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COVID-19 and the resultant impact on the distribution obligations of Real Estate Investment Trusts (REITs)

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The nationwide lockdown following the Covid-19 outbreak has undoubtedly impacted the property sector in South Africa and around the world. The challenges which accompany the virus and the resultant lockdown have affected the ability of companies, who have been granted REIT-status, to meet their obligations under the JSE Limited's Listing Requirements ("**Requirements**").

Distribution obligations under the Requirements

REITs are companies which own and operate income-producing immovable property. Certain criteria, set out in paragraph 13.46 of the Requirements, must be met by an applicant issuer in order to obtain REIT status from the Johannesburg Stock Exchange ("**JSE**"). Furthermore, in order to retain REIT status, further criteria set out in paragraph 13.49 of the Requirements must continuously be complied with. REITs are also the subject of a favourable tax dispensation under the Income Tax Act No 58 of 1962 (as amended) ("**ITA**").

One obligation which is of particular importance is contained in paragraph 13.49(a) of the Requirements, and deals with the continuing requirement to comply with the provisions relating to distributions pursuant to paragraph 13.47 of the Requirements. In turn, paragraph 13.47 of the Requirements states that -

"(a) the company must distribute at least 75% of its total distributable profits as a distribution to the holders of its listed securities (which includes shares and linked units) by no later than four months after its financial year end, subject to the relevant solvency and liquidity test as defined in the Act and applied in section 46 of the Act;

(b) interim distributions may occur before the end of a financial year end;

(c) the company will procure that, subject to the solvency and liquidity test and section 46 of the Act, those of its subsidiaries that are property entities incorporated in the Republic of South Africa will distribute at least 75% of their total distributable profits as a distribution by no later than four months after their financial year ends; [and]

(d) distributable profit in respect of a financial year is defined as:

(i) gross income, as defined in terms of the Income Tax Act;

(ii) less deductions and allowances that are permitted to be deducted by a REIT in terms of the Income Tax Act, other than the qualifying distribution, (as defined in terms of section 25BB of the Income Tax Act because qualifying distributions form part of distributable profit)."

As seen above, one of the requirements to maintain REIT status is the payment by the issuer of at least 75% of its taxable earnings available for distribution to investors as dividends, giving investors certainty that net income will be paid out. This must be done no later than four months after the REIT's financial year end.

Ordinarily, if a REIT fails to comply with this requirement, it will be at risk of having its REIT status revoked by the JSE, pursuant to paragraph 13.50 of the Requirements. However, the obligation to make the distribution in terms of paragraph 13.47(a) of the Requirements is explicitly subject to the REIT satisfying the solvency and liquidity test set out in the Companies Act No 71 of 2008 (as amended).

Therefore, if the REIT fails to make the required distribution within four months of its financial year end, and such failure is as a result of the REIT failing to satisfy the solvency and liquidity test in relation to that distribution, then such failure will not result in the revocation of its REIT status.

However, the appeal of a REIT lies in its favourable tax treatment, which is linked to another significant continuing obligation in paragraph 13.49(b) of the Requirements which states that -

"(b) the applicant issuer must -

(i) qualify for a tax deduction of an amount equal to its distributions under section 25BB(2) of the Income Tax Act for the immediately preceding financial year end; or

(ii) must not have failed the REIT tax test for the last 2 consecutive financial year ends;".

Where the distribution meets the requirements of a 'qualifying distribution' in terms of section 25BB of the ITA, it will be deductible by the REIT for income tax purposes. Given the fact that REITs distribute most of their net income to their shareholders, REITs pay very little income tax, and it is the shareholders instead who pay income tax on receipt of such distributions. In order for the distribution to constitute a 'qualifying distribution', at least 75% thereof must consist of rental income. In the light of the government-imposed lockdown, and the closure of all non-essential businesses across the country such as retailers in large shopping centres, the future rental income stream for REITS does not look promising. Accordingly, a significant consequence flowing from the non-payment of the distributions required in terms of paragraph 13.47(a) of the Requirements, is that REITs may not qualify for a tax deduction of distributions under section 25BB(2) of the ITA, thus resulting in a loss of the favourable tax treatment afforded to REITs under the ITA.

Concerns in meeting continuing obligations

If a REIT is otherwise concerned about meeting any of its continuing obligations under paragraph 13.49 of the Requirements, it should immediately consult with the JSE. In this regard, on 25 March 2020, the JSE issued a letter urging all issuers, in consultation with advisors or sponsors, to assess the impact of the Covid-19 outbreak on its ability to comply with the applicable requirements and the effect thereof on its REIT status. If there are any concerns in meeting such obligations, issuers are able to consult with the JSE.

Submissions must be submitted on the WEBSTIR system, under the event type "Ruling – Continuing Obligations". No fee will be levied for such submissions, and requests will be dealt with on an urgent basis. In order to expedite the process, sponsors are required to notify Annalie de Bruyn directly on annalie@jse.co.za of the WEBSTIR submission, with subject line "REIT Submission".

It is also worth noting that earlier this month the South African Real Estate Investment Trust Association made an urgent request to the National Treasury to provisionally relax the tax rules applicable to REITs in South Africa, including a request for a two-year reprieve from paying out dividends.

Once guidance has been received from the JSE and/or any official reprieve has been announced, REITs must take the provisions of paragraph 13.52 of the Requirements into account, which oblige an issuer with REIT status to keep the market informed regarding its tax status, by way of an announcement containing full details of the implications thereof for the issuer and its security holders, without delay.

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