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TAX & EXCHANGE CONTROL **ALERT**

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Key proposed amendments to the Real Estate Investment Trust (REIT) tax regime

The 2019 Draft Taxation Laws Amendment Bill (Draft TLAB) proposes key amendments to the Real Estate Investment Trust (REIT) taxation regime. In particular, the proposed amendments provide clarification of the definition of "rental income" in the REIT tax regime in respect of foreign exchange differences and also clarify the interaction between the corporate reorganisation rules and the REIT tax regime.

In alignment: Proposed amendments pertaining to amalgamation transactions

The Income Tax Act, No 58 of 1962 (IT Act) provides for corporate roll-over relief in respect of the transfer of assets between companies that form part of the same economic unit, as well as those transfers made to shareholders who are natural persons.

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Key proposed amendments to the Real Estate Investment Trust (REIT) tax regime

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The 2019 Draft Taxation Laws Amendment Bill (Draft TLAB) proposes key amendments to the Real Estate Investment Trust (REIT) taxation regime. In particular, the proposed amendments provide clarification of the definition of "rental income" in the REIT tax regime in respect of foreign exchange differences and also clarify the interaction between the corporate reorganisation rules and the REIT tax regime.

Clarification of the definition of "rental income" in the REIT tax regime

The dedicated taxation regime provided for in the Income Tax Act, No 58 of 1962 (Act) relating to REITs, makes provision for a flow-through principle in respect of income and capital gains to be taxed solely in the hands of the investor of the REIT and not in the hands of REIT itself. In turn, a REIT may claim distributions to its investors as a deduction against its income. This deduction may only be claimed if a distribution is considered a "qualifying distribution", which, amongst others requires more than 75 per cent of the gross income of a REIT to consist of "rental income".

The term "rental income" is defined in s25BB(1) of the Act to mean various amounts received and/or accrued to a REIT including most importantly an amount received and/or accrued in respect of the use of immovable property (ie rental income).

Given South Africa's stagnating economy and the desire for South African REITs to diversify their investments, many South African REITs have invested (and continue to invest) in real estate outside of South Africa. Given these investments, many REITS enter into foreign exchange derivative contracts for purposes of hedging themselves against fluctuations in the highly volatile South African Rand.

National Treasury has, however, identified that unrealised foreign exchange gains or losses arising from the foreign exchange derivative contracts of a REIT do not qualify as "rental income" of a REIT, even though they are incurred solely for the earning of such "rental income". Instead, such gains/losses are, in terms of paragraph (n) of the definition of "gross income" in s1, read with s24I(3) of the Act, taken into account in determining the taxable income of such REIT.

In order to address this anomaly, National Treasury thus proposes that changes be made to the definition of "rental income" in s25BB of the Act to include any foreign exchange gains and deduct foreign exchange losses arising in respect of an "exchange item" relating to the "rental income" of a REIT (or its subsidiary). The proposed s31 of the Draft TLAB thus contemplates two new insertions under the definition of "rental income" namely an "exchange gain" (EG) and an "exchange loss" (EL) which will be incorporated into the formula to calculate "rental income" for any REIT's relevant year of assessment.

Key proposed amendments to the Real Estate Investment Trust (REIT) tax regime...*continued*

National Treasury has identified an issue regarding the interaction of the anti-avoidance measures contained in the corporate reorganisation rules and the provisions of s25BB(5) of the REIT tax regime.

Clarification of the interaction between the corporate reorganisation rules and REIT tax regime

National Treasury has further identified an issue regarding the interaction of the anti-avoidance measures contained in the corporate reorganisation rules and the provisions of s25BB(5) of the REIT tax regime.

The Explanatory Memorandum on the Draft TLAB (Memorandum) states that in certain instances, if immovable property is disposed of by a REIT within 18 months after the implementation of the relevant corporate reorganisation, the anti-avoidance measures contained in the corporate reorganisation rules require that the rolled over capital gain in respect of such immovable property be added to the taxable capital gain of the REIT for the year of assessment in which the disposal of the immovable property takes place. On the other hand, s25BB(5) of the REIT tax regime provides for a capital gains tax exemption in respect of disposals of certain immovable property by a REIT.

The anti-avoidance measures contained in the corporate reorganisation rules, when read with the provisions of s25BB(5) of the REIT tax regime, create a discrepancy given that in general, corporate reorganisation rules override the provisions for the taxation of REITs in s25BB of the Act.

National Treasury thus proposes that in order to ensure that the rules for the REIT tax regime are aligned with the corporate reorganisation rules, amendments should be made in the tax legislation so that corporate reorganisation rules do not give rise to capital gains tax on disposal of assets within 18 months after their acquisition by a REIT under a corporate reorganisation rule.

Conclusion

The issues identified by SARS regarding the REIT tax regime and the proposed amendments aimed at clarifying the issues are likely to be welcomed in the real estate industry.

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In alignment: Proposed amendments pertaining to amalgamation transactions

The provisions of s41 outlining the steps to be taken by such a company do not have regard to the provisions of s116(5)(b) of the Companies Act.

The Income Tax Act, No 58 of 1962 (IT Act) provides for corporate roll-over relief in respect of the transfer of assets between companies that form part of the same economic unit, as well as those transfers made to shareholders who are natural persons. In order to avoid the abuse of these provisions, the legislature has incorporated numerous requirements and anti-avoidance provisions into the IT Act that must be adhered to in order for taxpayers to qualify for the relief.

However, an incongruency exists between the provisions of the Act and the operation of the Companies Act, No 71 of 2008 (Companies Act) in respect of specific types of transactions, as a result of which an amendment to the IT Act has been proposed in the 2019 Draft Taxation Laws Amendment Bill (Draft TLAB).

The incongruency

Section 44 of the IT Act, dealing with amalgamation transactions, and s47, dealing with transactions relating to the liquidation, deregistration or winding up of a company, both require that a company entering into a s44 or s47 transaction, whose existence is intended to cease must, within 36 months after the date of the transaction, take any of the steps contained in s41(4) of the IT Act to liquidate, wind-up or deregister the company. The failure to do so would prohibit the parties to the transactions from benefiting from the roll-over relief provided for in s44 and s47.

However, the provisions of s41 outlining the steps to be taken by such a company do not have regard to the provisions of s116(5)(b) of the Companies Act. This section in the Companies Act provides for the deregistration of a company by operation of law once a notice of amalgamation or merger has been furnished to the Companies and Intellectual Property Commission (CIPC).

As s41 does not provide for the deregistration of a company in terms of s116(5)(b) of the Companies Act, it has resulted in certain amalgamation transactions being excluded from the tax relief provided for in the IT Act.

In alignment: Proposed amendments pertaining to amalgamation transactions...*continued*

While the proposed amendment to s41(4) has not yet been made final, the change will be welcomed by many taxpayers who are party to statutory amalgamation or merger transactions.

The proposed amendment and reason for change

The Draft TLAB proposes an amendment to s41(4)(b) of the IT Act, which describes the steps that may be taken by a company in order for the company to be regarded as having taken steps to deregister. Specifically, it has been proposed that the scope of the steps to be taken to deregister a company be broadened to include the deregistration of a company by operation of law in terms of s116 of the Companies Act. The Explanatory Memorandum to the Draft TLAB explains that the change is necessary in order to ensure that statutory amalgamations and mergers are not unfairly excluded from benefitting from the tax neutral transfer of assets in terms of the IT Act.

Comment

While the proposed amendment to s41(4) has not yet been made final, the change will be welcomed by many taxpayers who are party to statutory amalgamation or merger transactions. It is also preferred that South African statutes work in conjunction with each other.

We remind our readers that the public now has the opportunity to submit comments regarding this proposed amendment to National Treasury and the South African Revenue Service before 23 August 2019.

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