

**ATTRACTING INVESTMENT INTO SOUTH AFRICAN PROPERTY
INVESTMENT VEHICLES: EVALUATING TAX**

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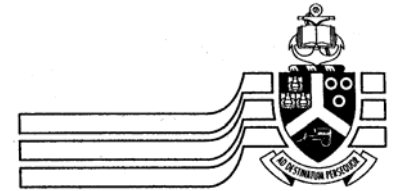
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ABSTRACT

ATTRACTING INVESTMENT INTO SOUTH AFRICAN PROPERTY INVESTMENT VEHICLES: EVALUATING TAX

by

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South African property investment vehicles consist of collective investment schemes in property (CISPs), also known as property unit trusts (PUTs) and property loan stock (PLS) companies. The application of sections 25B(1), 11(s), 10(1)(k)(i)(aa) and 64B(5)(b) of the Income Tax Act 58 of 1962 (“the Act”) and paragraph 67A(1) of the Eighth Schedule to the Act result in these property investment vehicles being taxed based on their legal form, that of a trust *versus* a company, rather than on their common purpose. The South African Revenue Service recognised these inconsistencies in the 2007/8 budget tax proposals and proposed that it be reviewed. In December 2007, National Treasury released a discussion paper on the reform of the listed property investment sector in South Africa. The discussion paper is aimed at adopting a real estate investment trust (REIT) regime in South Africa to make South African property investment vehicles more attractive to foreign investors as well as to address the current tax inconsistencies and fragmented regulation of the South African listed real estate sector. In this study, the current inconsistent tax treatment of these property investment vehicles is reviewed, both as to how they apply to the property investment vehicle and to their respective investors. This study further reviews how REITs in selected other countries are regulated and taxed and National Treasury’s proposals as to how REITs applicable in South Africa should be regulated and taxed.

Keywords: property investment vehicles, real estate investment trust (REIT), tax legislation, collective investment scheme in property (CISP), property unit trust (PUT), property loan stock (PLS) company.

OPSOMMING

VERKRYGING VAN BELEGGINGS IN SUID-AFRIKAANSE EIENDOMSBELEGGINGSMEDIUMS: BELASTINGONTLEDING

deur

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Suid-Afrikaanse eiendomsbeleggingsmediums bestaan uit kollektiewe beleggingskemas in eiendomseffekte, ook genoem eiendomseffektetrusts (EETs) en eiendomsleningseffektemaatskappye (ELEs). Die toepassing van artikels 25B(1), 11(s), 10(1)(k)(i)(aa) en 64B(5)(b) van die Inkomstebelastingwet 58 van 1962 (“die Wet”) en paragraaf 67A(1) van die Agtste Bylae tot die Wet het die uitwerking dat die belasting van eiendomsbeleggingsmediums gebaseer word op hulle regsform, naamlik ‘n trust teenoor ‘n maatskappy eerder as op hulle gemeenskaplike doel. Die Suid-Afrikaanse Inkomstediens het die teenstrydighede in die 2007/8 belastingsrede herken en voorgestel dat dit hersien moet word. Nasionale Tesourie het in Desember 2007 ‘n openbare besprekingsdokument voorgelê wat handel oor die hervorming van die Suid-Afrikaanse genoteerde eiendomsbeleggingsektor. Die openbare besprekingsdokument het ten doel om ‘n Suid-Afrikaanse eiendomsbeleggingstrustsbedeling (REIT) te aanvaar om sodoende Suid-Afrikaanse eiendomsbeleggingsmediums meer aantreklik te maak vir buitelandse beleggers en ook om die belastingteenstrydighede en gedeeltelike regulering van die Suid-Afrikaanse genoteerde eiendomsbeleggings sektor aan te spreek. In die studie word die huidige belastingteenstrydighede van die eiendomsbeleggingsmediums bespreek soos dit op die eiendomsbeleggingsmediums en op die beleggers in die mediums van toepassing is. Die belasting van REITs in geselekteerde ander lande asook die

geregulering daarvan word ook bespreek. Nasionale Tesourie se voorstelle vir die instelling, regulering en belasting van REITs in Suid-Afrika word ook bespreek.

Slutelwoorde: eiendommeleggingsmediums, eiendomsbeleggingstrust (REIT), belasting wetgewing, kollektiewe beleggingskemas in eiendomeffekte, eiendomsbeleggingstrusts (EETs), eiendomsleningseffektemaatskappye (ELEs).

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ATTRACTING INVESTMENT INTO SOUTH AFRICAN PROPERTY INVESTMENT VEHICLES: EVALUATING TAX

CHAPTER 1

BACKGROUND AND PROBLEM STATEMENT

1.1 BACKGROUND

The South African legislators have, since the first democratic elections in 1994 and consequently the abandonment of international sanctions, continuously been reviewing as well as introducing new legislation. This has been done in order to align South Africa's legislation with what is accepted internationally. A further aim is to promote investment, especially foreign investment, into South Africa and as such promote economic growth.

A recent area of focus is South Africa's ability to attract investment, especially foreign investment, into its property investment vehicles.

At present there are two recognised South African property investment vehicles in existence; they are property loan stock companies and collective investment schemes in property.

1.1.1 South Africa's inability to attract investment into its property investment vehicles

South Africa's inability to attract investment into its property investment vehicles has been debated by many and included comments like "*unnecessary confusion for investors*" and "*leading to an inconsistent tax treatment*" (eProp.co.za, 2008:[2]).

The South African Property Loan Stock Association (n.d.:[1]), reported that neither property loan stock companies nor collective investment schemes in property, also known as property unit trusts, offer foreign investors a simple and uniform structure that could

facilitate foreign investment. In addition, there has been some potential for tax controversy, which in itself is enough to put off international investors.

The controversy elevated to the authorities and as part of the 2007/8 budget tax proposals it was suggested that “*the tax treatment of such entities [collective investment schemes in property and property loan stock companies] is fragmented as it is based on their legal form (i.e., trusts versus companies), rather than their common purpose. The regulatory and tax regime relating to property holding entities will be reviewed during the course of 2007*” (South African Revenue Service, 2007:19).

1.1.2 The establishment of a South African real estate investment trust regime

Real estate investment trusts can be defined as regulated and internationally conventional property investment vehicles that promote tax efficiency and give investors access to diversified, both geographically and segmental, real estate portfolios. They further provide high liquidity potential to investors in real estate and prescribe good corporate governance.

Dimension Financial Services Group (2008:[2]) reported that real estate investment trusts were introduced in the United States of America in 1961 and since have been adopted by countries such as Australia, Canada, France, Japan, the Netherlands, Singapore and the United Kingdom amongst other countries. Ernst & Young (n.d.:[1]) reported in their overview of the Global Real Estate Investment Trust Report 2007 that listed real estate investment trusts have an estimated global market capitalisation in excess of US\$764 billion.

The Chairman of the South African Property Loan Stock Association mister Norbert Sasse commented (South African Property Loan Stock Association, n.d.:[1]) that “[t]his [real estate investment trusts] would serve to address disadvantages and weaknesses in the investment property vehicles currently in use in South Africa and to give the public face of listed property vehicles the uniformity and simplicity that could serve to attract international capital.”

Although authors suggest that the adoption of a South African real estate investment trust regime would simplify the regulation of South Africa's property investment vehicles, their concerns raised about the tax dispensation of the current property investment vehicles have been addressed less frequently in literature.

On the subject of adopting a more uniform property investment vehicle structure and their tax treatment, Jowell Glyn & Marais (2007:1) commented that “[t]he resounding conclusion seems to be that if South Africa wants to attract significant foreign investment to this sector, it needs to eschew its quaint local structures, such as property unit trusts (“PUTS”) and property loan stock (“PLS”) companies, and establish an internationally recognised real estate investment trust (“REIT”).”

After describing tax exemptions applicable to South Africa's current property investment vehicles, Jowell Glyn & Marais (2007:1) concluded that “[i]t is difficult to imagine that a South African REIT [real estate investment trust] could be any more beneficial for foreign investors.”

In summary, the various comments on South African property investment vehicles is that they are complex to understand, not well regulated and there are inconsistencies in the treatment of tax. The adoption of an internationally aligned real estate investment trust structure could resolve confusion and as a result potentially attract further investment into the sector.

1.2 PROBLEM STATEMENT

The main purpose of this study is to investigate and analyse the current differences in the tax treatment of collective investment schemes in property and property loan stock companies, to review the regulatory environment of South African property investment vehicles, to investigate the treatment of taxation and the regulatory environments of selected other countries that implemented real estate investment trust regimes and consider how this can be applied to successfully implement a South African real estate investment trust regime to ultimately attract desirable local and foreign investment into South African property investment vehicles.

1.3 RESEARCH OBJECTIVES

The study will be guided by the following specific research objectives to

- review the current tax legislation applicable to South African property investment vehicles;
- review the current regulatory environment of South African property investment vehicles and that of selected other countries that have implemented a real estate investment trust regime;
- review the tax treatment of real estate investment trusts in selected other countries;
- compare the current tax treatment of South African property investment vehicles to that of the selected countries that implemented real estate investment trusts; and
- review recent literature on the implementation of a South African real estate investment trust regime and its proposed tax treatment.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

As described in more detail later in the study, the current South African property investment vehicles are inconsistent in their tax treatment, complex in structure and as a result do not promote local or foreign investment. The authorities have recognised these shortcomings and limitations. They have recommended that the current South African property investment vehicles need to be reviewed and suggested the implementation of a South African real estate investment trust regime to promote investment into the listed real estate sector. This study is aimed at identifying how selected other countries regulate and treat tax in these real estate investment trust structures and recommend possible regulatory requirements and tax applications for the successful implementation of a South African real estate investment trust regime.

1.5 DELIMITATIONS

This study will review legislation in South Africa to determine the current tax treatment of property investment vehicles and their current regulatory environment. This study will also

review the regulatory environment and the tax dispensation of real estate investment trusts in selected other countries and National Treasury's proposals for the implementation of a South African real estate investment trust regime.

The study will not

- cover an in depth review of all countries that implemented real estate investment trust structures and their applicable tax legislation; and
- propose the specific tax treatment applicable to a South African real estate investment trust regime but rather recommend principles that have been implemented in selected other countries that have implemented a real estate investment trust regime.

1.6 DEFINITION OF KEY TERMS

This study includes a number of key definitions. The way in which these key terms are defined for purposes of this study is outlined below.

Collective investment scheme in property (CISP) is defined by National Treasury (2007:31) as one of the two types of property investment vehicles that investors can invest in to get exposure to commercial real estate. A CISP has the legal form of a vesting trust and the investors hold a participatory interest in the CISP. CISPs are regulated by the Financial Services Board in terms of the Collective Investment Schemes Control Act 45 of 2002. This type of property investment vehicle is also referred to as a property unit trust.

Conduit principle means that the income generated by an entity retains its nature and form in the hands of the investors when the income is distributed by or flows from that entity. An investor is taxed on the profits generated by the entity that they are investing in and no tax is levied on the entity (National Treasury, 2007:33).

Cost of capital is defined by Lilford (2006:139) as the average of the total cost that an entity would incur from the various types of funding it would require to acquire, develop or maintain future sources of income.

Fixed property company is defined in section 47(1) of the Collective Investment Schemes Control Act 45 of 2002 as a company of which all the issued shares are included in a portfolio and the main business of that company consists of the acquisition and holding of urban immovable property or other immovable property that the registrar may have approved. It includes an undivided share or interest therein or a leasehold in respect thereof.

Investment real estate or investment property is defined by the International Accounting Standards Board (2009:[4]) in IAS 40 'Investment Property' as property or real estate held by the owner to earn rental income or capital appreciation or both rather than to sell in the ordinary course of business or for the use in the production or supply of goods and services or for administrative purposes.

Linked unit is defined by National Treasury (2007:31) as an investment unit in a property loan stock company. The linked unit consists of one part equity and one part debenture and is also referred to as a stapled unit.

Participatory interest is defined in section 1 of the Collective Investment Schemes Control Act 45 of 2002 as any interest, undivided share or share, whether referred to as a "participatory interest, unit or by any other name" and whether the value of such interest, unit undivided share or share remains constant or varies from time to time, which may be acquired by an investor in a portfolio.

Property loan stock (PLS) company is defined by National Treasury (2007:32) as one of the two types of property investment vehicles that investors can invest in to get exposure to commercial real estate. The legal form of a PLS is a company with the investors holding stapled or lined units. PLS companies are not regulated by the Financial Services Board.

Real estate investment trust (REIT) is defined by National Treasury (2007:32) as an internationally recognised term and structure used to provide investors with the opportunity to participate directly in the ownership or financing of real estate projects by providing them with a tradable interest in a pool of real estate related assets. Real estate investment trusts own, and often operate, income-producing real estate.

The following abbreviations are used in this study and are summarised in Table 1 below.

Table 1: Abbreviations used in this study

Abbreviation	Meaning
CGT	Capital gains tax
CISP or CISPs	Collective investment scheme(s) in property
FSB	Financial Services Board
JSE	Johannesburg Securities Exchange
OECD	Organisation for Economic Co-operation and Development
PLS	Property loan stock
PUT or PUTs	Property unit trust(s)
REIT or REITs	Real estate investment trust(s)
SARS	South African Revenue Service
STC	Secondary tax on companies
The Act	Income Tax Act 58 of 1962
UK	United Kingdom
UK REIT or UK REITs	United Kingdom real estate investment trust(s)
USA	United States of America
USA REIT or USA REITs	United States of America real estate investment trust(s)

1.7 RESEARCH DESIGN AND METHODS

This study will be a conceptual study aimed at reviewing and developing theoretical frameworks through current literature and legislation on the subject of the regulation, taxation and implementation of real estate investment trusts. Comparisons will be drawn between the different regulatory and tax dispensation treatments of real estate investment trusts in selected other countries. This study will incorporate a comparative case study analysis of the application of current tax legislation on collective investment schemes in property and property loan stock companies to conceptualise principals for the implementation of a South African real estate investment trust regime.

1.8 CONCLUSION

South Africa's current property investment vehicles have been described as unnecessarily confusing for investors, inconsistent in their tax treatment and as only partially regulated. It has been suggested that South Africa adopt an internationally recognised real estate

investment trust regime in order to simplify and conform the existing fragmented South African property investment vehicle structures and as a result attract further investment into the Johannesburg Securities Exchange listed real estate sector.

In the next chapter the current South African tax legislation as it is applicable to collective investment schemes in property and property loan stock companies as well as its application on the investor in these structures are reviewed. Certain aspects of the regulatory environment of South African property investment vehicles are also reviewed in the next chapter as it affects the tax legislation applicable to them.

CHAPTER 2

REVIEW OF THE REGULATORY ENVIRONMENT AND TAX LEGISLATION APPLICABLE TO SOUTH AFRICAN PROPERTY INVESTMENT VEHICLES AND THE INVESTORS IN THOSE VEHICLES

2.1 INTRODUCTION

As previously mentioned, there are currently two recognised South African property investment vehicles in existence; they are collective investment schemes in property (CISPs) and property loan stock (PLS) companies. The investors in CISPs are referred to as participatory interest holders and the investors in PLS companies as linked unit holders.

To understand why the current CISP and PLS company structures and their respective tax treatment have been described as “*confus[ing]*”, “*inconsistent*” (eProp.co.za, 2008:[2]) and “*has the potential for tax controversy*” (South African Property Loan Stock Association, n.d.:[1]) one needs to investigate the differences in their legal form and the tax legislation applicable to them.

2.2 COLLECTIVE INVESTMENT SCHEMES IN PROPERTY (CISPS)

2.2.1 Regulatory environment and legal form

CISPs are regulated by the Financial Services Board (FSB) in terms of the Collective Investment Schemes Control Act 45 of 2002. The FSB for example, stipulate the conditions contained in the trust deeds of CISPs and through those conditions regulate how CISPs are managed, how investment decisions are made and how income is distributed to participatory interest holders.

A CISP is defined in section 47(1) of the Collective Investment Schemes Control Act as a scheme of which the portfolio consists of property shares, immovable property, assets that the registrar may allow or approve as well as investments in foreign property, foreign

property shares or foreign CISPs subject to further provisions contained in section 49 of that act. The registrar gave notice in terms of section 47(2) of the Collective Investment Schemes Control Act that a portfolio may include participatory interests in CISPs, linked units in PLS companies and shares in entities that derive income solely from real estate related investments (The Association of Property Unit Trusts, 2008:[1]).

CISPs are vesting trusts as clause 34 of the model trust deed issued by the Financial Services Board (n.d.:38) requires that the trustees “*shall*” pay to the participatory interest holders the amount available for distribution. This would therefore give the participatory interest holders or beneficiaries a vested right to the income derived by the CISP.

The Financial Services Board (n.d.:36) in terms of clause 32 of the model trust deed requires that the amount available for distribution includes

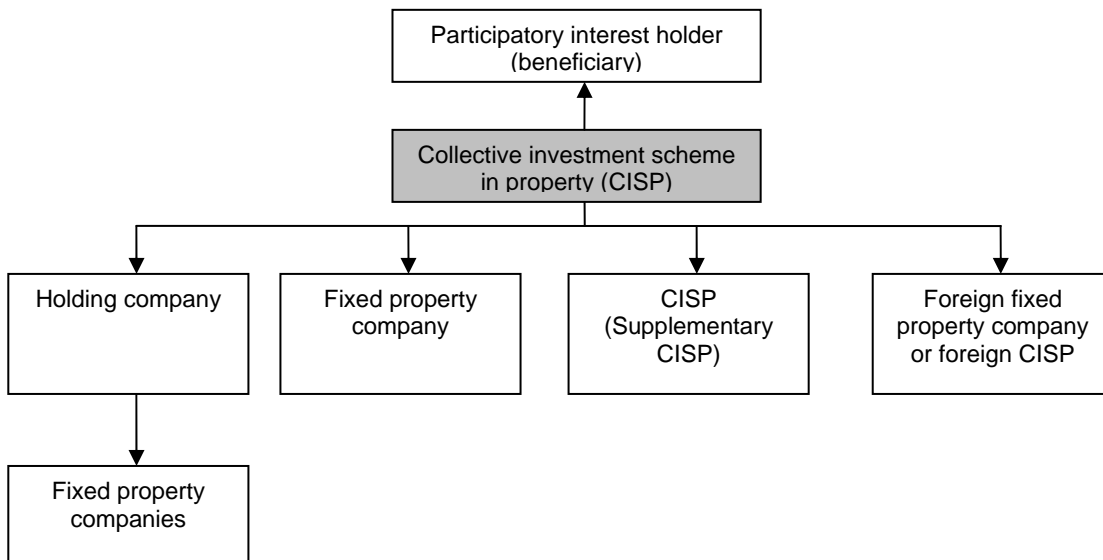
- monies received from the issue of participatory interests;
- dividends, interest and other accruals from the portfolio assets;
- commission received directly or indirectly from insurance or the purchase or disposal of real estate on behalf of the CISP or a fixed property company;
- proceeds of capital gains, rights or bonus issues; and
- monies received in respect of the disposal of portfolio assets.

The model trust deed, in clause 8.3, stipulates that any capital gains realised from the disposal of assets or from dividends of a capital nature received from a fixed property company or any other gains or receipts of a capital nature, form part of the portfolio of assets and must be invested on behalf of the participatory interest holders (Financial Services Board, n.d.:12).

In summary, the participatory interest holders in a CISP would therefore have a vested right to the income and capital gains derived by the CISP, but the capital gains will be reinvested on their behalf. This principal was confirmed by National Treasury (2007:20) that reported that capital gains realised from the disposal of assets also vests in the participatory interest holders.

Figure 1 below is a schematic diagram indicating a possible corporate structure of a CISP. Breaking down the definition of a CISP, as defined in the Collective Investment Schemes Control Act, a CISP could own real estate directly or could own real estate indirectly either through a fixed property company or through a participatory interest in another CISP. If a CISP holds a participatory interest in another CISP, that CISP would be the beneficiary of the income of that other CISP. A CISP can also be a shareholder of a holding company that in return is the shareholder of fixed property companies.

Figure 1: Schematic diagram – possible corporate structure of a collective investment scheme in property



2.2.2 Application of tax legislation

2.2.2.1 The confusion created by section 10(1)(iA) of the Act

As a first point of consideration to assess the possible confusion and inconsistency of the taxation applicable to property investment vehicles, section 10(1) of the Act, provides for the exemption from normal tax certain income received or accrued to a person, which otherwise would fall within the gross income definition as defined in section 1 of the Act and be included in determining gross income.

Section 10(1)(iA) of the Act provides that “*in the case of any portfolio of a collective investment scheme referred to in paragraph (e)(i) of the definition of “company” in section 1*”, income that accrues or is received in terms of such portfolio and has been distributed, or will be distributed to the commissioner’s satisfaction, through a dividend or a portion thereof, to persons that will be entitled to the dividend by way of their holding of a participatory interest in such portfolio, there will be an exemption from normal tax.

To determine if the exemption from normal tax in section 10(1)(iA) of the Act would apply to all collective investment schemes, the definition of a company in section 1 of the Act is studied further.

Section 1(e)(i) of the Act, as referred to by section 10(1)(iA), includes in the definition of a company any “*portfolio comprised in the collective investment scheme in securities contemplated in Part IV of the Collective Investment Scheme Control Act 2002.*”

CISPs are not regulated in terms of Part IV of the Collective Investment Schemes Control Act but in terms of Part V, neither do CISPs comprise a portfolio of securities but rather a portfolio of properties or real estate, therefore CISPs do not conform to the definition of “company” as contemplated in section 1 of the Act. The exemption in section 10(1)(iA) is therefore only applicable to collective investment schemes in securities and not to CISPs, the income distributed by a CISP to participatory interest holders or investors by way of a dividend will therefore not be exempt in terms of section 10(1)(iA) of the Act.

It should be noted that the Draft Taxation Laws Amendment Bill 2009 in clause 15(e) proposes the deletion of section 10(1)(iA) from the Act. This proposed deletion is as a result of clause 8(1)(a) of that bill that proposes the deletion of subsection (e)(i) from the definition of company as contained in section 1 of the Act. The Draft Taxation Laws Amendment Bill 2009 in clause 41 further proposes the introduction of section 25BA to the Act that will regulate collective investment schemes in securities. The proposed amendments are to address certain anomalies that could arise with the introduction of the new dividends tax as contemplated in sections 56(1) and 56(2) of the Revenue Laws Amendment Act 60 of 2008. The effect of these amendments have not been included for purposes of this study as they relate to collective investment schemes in securities and not

to CISPs, however they will address the current confusion created by section 10(1)(iA) of the Act.

2.2.2.2 The application of section 25B(1) to vesting trusts

As previously mentioned a CISP has the legal form of a vesting trust; therefore to the extent that the trust deed provides for it, income and capital derived by a CISP will accrue or vest in the participatory interest holders or the beneficiaries of that CISP.

Section 25B(1) of the Act provides that if an amount during any year of assessment is received by or accrues to a person in his or her aptitude as a trustee, to the extent that that amount has derived for the benefit of any established beneficiary who has a vested right to that amount, that amount will be deemed to have accrued to that beneficiary. Where that amount has not vested in that beneficiary it would be deemed to have accrued to the trust. Section 25B(1) is subject to the provisions of section 7 of the Act, containing certain deeming accrual provisions that have not been included for purposes of this study.

Section 25B(1) has the effect that a vesting trust acts purely as a conduit, the conduit principal applies and the income or capital received or accrued to the trust would accrue to the beneficiaries and retain its nature in the hands of those beneficiaries. Therefore to the extent that rental income was received by or accrued to the trust, the beneficiaries would be deemed to have received rental income, the same principal applies to dividends.

In the case where the beneficiaries do not have a vested right to certain income and capital received by or accrued to the trust, the trust would be liable for normal tax on the taxable income retained by the trust at the current tax rate of 40%. The capital amounts will be included in the taxable income of the trust at the applicable capital gains inclusion rate.

As mentioned previously, a CISP could either own real estate directly or could own real estate indirectly through an interest in a company that is a fixed property company or through a participatory interest in another CISP.

2.2.2.3 *Real estate held directly*

In the case where the CISP owns real estate directly and is obligated in terms of its trust deed to distribute all income received or accrued to the participatory interest holders, therefore being a vesting trust, the CISP would not derive taxable income. Section 25B(1) of the Act would apply, and the income that vested in the participatory interest holders in terms of that section would be taxable in their hands. The income derived by the trust, in terms of the conduit principal, would retain its nature in the hands of the participatory interest holders.

Section 25B(1) would also apply to capital distributions. Where a CISP disposes of real estate the capital gain would vest in the participatory interest holders in terms of the conduit principal as a capital gain.

There will be no CGT payable by the participatory interest holders on capital gains realised on the disposal of real estate by the CISP as paragraph 67A(1) of the Eighth Schedule to the Act have the effect that capital gains will not be taxable until such time the participatory interest holder sells its units in the CISP. The application of paragraph 67A(1) of the Eighth Schedule to the Act is discussed in more detail later in the chapter.

2.2.2.4 *Real estate held indirectly*

In the case where the CISP owns real estate indirectly, either through a participatory interest in another CISP or through a fixed property company, the conduit principal would apply to that other CISP and the CISP would receive income and capital distributions by way of its participatory interest in that other CISP. The CISP would receive a distribution by way of a dividend paid from after tax profits from that fixed property company.

- *Collective investment scheme in property holding a participatory interest in a supplementary collective investment scheme in property*

To assess the application of tax legislation on a CISP holding real estate indirectly, firstly the case where a CISP has an indirect holding through another CISP will be examined. For the sake of clarity that other CISP will be referred to as a supplementary CISP.

The supplementary CISP derives rental income as well as capital gains from the disposal of real estate. The supplementary CISP would also have the legal form of a vesting trust, and as previously indicated, section 25B(1) of the Act will have the implication that income as well as capital derived by the supplementary CISP would vest in the CISP. Since the participatory interest holders of the CISP have a vested right, the income and capital derived by the CISP would flow through the CISP to the participatory interest holders. In terms of the conduit principal the income and capital distributions by the supplementary CISP, would retain its nature through the CISP into the hands of the participatory interest holders.

There will be no CGT payable by the CISP on capital gains derived from the disposal of real estate by the supplementary CISP as paragraph 67A(1) of the Eighth Schedule to the Act has the effect that no capital gains will be taxable until such time the CISP sells its units in the supplementary CISP. The application of paragraph 67A(1) of the Eighth Schedule to the Act is discussed in more detail later in the chapter.

- *Collective investment scheme in property holding an interest in a fixed property company*

In the case where a CISP holds an interest in a fixed property company, section 11(s) of the Act provides that in determining the taxable income of that fixed property company the company would be allowed as a deduction from taxable income, the dividends it distributes from profits of an income nature but not from that distributed out of capital profits during the year of assessment. Section 11(s) of the Act would only apply should the shares be “*property shares*” as defined in section 47 of the Collective Investment Schemes Control Act and should those shares be included in “*a portfolio comprised in any collective investment scheme in property managed or carried on by any company registered as a manager under section 42 of that [a]ct for the purposes of Part V of that [a]ct*”.

Section 47 of the Collective Investment Schemes Control Act, defines property shares, as referred to in section 11(s) of the Act, as that of a fixed property company or a holding company with no subsidiaries other than fixed property companies which are wholly owned subsidiaries of that holding company.

To summarise, section 47(1) of the Collective Investment Schemes Control Act allows a CISP only to invest in a portfolio of property shares. Property shares are shares in a fixed property company as well as a holding company that has no subsidiaries other than wholly owned fixed property companies. Section 11(s) of the Act will therefore only apply to companies that are property shares as defined in section 47(1) of the Collective Investment Schemes Control Act and will only apply to dividends of an income nature on those shares held by a CISP. As part of the definition of a fixed property company in section 47(1) of the Collective Investment Schemes Control Act fixed property company means “*a company all the issued shares of which are included in a portfolio*”, the conclusion therefore can be drawn that section 11(s) would only apply where a fixed property company is a wholly owned by CISPs.

Section 11(s) of the Act, which is applicable where a CISP holds real estate indirectly through a fixed property company, has the effect that the fixed property company acts as a conduit to the extent that rental income from real estate is distributed by way of a dividend to the CISP. Profits that are not distributed to the shareholders of the fixed property company would incur normal tax at the current corporate tax rate of 28% on income retained by the fixed property company. A fixed property company earns taxable rental income and capital gains from the disposal of real estate. The fixed property company would therefore pay normal tax on the income derived from real estate and capital gains tax on the income derived from the disposal of real estate. Dividends declared from profits of an income nature would be deductible for the fixed property company in terms of section 11(s) of the Act but dividends declared from capital profits would not be deductible. Where a fixed property company is not wholly owned by CISPs section 11(s) cannot apply and the fixed property company would not receive a deduction in terms of section 11(s) for its dividend distributions.

Section 10(1)(k) exempts local dividends received by or accrued to a person from normal tax however the proviso in section 10(1)(k)(i)(aa) determines that a dividend received from property shares will not be exempt unless it was distributed out of capital profits by the fixed property company. The proviso in terms of section 10(1)(k)(i)(aa) of the Act is in lieu of the fact that income dividends have already been deducted in the hands of the fixed property company in terms of section 11(s) of the Act and is therefore taxable in the hands of the CISP.

Since the CISP is a vesting trust, dividends from a fixed property company would vest in terms of section 25B(1) of the Act to the participatory interest holders. The CISP would therefore not derive taxable income from the application of the proviso contained in section 10(1)(k)(i)(aa) of the Act as the taxable income dividends from a fixed property company would vest in the participatory interest holders. The proviso in section 10(1)(k)(i)(aa) would not apply to dividends distributed from capital profits and the non-taxable capital dividends in the hand of the CISP would flow to the participatory interest holders in terms of section 25B(1) of the Act, leaving the CISP with no taxable income from its interest in the fixed property company.

Since dividends declared from capital profits derived by fixed property companies are not deductible in terms of section 11(s) of the Act, the dividends are exempt from income tax in terms of section 10(1)(k)(i) as the proviso in section 10(1)(k)(i)(aa) does not apply to those capital dividends.

Should a fixed property company dispose of real estate, the fixed property company would be liable for capital gains tax calculated in terms of the Eighth Schedule to the Act and be included in taxable income in terms of section 26A of the Act. Paragraph 67A(1) of the Eight Schedule to the Act, which is discussed in more detail later in the chapter, does not apply to a fixed property company.

Section 64B(5)(b) states that a dividend declared by a fixed property company in terms of section 11(s) shall be exempt from secondary tax on companies, however since section 11(s) of the Act does not apply to capital dividends section 64B(5)(b) would not apply to capital dividends and the fixed property company would have to pay STC on those dividend distributions.

2.3 PROPERTY LOAN STOCK (PLS) COMPANIES

2.3.1 Regulatory environment and legal form

PLS companies have the legal form of a company and are regulated by the Companies Act 61 of 1973, and guided by its memorandum of articles and articles of association.

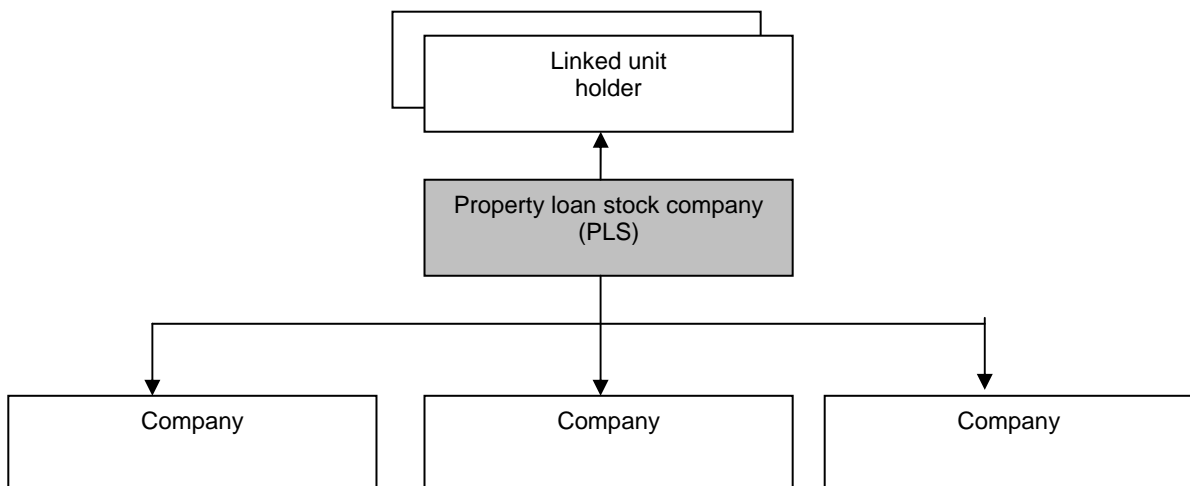
PLS companies are not regulated in terms of the Collective Investment Schemes Control Act and therefore are not restricted or regulated as to how it wishes to invest or divest in real estate or to how it wishes to distribute income and capital gains to their shareholders.

The linked unit holders or shareholders purchase a share in a PLS company that is stapled to a debenture. The PLS company would pay interest on the debenture and declare dividends in terms of the share.

PLS companies could either own real estate directly or indirectly through an interest in other entities. PLS companies are not restricted to only invest in property shares as defined in the Collective Investment Schemes Control Act and therefore could have interests in joint ventures and other partially owned subsidiaries.

Figure 2 below is a schematic diagram indicating a possible corporate structure of a PLS company. PLS companies could invest in several other companies or other legal entities and are not required to wholly own those entities.

Figure 2: Schematic diagram – possible corporate structure of a property loan stock company



2.3.2 Application of tax legislation

2.3.2.1 Real estate held directly

For income tax purposes a PLS company will fall within the ambit of the definition of a company as defined in section 1 of the Act and is liable for income tax at the current corporate tax rate of 28%.

Section 11(a) of the Act allows for the purposes of deriving the taxable income of a person from “*carrying on any trade*” a deduction from gross income of “*expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.*”

The interest paid by the PLS company to the linked unit holders in terms of the debenture portion of their linked unit would therefore be deductible in terms of section 11(a) of the Act.

Section 23(g) of the Act provides for certain deductions that are not allowed in calculating taxable income “*to the extent to which such moneys were not laid out or expended for the purposes of trade*”. This section is also referred to as the excessive expenditure clause.

Since interest in terms of the debenture portion of the linked unit is generally at a variable rate, PLS companies distribute generally in excess of 95% of operating profits (National Treasury, 2007:22). This distribution consists mainly of interest on the debenture part of the linked unit. The Commissioner could hold that a portion of the interest claimed in terms of section 11(a) of the Act by the PLS company is “excessive” and therefore not incurred for the purposes of trade in terms of section 23(g) of the Act and disallow the portion that the Commissioner regards as excessive.

The dividends declared by the PLS company in terms of the equity portion of the linked unit would be subject to STC for both income and capital distributions in terms of section 64B of the Act.

Should the PLS company dispose of real estate directly owned, CGT is payable by the PLS company in terms of the Eighth Schedule to the Act on the capital gain realised on disposal.

2.3.2.2 Real estate held indirectly

Where a PLS company owns real estate indirectly through a supplementary PLS company, the PLS company would receive interest from the debenture portion of the linked unit and dividend income from the share. Dividends, whether capital or income in nature, received from the supplementary PLS company would be deductible by the PLS company in terms of section 10(1)(k)(i) of the Act for both income and capital dividends. The proviso in section 10(1)(k)(i)(aa) of the Act would not apply to the PLS company as the PLS company has not derived the dividends from a “property share” as defined in section 11(s) of the Act.

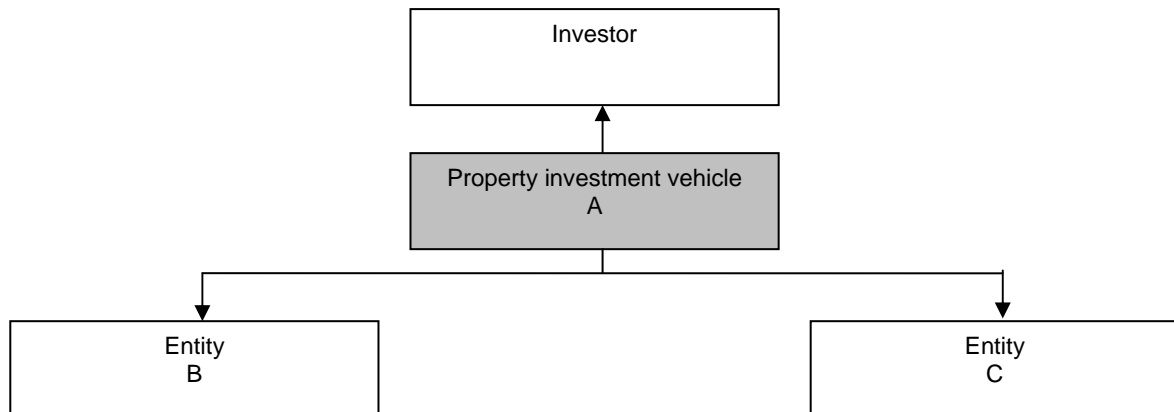
In terms of section 64B(3) of the Act the PLS company would be able to deduct these dividends received against any dividends paid before the STC payable by the PLS company is determined.

2.4 COMPARATIVE ANALYSIS OF THE APPLICATION OF TAX LEGISLATION ON PROPERTY LOAN STOCK COMPANIES AND COLLECTIVE INVESTMENT SCHEMES IN PROPERTY

From reviewing the tax legislation applicable to CISPs and PLS companies, one can establish that different clauses of the Act apply to these two types of property investment vehicles. The application of the Act is based on their legal form rather than their common purpose as property investment vehicles.

In order to determine whether the tax application of the two property investment vehicles is inconsistent, the following information is applicable to both types of property investment vehicles in the case study below. The basic structure applicable to the comparative analysis is outlined in Figure 3 below.

Figure 3: Schematic diagram - structure of the collective investment scheme in property and the property loan stock company in the case study



Since fixed property companies in terms of section 47(1) of the Collective Investment Schemes Control Act effectively may only be wholly owned by CISPs to qualify for the section 11(s) deduction, for purposes of this case study, the entities are considered to be wholly owned by the property investment vehicle.

For purposes of this case study, in the case where the property investment vehicle (entity A) is a CISP, entity C would be considered a CISP, and where the property investment vehicle (entity A) is a PLS company, entity C would be considered a PLS company.

Where entities C and A are PLS companies, interest paid to the unit holder in respect of the stapled debenture is calculated at approximately 95% of operating profit before debenture interest.

For purposes of the case study, the entities will distribute all of its income, whether capital or income in nature to their respective investors. Trusts are regarded as being vesting trusts and clause 8.3 of the model trust deed, which states that any capital gains realised from the disposal of assets or dividends from a capital nature received from a fixed property company or any other gain or receipt of a capital nature, form part of the portfolio assets and must be invested on behalf of the participatory interest holders, would apply.

Table 2 below comprises the income statement applicable to entity A, to determine the after tax effect of the various sections of the Act applicable to CISPs and PLS companies.

Entity A received the same return from its directly held real estate in the case of the CISP and the PLS company, however due to the application of the applicable sections of the Act the return entity A received from its indirectly held real estate through entity B and entity C are different. The distribution received by entity A from entity B was obtained from the calculation in table 4 and the distribution received by entity A from entity C from the calculation in table 6.

Table 2: Entity A – Income statement

Entity A	Reference	CISP Trust R	PLS Company R
Directly held real estate			
Rental income		600 000	600 000
Gain on disposal		300 000	300 000
Indirectly held real estate			
Distribution / vested from entity B	Table 4	334 545	300 000
Distribution / vested from entity C	Table 6	50 000	236 182
Profit before interest and taxation		1 284 545	1 436 182
Interest paid – rental income		(450 000)	(450 000)
– debenture		-	(142 500)
Interest received – debenture		-	47 500
Profit before taxation		834 545	891 182
Taxation – normal taxation	Table 3	-	(15 400)
– CGT	Table 3	-	(42 000)
– STC	Table 3	-	(27 055)
Profit after taxation		834 545	806 727
Distribution / vested to investor		(300 000)	(806 727)
Retained by entity A		534 545	-

Table 3 below comprise the calculation of taxation of entity A as it would apply to the information in table 2. It further indicates the application of the various sections of the Act as it would be applicable to the CISP and the PLS company.



Table 3: Entity A – Calculation of taxation payable

Entity A	Applicable section of the Act	CISP Trust R	PLS Company R
Normal taxation			
Rental income	s1	600 000	600 000
Vested gain on disposal from entity C	s25B(1)	300 000	-
Rental income from entity C	s25B(1)	50 000	-
Interest received entity C debenture	s1	-	47 500
Capital dividend from entity B	s1	234 545	-
Income dividend from entity B	s1	100 000	-
Dividend from entity B	s1	-	300 000
Dividend from entity C	s1	-	236 182
Interest paid rental income	s11(a)	(450 000)	(450 000)
Interest paid on debenture	s11(a)	-	(142 500)
Dividend from entity B exemption	S10(1)(k)(i)	-	(300 000)
Dividend from entity C exemption	S10(1)(k)(i)	-	(236 182)
Vested income in investor	s25B(1)	(150 000)	-
Capital gain exemption C	par67A(1)	(300 000)	-
Vested income dividend from B	s25B(1)	(100 000)	-
Vested capital dividend from B	s25B(1)	(234 545)	-
Vested income in investor from C	s25B(1)	(50 000)	-
Taxable income		-	55 000
Taxation rate		40%	28%
Normal taxation payable		-	15 400
Capital gains taxation (CGT)			
Gain on disposal (at inclusion rate)	s26A	150 000	150 000
Gain on disposal from entity C (at inclusion rate)	s26A	150 000	-
Vested capital gain in investor	s25B(1) par 67A(1)	(150 000)	-
Vested capital gain from entity C	s25B(1) par 67A(1)	(150 000)	-
Taxable capital gain		-	150 000
Taxation rate		40%	28%
Capital gain taxation payable		-	42 000
Secondary tax on companies (STC)			
Distribution to investor		-	806 727
Dividends received in cycle		-	(536 182)
Vested in investor	S25B(1)	834 545	-
CISP not a company as defined in Act	s1	(834 545)	-
Taxable distribution		-	270 545

Entity A	Applicable section of the Act	CISP Trust R	PLS Company R
Taxation rate		10%	10%
STC payable		-	27 055

In the case of entity A, the CISP and PLS company both derived rental income and a gain on the disposal of directly held real estate to the same amount and incurred interest paid in terms of a loan with a financial institution relating to that real estate also to the same amount, however the returns they generate for their respective investors are different. This is due to their legal form and the legal form of the entities they invested in.

In the case of the CISP, entity B is a fixed property company as defined and in the case of the PLS areal estate holding company. The reason for the difference in return for the property investment vehicle, CISP *versus* PLS company, is due to the application of section 11(s) and 64B(5)(b) of the Act, which are sections applicable to the CISP due to its legal form. Refer to Table 4 and Table 5 for the detail calculation of the after tax return received by entity A from entity B.

Entity C in the case of the CISP was a CISP and in the case of the PLS company a PLS company. The difference in return for the property investment vehicles from their investment in entity C is mainly due to the application of section 25B(1), paragraph 67A(1) of the Eighth Schedule to the Act, the definition of company contained in section 1 and section 64B(5)(b) of the Act that allows the CISP to be a conduit, again these sections are applicable to the CISP due to its legal form. Table 6 and Table 7 study the detail calculation and application of the legislation applicable to the supplementary CISP and the supplementary PLS company.

Although capital amounts from entity A vest in the participatory interest holder of the CISP, the manager is obligated to retain these amounts and reinvest it on behalf of the participatory interest holder as required in clause 8.3 of the model trust deed.

Table 4 below comprise the income statement applicable to entity B. In the case where the property investment vehicle (entity A) is a CISP, entity B is a fixed property company and in the case where entity A is a PLS company, entity B is a real estate holding company.

Table 4: Entity B – Income statement

Entity B	Reference	Fixed property company R	Company R
Directly held real estate			
Rental income		400 000	400 000
Gain on disposal		300 000	300 000
Profit before interest and taxation		700 000	700 000
Interest paid – rental income		(300 000)	(300 000)
– debenture		-	-
Profit before taxation		400 000	400 000
Taxation – normal taxation	Table 5	-	(28 000)
– CGT	Table 5	(42 000)	(42 000)
– STC	Table 5	(23 455)	(30 000)
Profit after taxation		334 545	300 000
Distribution to entity A		(334 545)	(300 000)
Retained by entity B		-	-

Table 5 below comprises the calculation of taxation of entity B, as it would apply to the information in Table 4. It further indicates the application of the various sections of the Act as they would be applicable to the fixed property company and the real estate holding company.

Table 5: Entity B – Calculation of taxation payable

Entity B	Applicable section of the Act	Fixed property company R	Company R
Normal taxation			
Rental income	s1	400 000	400 000
Interest paid rental income	S11(a)	(300 000)	(300 000)
Income dividend distributed	S11(s)	(100 000)	-
Taxable income		-	100 000
Taxation rate		28%	28%
Normal taxation payable		-	28 000



Entity B	Applicable section of the Act	Fixed property company R	Company R
Capital gains taxation (CGT)	s26A		
Gain on disposal (at inclusion rate)		150 000	150 000
Taxable capital gain		150 000	150 000
Taxation rate		28%	28%
Capital gain taxation payable		42 000	42 000
Secondary tax on companies (STC)	s64B(5)(b)		
Distribution to entity A		334 545	300 000
Exemption on income dividend		(100 000)	-
Taxable distribution		234 545	300 000
Taxation rate		10%	10%
STC payable		23 455	30 000

Table 6 below comprises the income statement applicable to entity C. In the case where the property investment vehicle (entity A) is a CISP, entity C is a CISP and in the case where entity A is a PLS company, entity C is a PLS company.

Table 6: Entity C – Income statement

Entity C	Reference	CISP Trust R	PLS Company R
Directly held real estate			
Rental income		200 000	200 000
Gain on disposal		300 000	300 000
Profit before interest and taxation		500 000	500 000
Interest paid – rental income		(150 000)	(150 000)
– debenture		-	(47 500)
Profit before taxation		350 000	302 500
Taxation – normal taxation	Table 7	-	(700)
– CGT	Table 7	-	(42 000)
– STC	Table 7	-	(23 618)
Profit after taxation		350 000	236 182
Distribution / vested in entity A		(50 000)	(236 182)
Retained by entity C		300 000	-

Table 7 below comprises the calculation of taxation of entity C, as it would apply to the information in Table 6. It further indicates the application of the various sections of the Act as they would be applicable to the supplementary CISP and the supplementary PLS company.

Table 7: Entity C – Calculation of taxation payable

Entity C	Applicable section of the Act	CISP Trust R	PLS Company R
Normal taxation			
Rental income	s1	200 000	200 000
Interest paid rental income	S11(a)	(150 000)	(150 000)
Interest paid debenture	S11(a)	-	(47 500)
Vested income in entity A	s25B(1)	(50 000)	-
Taxable income		-	2 500
Taxation rate		40%	28%
Normal taxation payable		-	700
Capital gains taxation (CGT)			
Gain on disposal (at inclusion rate)	s26A	150 000	150 000
Vested capital gain in entity A	s25B(1) p67A(1)	(150 000)	-
Taxable capital gain		-	150 000
Taxation rate		40%	28%
Capital gain taxation payable		-	42 000
Secondary tax on companies (STC)			
Distribution to entity A		-	236 182
Vested in entity A	s25B(1)	350 000	-
CISP not a company as defined in Act	s1	(350 000)	-
Taxable distribution		-	236 182
Taxation rate		10%	10%
STC payable		-	23 618

It is apparent from the case study above that the tax treatment of CISPs and PLS companies, although they have the same objectives and common purpose as property investment vehicles, are fragmented and inconsistent in their tax dispensation. The tax legislation applicable to them is based on their legal form rather than on their common objectives.

National treasury (2007:23) confirmed in their discussion paper on Reforming the Listed Property Investment Sector in South Africa that *“there should be a specific tax dispensation for all property investment vehicles, meaning that PLS companies should be able to enjoy the same tax dispensation as CISPs provided they are similarly regulated.”*

National treasury (2007:24) further commented that SARS are concerned over the high interest rates associated with the debenture portion of a linked unit in a PLS company and that it constitutes dividends rather than interest. Should the application of section 23(g) of the Act effectively be applied by SARS, this would further dilute the available operating profit for distribution to the linked unit holders of a PLS company as the high interest paid on the debenture effectively reduces the inconsistencies in the application of the tax legislation between a CISP and a PLS company.

2.5 PARTICIPATORY INTEREST HOLDERS AND LINKED UNIT HOLDERS

The current tax legislation applicable to the investors, participatory interest holders in a CISP or the holders of the linked units in a PLS company are discussed below.

Local and foreign dividends received or accrued to natural persons qualify for certain exemptions, subject to certain provisos, in terms of section 10 of the Act.

Section 10(1)(i)(xv) of the Act provides that any foreign dividends and interest received by or accrued to a natural person during a year of assessment will be exempted from normal tax up to a collective amount of R3 500. The exemption in terms of section 10(1)(i)(xv) of the Act would firstly be applied to foreign dividends and then to foreign interest (the first proviso to section 10(1)(i)(xv)(aa)).

The second proviso to section 10(1)(i)(xv)(bb) of the Act, provides an exemption from income tax for a natural person of so much of any interest received or accrued to that person from a South African source during the year of assessment and any dividends that are not foreign dividends and have not otherwise been exempt from tax, in the case of a natural person 65 or older R30 000 and in any other case R21 000 reduced by the amount of exemption allowed in terms of section 10(1)(i)(xv)(aa).

It should be noted that the exemptions in terms of section 10(1)(i)(xv) of the Act are only applicable to natural persons, legal persons would therefore not qualify for these exemptions.

Section 10(1)(k)(i) of the Act provides that any dividends that are not foreign dividends that accrued or was received by any person during the year of assessment are exempt from normal tax. This exemption would apply to natural as well as legal persons.

The exemption in terms of section 10(1)(k)(i) is subject to the proviso in section 10(1)(k)(i)(aa) that the exemption would not apply to dividends distributed by a company if the shares are property shares in terms of section 47 of the Collective Investment Schemes Control Act. This proviso would therefore only apply to distributions by a fixed property company from profits of an income nature as the fixed property company would have received a deduction from normal tax in terms of section 11(s) for the dividends distributed out of income profits. Section 11(s) was not applicable to distributions from capital profits and therefore the proviso in section 10(1)(k)(i)(aa) would not apply to capital distributions from the fixed property company.

For capital gains tax purposes, paragraph 67A of the Eighth Schedule to the Act provides that a participatory interest holder in a CISP will only calculate a capital gain or capital loss when he or she so disposes of their interest in the CISP. The capital gain or loss in terms of paragraph 67A(2) is determined by the proceeds received on the disposal of the participatory interest and the applicable base cost. The participatory interest holder therefore would only be liable for capital gains tax when he or she disposes of his or her participatory interest in a CISP and not when capital gains vest in the participatory interest holders in terms of section 25B(1) of the Act.

To the extent that the participatory interest holder received a distribution from a CISP, the distribution would retain its nature in terms of the conduit principal and the participatory interest holder would receive rental income, capital gains from the disposal of real estate as well as dividends from a fixed property company. Since the CISP in terms of the Collective Investment Schemes Control Act could also invest in foreign fixed property companies and foreign CISPs, potentially a participatory interest holder could through the conduit principal receive foreign income.

As the conduit principal does not apply to PLS companies, the linked unit holder in a PLS company would receive interest from the debenture portion of the linked unit and dividends from the equity portion. If the PLS company is local, the dividends and interest so derived would be considered from a South African source.

Capital gains or losses derived by foreign investors from the disposal of their interest in CISPs and PLS companies in terms of section 9(2) of the Act will be deemed from a South African source if the real estate held through that interest or right is situated in South Africa. The proviso's contained in section 9(2)(aa) and section 9(2)(bb) of the Act deem the disposal by a foreign investor to be from a South African source should 80% or more of the market value of those equity shares or vested interest disposed of at the time of the disposal be attributable directly or indirectly to real estate and that foreign investor together with any connected person directly or indirectly hold at least 20% of the equity share capital of the PLS company or ownership or right to ownership of that CISP.

In terms of paragraph 2(1)(b)(i) of the Eighth Schedule to the Act a foreign investor would be subject to capital gains taxation on the disposal of any real estate situated in South Africa or any interest or right to real estate in South Africa. An interest in real estate in South Africa includes in terms of paragraph 2(2) of the Eighth Schedule to the Act any equity shares held by a person in a company or ownership or the right to ownership in any other entity or a vested interest of a person in any assets of any trust if at least 80% of that interest at the time of disposal is attributable to real estate and that person together with any connected person directly or indirectly hold at least 20% of the equity share capital of the PLS company or ownership or right to ownership of that CISP.

Section 35A of the Act requires any person who is obligated to pay an amount to a non-resident in respect of the disposal of any real estate to withhold withholding tax in terms of section 35A(2) of the Act. The application of this section includes any disposals referred to in paragraphs 2(1)(b)(i) and 2(2) of the Eighth Schedule to the Act.

2.6 COMPARATIVE ANALYSIS OF THE APPLICATION OF TAX LEGISLATION ON PARTICIPATORY INTEREST HOLDERS AND LINKED UNIT HOLDERS

The distributions by the CISP and PLS company are considered in the hands of the investor by way of the following case study. For purposes of this case study the distributions by entity A in chapter 2.4 to their respective investors will be used.

Table 8 below indicate by comparison the after tax income, cash received and proportionate income and capital distributions received by the respective investors in property investment vehicles.

For purposes of this study the investors are assumed natural persons and will be taxed at a rate of 40%.

Table 8: Participatory interest holder and linked unit holder – Income statement

Distribution from entity A	Reference	Participatory interest holder CISP R	Linked unit holder PLS company R
Distribution received			
Dividends			
From PLS company	Entity A	-	806 727
Income dividend	Entity B	100 000	-
Capital dividend	Entity B	234 545	-
Interest from debenture	Entity A	-	142 500
Capital gain			
From CISP	Entity A	300 000	-
From supplementary CISP	Entity C	300 000	-
Rental income			
From CISP	Entity A	150 000	-
From supplementary CISP	Entity C	50 000	-
Total distribution before taxation		1 134 545	949 227
Taxation – normal taxation	Table 9	(111 600)	(48 600)
- CGT	Table 9	-	-
Total distribution / vested after taxation		1 022 945	900 627
Less amounts retained by entities	c8.3	(834 545)	-
Cash received by investor		188 400	900 627
Distribution comprises of			
Income distribution		188 400	196 991

Distribution from entity A	Reference	Participatory interest holder CISP R	Linked unit holder PLS company R
Capital distribution		834 545	703 636

Table 9 below comprises the calculation of taxation of the participatory interest holder in a CISP and the linked unit holder in a PLS company from the distributions received as indicated in Table 8.

Table 9: Participatory interest holder and linked unit holder – calculation of taxation payable

	Applicable section of the Act	Participatory interest holder CISP R	Linked unit holder PLS company R
Normal taxation			
Rental income from entity A	S25B(1)/s1	150 000	-
Rental income from entity C	S25B(1)/s1	50 000	-
Dividends from entity A	s1	-	806 727
Income dividends from entity B	s25B(1) /s10(1)(k)(aa)	100 000	-
Capital dividends from entity B	s25B(1)	234 545	-
Debenture interest from entity A	s1	-	142 500
Dividend exemption	S10(1)(k)(i)	(234 545)	(806 727)
Interest and dividend exemption	s10(1)(xv) (bb)	(21 000)	(21 000)
Taxable income		279 000	121 500
Taxation rate		40%	40%
Normal taxation payable		111 600	48 600
Capital gains taxation (CGT)			
Gain on disposal from entity A (at inclusion rate)	s25B(1)	75 000	-
Gain on disposal from entity B (at inclusion rate)	S25B(1)	75 000	-
Gain exemption	p67A(1)	(150 000)	-
Taxable capital gain		-	-
Taxation rate		40%	40%
Capital gains taxation payable		-	-

The participatory interest holder in the CISP would receive, in terms of section 10(1)(k)(i), an exemption from taxable income for the capital dividend received from the fixed property company. The income dividend distributed by the fixed property company however would be taxable in terms of the first proviso to section 10(1)(k)(i)(aa). The net rental income from the CISP and supplementary CISP, in terms of section 25B(1) would vest in the participatory interest holder.

The linked unit holder in a PLS company would qualify for the general dividend exemption in section 10(1)(k)(i), however the interest received from the PLS company in terms of the debenture portion of the linked unit would be taxable in his or her hands.

The participatory interest holder and the linked unit holder, both would receive an exemption in terms of section 10(1)(i)(xv)(bb), the linked unit holder in the PLS company on interest received and the participatory interest holder in the CISP on the income dividends from the fixed property company as these dividends have not been exempted for the participatory interest holder in terms of any other section of the Act.

The capital gain distributed to the participatory interest holder in the CISP would not be subject to capital gains tax in terms of paragraph 67A as paragraph 67A(1) provides that a participatory interest holder in a CISP should only determine a capital gain or capital loss *“in respect of any participatory interest in that portfolio”* when he or she disposes of the interest.

2.7 CONCLUSION

It is apparent that although both CISPs and PLS companies have common objectives and purpose, being that of property investment vehicles, the application of the Act results in different taxable income for these property investment vehicles as well as for the investors in them.

Section 25B(1) of the Act has the result that income derived by a trust to the extent that the beneficiaries of that trust have a vested right, will be taxed in the hands of the

beneficiaries. The application of section 25B(1) to the CISP is purely due to the CISP's legal form as a vesting trust.

Section 11(s) of the Act, applicable to fixed property companies, has the effect that a fixed property company can effectively act as a conduit for income dividends distributed to a CISP. Section 11(s) of the Act is only applicable to property shares, as defined, this section only has application to CISP's. This section applies due to its legal form rather than due to the objective as a property investment vehicle.

The exemption from STC granted in terms of section 64B(5)(b), applicable to fixed property companies on the income dividends distributed to a CISP, only applies to CISP's due to its legal form rather than the purpose of the fixed property company as part of the portfolio of investment in properties.

Paragraph 67A of the Eighth Schedule, which allows for the exemption of capital gains tax payable on capital gains from the disposal of immovable properties by the CISP or supplementary CISP in the hands of the participatory interest holders, is also applicable due to the legal form of the CISP.

Due to the application of the conduit principal, the investor in a CISP could derive various types of income, for example rental income, taxable income dividends, non-taxable capital dividends and capital gains from the disposal of immovable properties, all taxed differently in the hands of the participatory interest holder. All of which could be quite confusing for the average investor. The investor could be exposed to penalties and interest imposed by the commissioner should these different types of income not be correctly declared for income tax purposes. It is therefore important that a CISP keep detailed accounting records to ensure that the participatory interest holder in a CISP has clarity as to where the income was derived from and how it should declare this income for tax purposes.

Therefore the assessment of eProp.co.za (2008:[2]) that the tax treatment of property investment vehicles is “*unnecessary confus[ing] for investors*” and that it “*lead[s] to an inconsistent tax treatment*” is correct.

The assessment by SARS (2007:19) in the 2007/8 Budget Tax Proposals that “*the tax treatment of such entities* [collective investment schemes in property and property loan stock companies] *is fragmented as it is based on their legal form (i.e., trusts versus companies), rather than their common purpose*”, is also clear from application of the sections applicable to CISPs.

In the next chapter, National Treasury’s discussion paper on Reforming the Listed Property Investment Sector in South Africa is reviewed. The chapter also looks into the regulation of REITs internationally and National Treasury’s proposals for the regulation of REITs in South Africa. The chapter incorporates the current regulatory environment of South African property investment vehicles.

CHAPTER 3

REFORMING THE FRAGMENTED AND PARTIALLY REGULATED LISTED PROPERTY INVESTMENT VEHICLE SECTOR THROUGH IMPLEMENTING A REAL ESTATE INVESTMENT TRUST REGIME IN SOUTH AFRICA

3.1 INTRODUCTION

The Property Loan Stock Association (Business Day, 2006:10) on the subject of converting South Africa's current property investment vehicles into internationally recognised REIT structures argued that South Africa is one of only a few countries with a listed real estate sector that have not adopted a REIT structure and to be recognised by international investors, South Africa has to align itself with international trends and standards.

As part of the 2007/8 Budget Tax Proposals, SARS (2007:19) commented that the tax treatment of CISPs and PLS property investment vehicles are "*fragmented as it is based on their legal form (i.e., trusts versus companies), rather than their common purpose*" and that "[t]he regulatory and tax regime relating to property holding entities will be reviewed during the course of 2007."

On 3 December 2007, National Treasury issued a discussion paper to investigate the reformation of the listed property investment sector in South Africa. The discussion paper was open for public comment until 31 January 2008. As at the date of this study, National Treasury has not issued the public response document to the discussion paper.

In the 2008/9 Budget Tax Proposals, SARS elaborated further on property investment vehicles and stated that a response document would follow from the discussion document that will contain detail plans and draft legislation (South Africa Revenue Service, 2008:32).

The discussion paper issued by National Treasury investigates in part one the current regulatory environment in South Africa as well as reviews the REIT regulations imposed by

other countries. National Treasury then makes certain proposals on how a possible REIT applicable to South Africa should be regulated. Part two of the discussion paper investigates the current tax dispensation of South African property investment vehicles as well as makes proposals on how a REIT for South Africa should be treated for tax purposes (National Treasury, 2007:2.).

In this chapter, National Treasury's discussion paper on Reforming the Listed Property Investment Sector in South Africa, issued during December 2007, will be reviewed to determine their view on implementing and regulating a REIT regime in South Africa.

3.2 THE SOUTH AFRICAN PROPERTY INVESTMENT VEHICLE FRAGMENTED REGULATORY CONSTRAINTS AND LANDSCAPE

The purpose of a REIT as viewed by National Treasury (2007:1) is to make investment into large income producing real estate possible to a broader base of investors, something that currently is not catered for in the South African taxation and legislative environment. The closest South African context is CISPs and PLS companies.

National Treasury (2007:1-2) stated that they are reviewing the application of a possible REIT regime in South Africa for two reasons. The first being to optimise current legislation to rectify the current fragmented and only partly regulated property investment vehicle environment by relaxing or redesigning limiting and internationally uncompetitive legislation. The second reason is to deal with the current inconsistent tax treatment applicable to South African property investment vehicles, which arise due to their different legal forms.

National Treasury (2007:5) described the current listed real estate sector in South Africa as "*fragmented, only partly regulated and the regulatory framework is too restrictive and not internationally competitive*", a view that has been shared by others as previously stated in this study.

The two property investment vehicles currently in use in South Africa namely CISPs and PLS companies, are fragmented due to the different regulations and acts applicable to

them. CISPs that take the legal form, although not prescribed by the Collective Investment Schemes Control Act, of a trust and PLS companies that take the legal form of a company. National Treasury (2007:4) argued that the reason why CISPs adopt the legal form of a trust is because the Collective Investment Schemes Control Act and other supplementary regulations applicable to CISPs are not tailored to cater for legal structures other than that of a trust.

PLS companies are not regulated and only have to comply with the requirements of the Companies Act 61 of 1973 and should they be listed with the listing requirements of the JSE. CISPs are regulated by the FSB in terms of the Collective Investment Schemes Control Act.

Section 48(1) of the Collective Investment Schemes Control Act prescribes that only the registered manager of the CISP may “*administer*” a CISP and that the appointed manager in terms of section 48(2) must be a company registered in terms of the Companies Act. These requirements are not imposed on a PLS company, which is typically managed internally.

The manager of a CISP also needs to maintain certain capital requirements imposed by section 88 of the Collective Investment Schemes Control Act, a requirement that would not be applicable to PLS companies as they do not fall within the ambit of the Collective Investment Schemes Control Act.

The FSB regulates the trust deed of a CISP. In terms of clause 21.1.7.2 of the model trust deed, the Financial Services Board (n.d.:30) prohibits a CISP to be geared more than 30%, which means that a CISP needs to derive 70% of their capital requirements from their investors and 30% of their capital requirements can be raised through debt. PLS companies do not have the same gearing limitations and therefore have greater flexibility in terms of their investment decisions.

Since 1998 the number of JSE listed CISPs have decreased and have also underperformed in capitalising on market share (National Treasury, 2007:4). National Treasury (2007:5) commented that the “*relatively higher growth in PLS companies (both in*

number and size) can, at least in part, be attributed to the greater flexibility afforded to PLS companies.”

In 2007 only 1% of South Africa's total listed real estate sector was owned by international investors (National Treasury, 2007:6). This is surprising as Ernst & Young reported, having measured the performance of internationally listed real estate, South Africa being in the top five international listed real estate performers, with a three year average total rate of return of 7.7% (Ernst & Young, 2008:11). In 2007 and 2006, South Africa held the position of the top listed real estate performer in the world (Ernst & Young, 2008:29) at 34% average total rate of return over a three year period in 2007 (National Treasury, 2007:6). Furthermore South Africa's listed real estate sector has the lowest average gearing of 13% and the fourth lowest volatility at 0.49 (Ernst & Young, 2008:12-13). However, even though South African property investment vehicles do perform well they do not capitalise on attracting international investors, which is evident from the low percentage of international investors that invest in the listed South African real estate sector.

As a result of the low percentage of foreign investment into South African property investment vehicles and the fact that South Africa internationally is one of the top performers when it comes to generating return for its investors at a reasonably low risk, National Treasury deems it necessary to remove the obstacle of the fragmented regulatory structure governing the listed property investment vehicles in South Africa (National Treasury, 2007:7).

3.3 REVIEW OF INTERNATIONAL REAL ESTATE INVESTMENT TRUST REGULATORY FRAMEWORKS

Although the regulatory framework and tax dispensation of a REIT is in no way uniform across all countries that have implemented or partly implemented the structure, they do have the following uniform advantages for investors, namely: tax-efficiency, diversification, liquidity, accessibility, provider of income and good governance (National Treasury, 2007:7).

National Treasury (2007:8) suggested that the transition from the current property investment vehicles to a REIT regime in South Africa should be smooth as the core fundamentals of CISPs and PLS companies are similar to that of most international REIT structures. The similarities, as it would apply to either CISPs or PLS Companies or both, include that the investment returns of a REIT are taxed in the hands of the investor, investing in real estate and real estate related business and should be listed on a licensed stock exchange.

A REIT is beneficial to the investor in that a REIT is generally not taxed and acts as a conduit. It provides continual income to the investor because a REIT generally has to pay out most of its income to its investors and is well governed because of prescribed listing rules and regulations. They also allow an investor to invest in a diversified portfolio of real estate which therefore lowers the risk and exposure to the investor.

A REIT should have certain design features that are supported through policy and purpose. These are also the measures used by Ernst & Young in their Global Real Estate Investment Trust Report in order to compare international REIT structures.

3.3.1 Organisation rules

The organisation rules generally cover the allowed legal structure, management limitations, listing requirements and in some cases certain requirements applicable to the investors.

3.3.1.1 Organisational rules applicable to real estate investment trusts in selected other countries

As indicated by the Ernst & Young (2008:54-63) Global Real Estate Investment Trust Report 2008 most countries allow for a REIT to be incorporated as either a trust or a company and require that a REIT be listed.

In Australia a REIT can be a listed or unlisted unit trust and is known as Listed Property Trusts (LPTs) (Ernst & Young, 2008:56). In the United Kingdom (UK) a REIT must be a

closed-ended corporation and be listed on a recognised stock exchange (Ernst & Young, 2008:63).

The management of a REIT, in most countries, dependant on its legal form can either be performed by an independent body or it can be performed internally. If a REIT is managed internally, typically investors benefit from some other form of protection. Australia's LPTs for example must be managed by a corporate trustee or responsible entity or fund manager. In Hong Kong a REIT must appoint a management company that is acceptable to the Securities and Futures Commission (SFC). In the UK, management of a UK REIT may be performed externally or internally. The United States (USA) requires that a USA REIT be managed by one or more trustees or directors (Ernst & Young, 2008:56-63.).

Most REIT countries introduced certain shareholder or unit holder requirements. Australia for example did not impose any restrictions on the number of or the make up of the unit holders that are allowed to invest in a LPT while Belgium requires that at least 30% of shares with voting rights have to be publicly offered within one year from the date of incorporation of the REIT. Canada imposed that a certain class of units must be offered publicly and comprise of at least 150 unit holders. German REITs require that at least 15% of its shares must trade regularly publicly and that a single investor is not allowed to have more than 10% of the voting rights in that REIT. Malaysia imposed restrictions on the percentage of foreign investors investing in a Malaysian REIT in that no more than 49% of the holders may be foreign investors. South Korea and Japan for example imposed a restriction on the minimum size of the fund assets in order to qualify as a REIT (Ernst & Young, 2008:56-63.).

3.3.1.2 National Treasury's proposals for organisation rules applicable to real estate investment trusts in South Africa

The objective of National Treasury (2007:9) on imposing organisation rules is to ensure that investors' investment is protected; the status of the industry maintained and that the investment is flexible enough to allow maximum returns for investors.

National Treasury proposes that a South African REITs should be incorporated and the effective place of management must be in South Africa. It should have the legal form of

either a trust or company and be listed on a South African listed exchange to ensure liquidity for the investor. National Treasury would consider certain exemptions where the REIT only has a single investor (National Treasury, 2007:10.).

In order to protect the rights of the investor, National Treasury (2007:10) proposes that investors be represented in management to ensure transparency of investment or divestment decisions.

National Treasury (2007:10) does not propose investment limits, however it is considering investment restrictions in order to limit possible losses to the fiscus, for example like Malaysia that imposed limits on the percentage of foreign investors.

It is proposed that a REIT applicable to South Africa be included in the scope of the Collective Investment Schemes Control Act. CISPs would therefore automatically be converted to REITs but PLS companies will have to apply for REIT status under the Collective Investment Schemes Control Act as amended. This will also have the result that REIT entities in South Africa will be regulated by the FSB (National Treasury, 2007:10.).

3.3.2 Income and asset rules

Income and asset rules are imposed by all countries. The rules restrict the asset classes that REITs may invest in as well as income types that may be derived by the REIT.

3.3.2.1 Income and asset rules applicable to real estate investment trusts in selected other countries

Although income and asset rules are imposed by all countries, they allow enough flexibility to allow the REIT to operate rather unrestricted.

Ernst & Young (2008:64-67) reported in the Global Real Estate Investment Trust Report 2008 that most countries require that the REIT generate rental income from real estate and that the REIT may only invest in real estate or real estate related activities and certain consequential activities.

Restrictions imposed for example, Australian REITs may not directly or indirectly derive income from a trading business which is a business that does not consist wholly of an investment business. Although not specified this would have the implication that an Australian REIT will have to invest in land with the main purpose of deriving rental income. Income from loans or derivatives is also allowed (Ernst & Young, 2008:64.).

German REITs have to generate 75% of their gross income from renting or disposing of real estate and can only invest in real estate or have investments in local or foreign entities whose main purpose is to derive rental income from real estate, 75% of a German REITs asset base must comprise of fixed assets. German REITs are prohibited from trading in real estate. If a German REIT derives, within a five year period, income from the disposal of real estate that amounts to more than half the value of its average real estate portfolio within the same period it would be considered to have derived income from the disposal of real estate (Ernst & Young, 2008:65.).

Hong Kong REITs are not allowed to invest in vacant land or undertake development activities unless the activity is that of renovating (Ernst & Young, 2008:65).

Ernst & Young (2008:66) reported in the REITs Global Real Estate Investment Trust Report 2008, REITs incorporated under Japanese legislation are not allowed to have a more than 50% investment in other companies.

REITs in the UK have to derive 75% of its income from qualifying assets and may not invest in a single asset that will exceed 40% of the total value of the portfolio of assets and its portfolio has to comprise of more than three properties (Ernst & Young, 2008:67).

The Netherlands do allow a Dutch REIT to undertake development activities for its own investment portfolio however they require that its development activities be ring-fenced in a separate legal entity (Ernst & Young, 2008:66).

From the above it can be concluded that a REIT is to derive rental income from its investment in real estate or real estate related activities. As described in chapter 2, CISPs and PLS companies derive income from real estate investments. The investments by CISPs are regulated by the FSB; PLS companies are not regulated and can undertake

more risk in their real estate investment decisions for example doing developments and facility management.

3.3.2.2 National Treasury's proposals for income and asset rules applicable to a real estate investment trusts in South Africa

The objective of National Treasury (2007:12) is to reconsider the investments that CISPs are allowed as well as to promote investment in South Africa's property investment vehicles.

National Treasury (2007:12-13) proposes that a South African REIT will only be allowed to invest in another REIT should that REIT not have an investment in another REIT. A REIT would be allowed to invest in real estate in South Africa as well as abroad but international investment will be limited in order to promote South African real estate. International real estate investment will be limited to countries that have a foreign currency sovereign rating provided by a rating agency as currently is the case with CISPs.

National Treasury does not propose a restriction on the type of real estate that will be allowed for example undeveloped land and neither consider a restriction on the type of income derived from real estate for example to impose a restriction on deriving income from facility management services. It is further proposed that a REIT in South Africa should derive at least 75% of its total income from real estate rental income. Development activities will be permitted provided that the real estate is developed for purpose of generating rental income and may not be disposed of for at least three years (National Treasury, 2007:13.).

National Treasury proposes to adopt the REIT principal applicable in the UK so that a REIT in South Africa should own at least three properties and that a single property may not exceed 40% of the total portfolio value (National Treasury, 2007:13).

In order to promote flexibility a South African REIT would be allowed to invest in cash, money-market instruments and government bonds. These balances would be included in calculating the 75% requirement to derive rental income. National Treasury makes this allowance in order to facilitate effective employment of capital as well as allow for divesting

into lower risk instruments during a melt-down in the real estate sector. (National Treasury, 2007:13.).

3.3.3 Distribution rules

The distribution rules imposed by a REIT regulate how income derived by a REIT from real estate rental activities is distributed to its investors.

3.3.3.1 Distribution rules applicable to real estate investment trusts in selected other countries

In most countries REITs are required to distribute most of their income annually or they will be subject to taxation on income that is not distributed to investors. Australia for instance has no minimum distribution rules but undistributed income is taxed in the REIT. As per the Ernst & Young Global Real Estate Investment Trusts Report 2008, German REITs have to distribute at least 90% of the distributable profit as stated on the annual financial statements for the year, adjusted for depreciation calculated on a straight-line basis. German REITs allows that 50% of the proceeds from disposal of real estate to be transferred to a reserve. A Dutch REIT has to distribute its distributable profits annually within eight months after the end of its tax year. In Malaysia a REIT will not be taxed on their income, provided that at least 90% of their total income is distributed to its investors. Singapore requires that 90% of income derived from Singapore assets must be distributed. The USA requires that 90% of the taxable income of the REIT be distributed annually (Ernst & Young, 2008:68-70.).

3.3.3.2 National Treasury's proposals for distribution rules applicable to real estate investment trusts in South Africa

National Treasury's (2007:14) objective for the distribution of income is to establish a vehicle that promotes low risk savings for its investors and limits possible loss of income to the fiscus.

National Treasury (2007:14) proposes that international trends are followed and to allow a REIT in South Africa to distribute 90% of its accounting profits on an annual basis. To ensure that the full tax benefit of the REIT in South Africa is passed to its investors, National Treasury (2007:14) proposes that expenses charged by service providers to the REIT be regulated.

National Treasury (2007:14) wishes to keep the *status quo* applicable to CISPs, where a CISP is not allowed, other than on liquidation, to distribute proceeds realised on the disposal of assets to its investors. Their argument for not allowing the distribution of capital gains is that it deteriorates the long term value of the fund for short term gains.

3.3.4 Gearing rules

Gearing rules are imposed to protect the investor in the case of a real estate melt-down and should interest rates increase.

National Treasury (2007:15) states that real estate is typically less volatile than other asset classes like securities. A REIT can be as volatile as other securities due to the fact that they are traded on a securities exchange. Because a REIT has tangible assets to support the value of the REIT it generally has a higher liquidation value and therefore can support a higher gearing ratio than previously permitted for CISPs.

3.3.4.1 Gearing rules applicable to real estate investment trusts in selected other countries

Ernst & Young (2008:71-72) reported in the Global Real Estate Investment Trusts Report 2008 that most countries impose gearing rules. In Belgium a REIT is permitted to gear 50%. Germany also allows gearing of 50% of the market value of the real estate. The USA and Canada have no gearing restrictions. Japan requires that loans can only be obtained from qualified institutional investors. The UK did not directly impose a gearing limitation but a UK REIT should perform an annual interest cover test whereby the total profits from qualifying assets divided by the finance costs incurred during the accounting period must be greater than 1.25 (Ernst & Young, 2008:71-72.).

According to the Ernst & Young (2008:12) Global Real Estate Investment Trust Report Canada and the USA, neither of whom impose gearing restrictions, are the highest geared of all countries at 69% and 64% respectively, with most REITs being more conservative. According to the report South African property investment vehicles are the lowest geared at 13%.

3.3.4.2 National Treasury's proposals for gearing rules applicable to real estate investment trusts in South Africa

National Treasury's (2007:16) objective is to ensure that investors are protected against losing the capital invested in a REIT; however a REIT should be permitted to generate higher returns for its investors through the use of borrowings to enable the REIT to increase its investment base.

The current requirements imposed by the FSB on CISPs that allows a CISP only to gear up to 30% of its asset value compares well with that of Malaysia. National Treasury (2007:16) acknowledges that since South Africa has a stable banking sector with good corporate governance across the listed sector, they would propose a more flexible approach.

National Treasury (2007:17) suggests that the base for the calculation of the gearing limit should be the value of the fixed assets as stated in the last published financial statements. It is proposed that a gearing limit of 70% be imposed.

3.3.5 The roles and duties of trustees or directors

A PLS company is managed by its directors; the duties of directors are prescribed by the Companies Act and in the memorandum of articles. These duties are different to the duties imposed on trustees of a CISP in terms of the Collective Investment Schemes Control Act. National Treasury (2007:17) holds the view that the duties of a trustee as imposed by the Collective Investment Schemes Control Act would not be workable in a South African REIT regime. National Treasury (2007:17) acknowledges that the trustees of a CISP and the

directors of a PLS company should have the same duties in terms of their obligations to its investors.

National Treasury's (2007:18) objectives for a REIT applicable to South Africa in terms of the responsibilities and duties of a trustee or director are to ensure that the trustees or directors are held responsible and accountable for the protection of the interests of unit holders or shareholders without unnecessarily burdening the trustees or directors.

National Treasury (2007:18) proposes that the Collective Investment Schemes Control Act be reviewed and restructured to be applicable to REITs irrespective of their legal form.

3.4 CONCLUSION

The regulatory environment of PLS companies and CISPs are fragmented and based on their respective legal forms rather than on their similar objectives as property investment vehicles.

CISPs are regulated in terms of the Collective Investment Schemes Control Act and regulations imposed by the FSB. PLS companies are regulated in terms of the Companies Act, and should they be listed certain regulations imposed by the JSE would be applicable to them.

National Treasury (2007:2) proposes that the Collective Investment Schemes Control Act be amended to regulate a REIT applicable to the South African environment. They further propose that PLS companies be included under the amended Collective Schemes Control Act in order to regulate a combined REIT dispensation applicable to all South African property investment vehicles, which would include both CISPs and PLS companies (National Treasury, 2007:10.). The Association of Property Unit Trusts (Business Day, 2006:10) also suggested that modifying the existing CISP structure to incorporate both CISPs and PLS companies would be the simple solution in adopting a REIT regime in South Africa. Their argument is based on the fact that the conduit principal of taxation is legislated for CISPs while PLS companies have tax issues that need to be addressed (Business Day, 2006:10).

The regulatory environment proposed by National Treasury under a REIT environment applicable to South Africa is summarised in Table 10.

Table 10: Summary of National Treasury’s proposals for a real estate investment trust applicable to South Africa

Rule	REIT proposal
Organisation rules	
- Regulation	- Regulated by the Collective Investment Schemes Control Act with amendments to apply to a South African REIT dispensation; - Incorporated and effectively managed in South Africa; and - Sector regulated by the FSB.
- Legal form	- Public company or trust.
- Listing requirement	- Listed on South African licensed exchange.
- Investment limits	- No minimum or maximum investment requirements; and - Investment parameters considered to protect fiscus.
Income and assets rules	
- Layering	- REIT will only be allowed to invest in a REIT that directly invests in real estate.
- Bundling of assets for finance purposes	- Not allowed to be referred to as a REIT.
- Foreign investment	- Limited foreign investment will be allowed; and - Only allowed in countries with a foreign currency sovereign rating.
- Income restrictions	- Real estate investment will not be limited; - Asset management and administration services will be allowed; - 75% of total income must be derived from real estate rental; and - Direct and indirect development activities allowed but fixed asset must be retained to generate rental income and be retained for at least three years.
- Asset restrictions	- Must have at least three properties in portfolio through all financial periods; - No asset may consist of more than 40% of the total fixed asset value; and - May invest in cash, money market instruments and government securities.
Distribution rules	
	- 90% of income to be distributed to investors on an annual basis; - Proposed regulation of expenses charged to REIT to prohibit subsidisation of service providers; and - Profits from disposal of real estate may not be distributed but have to be reinvested within 12 months from realising the property.
Gearing rules	
	- Gearing limit of 70% proposed; and - Calculated on the value of fixed assets as reflected in last published financial statements.
Management rules	
	- Investors represented by elected trustees or directors.

Rule	REIT proposal
Roles of directors and trustees	
	<ul style="list-style-type: none"> - Proposed that the Collective Investment Schemes Control Act and the model trust deed applicable to CISPs as imposed by the FSB be reviewed as a generic founding document applicable to REITs irrespective of their legal form.

The framework of regulations proposed by National Treasury appear to be in-line with that of the selected other countries that have already implemented the REIT regime and appears to be less complex than the regulations that were applicable to CISPs. The inclusion of PLS companies in the regulatory framework of the amended Collective Investment Schemes Control Act would eliminate the fragmented regulatory framework and the confusion that exists with investors.

In the next chapter, the tax treatment applicable to REITs and the investors in those REITs of selected countries are reviewed. National Treasury's proposals for the tax principals as they would apply on a REIT dispensation in South Africa and the investors in those REITs are also reviewed.

CHAPTER 4

THE TAX TREATMENT OF REAL ESTATE INVESTMENT TRUSTS IN SELECTED OTHER COUNTRIES

4.1 INTRODUCTION

According to Ernst & Young (2008:50) in the Global Real Estate Investment Trust Report 2008 many countries that implemented REIT regimes allow special tax dispensation. This is generally in the form of flow-through where the REITs are regarded conduits for tax purposes should they comply with certain organisational, income and asset, distribution as well as gearing rules. These rules and their application in selected countries were reviewed in chapter 3.

Ernst & Young (2008:50) further reported that the tax treatment of most REITs dispensations are uniform in that profit derived directly from real estate investment activities are taxed in the hands of the investors and that income derived from auxiliary real estate activities are taxable in the hands of the REITs at corporate rates. This principal would place the investors in the same tax position as if they invested directly in real estate.

REITs primarily allow for passive real estate investment. Most REIT countries allow REITs to develop real estate, but require that this real estate is held as investment to derive rental income and capital growth in the long term. Most countries limit REITs to derive profit from trading in real estate and restrict their ability to derive income from non-rental activities. When REITs breach these income and asset rules they may either lose their REIT status or the income derived from non-REIT activities are taxed in those REITs at the applicable corporate tax rate. In the case of USA REITs for example the entire profits of those REITs become taxable. Other REIT dispensations allow the REITs to derive non-core activities in a ring-fenced entity that would be taxable under normal tax rules (Ernst & Young, 2008:50.).

4.2 TAXATION OF REAL ESTATE INVESTMENT TRUSTS IN SELECTED OTHER COUNTRIES

National Treasury (2007:24) summarises that the tax applicable to REITs internationally depends on whether certain rules imposed by either regulatory or tax authorities are adhered to.

Most REIT countries impose tax in the hands of the investors and require that most of the income generated by REITs be distributed to its investors as described in chapter 3.3.3, thereby giving effect to the conduit principal of taxation. In order to avoid loss of income to the fiscus, should the investor be a foreign investor, most countries impose withholding tax on either all distributions or on distributions to those foreign investors. Countries that impose withholding tax on the income distributed to foreign investors by REITs include, Belgium, France, Japan, the Netherlands, and the USA (National Treasury, 2007:24.).

Capital gains realised by REITs generally are exempt from capital gains taxation. Countries that allow for exemption of capital gains taxation include Belgium, France, Italy, the Netherlands and the UK (National Treasury, 2007:25).

To avoid loss to the fiscus most countries levy an entry or conversion charge based on the value of the real estate held by the entity at the date of entering or converting to a REIT applicable in that country (National Treasury, 2007:25).

The taxation treatment of REITs in selected countries is discussed below. The discussion is not aimed to provide a detailed overview of the respective country's application of taxation but rather to provide an understanding of the general application of taxation on REITs and the investors in those REITs.

4.2.1 Australian real estate investment trusts

Australian REITs were established in 1985 and are regulated by the Income Tax Assessment Acts 27 of 1936 and 38 of 1997 as well as the Corporations Act 2001 (KPMG, 2007:11).

The general taxation principals applicable to Australian REITs and their application in the hands of their investors are discussed below.

4.2.1.1 Taxation principals applicable to Australian real estate investment trusts

According to the Ernst & Young (2008:56) Global Real Estate Investment Trust Report 2008 should Australian REITs purely generate passive income from investment in real estate the net profit derived by Australian REITs are taxed in the hands of their investors, however income from real estate related activities, for example from real estate development or facility management activities, are taxed in the Australian REITs at corporate rates.

Should Australian REITs generate taxable income that is not distributed to their investors, the income retained would be taxable in those Australian REITs at the top marginal taxation rate applicable to individuals (Ernst & Young, 2008:68).

Capital gains realised by Australian REITs from the disposal of real estate held for investment will be included in the taxable income of those Australian REITs (KPMG, 2007:15).

Australian REITs are obligated to withhold a final withholding tax from the interest, dividend and royalty distributions made to their foreign investors. On any other distribution to foreign investors, a non-final withholding tax is applicable. The rate of the withholding tax is dependant on whether Australia has an exchange of information arrangement with the resident state of those foreign investors. Foreign investors to whom a non-final withholding tax were applied are obligated to complete an Australian tax return and certain allowable expenses are deductible from the distributions to which the non-final withholding tax applied (Ernst & Young, 2008:73.).

Assessed losses derived by Australian REITs cannot be distributed to their investors (Ernst & Young, 2008:73).

4.2.1.2 Taxation principals applicable to investors in Australian real estate investment trusts

In terms of the conduit or flow-through principal, income distributed by Australian REITs will retain its nature in the hands of their investors (Ernst & Young, 2008:73).

Dividend distributions received from Australian REITs and capital gains realised on the disposal of its interest in Australian REITs by domestic corporate investors are subject to normal corporate taxation rules. Income distributed, derived from a foreign source, by Australian REITs is subject to normal corporate taxation. The domestic corporate investors will however be able to claim any foreign withholding taxes paid in that foreign jurisdiction against their Australian tax liability (KPMG, 2007:18.).

Domestic individual investors in Australian REITs would include distributions received from Australian REITs in their taxable income. Capital gains realised by domestic individual investors on the disposal of their interest in Australian REITs would be included in their taxable income at the applicable capital gains inclusion rate should that investor have held their investment in the Australian REIT for a period longer than 12 months. Income distributed by Australian REITs that were derived from a foreign source is subject to taxation for the domestic individual investors. Any withholding taxes paid in a foreign jurisdiction may be credited against their Australian tax liability (KPMG, 2007:19.).

When cash distributions by Australian REITs exceed their taxable income, the difference is not subject to taxation in the hands of either the REITs or their investors and is deferred. These tax deferred amounts reduce the base cost of the units in the hands of the investors and when these tax deferred amounts exceed the base cost of the units in the hands of the investors, a taxable capital gain arises in the hands of the investor (Ernst & Young, 2008:73.).

Capital gains distributed from real estate directly or indirectly held by Australian REITs to foreign investors are taxable. Gains realised by Australian REITs from the disposals of investments in other subsidiary REITs would not be taxable provided that the market value of the underlying capital gains tax assets held by that subsidiary REIT consists at least 90% of non Australian real estate (Ernst & Young, 2008:73.).

Foreign investors in Australian REITs are subject to Australian tax on income from an Australian source. Dividends and interest received by foreign investors from Australian REITs are subject to a final withholding tax. The rate of withholding tax differs on dividend and interest distributions. Non-dividend and non-interest related income distributions to foreign investors, from an Australian source are subject to a non-final withholding tax. Foreign investors are obligated to complete an Australian tax return and are allowed to claim withholding taxes paid on non-dividend and non-interest distributions as a credit against their Australian tax liability (KPMG, 2007:20.). As previously mentioned, withholding tax on dividend, interest and royalty distributions are a final withholding tax and are not included in the Australian tax return completed by foreign investors.

Should foreign investors in Australian REITs hold at least 10% of the issued units in that Australian REIT and at least 50% of the total assets, at their fair market value, comprise of real estate located in Australia then those foreign investors would be subjected to Australian capital gains tax (Ernst & Young, 2008:73).

Foreign investors in Australian REITs are subject to capital gains tax on the disposal of their interest in Australian REITs at a 50% inclusion rate (KPMG, 2007:20-21).

Income distributed from a foreign source by Australian REITs is not taxed in Australia (KPMG, 2007:21).

4.2.2 Canadian real estate investment trusts

The Canadian REIT regime was established in 1994 and is regulated by the federal Income Tax Act 1985 (KPMG, 2007:22).

The general taxation principals applicable to Canadian REITs and their application in the hands of their investors are discussed below.

4.2.2.1 Taxation principals applicable to Canadian real estate investment trusts

Ernst & Young (2008:64) reported that Canadian REITs would be exempt from distributions tax on distributions to its investors should those Canadian REITs have complied with the following conditions, the Canadian REITs

- do not hold any non-portfolio or non-Canadian immovable real estate;
- 95% of the Canadian REIT's revenue is derived from immovable real estate rentals, capital gains from disposal of immovable real estate, interest, dividends and royalties;
- 75% of its revenue is derived from a Canadian source; and
- 75% of that Canadian REIT's equity value comprises of Canadian immovable real estate (calculated at their fair market value), cash and Canadian account receivables.

Should Canadian REITs qualify as a mutual fund trust and meet the Income Tax Act's definition of a REIT, those Canadian REITs would be exempt from income tax to the extent that the income, either capital or revenue, becomes payable or has been paid to its investors in that year of assessment. If the income or capital revenue has not been paid or is not considered to be payable to its investors, the Canadian REITs would be taxed on that income at the highest marginal tax rate applicable to individuals (Ernst & Young, 2008:68.).

Losses generated by Canadian REITs cannot be distributed to their investors (Ernst & Young, 2008:74).

4.2.2.2 Taxation principals applicable to investors in Canadian real estate investment trusts

Distributions by Canadian REITs to foreign investors are subject to withholding tax. The withholding tax would only apply to capital distributions of those Canadian REITs if they have a taxable Canadian real estate gain reserve at the time the distribution is made and the distribution represents 5% or more of the total distributions received by those foreign investors during the year of assessment (Ernst & Young, 2008:74.).

4.2.3 French real estate investment trusts

The French entered the REITs regime in 2003 and French REITs are governed by the *Autorité des Marchés Financiers* (KPMG, 2007:1).

The general taxation principals applicable to French REITs and their application in the hands of their investors are discussed below.

4.2.3.1 Taxation principals applicable to French real estate investment trusts

French REITs have to distribute operating income before the end of the tax year following the year in which it was realised. Capital gains on the disposal of real estate have to be distributed before the end of the tax year two years after the real estate was disposed of (KPMG, 2007:4.).

French REITs do not receive preferential taxation treatment. However eligible activities or income from passive real estate investments qualify for tax exemption (Ernst & Young, 2008:75). Non-eligible activities are taxable in the French REIT (KPMG, 2007:4).

Capital gains realised from the disposal of investment real estate or real rights to investment real estate under eligible activities by French REITs are exempt from taxation (KPMG, 2007:4).

French REITs are required to withhold withholding tax on distributions to foreign investors (KPMG, 2007:4).

Distributions by a French REIT to another French REIT as well as distributions received by a French REIT from a foreign REIT are exempt from taxation should that French REIT have held at least 5% of the share capital and voting rights in that foreign REIT for a minimum period of at least 2 years (Ernst & Young, 2008:68).

According to Ernst & Young (2008:68) distributions by French REITs to investors that are not natural persons and that hold at least 10% of the dividend rights in those French REITs would be subject to a levy.

4.2.3.2 Taxation principals applicable for conversion to French real estate investment trusts

An entity that is converted to a French REIT is subject to an exit tax on unrealised capital gains on qualifying investments payable in instalments over the next four years. Assessed taxation losses carried forward by that entity are deductible from the unrealised capital gains exit tax payable (KPMG, 2007:5.).

4.2.3.3 Taxation principals applicable to investors in French real estate investment trusts

Domestic corporate investors are fully taxed on dividends received from French REITs, irrespective of whether that distribution was made from the French REIT's exempt or taxable income (KPMG, 2007:7).

Capital gains realised by domestic corporate investors on the disposal of their units in French REITs are fully taxable. However if the investor held the units for at least 2 years the rate is reduced (KPMG, 2007:7).

Distributions received by domestic individual investors from French REITs are taxable after the deduction of a 40% allowance on the dividends received (KPMG, 2007:9).

When domestic individual investors dispose of their units in French REITs at a gain, the capital gain is taxed at a reduced capital taxation rate (KPMG, 2007:9).

4.2.4 Hong Kong real estate investment trusts

The Hong Kong REIT was established in 2002 and is regulated by the Securities and Futures Commission (KPMG, 2007:11).

REITs established in Hong Kong have no preferential tax treatment (Ernst & Young, 2008:76).

4.2.5 Japanese real estate investment trusts

The Japanese REIT dispensation was established in 2000 and is regulated by the Law Concerning Investment Trusts and Investment Corporations of Japan 198 of 1951, Investment Trust Association and needs to comply with the Income Tax Act 33 of 1965 and Corporation Tax Act 34 of 1965 in order to qualify for tax exempt status (KPMG, 2007:11).

The general taxation principals applicable to Japanese REITs and their application in the hands of their investors are discussed below.

4.2.5.1 Taxation principals applicable to Japanese real estate investment trusts

In order for Japanese REITs to deduct the distribution to its shareholders from its taxable income it is required to at least distribute 90% of its distributable income to its investors (Ernst & Young, 2008:69).

Ernst & Young (2008:77) reported that Japanese REITs are subject to withholding tax on distributions to foreign investors unless the investor is an individual owning more than 5% of the total issued units.

4.2.5.2 Taxation principals applicable to investors in Japanese real estate investment trusts

Dividend distributions by Japanese REITs are subject to taxation in the hands of the domestic corporate as well as the domestic individual investor (KPMG, 2007:18-19).

Capital distributions by Japanese REITs are subject to capital gains tax in the hands of their investors. Should an investor own more than 5% of a listed Japanese REIT or 2% of an unlisted Japanese REIT the capital distribution would not be subject to Japanese income tax (Ernst & Young, 2008:77.).

Dividends distributed to foreign investors are subject to withholding tax. Capital gains realised by foreign investors on the disposal of their interests in Japanese REITs are not

subject to capital gains tax provided that the investor does not sell more than 5% of the investment in one tax year (KPMG, 2007:20.).

4.2.6 Malaysian real estate investment trusts

Malaysian REITs were established in 2005 and are regulated by the Securities Commission in terms of the Securities Commission Act 498 of 1993 (Securities Commission, 2005:9).

The general taxation principals applicable to Malaysian REITs and their application in the hands of their investors are discussed below.

4.2.6.1 Taxation principals applicable to Malaysian real estate investment trusts

Ernst & Young (2008:69) reported that Malaysian REITs would be exempt from tax if at least 90% of its total income is distributed to its investors. If a Malaysian REIT does not meet this requirement, a Malaysian REIT would be subject to tax on its total income, however the investors would be eligible to qualify for a tax credit.

Malaysian REITs are not subject to capital gains tax on disposal of real estate (Ernst & Young, 2008:77).

4.2.6.2 Taxation principals applicable to investors in Malaysian real estate investment trusts

Distributions by Malaysian REITs to foreign as well as domestic corporate investors are subject to withholding tax, however different withholding tax rates apply (Ernst & Young, 2008:77).

4.2.7 Taiwanese real estate investment trusts

Taiwanese REITs were established in 2003 and are regulated by the Financial Supervisory Commission under the Real Estate Securitization Act of 2003 (Lin, 2007:288).

The general taxation principals applicable to Taiwanese REITs and their application in the hands of their investors are discussed below.

4.2.7.1 Taxation principals applicable to Taiwanese real estate investment trusts

The distribution of net profits by Taiwanese REITs is taxed in the hands of their investors (Ernst & Young, 2008:62). Although Taiwanese REITs are treated as conduits, the income distributed by Taiwanese REITs does not retain its nature in the hands of their investors but is regarded to be interest (Ernst & Young, 2008:80).

Assessed losses derived by Taiwanese REITs are ring-fenced and cannot be distributed to their investors (Ernst & Young, 2008:80).

4.2.7.2 Taxation principals applicable to investors in Taiwanese real estate investment trusts

Income received by domestic as well as foreign investors from Taiwanese REITs is subject to a final withholding tax (Ernst & Young, 2008:70). The investors are not required to declare the income on their personal income tax returns and are not allowed to claim the withholding tax as a credit against other taxation payable (Ernst & Young, 2008:80).

4.2.8 United Kingdom real estate investment trusts

The UK enacted the REIT regime in 2007 and the UK REITs are governed through the Finance Act 6 of 2006 (KPMG, 2007:1).

The general taxation principals applicable to UK REITs and their application in the hands of their investors are discussed below.

4.2.8.1 Taxation principals applicable to United Kingdom real estate investment trusts

Ernst & Young (2008:67) reported that in order for REITs in the UK to maintain tax exempt status, 75% of its income must be derived from qualifying real estate investment activities.

Non qualifying activities, such as real estate development and other trading activities are taxed under normal corporate taxation rules.

KPMG (2007:[1]) reported that UK REITs are required to distribute 90% of their exempt rental income, also known as the property income distribution, to their investors. Should a UK REIT elect to distribute more than 90% of its exempt rental income, that UK REIT can elect whether such distribution would be regarded as a property income distribution or as a dividend.

KPMG (2007:4) reported that UK REITs are obligated to distribute 90% of its exempt rental income, also known as the property income distribution, to its investors before or on the UK REITs own assessment date. This distribution will be deductible from the UK REITs taxable income and indirectly be exempt from taxation. Income, other than exempt rental income, derived by UK REITs would be taxable under normal UK taxation rules (KPMG, 2007:4.).

As discussed in chapter 3.3.4 of this study, the UK does not directly impose gearing limitation rules on UK REITs but they are required to perform an annual interest cover test whereby the total profits from qualifying assets divided by the finance costs incurred during the accounting period must be greater than 1.25. If a UK REIT fails this interest cover test that UK REIT would be subject to taxation on the excess finance costs (Ernst & Young, 2008:72.).

Capital gains derived by UK REITs from the disposal of real estate held purely to derive exempt rental income would be exempt from capital gains tax. However capital gains arising from the disposal of real estate from its non-exempt business activities would be subject to corporation tax (KPMG, 2007:4.).

UK REITs are obligated to withhold withholding tax from distributions to foreign investors from its exempt business also known as the property income distributions (KPMG, 2007:4).

4.2.8.2 Taxation principals applicable for conversion to United Kingdom real estate investment trusts

UK REITs are subject to a conversion charge of 2% calculated on the total fair market value of the real estate transferred into the REIT's tax exempt business (Ernst & Young, 2008:80).

When an entity is converted to a UK REIT or a UK REIT purchases real estate from any other entity, the real estate is transferred to the UK REIT at its existing tax value. The UK REIT would therefore be unable to claim wear-and-tear allowances on the purchase price of that real estate and can only claim the remaining wear-and-tear allowances (Ernst & Young, 2008:80.).

UK REITs are not allowed to off-set losses that arise from its tax exempt business from profits that arise from its taxable business, the opposite also applies (KPMG, 2007:5).

4.2.8.3 Taxation principals applicable to investors in United Kingdom real estate investment trusts

The property income distributions received from UK REITs are taxed in the hands of domestic corporate investors, as property letting income from a UK source but are ring-fenced from any other property letting business income from a UK source for that investor. Domestic corporate investors are eligible to receive dividends from UK REITs on a gross basis (KPMG, 2007:1.).

Income distributed from non-qualifying activities by UK REITs are treated as dividends in the hands of the investor (Ernst & Young, 2008:70).

Capital gains realised by the domestic corporate investor from the disposal of its units in UK REITs are taxable under normal taxation rules (KPMG, 2007:7).

Property income distributions by UK REITs are subject to withholding tax and are treated as property income in the hands of the domestic individual investor. Any other distributions

by UK REITs are regarded dividends in the hands of their investors (Ernst & Young, 2008:70.).

Domestic individual investors can credit the withholding tax against its own tax liability and should the investor's effective tax rate be less than the withholding tax paid that domestic individual investor can reclaim the difference from HM Revenue & Customs (KPMG, 2007:[1]).

Distributions received by domestic individual investors are ring-fenced from other taxable income from rental businesses (KPMG, 2007:9).

Capital gains realised on the disposal of its investment in UK REITs by domestic individual investors are taxable in the ordinary manner (KPMG, 2007:9).

Dependant on international tax treaties, foreign investors are able to claim the withholding tax as a credit against taxation payable in their resident countries (Ernst & Young, 2008:80).

4.2.9 United States of America real estate investment trusts

KPMG (2007:22) reported that the USA REIT was established in 1960 and is regulated by tax regulatory laws. The USA REIT is regulated by the National Association of Real Estate Investment Trusts, Real Estate Investment Trust Act of 1960 (Public Law 86-779 – Federal Internal Revenue Code of 1954 section 856 *et seq.*), REIT modernization Act of 1999 and the Tax Reform Act of 1986.

The general taxation principals applicable to USA REITs and their application in the hands of their investors are discussed below.

4.2.9.1 Taxation principals applicable to United States of America real estate investment trusts

Obringer (n.d.:^[1]) stated that for USA REITs to qualify as a conduit for corporate, federal and state income tax the USA REIT needs to distribute at least 90% of its income to its stock-holders, the distribution will then qualify as a deduction from its corporate taxable income.

For a corporation to qualify as an USA REIT and retain its pass through or conduit taxation status the corporation according to Obringer (n.d.:^[1]) must

- be incorporated as a corporation, business trust or similar association;
- managed by a board of directors of trustees;
- offer fully transferable shares;
- have at least 100 investors;
- pay dividends of at least 90% of their REITs taxable profits;
- have not more than 50% of its stock held by five or less investors;
- hold 75% of total investments in real estate assets;
- have no more than 20% of its assets consist of stock in taxable REIT subsidiaries;
and
- derive 75% of gross profits from rental income or bond interest and 95% from rental, dividends, interest and capital appreciation.

Dividends distributed by USA REITs, whether income or capital in nature, are deductible from the USA REITs taxable income (KPMG, 2007:23-24).

USA REITs are subject to corporate tax on any undistributed income and further tax is levied on the undistributed amounts (Ernst & Young, 2008:70.).

USA REITs are subject to 100% tax on transactions with taxable REIT subsidiaries should those transactions not be at arms length. The same tax rate applies on profits from trading activities derived by USA REITs (Ernst & Young, 2008:81.).

Distributions by USA REITs to foreign investors are subject to withholding tax. The withholding tax rate applicable to income and capital distributions differ (KPMG, 2007:24.).

USA REITs can elect not to distribute capital gains to their investors and then may retain capital gains, they can also elect not to qualify as a tax exempt corporation and pay tax (Ernst & Young, 2008:81).

USA REITs cannot distribute losses to its investors (Obringer, n.d.:1).

4.2.9.2 Taxation principals applicable for conversion to United States of America real estate investment trusts

A conversion tax is payable should a USA REIT dispose of assets within a period of ten years. All retained earnings a corporation accumulated before it became a USA REIT have to be distributed to its investors before the end of the USA REITs first taxable year (KPMG, 2007:24.).

4.2.9.3 Taxation principals applicable to investors in United States of America real estate investment trusts

Distributions from a USA source to foreign investors, other than those designated as capital gain dividends, are subject to withholding tax. Should the foreign investor own more than 5% of the stock in the USA REIT, the distribution is subject to ordinary dividend treatment. (Ernst & Young, 2008:81.).

Obringer (n.d.:5) reported that dependant on the REIT distribution policy and its yearly profits, a portion of the distributed dividends can be considered to be a return on capital and is therefore not taxable. The investor therefore does not have to pay taxes on that capital part of the dividend the year the dividend is received and the payment of taxes is deferred to such time the share is sold.

Ordinary dividends and capital gain distributions from USA REITs to domestic corporate investors are subject to corporate income tax (KPMG, 2007:25).

Ordinary dividends and capital gain distributions by USA REITs to domestic individual investors are subject to income tax at different rates of taxation (KPMG, 2007:26).

Since distributions received by investors in USA REITs are not subject to corporate taxation, the dividends in the hands of the investors do not qualify for the reduced rate of taxation applicable to dividends but will be included in the taxable income of those investors and taxed at normal taxation rates (Obringer, n.d.: [6]).

Capital distributions are taxed as capital gains on disposal of the investor's interest in the USA REIT to the extent that they exceed the base cost of that investment (KPMG, 2007:25-26).

4.3 NATIONAL TREASURY'S PROPOSALS FOR THE TAX DISPENSATION APPLICABLE TO REAL ESTATE INVESTMENT TRUSTS IN SOUTH AFRICA

As discussed in chapter 2, the tax dispensation of the current South African property investment vehicles is inconsistent and unnecessarily confusing. National Treasury (2007:23) recognised that there is a need for change.

National Treasury (2007:25) argues that in order to award special tax dispensation to a REIT regime in South Africa it should be distinguished from other operating companies. REITs invest in real estate to generate rental income for distribution to its investors. REITs could therefore be categorised as a pool of capital contributions from investors to purchase real estate in order to generate passive income. The main reason for National Treasury (2007:25) to support its argument to award special tax dispensation rules to a South African REIT regime is to enable South African property investment vehicles to compete internationally without increasing the risk to its investors.

National Treasury (2007:26) proposes that regulatory rules applicable to CISPs be reviewed in line with international trends and to accommodate PLS companies. They further propose that beneficial tax rules applicable to CISPs be extended to include PLS companies.

4.3.1 Basic considerations

National Treasury (2007:26-27) proposes the following basic principals to apply, a straightforward and standardised tax dispensation applicable to all REITs, the new applicable tax dispensation should only allow for a single level of tax, therefore investors in a REIT will only be taxed on distributions of an income nature from a REIT and will only pay capital gains tax on gains realised on the disposal of their investment in a REIT. No tax would be levied on distributions of a capital nature by a REIT. National Treasury (2007:26-27) proposes that this exemption would be made on the condition that earnings by a REIT must be distributed to its investors and capital gains must be reinvested.

4.3.2 Income distributions

National Treasury (2007:27) proposes that a REIT in South Africa should, by way of regulations imposed, distribute most of its income to its investors within each financial year. Since the REIT would therefore have marginal or no taxable income, the investors in that REIT would be taxed on the distributions received.

Profits distributed by a REIT will keep their nature; therefore rental income derived by a REIT will be distributed to its investors as rental income. This will also ensure that the income from a REIT is treated the same as income from fixed property or real estate as provided for in South Africa's international tax treaties (National Treasury, 2007:27.).

4.3.3 Capital distributions

National Treasury (2007:28) proposes that the regulatory framework applicable to a South African REIT should prevent those REITs from distributing capital gains or any proceeds from the disposal of real estate to investors to ensure that it is reinvested. REITs therefore would be exempt from paying capital gains tax on gains derived from the disposal of real estate. However investors will pay capital gains tax when their units are disposed of. The three year capital rule should be extended to REITs, therefore investors realising units within three years from date of acquisition would be regarded income nature (National Treasury, 2007:28.).

Since the disposal of units or shares in a South African REIT would be regarded as property in nature, capital gains realised by a foreign investor in a South African REIT would be taxable in terms of domestic legislation and double taxation agreements. Consideration should be given to amend section 9(2) and paragraph 2(2) of the Eighth Schedule to the Act, to allow for gains on the disposal of investments units in a South African REIT by non-residents to be subject to tax in South Africa.

4.3.4 Conversion to South African real estate investment trusts

National Treasury (2007:30) proposes that the conversion of existing property investment vehicles to a South African REIT regime to be tax-free, but that an entry levy may be considered. CISPs are already in the tax-free environment and no tax event will be triggered when they convert to a South African REIT. PLS companies would not trigger capital gains on underlying assets, but income earned up to the date of conversion may have to be paid out to investors shortly before they convert to a South African REIT (National Treasury, 2007:30.).

Should an investor have to swap its existing shares for units in a South African REIT the swap will be considered tax free, provided that the base cost of the original investment is retained and applies to the new units (National treasury, 2007:30).

Fixed property companies owned by CISPs and subsidiaries owned by PLS companies will have to be amalgamated in order to comply with National Treasury's proposal for a single layer of investment; income earned to the date of amalgamation will have to be distributed. These amalgamations will not be subject to capital gains tax but the fiscus could consider an entry levy. In order to achieve a tax free amalgamation, the original cost of the real estate at acquisition date by the fixed property company and the subsidiary PLS company should be retained by the REIT (National Treasury, 2007:30.).

4.3.5 Company reformations

National Treasury (2007:23) highlights that sections 41 to 47 of the Act that deal with company formations, amalgamation transactions, intra-group transactions, unbundling

transactions and liquidation distributions, will not be applicable to CISPs since CISPs are not companies as they do not conform to the definition of a company in section 1 of the Act. CISPs would therefore not be able to make use of these sections should they need to restructure to conform with the proposals made by National Treasury and would therefore not be able to defer the tax implications of such a restructuring.

4.3.6 Double taxation agreements

Olivier and Honiball (2005:8) stated that although South Africa is not a member of the Organisation for Economic Co-operation and Development (OECD) many of South Africa's double taxation agreements are based on the OECD model tax treaty.

National Treasury (2007:25) states that double taxation agreements do not specifically cater for a REIT's tax dispensation and that the OECD is working on a specific REIT clause to be included in the model OECD tax treaty.

It would therefore be imperative, to avoid possible double taxation for foreign investors in South African REITs, that current tax treaties be amended to cater for the taxation of South African REITs should that be required as discussed in chapter 4.3.2.

4.4 CONCLUSION

As previously discussed, National Treasury describes a REIT as a pool of capital contributions from investors used to purchase real estate and generate passive income without increasing risk. Compared to direct investment in real estate a REIT provides added advantages to its investors, as described in chapter 3.3, namely tax-efficiency, diversification, liquidity, accessibility and good governance. Internationally, REIT regimes impose certain organisation rules, as discussed in chapter 3.3.1, to ensure that these principals are achieved.

In fact a REIT regime caters for a broader base of investors to partially own real estate that in their personal capacity would have been out of reach due to affordability. It further

provides more liquidity than in the case of direct investment in real estate in that the commodity is more affordable and traded on a listed exchange.

South Africa's consideration for entering the REITs regime as opposed to keeping the current CISP and PLS companies are to compete internationally and increase return for investors.

The tax treatment of South African REITs should also be internationally competitive to enable South African REITs to attract foreign investment.

Most REIT dispensations are uniform in their tax treatment in that profit derived from real estate investment activities is exempt from tax in the hands of the REITs and income derived from auxiliary real estate activities is taxable in the hands of the REITs at corporate rates (Australia, Taiwan, Canada, UK, France and Malaysia). REITs generally are not allowed to trade in real estate. In certain other cases REITs are not exempt from tax, but distributions made by those REITs to their investors are deductible in the calculation of its taxable income (Japan and USA). This concession is made by the respective tax authorities as the regulatory requirements imposed on those REITs in terms of their applicable income and asset as well as distribution rules are that a REIT must distribute most of its income to its investors. It further regulates the auxiliary income that a REIT may derive (France, Hong Kong, Germany, Japan, Malaysia, Taiwan, UK and USA). In cases where minimum distributions are not prescribed, regulations normally prescribe that the income so retained is taxable in the hands of the REIT (Australia, Canada and Italy).

National Treasury's proposal to require that a South African REIT distributes most of its income would be in-line with international trends. National Treasury does however not make a proposal on how auxiliary income derived by a South African REIT should be treated.

Capital gains derived from the disposal of real estate by a REIT is generally tax exempt in the hands of the REIT (UK, France, Italy, Germany, Hong Kong), others treat capital gains on disposal of investment real estate the same as income distributions; for example, a Japanese REIT can deduct the capital distribution from taxable income if distributed to its

investors. An Australian REIT is taxed at the capital gains inclusion rate on the capital gain derived from disposal of investment real estate. The tax application generally follows the distribution rules imposed by regulatory authorities; for example, the capital gains derived by a Belgium REIT on the disposal of investment real estate may be retained, provided they are reinvested within four years (Ernst & Young, 2008:68). A Canadian REIT's capital gains derived from the disposal of investment real estate would not be taxable, provided that all of its income, which includes the capital gains are paid or become payable to its investors in that year. In the case of a French REIT the distribution rule is that at least 80% of its rental income must be distributed and therefore does not require capital gains on the disposal of investment real estate to be distributed. A German REIT can retain 50% of its capital gains derived from the disposal of investment real estate in a reserve. A Hong Kong REIT must distribute 90% of its net income, which would include capital gains. A Malaysian REIT must distribute at least 90% of their total income for the year to its investors in order to retain its tax exempt status, this would include capital gains. In the UK at least 90% of its qualifying activities (excluding capital gains derived from disposal of real estate) must be distributed.

National Treasury's proposal is to prohibit, in terms of regulatory requirements, the distribution of capital gains derived from the disposal of investment real estate and in doing so retain the profits in the REIT to be reinvested. The proposal by National Treasury would therefore not be in-line with international trends that in general do not require that capital gains be distributed or retained.

National Treasury should consider how not allowing the distribution of capital gains could have other consequential affects. The units or shares of the REIT may trade at a discount as a portion of the value of the unit held by the investor could never be realised in cash. A further consideration is the fact that the REIT would be geared lower than other comparative companies due to the retention of realised capital gains. As a result the REIT will have a lower cost of capital requirement when making an investment decision and potentially could acquire real estate at a higher value yielding a lower return to its investors. This could be truer when a country has a high growth rate and real estate is in high demand.

An underlying risk of granting a tax exempt status is that tax is not collected from foreign investors. To limit this risk to the various fiscus' many jurisdictions impose withholding tax on the distribution to either all investors or only to foreign investors (UK, France, Belgium, Italy, Germany, Netherlands, Australia, Japan, USA and Canada). National Treasury proposes that the distribution by a South African REIT would retain its nature in the hands of the investor. South African legislation and double taxation agreements would therefore apply and a South African REIT would not be required to withhold withholding tax in terms of section 35 or 35A of the Act on its distributions.

All income distributions received by an investor from a REIT is generally taxed in the hands of the investor (UK, France, Australia, Japan, USA and Canada).

In a country like France, the domestic corporate investor is fully taxed on the dividends received from a French REIT. However the domestic individual investor receives an allowance against the dividend received and the balance is fully taxed.

In certain countries the income distributed by a REIT retains its nature in the hands of the investor, like for example, Australia. In other countries the nature of the distribution changes, for example in Taiwan the nature of the distribution is regarded as interest and in the UK it is regarded as profits from a property business.

National Treasury proposes that the income distributed by a REIT retains its nature.

Certain countries tax the capital gain realised by the investor on the disposal of his/her interest in a REIT as income (UK and USA), others tax it as a capital gain (France, Canada and Australia) in the hands of the Australian domestic corporate investor it is taxed as income.

National Treasury proposes that the disposal of an investor's interest in a South African REIT be treated as a capital gain should the investor have retained that investment for a period of longer than three years.

Most countries impose a withholding tax on the distribution from a REIT to a foreign investor (Australia, Taiwan, Canada, UK, Japan, USA and Malaysia). In some cases the

withholding tax is a final tax (Taiwan) in other cases the investor is required to complete a tax return in which the investor can claim the withholding tax paid against the total tax liability in that country (Australia, and the UK).

National Treasury does not propose a withholding tax but envisages that South African domestic legislation and double taxation agreements will apply.

In the next chapter, concluding on the regulation, implementation and taxation of REITs applicable to South Africa will be discussed.

CHAPTER 5

CONCLUSION: SOUTH AFRICAN REAL ESTATE INVESTMENT TRUSTS

5.1 INTRODUCTION

South Africa is one of only a few countries with a listed real estate sector that have not yet adopted a REIT structure and in order for South Africa's listed real estate sector to be recognised by international investors, South Africa has to align itself with international trends and standards (Business Day, 2006:10). National Treasury (2007:5) described the current listed South African real estate sector as "*fragmented, only partly regulated and the regulatory framework [as] too restrictive and not internationally competitive*". It is suggested that these inconsistencies in the current property investment vehicles are rectified by adopting an internationally recognised REIT regime in South Africa.

The Association of Property Unit Trusts (Business Day, 2006:10) argued that modifying the existing CISP structure, incorporating both CISPs and PLS companies, would lead to the simple solution of adopting a REIT structure in South Africa. The reason for this argument is that the conduit principal of taxation is already legislated for CISPs while PLS companies have tax issues that need to be addressed. As discussed in chapter 3, National Treasury also proposes that the current Collective Investment Schemes Control Act be amended to regulate a combined REIT dispensation in South Africa, which will include both CISPs and PLS companies.

A first step in introducing a REIT regime in South Africa was announced by the South African Property Loan Stock Association (2008:[1]) on 21 November 2008 when SA REIT Limited agreed to change its name to Ingenuit Property Investments Limited, allowing the JSE listed real estate sector in future to use the name South African Real Estate Investment Trust (SA REIT).

5.2 THE CURRENT FRAGMENTED REGULATORY ENVIRONMENT OF SOUTH AFRICAN PROPERTY INVESTMENT VEHICLES

The fragmented regulatory environment of the current South African property investment vehicles was reviewed in chapter 2. In summary, the South African listed real estate sector currently comprises of CISPs and PLS companies. CISPs have the legal form of vesting trusts and are regulated by FSB in terms of the Collective Investment Schemes Control Act. The FSB regulates CISPs by prescribing in the model trust deed how CISPs should conduct business and are managed. PLS companies have the legal form of companies and are regulated in terms of the Companies Act. The Companies Act does not specifically prescribe how PLS companies should conduct business or are managed.

National Treasury proposes that REITs in South Africa have the legal form of either a trust or a public company. As proposed by the Association of Property Unit Trusts, National Treasury also proposes that the scope of the Collective Investment Schemes Control Act be amended to incorporate a REIT regime for South Africa and those REITs in South Africa are regulated by the FSB. PLS companies will therefore have to apply with the FSB to be converted to REITs in South Africa while CISPs automatically would be converted to REITs as they are already regulated by the Collective Investment Schemes Control Act and the FSB. The FSB will also have to amend the model trust deed to incorporate a generic founding document applicable to REITs irrespective of their legal form. National Treasury proposes that the term CISP in the Collective Investment Schemes Control Act be replaced with the internationally recognised term REIT and that an investment unit in a REIT be referred to as “property units” consisting of “participatory property interests” in trusts and “property shares” in companies.

5.3 ENVIRONMENT AND INCONSISTENT TAX TREATMENT OF SOUTH AFRICAN PROPERTY INVESTMENT VEHICLES

The inconsistent tax treatment of the current South African property investment vehicles was reviewed in chapter 2. In summary, the tax treatment of current South African property investment vehicles is dependent on their legal form, trusts *versus* companies, rather than their common purpose as property investment vehicles. Since CISPs do not conform with

the definition of a company as defined in section 1 of the Act, section 25B(1) of the Act, applicable to vesting trusts, it has the result that income profit and capital gains derived by the CISP flow through the CISP to the participatory interest holders. These profits and gains retain their nature in terms of the conduit principal and are taxed in the hands of those participatory interest holders.

Paragraph 67A(1) of the Eighth Schedule to the Act has the effect that capital gains derived by CISPs or the participatory interest holders would not be taxable until such time when the participatory interest holders dispose of their interest in the CISP.

Section 11(s) of the Act, applicable to property shares held in fixed property companies by CISPs, does not apply to PLS companies as PLS companies do not fall within the scope of the Collective Investment Schemes Control Act.

Section 10(1)(k)(i) of the Act applicable to dividends received by CISPs and PLS companies from their investment in fixed property companies or real estate holding companies and to participatory interest holders and linked unit holders would not apply in terms of the proviso contained in section 10(1)(k)(i)(aa) to CISPs and their participatory interest holders in terms of income dividends derived from property shares as these shares were exempt in terms of section 11(s) of the Act.

5.4 REFORMING THE SOUTH AFRICAN LISTED REAL ESTATE INVESTMENT VEHICLE SECTOR AND THE IMPLEMENTATION OF A SOUTH AFRICAN REAL ESTATE INVESTMENT TRUST REGIME

In chapter 3, the design features and regulatory environment of REITs in selected other countries as well as National Treasury's proposals as how they would apply to REITs in South Africa were discussed. With the exception of National Treasury's proposal not to allow the distribution of capital gains derived from the disposal of real estate to investors, the proposals by National Treasury appear to be aligned with that applicable to REITs in the selected other countries.

Table 11 below summarises National Treasury’s proposals for the design features and regulatory environment applicable to a REIT dispensation in South Africa and those applicable to the current property investment vehicles namely CISPs and PLS companies.

Table 11: Summary of National Treasury’s proposals for design features and the regulatory environment applicable to South African real estate investment trusts and those of collective investment schemes in property and property loan stock companies

Design feature	National Treasury’s proposal for REITs in South Africa	Current Collective Investment Schemes in Property	Current Property Loan Stock companies
Organisational rules			
- Regulation	Regulated by the Collective Investment Schemes Control Act as amended to apply to REIT entities in South Africa.	Regulated by the Collective Investment Schemes Control Act.	Regulated by the Companies Act.
	Incorporated and effectively managed in South Africa.	Section 101 of the Collective Investment Schemes Control Act requires that a CISP maintain a principal office and appoint a public officer in the Republic.	Incorporated in South Africa under the Companies Act. South African effective management is not required.
	Regulated by the FSB.	Regulated by the FSB.	
- Legal form	Public company or trust.	Trust.	Public company.
- Listing	Listed on a South African licensed exchange.	Listed on a South African licensed exchange in terms of section 50 of the Collective Investment Schemes Control Act.	Listed on a South African licensed exchange.
- Investment limits	No minimum or maximum investment requirements.	As required by section 4 and 13 of the JSE listing requirements.	As required by the JSE listing requirements.
Income and asset rules			
- Layering	REITs are only allowed to invest in another REIT if that REIT directly holds real estate.	In terms of section 47(1) of the Collective Investment Schemes Control Act, CISPs are allowed to invest in property shares, real estate and other assets as defined in section 49. Layering is therefore not prohibited.	
- Bundling of assets for finance purposes	Not allowed to be referred to as a REIT.		



Design feature	National Treasury's proposal for REITs in South Africa	Current Collective Investment Schemes in Property	Current Property Loan Stock companies
- Foreign investment	Foreign investment will be allowed should that foreign country have a foreign currency sovereign rating.	Foreign investment is allowed in terms of Section 49 of the Collective Investment Schemes Control Act if that foreign country has a foreign currency sovereign rating.	
- Income restrictions	Real estate investment will not be restricted to specific types of real estate.	Section 47(1) of the Collective Investment Schemes Control Act allows the portfolio to comprise of property shares, immovable property, assets that the Registrar may allow or foreign property shares or foreign immovable property.	
	Other real estate sourced income for example asset management and administration services will be allowed.	Income can only be derived from investments permitted in terms of section 47(1) of the Collective Investment Schemes Control Act.	
	75% of total income is derived from real estate rental.		
	Direct and indirect development activities allowed but real estate must be retained for at least three years to generate rental income.	Clauses 4 and 16 of the model trust deed allow the manager to invest in fixed property companies that will own or develop real estate.	
	The activities of the REIT should reflect that the REIT invests in real estate rather than trading or speculating with real estate.		
- Asset restrictions	Must have at least three properties in portfolio through all financial periods.		
	No asset may consist of more than 40% of the total value of the real estate.		
	May invest in cash, money market instruments and government securities.	Clause 4.1 of the model trust deed allows the manager to invest in cash.	

Design feature	National Treasury's proposal for REITs in South Africa	Current Collective Investment Schemes in Property	Current Property Loan Stock companies
Distribution rules			
	90% of accounting profits to be distributed to investors on an annual basis.	Clause 33 and 34 of the model trust deed regulates the calculation and payment of distributions, the result is that 100% of profits are distributed.	Although not prescribed, 95% of profits are generally distributed.
	Proposed regulation of expenses charged to REIT to prohibit subsidisation of service providers.	Clause 6 of the model trust deed prohibits transactions with an associate of the manager and remuneration of the manager is regulated in terms of clause 18, 30 and 35 of the model trust deed. Section 93 of the Collective Investment Schemes Control Act describes permitted deductions from a portfolio.	
	Profits from disposal of real estate may not be distributed but have to be reinvested within 12 months from realising the property.	Clause 8.3 of the model trust deed prohibits the distribution of capital gains from the disposal of real estate.	
Gearing rules			
	Gearing limit of 70% proposed based on the base value of the fixed assets as reflected in the last published financial statements.	Clause 21.1.7.2 of the model trust deed read with clause 15.2 prohibits the indebtedness of a CISP to exceed 30% of the value of the underlying assets. Section 96 of the Collective Investment Schemes Control Act permits a manager to borrow money to bridge insufficient liquidity provided that the amount borrowed may not exceed 10% of the market value of the portfolio.	



Design feature	National Treasury's proposal for REITs in South Africa	Current Collective Investment Schemes in Property	Current Property Loan Stock companies
	Debt can only be raised from banking institutions.	Clause 21.1.7 of the model trust deed read in conjunction with clause 15.2 allows the manager to obtain loans from persons including banks and other financial institutions that do not have a portfolio. Section 96 of the Collective Investment Schemes Control Act allows a manager to borrow money from a registered financial institution.	
Management rules			
	Investors represented by elected trustees or directors.	Clause 13 of the model trust deed requires that the manager administer the scheme in terms of the Collective Investment Schemes Control Act and in terms of the model trust deed. Section 4 of the Collective Investment Schemes Control Act describes the duties of the manager. The Collective Investment Schemes Control Act in sections 8 to 13 requires the establishment of a Unit Trusts Advisory Committee, the appointment and duties of the advisory committee. The duties of a manager are described in Part IV of the model trust deed.	Although not regulated, PLS companies are generally internally managed.

Design feature	National Treasury's proposal for REITs in South Africa	Current Collective Investment Schemes in Property	Current Property Loan Stock companies
Roles of directors and trustees			
	Proposed that the Collective Investment Schemes Control Act as amended and the generic founding document should prescribe the roles and duties of trustees or directors to allow trustees and directors to focus on the protection of investors rather than the daily operation of the REIT.	The duties of a trustee are described in Part VII of the model trust deed as well as in Part IX of the Collective Investment Schemes Control Act.	The duties of directors are contained in Chapter VIII of the Companies Act.
Non-compliance with regulatory requirements			
	Non compliance with regulatory requirements will result in the REIT losing its tax exempt status.		
	Penalties applicable to managers and trustees or directors will be enforced.	Section 106 of the Collective Investment Schemes Control Act provides for a fine to be imposed or imprisonment.	Section 441 of the Companies Act regulates penalties for offences.

From the summary of National Treasury's proposals for a REIT regime in South Africa compared to the current regulatory environments of CISPs and PLS companies as contained in Table 11, it is evident that the proposal from National Treasury and The Association of Property Unit Trusts to incorporate a REIT regime applicable to South Africa in the scope of the Collective Investment Schemes Control Act and to manifest the regulation thereof under the FSB, would be more practical and feasible as the Collective Investment Schemes Control Act present a framework that is compatible with the requirements of a REIT regime.

5.5 THE TAX TREATMENT OF REAL ESTATE INVESTMENT TRUSTS

National Treasury proposes to retain the current beneficial taxation treatment applicable to CISPs as these are aligned with the selected other countries. PLS companies would be accommodated under this beneficial taxation treatment to ensure that REIT entities in

South Africa are consistent in their treatment of taxation and aligned with the international tax dispensation of REITs. REITs internationally allow for a single level of taxation in the hands of the investors. National treasury proposes that REITs in South Africa are tax exempt to the extent they conform to the regulatory requirements as imposed by the amended Collective Investment Schemes Control Act.

Income distributed by REITs in South Africa to their investors will retain its nature; current double taxation agreements will therefore cover distributions from REIT entities in South Africa to foreign investors. Foreign investors would be required to complete a South African tax return for income derived from immovable property situated in South Africa.

REIT entities in South Africa will be exempt from capital gains taxation as these REIT entities will be prohibited from distributing capital gains from the disposal of real estate. Capital gains taxation will therefore only be payable by the investor should they dispose of their property units in a REIT in South Africa.

The current taxation inconsistencies between CISPs and PLS companies arise due to the difference in their legal form, trusts *versus* companies, rather than the application of specific sections of the Act. National Treasury proposes that REITs in South Africa have the legal form of either a vesting trust or a public company. Section 25B(1) of the Act applies to CISPs and not to PLS companies as they fall within the definition of company in terms of section 1 of the Act. From National Treasury's proposals for the tax treatment of REIT entities in South Africa it is therefore evident that section 25B(1) of the Act needs to be amended or that a section specifically applicable to REIT entities in South Africa is introduced. This will ensure that REIT entities in South Africa that are incorporated as vesting trusts be excluded from the ambit of section 25B(1) and that those REIT entities incorporated as companies benefit from the conduit principal established by section 25B(1).

National Treasury proposes that the Collective Investment Schemes Control Act be amended to regulate both REIT entities incorporated in South Africa as vesting trusts and public companies. Section 11(s) of the Act would therefore apply and needs minor amendment to cater for the applicable sections of the Collective Investment Schemes

Control Act as amended. This will also apply to sections 10(1)(k)(i) and the proviso contained in 10(1)(k)(i)(aa).

The exemption from STC (in terms of section 64B(5)(b) of the Act) applicable to fixed property companies does not require amendment if section 11(s) of the Act is made applicable to REITs in the amended Collective Investment Schemes Control Act.

Paragraph 67A(1) of the Eighth Schedule to the Act needs minor amendment to cater for the applicable sections of the Collective Investment Schemes Control Act as amended.

5.6 RECENT DEVELOPMENTS FOR THE IMPLEMENTATION OF REAL ESTATE INVESTMENT TRUSTS IN SOUTH AFRICA

On 10 July 2008, The Association of Property Unit Trusts (2008:[1]) issued a press release stating that the Registrar in terms of section 47(2) of the Collective Investment Schemes Control Act has given notice that the following assets can be included in a portfolio of assets

- participatory interests in a collective investment scheme in property;
- linked units in a PLS company; and
- shares or interests in a company or concern, which derives its income solely from property related investments.

This pronouncement allows CISPs to invest in listed real estate that is in-line with PLS companies and is considered a step forward in the conversion of CISPs to REITs in South Africa.

On 21 November 2008, The South African Property Loan Stock Association (2008:[1]) announced that the South African listed real estate sector will in future be able to use the name South African Real Estate Investment Trust (SA REIT). This resulted from SA REIT Limited, a listed entity, agreeing to change its name to Ingenuit Property Investments Limited.

5.7 PRINCIPAL RECOMMENDATIONS IN THE IMPLEMENTATION OF REAL ESTATE INVESTMENT TRUSTS IN SOUTH AFRICA

From the proposals made by National Treasury, the following are recommendations in adopting and implementing a REIT regime applicable to South Africa.

5.7.1 Making use of the current collective investment schemes in property regulatory environment as guideline for the implementation of a REIT regime in South Africa

As referred to in chapter 3.2, National Treasury (2007:4) reported that since 1998 the number of listed CISPs has decreased and have also underperformed in capitalising on market share. The better performance by PLS companies is attributed to the greater flexibility given to PLS companies (National Treasury, 2007:5). Currently there are six PUTs or CISPs listed in the real estate sector of the JSE (The Association of Property Unit Trusts, n.d.:^[1]), compared to the 15 PLS companies. A possible reason for this uneven distribution between CISPs and PLS companies, taking into account National Treasury's comment on greater flexibility awarded to PLS companies, is the stringent regulatory requirements imposed on CISPs. National Treasury should be wary that using the current regulatory environment of CISPs and applying that to the proposed REIT regime in South Africa does not have the same result.

5.7.2 Disallowance to distribute gains from the disposal of real estate by real estate investment trusts in South Africa

As discussed in chapter 3.3.3 and in chapter 4.3.3, National Treasury proposes to keep the *status quo* applicable to CISPs and disallow REIT entities in South Africa to distribute proceeds realised on the disposal of real estate to property unit holders and require that these proceeds be reinvested on behalf of the property unit holders. As previously discussed, this proposal does not appear to be aligned with the capital distribution rules of the selected other countries. Their argument for not allowing the distribution of capital gains is that it deteriorates the long term value of the portfolio for short term gains.

Although their argument is justifiable, it should be considered to impose a more flexible capital distribution rule.

An example of a more flexible capital distribution rule that would satisfy National Treasury's concern over the deterioration of the portfolio, would be to impose a condition that REIT entities in South Africa cannot distribute gains from the disposal of real estate to the extent that those capital distributions have not been replaced in value, realised or unrealised, by the remaining assets in that portfolio. It should be considered to keep realised gains from the disposal of real estate as well as unrealised gains from fair values on investment real estate in reserve, to the extent that a capital distribution would result in a deterioration of that reserve, a REIT in South Africa should be prohibited from distributing those realised gains. The legislator can then, to regulate potential irregularities in determining fair values of investment real estate, impose a regulation that real estate be valued annually by an independent valuator.

5.7.3 Restructuring of existing property investment vehicles to conform with the proposed regulatory requirements of real estate investment trusts in South Africa

In order for CISPs and PLS companies to conform with the proposals made by National Treasury under the proposed REIT regime, for example the single layering of investment and investing in property shares and fixed property companies, legislators need to consider interim transitional measurements to allow CISPs as well as PLS companies to restructure their operations. Sections 41 to 47 of the Act, applicable to the restructuring of companies, would not apply to CISPs as they are not companies as defined in section 1 of the Act. This will result in potential tax liabilities for CISPs that cannot be deferred in terms of those sections of the Act as would be the case for PLS companies. Consideration should also be given to property investments by PLS companies that would not comply with the amended Collective Investment Schemes Control Act, for example non-REIT activities and how these would be dealt with under the proposed transition or conversion rules.

5.8 SUMMARY AND CONCLUSION

South African property investment vehicles are currently only partially regulated. CISPs are regulated by FSB in terms of the Collective Investment Schemes Control Act while PLS companies are regulated in terms of the Companies Act.

Although current South African property investment vehicles have a common purpose, their treatment of taxation is based on their legal form, that of a trust *versus* a company that leads to inconsistencies in the treatment of taxation for these property investment vehicles as well as for the investors in these property investment vehicles.

National Treasury proposes that these fragmented and only partially regulated property investment vehicles be reviewed and aligned with the internationally recognised REITs structure. It is proposed that the current South African property investment vehicles be integrated into a REIT regime applicable to South Africa by amending the Collective Investment Schemes Control Act to apply to REIT entities with the legal form of both vesting trusts and public companies.

To resolve the inconsistencies in the tax treatment of property investment vehicles under a REIT regime in South Africa, should the Collective Investment Schemes Control Act be amended to incorporate REIT entities with the legal form of both vesting trusts and public companies, minor amendments to the Act would be required.

The proposals made by National Treasury to regulate and tax these REIT entities in South Africa are aligned with that of selected other REIT countries. It is also considered that the implementation of a REIT regime applicable to South Africa would attract investment especially foreign investment into South African property investment vehicles.

5.9 FUTURE RESEARCH

The following could be considered as further objectives for future research on the subject of Attracting Investment into South African Property Investment Vehicles: Evaluating Tax

- possible practical concerns raised by the listed real estate sector from the public comment document yet to be released by National Treasury and the actual implementation of a REIT regime applicable to South Africa;
- the effect on yields or returns derived by CISPs or REITs in South Africa due to the disallowance to distribute gains from the disposal of real estate to investors and the requirement that these have to be reinvested as well as the affect on participatory interests or property unit prices derived on the JSE as a result of these limitations; and
- the effect on yields could also be investigated for the difference in gearing requirements between PLS companies and CISPs. The South African Property Loan Stock Association (2009:[1]) measuring the performance of the South African listed real estate sector on 30 June 2009, indicated the one year returns for listed PLS companies at 30.5% compared to 30.7% for listed PUTs or CISPs. The same performance measured over three years indicate returns of 17.2% (annualised) for listed PLS companies and 11.5% (annualised) for listed PUTs or CISPs. Measured over five years returns generated by listed PLS companies were 28.1% (annualised) compared to 20.4% (annualised) for listed PUTs or CISPs. Better one year returns derived by PUTs or CISPs could be as a result of less exposure to borrowings due to their lower gearing requirements. The one year measurement of returns was during a downturn in the South African economy, while the three and five year returns were measured at favourable economic conditions.

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