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TAX & EXCHANGE CONTROL ALERT

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REVIEWING THE REAL ESTATE INVESTMENT TRUST TAX REGIME

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REVIEWING THE REAL ESTATE INVESTMENT TRUST TAX REGIME

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The Real Estate Investment Trust (REIT) tax regime in South Africa was addressed for general review in Annexure C. Annexure C also referred to the implementation of the Financial Sector Regulation Act, No 9 of 2017 and the establishment of the Financial Sector Conduct Authority (FSCA) which provide for the regulation of unlisted REITs, as it is proposed that "government consider the regulation and tax treatment of unlisted REITs that are widely held or held by institutional investors, in line with the announcement in the 2013 Budget Review".

The "inconsistencies" in the current REIT tax regime have also been highlighted in Annexure C, particularly with regard to "the definition of rental income applied to foreign exchange differences", as well as "the interaction between the REIT tax regime and corporate reorganisation rules".

REIT Refresher

A REIT is a company that owns and operates income-producing immovable property. Until recently, the definition of a REIT in the Income Tax Act, No 58 of 1962 (Act) referred to a company that is a South African tax resident whose shares are listed on the JSE as shares in a REIT, as defined in the JSE Limited Listing Requirements. Pursuant to the promulgation of the Taxation Laws Amendment Act, No 23 of 2018 (TALA), the definition of a REIT was extended to include companies with shares listed on an exchange as shares in a REIT, as defined in the listing requirements of an exchange approved in consultation with the Minister and published by the FSCA, in terms of s11 of the Financial Markets Act, No 19 of 2012 (FMA). Governed by s25BB of the Act, and introduced in South Africa with effect from 1 April 2013, a REIT, and a "controlled company" as defined, may deduct for income tax purposes the qualifying distributions made to its shareholders. The deduction set out in s25BB aims to provide REIT investors with steady rental income and capital growth in the underlying properties.

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It is common for South African REITs to own commercial property ie hospitals, factories, shopping centres, office buildings, hotels, factories, warehouses. Residential property and international property are owned by REITs to a comparatively lesser extent.

For taxation purposes, a REIT is a company as commonly understood or may be deemed to be a company, for example, a portfolio of a collective investment scheme in property that qualifies as a REIT is deemed to be a "company". Provided that they comply with JSE Limited Listings Requirements, shares in REITs are listed and publicly traded on the Johannesburg

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Stock Exchange (JSE). Pursuant to the promulgation of the TALA, the same will apply to the shares of a REIT listed on an exchange approved in consultation with the Minister and published by the FSCA, in terms of s11 of the FMA. The shares of the REIT must be listed as shares in a REIT as defined in the listing requirements of an exchange approved in consultation with the Minister and published by the FSCA in terms of s11 of the FMA, at s1(1) of paragraph (*b*)(ii) of the definition of REIT, so that the REIT will qualify as a REIT for income tax and CGT purposes. A REIT and a controlled company must also consider dividends tax (in the case of foreign income), transfer duty, securities transfer tax and VAT.

Tax Neutral

Practically, a REIT is a conduit through which net property income flows to investors. In this way, as a result of this 'flow through' principle, the investors are subject to tax on income received from the REIT, while the REIT itself will be taxed on taxable income retained at the standard corporate tax rate. As a REIT by its nature distributes most of its net income to its investors, the REIT usually pays little or no income tax and the shareholder will instead pay income tax on the distributions received from the REIT. REITs are therefore effectively allowed to operate on a tax neutral basis. Moreover, it must be noted that a REIT is not subject to capital gains tax in respect of properties that it disposed of, and dividends declared by a REIT to South African shareholders are not exempt, but are in fact part of the shareholders' taxable income.

Rental income & foreign exchange differences

A distribution by a REIT is only deductible if it falls within the definition of 'qualifying distribution' in s25BB(1) of the Act. Notably, to fall under the definition, at least 75% of the gross income of the REIT (or a controlled company in relation to the REIT) during its first year of assessment must consist of rental income or, in any other case, at least 75% of the gross income of a REIT or a controlled company in the preceding year of assessment must have consisted of rental income.

The term 'rental income' is therefore of utmost importance within the REIT regime and is defined in s25BB(1) of the Act, as any amount received or accrued to a REIT or controlled company for the use of immovable property (including any penalty or interest charged on the late payment of such amount), or for any dividend, other than a share buy-back, from a company that is a REIT at the time of the distribution of that dividend, or for a qualifying distribution from a company that is a controlled company at the time of that distribution, or for a dividend or foreign dividend from a company that is a property company at the time of that distribution, or for an amount recovered or recouped under s8(4) in respect of an amount of an allowance previously deducted per relevant sections in the Act.

It appears that Annexure C highlights the concern that qualifying distributions may be fettered by the lack of clarity surrounding the definition of rental income insofar as this has been shown to overlap

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with foreign exchange differences resulting from currency fluctuations. Of particular concern is the impact of s24I of the Act, which governs the income tax treatment of exchange gains or losses made in respect of both realised and unrealised foreign exchange transactions. This provision requires that certain taxpayers include or deduct from their income the exchange differences arising from exchange items (foreign currency, foreign denominated debt [eg bonds], forward exchange contracts [FEC] and foreign currency option contracts [FCOC]) ie exchange gains or losses will be taken into account for tax purposes, whether they have realised or not, and be taxed at the normal rate of tax at which any other income is taxed. Section 24I may become relevant to REITs where foreign currency fluctuations result in unrealised exchange differences after foreign rental income is generated from investing offshore. In such instances, the amount of capital gains tax to be paid will be impacted by the type of investment structure utilised.

Listed vs Unlisted

Initially, the provisions of s25BB of the Act (and other related provisions) only applied to listed REITs, which required that, *inter alia*, the REIT own property with a value in excess of R300 million, maintain its debt below 60% of its gross asset value, earn 75% of its income from rentals; and distribute 75% of its taxable earnings available for distribution each year. As part of the 2015 Budget, however, the Minister announced that unlisted property-owning companies should qualify for the same tax treatment as listed REITs, provided that they become regulated. At this time, the Minister indicated that the regulations governing unlisted property companies would still have to be developed, with the unlisted property company sector no doubt eager for regulations to be finalised and circulated for public comment. Though it had been contemplated that, if the REIT regime were to mimic the JSE Limited Listing Requirements, reporting requirements, specific debt gearing ratios and minimum distribution limits were to be expected, it appears from Annexure C of the 2018 Budget that the implementation of the Financial Sector Regulation Act, No 9 of 2017 and the establishment of the FSCA (which currently caters for the regulation of unlisted REITs) must be considered in the future regulation of unlisted REITs and the inclusion of unlisted REITs in the Act's regime.

REITs & Restructure

The nature of REITs ties the regime intrinsically to the corporate restructuring rules at s41 to s47 of the Act. The REIT regime has an impact on tax considerations surrounding, for example, asset-for-share transactions, substitutive share-for-share transactions, amalgamation transactions, intra-group transactions, unbundling transactions and transactions relating to liquidation, winding-up and deregistration. Demonstrative of the potential complications that arise is in respect of a transaction in terms of s42 of the Act where roll-over relief is provided for a disposer of assets who acquires a qualifying interest in the company which has acquired the disposer's assets. In the context of a listed entity such as a REIT, a single equity share issued to the disposer could potentially suffice.

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A further example of the effect of the restructuring rules on the REIT regime is in circumstances where REITs are party to merger and acquisition transactions, as s46(6A) of the Act specifically excludes a REIT or 'controlled company' from obtaining any tax relief under s46 when unbundling any shares held in another company. Consequently, as an example, any *in specie* distribution received from a REIT or controlled company is subject to tax. Section 47 of the Act further highlights the manner in which the treatment of REITs must be specifically considered as, whilst a liquidation distribution is exempt from income tax as a consequence of the normal s10(1)(k) dividend exemption, to the extent that it is a 'REIT' or a controlled company which is being liquidated, the dividend exemption in the hands of the recipient will not apply and the 'liquidation distribution' is subject to tax.

As such, in practice, and in order to maintain tax transparency, a REIT or controlled company is required to "on distribute" any amounts received from other REITs or controlled companies in terms of a liquidation distribution or an unbundling transaction, failing which tax consequences may arise. As previously mentioned, per s25BB of the Act, REITs must distribute 75% of their taxable earnings available for distribution each year. Furthermore, it is likely that in most instances the 'liquidation distribution' or *in specie* distribution arising from an unbundling transaction would be capital in nature.

Whilst the Minister has said in the Budget that "we need to free our entrepreneurs from stifling regulations and complicated taxes", the corporate restructure rules in the Act inevitably affect REITs at various stages and with various consequences, which result in precisely the complicated transactions and tax implications that the Minister would like to avoid.

Annexure C certainly makes no promises in respect of the tax treatment of REITs for 2019, however, entrepreneurs and investors may take comfort in the specific consideration that the Minister has indicated will be paid to reviewing the REIT provisions.

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