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REITS – some clarification of the taxation of investment vehicles in real estate in the form of REITS and controlled companies

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A traffic standstill is rarely the result of retail specials; however, on 28 April 2016 the greater Johannesburg area had a gridlock on major highways on the opening day of a new mall. Various real estate developments are expanding the larger metropolitan cities of South Africa and investment is growing in the real estate industry. Specialised investment vehicles or products have been developed internationally and locally, and one such investment vehicle is the Real Estate Investment Trust ("REIT").

INTRODUCTION

On 13 May 2016 the South African Revenue Service ("SARS") released a draft interpretation note on the taxation of REITs and controlled companies. One of the four elements to ensure the efficacy of a tax according to Adam Smith is certainty, meaning a taxpayer can determine with ease what amounts are taxable, the applicable tax rate, and the reason for the particular type of tax. The taxation of REITs has prior to the legislation to which this draft interpretation note applies, and even to the new legislation, been a matter of interpretation by tax advisers, academics, and SARS of the various provisions in each factual circumstance. The interpretation included the applicability of various provisions such as the corporate rollover relief to REITs. Taxpayers have also been able to apply for tax rulings if a clear interpretation was required prior to concluding a transaction. The interpretation note once finalised will provide the certainty needed in the alignment of tax policy with revenue growth for the fiscus and economic development.

On the introduction of the section to create a unified taxing system for real estate investment vehicles such as REITs, Treasury indicated in the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2012, that there was a growing investor demand to invest in real estate investment vehicles and that the special features of a REIT made it a preferred investment vehicle.

Section 5 of the Tax Administration Act states that a practice generally prevailing is a practice set out in an official publication regarding the application or interpretation of a tax Act. An interpretation note does not enjoy equal weighting with a practice note, however it is an official publication regarding the interpretation of a tax Act. The draft interpretation note on REITS will become an official publication once published with a date subsequent to conclusion of the public consultation process after the end of July 2016.

The rationale for creating the REIT structure was to ensure that the taxing of returns made on these investment vehicles did not require an evaluation of substance over form of the returns on investment and that all investment vehicles were subject to regulation. The special features of a REIT are the income generated from the compulsory annual distribution, of the majority of profits, similar to interest on a loan. In addition a REIT provides the ability to raise debt against the rental income generated by the underlying immovable property.

A REIT is defined as a resident company that is listed on an exchange with its shares classified as a REIT as defined in the JSE Limited Listing Requirements. A controlled company is defined as a subsidiary of a REIT. The Explanatory Memorandum raised that although the term REIT suggests the legal form of a trust it may also take the form of a company. A portfolio of a collective

investment scheme in property may also qualify to be deemed a company if it meets all the other requirements to be considered a REIT.

To qualify as a controlled company, in essence the REIT needs to directly or indirectly hold 50% or more of the voting rights in the controlled company and have the ability to govern the financial and operating policies of the controlled company so as to obtain benefit from its activities. For controlled companies as the IFRS subsidiary definition includes a trust, a controlled company may also be a trust. An associated property company is one which is held at least 20% by a controlled company or a REIT.

Prior to the REIT structure, there were two investment vehicles providing similar benefits. The first type of investment was termed a Property Unit Trust ("PUT") and the second type was termed Property Loan Stock ("PLS"). Investors in a PUT would hold units in the trust and distributions would be taxed as ordinary revenue in the hands of investors. Investors in a PLS would hold a share in the company and a debenture, with virtually all of the value attributable to the debenture, and interest on the debentures would be taxed in the hands of the investors. Only the PUT was subject to Financial Services Board ("FSB") regulation. Investors in PLS were therefore not afforded the protections that existed for PUT investors and enjoyed interest income which was analogous to a dividend in substance. The tax policy decision was to tighten controls and take advantage of the growth in the REIT investment market for South African property companies and the development of industrial and commercial property.

GENERAL TAXATION PRINCIPLES

The general taxing principle of a REIT is the flow through principle so that income and gains are taxed in the hands of the investor and not in the REIT. Amounts received in respect of financial instruments by a REIT or a controlled company are revenue. However receipts by a REIT in respect of the disposal of immovable property, a share or linked unit in a REIT or a property company (i.e. REIT or controlled company that holds 20% or more of the equity shares or linked units in the company and, in the previous year of assessment, 80% or more of the value of the assets of the company are directly or indirectly attributable to immovable property) are only revenue if they are held on revenue account. If the immovable property, share or linked unit is held as a capital asset the capital gain is exempt from CGT.

For SA resident shareholders in a REIT, whether they are natural persons, trusts, or companies, any dividend or interest income (deemed a dividend) does not qualify for the dividend exemption and is thus subject to normal tax. For non-resident shareholders any dividend or interest income (deemed a foreign dividend) is subject to dividends withholding tax (reduced where relevant by a double tax agreement).

A REIT or controlled company can make a distribution to its shareholders from income that in the prior year was comprised 75% or more of rental income or other income from specified property entities ("qualifying distribution"). In the year of incorporation a REIT needs to meet the 75% rule in respect of its current year gross income resulting from rental income. The REIT receives the qualifying distributions from a controlled company as "rental income". A qualifying distribution by an associated property company is rental income in the hands of the controlled company or REIT.

Rental income is amounts received by or accrued to a REIT or controlled company, as follows:

- any amounts received by or accrued for the use of immovable property, including any penalty or interest charged on the late payment of such amount;
- any REIT dividend, excluding a share buy-back from a company that is a REIT at the time of the distribution of that dividend, but including interest paid on a debenture forming part of a linked unit held in a REIT;
- a qualifying distribution from a company that is a controlled company at the time of that distribution; and
- a dividend or foreign dividend from a company that is a property company at the time of that distribution.

In terms of deductions, the REIT is allowed a deduction of distributions and interest where the investment vehicle included a debenture portion linked to the units (i.e. PLS type investment vehicle). However deductions are only allowed where the REIT or controlled company made a qualifying distribution and remained a resident REIT or resident controlled company on the last day of that year of assessment. In other words, unlike ordinary companies, dividends to shareholders are deductible in determining taxable income.

Deductions are also limited to the taxable income before the inclusion of capital gains, any assessed loss carried forward and the distribution deduction. This ensures that the REIT or controlled company cannot create an assessed loss or increase an assessed loss carried forward by means of a qualifying distribution. Any qualifying distribution amount in excess of the deductible amount is forfeited.

No capital gain or loss is recognised, or no capital gains tax liability arises, in a REIT or controlled company on the disposal of immovable property, a share or linked unit in a REIT or a share in a controlled company. A REIT or controlled company cannot claim any capital allowances related to immovable property. A REIT or controlled company may still claim a depreciation allowance on assets excluding immovable property. The investors (shareholders) in a REIT will however need to include any capital gain or loss on the disposal of a share or linked unit in a REIT.

Where a REIT or controlled company is the vested beneficiary of a foreign trust, which is liable for tax in the country where it is established or formed, with no right of recovery of the tax by any person, then any foreign tax that the foreign trust is under an unconditional legal liability to pay will be available as a deduction against the income attributable to the REIT or controlled company. Any losses carried forward to a subsequent year of assessment do not qualify as a right of recovery of a tax. The foreign tax will have to be shown to be a tax on income that is substantially similar to a tax in terms of a South African tax Act. Interest, penalties, and fines are excluded from being considered taxes on income. Withholding taxes that constitute an advance payment of the foreign tax liability or that do not meet the abovementioned criteria will not be considered taxes on income.

REITs and controlled companies may deduct *bona fide* donations of up to 10% of their taxable income, after taking into account any deductions for foreign taxes, made to public benefit organisations that are authorised to provide certificates confirming the deductibility of donations. Any donations made in excess of the 10% limitation will be forfeited from being deductible.

A REIT or controlled company may be liable for capital gains tax on the disposal of assets that are not immovable property, a share or linked unit in a REIT or a share in a controlled company.

When a REIT or controlled company ceases to satisfy the requirements of their respective classifications, their year of assessment ends on that day and a new year of assessment begins on the following day. The taxing of the entity will thereafter follow the taxing principles of an ordinary trust, company, or collective investment scheme.

SPECIAL PROVISIONS

The interest on a debenture forming part of a linked unit that constitutes a hybrid debt instrument, or hybrid interest, is deemed a dividend *in specie,* is exempt from dividends tax but subject to income tax in the hands of the investor. The REIT or controlled company may be able to deduct the deemed dividend as a qualifying distribution.

The limitation of interest deductions on reorganisation or acquisition transactions using a formula applies to the interest on a linked unit issued by a REIT or controlled company from 31 December 2015.

The corporate rollover provisions in respect of substitutive share-for-share transactions apply where a share in a linked unit is disposed of and substituted for an ordinary share in the same REIT, controlled company, or property company.

The corporate rollover relief provisions applicable to companies in amalgamation transactions extend to a collective investment scheme that qualifies as a REIT (i.e. a PUT).

A REIT or controlled company does not qualify for the corporate rollover relief provisions applicable to unbundling transactions due to the unintended double taxation that would result.

There is no mention in the draft interpretation note of the following corporate rollover relief provisions: asset for share transactions, intragroup transactions or transactions relating to liquidation, winding up or deregistration. However, there seems to be no reason why these provisions cannot apply, at any rate to a REIT which is a company

The transfer of shares in a REIT is exempt from securities transfer tax. These exemptions do not extend to the transfer of shares in a controlled company which is not a REIT.

CONCLUSION

Interpretation Notes are not binding, however they provide taxpayers with an indication of the manner in which SARS will apply the taxation principles to particular types of income or amounts.

REITs provide a means of investing in immovable property and receiving annual income. The taxation of REITs takes place mainly at the level of the investor who receives dividends or interest income. The general taxation principles applied to REITs and controlled companies indicate why even though a REIT is a company it is taxed using the conduit principles of applied to trusts.

Increased clarity on the deductibility of foreign taxes, reorganisation and acquisition transactions and transfer taxes is welcomed. The absence of clarity on intragroup transactions for REITs and controlled companies does mean the draft interpretation note may change prior to becoming an official publication.

Immovable property is a major feature of national and international tax policy and therefore tax in this area will continue to develop encouraging investment and growing revenue for the fiscus.



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