statements prepared for that year of assessment. Where that year of assessment is the first year of assessment,

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The definition of *"qualifying distribution"* excludes a dividend contemplated in paragraph (b) of the definition of *"dividend"*, being any amount other than a dividend consisting of a distribution of an asset in specie declared and paid, transferred or applied by a company that is resident for the benefit of or on behalf of any person in respect of any share in that company whether that amount is transferred or applied as consideration for the acquisition of any share in that company.

at least 75% of the gross income received by or accrued to the REIT must consist of rental income and in any other case (i.e. in subsequent years), at least 75% of the gross income received by or accrued to the REIT in the preceding year of assessment must consist of rental income. *"Rental income"* not only includes the normal concept of rental income (i.e. any amount received by or accrued to a person in respect of the use of immovable property), but the defined term in section 25BB(1) has an expanded definition and it includes, amongst others; any amount received or accrued as a dividend or foreign dividend from a company that is a property company at the time of that distribution and any amount received as a dividend from a REIT. Importantly, it now also includes any foreign exchange differences arising in respect of an *"exchange item"* relating to a *"rental income"* of a REIT or a controlled company. Please see our previous Tax & Exchange Control Alert where this amendment was discussed.

The definition of *"qualifying distribution"* excludes a dividend contemplated in paragraph (b) of the definition of *"dividend"*, being any amount other than a dividend consisting of a distribution of an asset in specie declared and paid, transferred or applied by a company that is resident for the benefit of or on behalf of any person in respect of any share in that company whether that amount is transferred or applied as consideration for the acquisition of any share in that company. This essentially excludes a dividend constituting a share buy-back from a qualifying distribution. This is because a dividend constituting a share buy-back is exempt from normal tax in terms of section 10(1)(k)(i) of the Act and therefore a REIT is not allowed to deduct it as part of a qualifying distribution.

A *"property company"* means a company in which 20% or more of the equity shares or linked units are held by a REIT or a controlled company, (whether alone or together with any other company forming part of the same group of companies as that REIT or that controlled company) in respect of which, at the end of the previous year of assessment, 80% or more of the value of the assets reflected in the annual financial statements is directly or indirectly attributable to immovable property. The importance of this definition will emerge below.

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Generally, domestic dividends received by or accrued to a resident holder of shares are exempt from normal tax under section 10(1)(k)(i) of the Act.

Tax treatment of local dividends received by REITs

Generally, domestic dividends received by or accrued to a resident holder of shares are exempt from normal tax under section 10(1)(k)(i) of the Act. In terms of this section, dividends received by or accrued to any person shall be exempt from normal tax, subject to numerous provisos. This means that generally, when a REIT receives a dividend, that dividend is exempt from normal tax. Subparagraph (aa), however, provides that a dividend distributed by a company that is a REIT (or controlled company) is not exempt from normal tax. Therefore, when a REIT receives a dividend from another REIT (or controlled company) it will not be exempt from normal tax in terms of subparagraph (aa) and will thus be subject to normal income tax in the hands of the REIT recipient.

A REIT can make a qualifying distribution with reference to amounts that comprise dividends or foreign dividends from resident and non-resident "*property companies*" respectively and will receive a full deduction from its income of the amount of the distribution, provided it meets the requirements of a qualifying distribution. The amount allowed as a deduction is limited in terms of section 25BB(2)(b), which provides that the aggregate amount of the deduction may not exceed the taxable income for that year of assessment of that REIT before taking into account deductions in terms of section 25BB, any assessed loss brought forward in terms of section 20 and any taxable capital gain included in income in terms of section 26A of the Act.

For practical purposes, where a REIT receives a dividend from a resident property company (not comprising another REIT or controlled company) that dividend will be included in the gross income of the REIT. The dividend will, however, qualify for an exemption from normal tax under section 10(1)(k)(i). If that REIT makes a qualifying distribution (i.e. an amount determined with reference to, *inter alia*, the dividend received from the property company), it will effectively receive a deduction of that amount to the extent that it does not exceed the taxable income of the REIT.

If the shareholder of the REIT is a resident company, the dividend from the REIT is included in the income of the shareholder in terms of subparagraph (aa) and is subject to normal tax. In terms of section 64F(1)(l), the dividend paid by the REIT to the resident shareholder will be exempt from dividends tax since the dividend is required to be included in the income of the resident. Where the shareholder of the REIT is a non-resident, the dividends received or accrued to that person are exempt from normal tax. These dividends are, however, subject to dividends tax because they do not qualify for exemption under section 64F(1)(l) as they do not constitute income in the hands of the recipient.

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National Treasury has now identified the mismatch where a REIT holding shares in a non-resident property company qualifies for a participation exemption in respect of the foreign dividends from that non-resident property company and also gets a full deduction when it distributes profits from those foreign dividends.

Tax treatment of foreign dividends received by REITs

In the case of foreign dividends, section 10B(2) provides that there must be exempt from normal tax any foreign dividend received by or accrued to a person if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend.

Therefore, where a REIT holds, say 20% of the equity shares and voting rights in a non-resident property company and foreign dividends are received by the REIT in respect of those shares, then the foreign dividend will be included in the gross income of the REIT but will be exempt from normal tax as it will fall within the participation exemption in terms of section 10B. When the REIT makes a distribution to its shareholders of the income, the distribution will constitute a qualifying distribution, and this will be deducted from its income in terms of section 25BB(2). Importantly, the foreign dividends received from the non-resident property company will fall within the REIT's rental income and will thus contribute to ensuring the REIT's gross income breaches the 75% threshold.

Not all foreign dividends received by a REIT will fully benefit from this scenario. Where a REIT holds more than 10% of the equity shares and voting rights in a non-resident company (but less than 20%), the foreign dividends would also be subject to a participation exemption in terms of section 10B(2) of the Act, however, such foreign dividends would not constitute rental income of the REIT as the foreign dividend would not be from a property company as defined. Thus, when the REIT makes a qualifying distribution to its shareholders, the foreign dividends so received will not form part of the 75% calculation.

Mismatch and policy proposals

National Treasury has now identified the mismatch where a REIT holding shares in a non-resident property company qualifies for a participation exemption in respect of the foreign dividends from that non-resident property company and also gets a full deduction when it distributes profits from those foreign dividends.

It would appear that National Treasury has identified that the tax effect is that the REIT receives a double benefit in respect of the same amount. In other words, foreign dividends may fall within the section 10B(2) participation exemption,

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Interestingly, although the same mismatch occurs with respect to local dividends received by or accrued to REITs, it appears that National Treasury seeks to remedy the position in respect of foreign dividends only.

thereby being exempt from normal tax and the REIT potentially receives a full deduction in respect of an amount determined with reference to the foreign dividend when it makes a qualifying distribution. This means that the REIT's tax position is no longer neutral as the foreign dividend escapes taxation altogether in the hands of the REIT.

In Annexure C of the 2020 Budget Review, National Treasury proposes that the legislation be amended so that the full foreign dividend is subject to tax if the recipient company is a REIT. This would address the mismatch that occurs when a participation exemption and a deduction is effectively granted in respect of the same amount when the REIT makes a qualifying distribution. The proposal may, however, not be an issue given the flow through principle. In other words, to the extent that the REIT distributes the foreign dividend to its shareholders it may still be able to claim a qualifying distribution deduction against its income with reference to that foreign dividend.

Interestingly, although the same mismatch occurs with respect to local dividends received by or accrued to REITs, it appears that National Treasury seeks to remedy the position in respect of foreign dividends only. While the next round of amendment bills detailing the proposed amendments are only expected later in the year, relevant stakeholders would do well to monitor developments in this regard.

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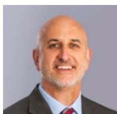

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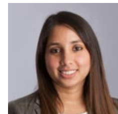

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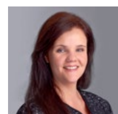

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