



Real estate investment trust tax regime: Analysing the implications of building allowances

JH Coetzee

 orcid.org/0000-0001-9930-860

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Supervisor: Prof K Coetzee

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Student number: 26751984

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REMARKS

The author of this research article would like to remind the reader of the following:

The mini-dissertation has been prepared in article format and is in accordance with the policies of the North-West University's Faculty of Economic and Management Sciences.

The research article has been prepared in accordance with the requirements of the Journal of Economic and Financial Sciences (JEF).

SELECTED JOURNAL`S GUIDELINES FOR AUTHORS

JEF style requirements:

Title page: This page must include a descriptive title that also summarises the most important argument of the manuscript. The title length is limited to 75 characters. If it is longer, a running title is required for editorial purposes. The author's title, name and surname, as well as the name and address of the institution where the work originates from, should be included.

Abstract and keywords: The page following the cover page must include the title, the author's name, one paragraph (consisting of a maximum of 150 words) describing the article and a minimum of 5 keywords.

Text: This must begin on a new page, following the abstract and keywords page. Tables and figures that are used, must be mentioned in the text, have a unique caption, and must be self-explanatory.

References: This section should be on a separate page, which follows the text section – based on the Harvard Referencing style.

JEF technical requirements:

The manuscript should not exceed twenty-five (25) pages.

The manuscript should be typed in Times New Roman 12-point font, using 1.5 line spacing and English UK spelling.

No running header, footers, end notes or footnotes are permissible. All page numbers should be inserted at the bottom of each page.

All tables and figures should have a title, a number and a source.

The Harvard Referencing method of in-text citations/refences should be used throughout the manuscript.

ABSTRACT

In a relatively short space of time the South African Real Estate Investment Trust (REIT) regime has become a major factor in the South African listed property sector. Consequently, it created significant taxation considerations for the listed property company, its shareholders and the South African Revenue Service (SARS). One of these considerations is the disallowance of building allowances under the REIT regime. A building allowances can be a significant tax deduction for property companies and therefore raises the question of whether the South African REIT regime can accommodate the building allowances tax deduction and take advantage of the benefits. Unfortunately, the current regime will not be able to function effectively with building allowances, however these obstacles can be overcome by making adjustments to REIT tax legislation. The amendments will allow the REIT to distribute and deduct the maximum available cash flow when declaring the REIT dividend. As well as the deferment of the future recoupment when a building is disposed of and replaced with another building.

KEYWORDS:

Building allowances

Listed property company

Recoupment of building allowances

REIT

South African REIT regime

LIST OF ABBREVIATIONS

IRS	Inland Revenue Service
JSE	Johannesburg Stock Exchange
PLS	Property Loan Stock companies
PUT	Property Unit Trust
REIT	Real Estate Investment Trust
SARS	South African Revenue Service
UK	United Kingdom
US	United States

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND AND MOTIVATION OF TOPIC

Background

According to the Oxford living dictionary, the term 'investing' can be defined as the act of committing money to a commercial venture with the expectation of achieving a profit (Oxford dictionaries, 2017). Investing is important to everybody, as it provides a vehicle for an individual or corporate to build wealth (All Business, 2017). However, finding the correct vehicle or combination of vehicles remains the challenge.

When investing there are several asset classes to invest in. The four principal classes are: Cash (money market), bonds, real estate and equities (share market). Cash and bonds are normally the saver asset option, but also yield the lowest return (Bradley, 2017). Real estate, and especially equities, are higher risk investment instruments, but generally they have the potential to yield the higher return (Bradley, 2017).

South African listed property has proven to be the best performing asset class investment over the last couple of decades. A study by Morningstar and Investec provided that listed property yielded (on average from 1997–2016) a return on investment of 20.4% (Hutchinson, 2017). This outperformed all other asset classes by a considerable margin. Other South African listed shares yield 14.51%, South African bonds 12.07%, cash 9.47%, foreign listed shares 11.66%, foreign cash 8.10% and foreign bonds 9.85%. Foreign listed property investment yielded a return of 12.50% (Griesel, 2017). This evidence proves it worthy to invest in listed property.

Listed property companies are companies which develop and manage different types of properties which are listed on stock exchanges. They offer the benefits of real estate ownership without the problems of being a landlord and they are, unlike traditional real estate investments, extremely liquid (Prudential, 2017).

Historically the South African listed property sector consisted of two investment vehicles: Property Loan Stock companies (PLS) and Property Unit Trusts (PUT) (SARS, 2017). The National Treasury considered the tax treatment of these property investment vehicles as inconsistent and had tax inefficiencies which was problematic (Kantilal, 2016). In 2013 the REIT regime was introduced to the South African listed property sector (PWC, 2015). The original aim of the South African REIT regime was to establish an internationally recognised listed property investment vehicle, which included consistent and efficient tax treatment (Fourie, 2009).

A South African REIT is a company which owns and operates income producing immovable property and must be listed on the Johannesburg Stock Exchange (JSE). The REIT must own at least R300 million worth of property, the company`s total debt must be less than 60% of its asset value, 75% of income must be from rental income and the company must distribute a minimum of 75% of distributable profits to its investors annually (all these aspects are compulsory) (SA REIT Association, 2017). Section 13.47(d) of the JSE listing requirements defines “distributable profits” as: (i) gross income, as defined in terms of the Income Tax Act; (ii) less deductions and allowances that are permitted to be deducted by a REIT in terms of the Income Tax Act, other than the qualifying distribution (in terms of section 25BB of the Income Tax Act)” (Nexis, n.d.).

The great advantages of a REIT regime are that they provide an individual investor the opportunity to own an interest and indirectly participate in large real estate projects. The REIT regime also provides great diversity by allowing the investor the opportunity to own and earn rental income from real estate across a wide geographical area, domestically and internationally, as well as in various property sectors like shopping malls, office buildings, factories, warehouses, hotels, hospitals and residential properties (SA REIT Association, 2017).

Examples of prominent South African REITs include companies like Growthpoint Properties, Redefine Properties, Hyprop Investments Ltd, Hospitality Property Fund and Stor-age Proprietary REIT Ltd, just to mention a few.

Owning top retail spaces which include:

V&A Waterfront

Brooklyn Mall

Canal Walk

Rosebank Mall

Owning top hotels which include:

Arrabella Hotel & Spa

Holiday Inn Sandton

Radisson Blu Waterfront

Radisson Blu Gautrain.

Owning top office spaces:

The Towers (Cape Town CBD)

Alice Lane Building 1 (Sandton)
Black River Office Park (Observatory)
Graystone Drive (Investec head office – Sandton)

Owning top industrial spaces:

28 Macsteel industrial properties
Pepkor Distribution Centre (Johannesburg)
Adcock Ingram (Midrand)
Epping Industrial 1 & 2 (Cape Town) (SA REIT Association, 2017)

The regime is essentially designed to provide a 'flow through' structure that results in taxable income of the property company that are taxed in the hands of the shareholders (PWC, 2015). Essentially the rental income and the associated tax liability of the REIT are distributed to the shareholders of the REIT which become liable for the tax. Section 25BB of the Income Tax Act No. 58 of 1962 (the Act), was introduced in the South African tax legislation and it governs the taxation implications of the REIT regime in South Africa (Haupt, 2017). The sections which provide the flow through structure is section 25BB(2) read with section 25BB(1) of the Act (South African Income Tax Act No.58 , 1962).

Section 25BB(2):

- (a) There must be deducted from the income for a year of assessment of*
- (i) a REIT; or*
 - (ii) a controlled company that is a resident, the amount of any qualifying distribution made by that REIT or that controlled company in respect of that year of assessment*
- (b) The aggregate amount of the deductions contemplated in paragraph (a) may not exceed the taxable income for that year of assessment of that REIT*

Section 25BB(1):

“qualifying distribution”, in respect of a year of assessment of a company that is a REIT or a controlled company as at the end of a year of assessment, means any dividend (other than a dividend contemplated in paragraph (b) of the definition of “dividend”) paid or payable, or interest incurred in respect of a debenture forming part of a linked unit in that company if the amount thereof is determined with reference to the financial results of that company as reflected in the financial statements prepared for that year of assessment if—

(a) at least 75 per cent of the gross income received by or accrued to a company during the first year of assessment that the company qualifies as a REIT or controlled company, consists of rental income; or

(b) in any other case, at least 75 per cent of the gross income received by or accrued to a REIT or a controlled company in the preceding year of assessment consists of rental income:

Section 25BB is therefore in line with the JSE requires of 75% of the company`s income must be from rental income. This must not be confused with the JSE requirement of 75% of distributable profits which must be distributed as a dividend to the REIT company`s shareholders. The link between the two requirements/concepts is that the distributable profits can only be deducted from income tax as a qualify distribution (s25BB(1)) if 75% of the gross income of the REIT was earned from rental income. Therefore, if the REIT company`s rental income is less than 75% of the gross income the REIT will not be able to deduct the qualify distribution.

The dividend received by the shareholder from the REIT is exempt from dividend tax in terms of section 64F(1)(l). The proviso (aa) to section 10(1)(k) of the Act provides that a dividend received by a South African resident from a REIT are not exempt from income tax. Therefore, the shareholder will be liable for income tax and not dividend tax when a dividend is declared from a REIT to the shareholder (SARS, 2017).

An interesting aspect of the South-African REIT regime is the disallowance to claim any building allowances, such as section 11(g) (leasehold improvements allowance), section 13bis (hotel buildings allowance), section 13ter (residential building allowance), section 13quat (urban development zone allowance), section 13quin (commercial building allowance) and section 13sex (residential unit allowance) (Kantilal, 2016).

Section 25BB(4) of the Act provides:

(4) A company that is a REIT or a controlled company on the last day of a year of assessment may not deduct by way of an allowance any amount in respect of immovable property ...

The disallowance to claim building allowances will result in no recoupment of building allowance with the disposal of properties. Furthermore section 25BB(5) of the Act exempts a REIT from capital gains tax. Therefore, the full amount of proceeds can be used to re-invest in a next property development venture, which will aid capital growth.

Motivation of topic actuality

Investments and deciding on the asset class to invest in, will always be of interest to all role players of an economy. The listed property investment sector, as an investment asset class, is a massive income generator. Where money is earned, taxation follows and becomes extremely relevant and topical to taxpayers and tax authorities.

The tax treatment of REITs is interesting. REIT companies can deduct the distribution (REIT dividend) to the shareholders as a tax deduction and the shareholders will be liable for income tax on the receipt of the REIT dividend and not dividend tax as is the case with "standard" dividends. Building allowances are an important tax deduction for property companies and the policy of excluding the REIT sector from the allowance is an interesting consideration.

1.2 PROBLEM STATEMENT AND RESEARCH QUESTION:

South African REIT property companies are not allowed to claim building allowance deductions for income taxation. This is in stark contrast with the non-REIT listed property companies, which utilise a significant building allowance deduction regarding income taxation annually. The research question that this study aims to answer is, whether this policy is appropriate from a taxpayer point of view, as well as from the South African government point of view.

1.3 RESEARCH OBJECTIVES:

Main Objective

The main objective of this study was to critically analyse the South African REIT listed property company's inability to claim building allowances from income tax, and to evaluate whether the policy is appropriate for the taxpayer and the South African government.

Secondary Objectives

1. To gain a basic understanding of the South African non-REIT property company tax treatment of building allowances, and the impact it has on the property company's and its shareholders taxation and financial circumstances.
2. To gain a basic understanding of the South African REIT landscape and the associated tax treatment thereof. With the aim of establishing whether the building allowances tax deduction can suffice under the REIT taxation policy.
3. To gain a basic understanding of the capital gains and recoupsments of allowances under the REIT regime and how that links with building allowances under the REIT regime.

1.4 RESEARCH METHODOLOGY

Research paradigm and the description of methodology

A paradigm is a pattern, structure and framework or system of scientific and academic views on a subject (Explorable.com, 2017).

The research paradigm is based on the researcher's ontology and epistemology, which is essentially the researcher's worldview. Ontology is the nature of reality (Merriam-Webster, 2017) and epistemology is the relationship between the researcher and reality. It deals with how knowledge is derived and how it is tested (Business Dictionary, 2017).

Positivism and interpretivism are the dominant ontological and epistemological ideologies. The positivist researcher aims for objectivity and the consistent use of rational and logical approaches to research, focusing on generalising of research findings. The ultimate purpose of the research is to discover the truth. Conversely, the interpretivist researcher aims to understand and interpret the meaning in human behaviour, focussing on unique aspects of the context (UNM, 2017).

This study will, from an objective point of view, aim to understand the impact of the section 25BB(4) (i.e. the disallowance of building allowances deduction) on the South African REIT regime. Therefore, the interpretivist approach will be the most suitable approach for the current research study.

A conceptual study will aim to add new insights into an existing problem, which will be illustrated through case study examples, to develop a theory (Wacker, 1998). A case study report can have a single case format or a multiple case format. The single case format uses a single text to describe and analyse the case. The multi case format will have several single cases which are reported separately and then a final report that covers cross case analysis and results. In case study research using tables are very common (Yin, 2014).

The case study examples will be based on certain comparisons which will indicate the effect of disallowing building allowances within the REIT regime and test the impact and the suitability of the possible inclusion of building allowances to the REIT regime. Generally comparative research includes both quantitative and qualitative comparisons. The main objective of comparative research is to search and identify similarities and variances (Mills, et al., 2006).

To review the concept of the disallowance of the building allowances under the REIT regime the study will firstly analyse the benefits of claiming the building allowance deduction (outside the REIT regime). Secondly compare the REIT property company with the non-REIT property company under the current legislation for a single year of assessment. The comparison will focus on the REIT not being able to utilise a building allowance deduction and the non-REIT claiming a building allowance tax deduction.

To consider whether the building allowance can be introduced to the REIT regime the study will need to analyse whether the building allowance deduction can suffice under the current REIT regime and if not establish what possible amendments to legislation can be considered to accommodate the building allowance deduction under the REIT regime.

The case study comparisons will be conducted on a single year basis as well as on the full lifespan of the building allowance which will include the recoupment and capital gains considerations.

1.5 OVERVIEW OF MINI-DISSERTATION

Chapter 1: Introduction

This chapter includes background as well as motivation for the chosen study, followed by the problem statement, research question, research objectives, research methodology and overview of the mini-dissertation.

Chapter 2: Research article

This chapter is the research article and will include an abstract and key words, the background and formation of the study, the research methods, the results and discussions, the conclusion and recommendations for future study and the list of references used.

Chapter 3: Summary of findings, overall conclusion and recommendations

In this chapter we will revisit the research article objectives, followed by the findings of the research, the overall conclusion and the recommendations. It will also mention the limitations of the research and it will suggest probable future research opportunities regarding the topic.

CHAPTER 2: RESEARCH ARTICLE

RUNNING TITLE

REIT tax regime: Analysing the implications of building allowances

AUTHORS NAME

Herman Coetzee (M.Com (SA & International Tax) student at the North-West University)

ABSTRACT

In a relatively short space of time the South African Real Estate Investment Trust (REIT) regime has become a major factor in the South African listed property sector. Consequently, it created significant taxation issues for the listed property company, its shareholders and the South African Revenue Service (SARS). One of these aspects is the disallowance of building allowances under the REIT regime. Considering that building allowances are a significant tax deduction for property companies, it raises the question of whether the South African REIT

regime can accommodate the building allowances tax deduction and take advantage of the benefits. Unfortunately, the current regime will not be able to function effectively with building allowances, however these obstacles can be overcome by making three adjustments to REIT tax legislation.

KEYWORDS:

Building allowances

Listed property company

Recoupment of building allowances

REIT

South African REIT regime

2.1 BACKGROUND AND FORMULATION OF STUDY

Listed property companies are companies which operate in the real estate industry and are listed on stock exchanges. The benefits of investing in a listed property company is that the investor gets the opportunity to indirectly own investment property, but does not have to manage the property and they are, unlike traditional real estate investments, extremely liquid (Prudential, 2017).

A major discussion point in recent history was the introduction of the REIT model to the South African listed property market. With inception on 1 May 2013, one could argue that the REIT concept is still relatively new to South Africa (PWC, 2015). However, since then the South African REIT market has grown substantially to over 30 REITs, with a total combined market capitalisation of more than R360 billion. Nine of the South African REITs feature in the Top 100 most powerful South African companies for 2016 (Fin24, 2016).

The great advantages of a REIT regime are that it provides an individual investor the opportunity to own an interest in and participate indirectly in large real estate projects. The REIT regime also provides great diversity by allowing the investor the opportunity to own and earn rental income from real estate across a wide geographical area, domestically and

internationally, as well as in various property sectors like shopping malls, office buildings, factories, warehouses, hotels, hospitals and residential properties (SA REIT Association, 2017).

More than 25 countries use the REIT model, making it a truly international concept (SA REIT Association, 2017). The South African REIT market is grouped as an emerging REIT regime, alongside countries like Belgium, Finland, Ireland, Italy, Malaysia, Mexico, South Korea, Spain and Turkey (Roth & Kasper, 2016).

What exactly constitutes a South African REIT? A South African REIT is an entity which owns and operates an income producing immovable property and is listed on the Johannesburg Stock Exchange (JSE). It must own at least R300 million worth of property, the total debt must be less than 60% of asset value, 75% of income must be earned from rental income, and it must distribute a minimum of 75% of the distributable profits to its investors. All of the criteria are compulsory and must be present for a property company to qualify and retain the REIT status (SA REIT Association, 2017).

Section 1 of the Income Tax Act No. 58 of 1962 defines a "REIT" as a company—

- a) *that is a resident; and*
- b) *the shares of which are listed—*
 - i) *on an exchange (as defined in section 1 of the Financial Markets Act, and licensed under section 9 of that Act); and*
 - ii) *as shares in a REIT as defined in the JSE Limited Listings Requirements;*

South African REIT includes companies like Growthpoint Properties, Redefine Properties, Hyprop Investments Ltd, Hospitality Property Fund and Storage Proprietary REIT Ltd. It owns top properties like the V&A Waterfront, Brooklyn Mall, Arrabella Hotel & Spa, Holiday Inn Sandton, Alice Lane Building 1 (Sandton), The Towers (Cape Town CBD) and Epping Industrial 1 & 2, just to mention a few (SA REIT Association, 2017).

The regime is essentially designed to provide a 'flow through' structure that results in taxable income of the property company distributed to the shareholders and that the tax liability follows the income and therefore be taxed in the hands of the shareholders (SARS, 2017). Essentially the net rental income (the income and the expenditure) and the associated tax liability of the REIT are distributed to the shareholders of the REIT which become liable for the tax. Section 25BB of the Income Tax Act No. 58 of 1962 (the Act), was introduced in the South African tax legislation and it governs the taxation implications of the REIT regime in South Africa (Haupt, 2017). The distribution of a REIT comes in the form of REIT dividend declared by the REIT to

the shareholders of the REIT. The dividend received by the shareholder from the REIT is exempt from dividend tax in terms of section 64F(1)(l). The proviso (aa) to section 10(1)(k) of the Act provides that a dividend received by a South African resident from a REIT are not exempt from income tax. Therefore, the shareholder will be liable for income tax and not dividend tax when a dividend is declared from a REIT to the shareholder (SARS, 2017).

An interesting aspect of the South-African REIT regime is the disallowance to claim any building allowances (as provided by section 25BB(4)), which include all the building allowances available in the Act, such as section 11(g) (leasehold improvements allowance), section 13bis (hotel buildings allowance), section 13ter (residential building allowance), section 13quat (urban development zone allowance), section 13quin (commercial building allowance) and section 13sex (residential unit allowance) (Kantilal, 2016). There are also no recoupments under section 8(4) of the Act or capital gains (as provided by section 25BB(5)).

The study will be analysing the impact of the differences in the tax treatment of the building allowances for property companies and their shareholders under the REIT regime, versus traditional property companies and their shareholders. It will also analyse the possible impact that the building allowance deductions could have on the South African REIT regime, and the tax liability of the property companies and their shareholders within the ambit of the REIT regime.

2.2 RESEARCH METHODS

This study is mainly a conceptual study focussing on reviewing the policy of disallowing the building allowance tax deductions within the South African REIT regime and to consider whether building allowances can indeed suffice within the REIT regime if it were to be allowed. The conceptual study will aim to add new insights into an existing problem, which will be illustrated through case study examples to develop a theory (Wacker, 1998). A case study report can have a single case format or a multiple case format. The single case format uses a single text to describe and analyse the case. The multi case format will have several single cases which are reported separately and then a final report that covers cross case analysis and results. In case study research using tables are very common (Yin, 2014).

Case study research is a flexible form of qualitative inquiry which is ideal for an in-depth and holistic investigation of a complex issue. Defining the case and limiting the case can be a

challenge. Refining the research question and setting boundaries to the study is preferable (Helen Harrison, 2017).

The case study examples will be based on certain comparisons which will indicate the effect of disallowing building allowances within the REIT regime and test the impact and the suitability of the possible inclusion of building allowances to the REIT regime. Generally comparative research includes both quantitative and qualitative comparisons. The main objective of comparative research is to search and identify similarities and variances (Mills, et al., 2006).

To review the concept of the disallowance of the building allowances under the REIT regime the study will firstly analyse the benefits of claiming the building allowance deduction (outside the REIT regime). Secondly compare the REIT property company with the non-REIT property company under the current legislation for a single year of assessment. The comparison will focus on the REIT not being able to utilise a building allowance deduction and the non-REIT claiming a building allowance tax deduction.

To consider whether the building allowance can be introduced to the REIT regime the study will need to analyse whether the building allowance deduction can suffice under the current REIT regime and if not establish what possible amendments to legislation can be considered to accommodate the building allowance deduction under the REIT regime.

The case study comparisons will be conducted on a single year basis as well as on the full lifespan of the building allowance which will include the recoupment and capital gains consideration.

2.3 RESULTS AND DISCUSSIONS

2.3.1 Background to the case study examples

The case study is based on a REIT company holding R300 million worth of prime office space in Cape Town, consisting of 10 office buildings with a total combined size of 18,520 square meters and charging market related rental of R180 per square meter per month. Rental income: 10 buildings x 1,852 square meters per building x R180 per square x 12 months = R40 million rental income per annum. All 10 office buildings are

newly erected and unused and would therefore meet the requirements of section 13quin of the Act's commercial building allowance, which is equal to 5% of the cost value of the buildings (i.e. R300 million x 5% = R15 million annual allowance). Only 20% of the R300 million will be financed via a financial institution, hence the finance cost component is valued at R5 million annually (R300 million x 20% x 8.25% (prime less 2%) which is rounded to the nearest million).

Assumptions:

- The REIT company will pay tax at the flat rate of 28%.
- The individual investors are all at the top marginal tax rate of 45%.
- The dividend tax rate is at the flat rate of 20%.
- The non-REIT shareholder pays dividend's tax and the REIT shareholder pays income tax in respect of the REIT dividend received.
- The deferred tax is based on the future recoupment of building allowances.
- 80% of the R300 million office buildings are funded via equity financing and 20% via debt financing (finance cost R300m x 20% x 8% rounded=R5m).
- All amounts are rounded to the nearest rand.

2.3.2 An Analysis of the benefits of claiming building allowances

Before analysing the merits of not allowing building allowances within the REIT regime, the benefit of the building allowance to a property company outside the REIT regime need to be analysed. Also discussing the logic behind the tax deduction and the aim thereof. Please take note that we are using section 13quin for the case studies.

The Revenue Laws Amendment Act of 2007 introduced the section 13quin allowance for depreciation of commercial building allowances and came into effect on 1 April 2007. At the time building allowances were only available to manufacturing buildings, residential buildings and buildings situated in urban development zones. There was however, no reason to exclude the commercial property market from the allowance for depreciation and therefore the tax concession was expanded (Integritax, 2008).

The concept behind a building allowance, such as section 13quin, is to provide the investor a form of relief from the cost associated with the investment in the building

and therefore serving as an investment incentive (Wentzel, 2010). The building allowance also makes provision for the deterioration and the replacement of the asset on a gradual basis.

This following scenario will compare the impact of building allowances on a non-REIT property company when it qualifies to claim the allowances as a deduction from income tax, compared to when it does not qualify to claim the allowances from income tax. Therefore, analysing the effect of the commercial building allowances (section 13quin). This sole focus of this analysis is to illustrate the advantage of the building allowance tax deduction and does not have any bearing on section 25 of the REIT tax legislation. In both cases 75% of the profit (which would be similar to the distributable profit is REIT tax legislation was applicable) is distributed to the shareholders in the form of a dividend. The 75% dividend declaration is merely to be consistent with the following case study scenarios which will adhere to the minimum REIT dividend distribution requirement of 75% of the distributable profits.

Table 1: Building allowances vs No building allowances (All Non-REITs) (annual calculation of the advantage of section 13quin)

Non-REIT not qualifying for a building allowances		Non-REIT qualifying for a building allowances	
	Rm		Rm
Rental income	40	Rental income	40
Operating expenses	(10)	Operating expenses	(10)
Finance cost	(5)	Finance cost	(5)
Profit before building allowance	25	Profit before building allowance	25
Building allowance - do not qualify	-	Building allowance @ R300m x 5%	(15)
Profit after building allowance	25	Profit after building allowance	10
Profit before tax	25	Tax @ 28% (R10m x 28%)	(2,80)
Tax @ 28%	(7)	Deferred tax on building allowance (R15m x 28%)	(4,20)
(After Tax) income @ property company level	18	(After Tax) income @ property company level	18,00
		(R25m(acc profit) - R2,80m(inc tax) - R4,20m(deferred tax) = profit available for dividend distribution)	
Individual investor (75% dividend declared)	13,50	Individual investor (75% dividend declared)	13,50
Dividend tax @ 20%	(2,70)	Dividend tax @ 20%	(2,70)
Income after tax	10,80	Income after tax	10,80
Total tax paid (7 + 2,70)	9,70	Total tax paid (2,80 + 2,70) (deferred tax excluded)	5,50
Total tax as % of profit before building allowance	39%	Total tax as % of profit before building allowance	22%
% tax at property company level	28%	% tax at property company level	11%
% tax at individual shareholder level	11%	% tax at individual shareholder level	11%

Source: Author`s compilation

The individual investors will receive the same income from the property company, regardless of building allowance deductions. The notable difference between the two property company scenarios is the total tax collected by SARS (from the property company and the investors) that is 43% less (down from R9.7m to R5.5m) when

building allowances are available for the property company. The reduction in tax collection is at the property company level (R7m v R2.8m).

The table illustrates that the building allowance deduction is a significant tax concession for a property company and it reduces the tax liability of the company considerably. Therefore, achieving the goal of providing the property company a form of relief from the cost associated with the investment in the building and ultimately serving as an investment incentive. As well as providing for a gradual deterioration of the asset and the eventual replacement thereof.

What should not be forgotten is the deferred tax of R4.2m which implies that the tax saving generated by the building allowances will be accounted for in the future when the building is disposed off and the allowance is recouped. The R4.2m deferred tax represents 17%(rounded) as a percentage of profit before building allowances which, if added to the income tax, which represent 22% of the tax as a percentage of profit before tax increase to 39% for the non- REIT with the building allowance compared to the non-REIT without building allowances percentage of 39% tax as a percentage of profit before tax. The difference is that the 39% tax of the non-REIT without the building allowance is payable in the current year compared to only 22% for the non-REIT with the building allowance.

2.3.3 An analysis of the REITs inability to claim building allowances

Prof Haupt referred to a REIT's inability to claim a building allowance deduction as a certain disadvantage for the REIT property company (Haupt, 2015). Kantilal commented in her study that the disallowance of the REIT claiming a tax deduction via a building allowance prevents the subsequent recoupment of the allowance and gives rise to the exemptions of capital gains (Kantilal, 2016). SARS are of the opinion that the disadvantage is counter balanced by the fact that no capital gains will be taxed (South African Revenue Service, 2017). The exemption of the capital gains was an attempt by the National Treasury to prevent REITs from distributing capital profits and to encourage reinvestment (Fourie, 2009).

The recoupment of the building allowances and the capital gains implications will be discussed later in the study (2.3.6 and 2.3.7) and will not be considered for this specific case study. The following scenario will compare the non-REIT property company to the REIT property company, if building allowances are available to the non-REIT property company and both companies distribute 75% of the distribution profits.

Both the property companies in the case study only earn rental income and therefore will meet the requirements of the section 25BB(1)'s qualifying distribution definition, which require a minimum of 75% of the gross income to be rental income. A further requirement of a REIT will be to distribute a minimum of 75% of the REIT's distributable profits to the shareholders (SA REIT Association, 2017). Therefore, the REIT company will distribute 75% of the distributable profits and for ease of comparison the non-REIT company as well.

It is important to remember that the REIT company will deduct the qualifying distribution from the company's taxable income (section 25BB(2)(a) of the Act) and the shareholders which receive the distribution (i.e. REIT dividend) will pay income tax on the amount distributed (at 45% as the individuals are at the top marginal tax bracket as mentioned under the assumptions to the case studies), because a REIT dividend is not exempt from income tax (section 10(1)(k)(j)(aa) of the Act). The non-REIT company will pay income tax and then distribute the after-tax income to the shareholders after deducting dividend tax (at 20%).

This case study compares the REIT property company's advantage of deducting the qualifying distribution to shareholders from income tax to the non-REIT company's advantage of deducting the building allowance from income tax.

Table 2: Non-REIT vs REIT (Building allowances vs no building allowance)

Non-REIT qualifying for a building allowances		REIT not allowed to utilise building allowances	
	Rm		Rm
Rental income	40	Rental income	40
Operating expenses	(10)	Operating expenses	(10)
Finance cost	(5)	Finance cost	(5)
Profit before building allowance	25	Profit before building allowance	25
Building allowance @ R300m x 5%	(15)	Building allowance not allowed	-
Profit after building allowance	10	Profit after building allowance	25
Qualifying distribution	-	Qualifying distribution @ 75%	(18,75)
Tax @ 28% (R10m x 28%)	(2,80)	Profit before tax	6,25
Deferred tax on building allowance (R15m x 28%)	(4,20)	Tax @ 28%	(1,75)
(After Tax) income @ property company level	18,00	(After Tax) income @ property company level	4,50
<small>(R25m(acc profit) - R2,80m(inc tax) - R4,20m(deferred tax) = profit available for dividend distribution)</small>			
Individual investor (75% dividend declared)	13,50	Individual investor	18,75
Dividend tax @ 20%	(2,70)	Tax @ 45%	(8,44)
Income after tax	10,80	Income after tax	10,31
Total tax paid (2,80 + 2,70) (deferred tax excluded)	5,50	Total tax paid (1,75 + 8,44)	10,19
Total tax as % of profit before building allowance	22%	Total tax as % of profit before building allowance	41%
% tax at property company level	11%	% tax at property company level	7%
% tax at individual shareholder level	11%	% tax at individual shareholder level	34%

Source: Author`s compilation

The income before tax for the shareholders under the REIT regime is R18.75 million, compared to the R13.50 million income before tax of the non-REIT shareholders. Therefore, the shareholders will receive 39% more income before tax from the property company`s rental income under the REIT regime.

The after-tax profit for the shareholders under the REIT regime is R10.31 million compared to the non-REIT shareholders` after-tax profit of R10.80 million. Therefore, the REIT shareholders will receive 5% less income after tax compared to the non-REIT shareholders.

The table, however, illustrates that the building allowance impacts the total tax revenue generated by SARS greatly. It reduces the total tax as a percentage of profit before building allowances, from 41% for the REIT and shareholders, to 22% for a non-REIT and shareholders that can claim a building allowance.

The building allowance does impact the difference in the split of the tax liability between property company and shareholder. The non-REIT is liable for 50% (2.80 / 5.50) of the tax compared to the REIT that is liable for only 17% (1.75 / 10.19) of the tax. The non-

REIT shareholder is liable for 50% of the tax compared to the REIT shareholder that is liable for 83% of the tax.

The aforementioned indicates that non-REITs shareholder receive less income before tax than the REIT property company's investors. However, the REIT investors pay more tax (income tax at 45%) than the non-REIT shareholders (dividend tax at 20%) and therefore both sets of shareholders' after-tax income are at a similar level, but the tax collected by SARS is significantly less under the non-REIT property company regime which utilises the building allowance.

This indicates that the building allowance deduction on a single year basis does not result in less after-tax income in the pockets of the shareholders of the non-REIT when compared to the after-tax income of the REIT shareholders. This case study also indicates that the SARS collects less tax revenue from non-REIT companies and shareholders than REIT companies and shareholders. It will be interesting to analyse the effect of the REIT regime using the dividend distribution to reduce the income tax of the company and using the building allowance deduction. However, whether the building allowance can suffice under the current REIT regime needs to be analysed.

What should not be forgotten is the deferred tax of R4.2m which implies that the tax saving generated by the building allowances will be accounted for in the future when the building is disposed of and the allowance is recouped. The R4.2m deferred tax represents 17%(rounded) as a percentage of profit before building allowances which, if added to the income tax, which represent 22% of the tax as a percentage of profit before tax increase to 39% for the non- REIT with the building allowance compared to the REIT without building allowances' percentage of 41% tax as a percentage of profit before tax. The difference is that the 41% tax of the REIT without the building allowances is payable in the current year compared to only 22% for the non-REIT with the building allowance.

2.3.4 An analysis of the possible impact of introducing building allowances to the REIT regime

Section 25BB(4) of the Act provides that a South African REIT cannot claim any building allowance. The United States (US) tax legislation allows for the depreciation of rental property. Publication 946 of the US Inland Revenue Service (IRS) explains in detail the workings of the depreciation of property and it essentially provides for tax

allowances similar to South Africa's building allowances provisions. This aims to reduce the property owners' tax liability when engaged in the production of rental income. The depreciation allowances are also available for the US REIT market (IRS, 2017).

The United States (US) has the oldest and most advanced REIT regime in the world (Roth & Kasper, 2016). The US REIT has been active for the last 56 years and has grown to a market value of more than USD 800 billion (PWC, 2015). It is viewed as the only mature REIT market in the world and it is therefore worthwhile to consider approaches and practices employed by their REIT regime.

The following scenario will compare the REIT property company, which can deduct the building allowance, to the REIT property company which is not allowed to deduct the building allowances, and both companies distribute 75% of the profits. The effect of the REIT property company that is able to deduct a non-cash-flow deduction from income taxation, is analysed. This test would disregard section 25BB(4) of the Act's disallowance of building allowances deduction under the REIT regime.

In both cases the REIT will be able to deduct the qualifying distribution to the shareholders from the company's taxable income and the shareholder will pay income tax on the amounts distributed (at 45%). No dividend tax (at 20%) will be applicable. Only the REIT will be allowed to claim the building allowance and not the shareholder. Otherwise there will be a double deduction.

Table 3: Building allowance vs No building allowance (all REIT companies)

REIT allowed to utilise building allowances		REIT not allowed to utilise building allowances	
	Rm		Rm
Rental income	40	Rental income	40
Operating expenses	(10)	Operating expenses	(10)
Finance cost	(5)	Finance cost	(5)
Profit before building allowance	25	Profit before building allowance	25
Building allowance @ R300m x 5%	(15)	Building allowance not allowed	-
Profit after building allowance	10	Profit after building allowance	25
Qualifying distribution @ 75%	(7,50)	Qualifying distribution @ 75%	(18,75)
Profit before tax	2,50	Profit before tax	6,25
Tax @ 28%	(0,70)	Tax @ 28%	(1,75)
(After Tax) income @ property company level	1,80	(After Tax) income @ property company level	4,50
Individual investor	7,50	Individual investor	18,75
Tax @ 45%	(3,38)	Tax @ 45%	(8,44)
Income after tax	4,13	Income after tax	10,31
Total tax paid (0,70 +3,38)	4,08	Total tax paid (1,75 + 8,44)	10,19
Total tax as % of Profit before building allowance	16%	Total tax as % of Profit before building allowance	41%
% at property company level	3%	% at property company level	7%
% at individual shareholder level	13%	% at individual shareholder level	34%

Source: Author`s compilation

Noteworthy is the R7.5 million income before tax for the shareholders under the REIT regime, which includes the building allowances deduction, compared to the R18.75 million income before tax for the shareholders under the REIT regime, which excludes the building allowance deduction. Therefore, the shareholders will receive 2.5 times more income from the property company`s rental income under the REIT regime without the building allowance deduction.

The table illustrates that the building allowance greatly impacts the tax revenue generated by SARS. Reducing the total tax as a percentage of profit before building allowances from 41% for the REIT which are not allowed to claim building allowances and its shareholders, to 16% for a REIT which can claim a building allowance and its shareholders.

The building allowance does not impact the difference in the split of the tax liability between property company and shareholder significantly. The REIT which can claim the building allowance, is liable for 17% (0.70 / 4.08) of the total tax and the REIT which cannot claim building allowances is liable for 17% (1.75 / 10.19) of the total tax. The shareholders of the REIT allowed to claim building allowances are liable for 83% of the tax and the shareholders of the REIT which cannot claim building allowances are liable for 83% of the tax.

The results indicate that if a REIT listed property company was allowed to claim building allowance deduction and distribute the mandatory 75% of the distributable profits to the shareholders, then the shareholders of the REIT will earn 2.5 (10.31 / 4.13) times less income and SARS will earn 2.5 (10.19 / 4.08) times less tax revenue. The majority of the tax liability will be with the shareholder and not with the property company, regardless of the building allowances inclusion. The property company (which deduct the building allowances) will have far greater net cash flow than net taxable profit. However, the REIT will be limited to distributing the taxable profit only. As section 25BB(2) of the Act limits the deduction of the distribution of more than 100% of the company's taxable income.

The aforementioned indicates that the building allowances deduction will reduce the functionality of the REIT concept considerably. The deduction of the distribution of profits will reduce by 250%. Therefore, losing the investor appeal of receiving the majority of the rental income in the form of a REIT dividend distribution. Creating a clog in the REIT "flow through" principle. Essentially the REITs taxable income will be significantly different from the REITs cash flow. The problem can possibly be addressed by considering to base the distribution on available cash flow instead of taxable income.

What should not be forgotten is the deferred tax of R4.2m which implies that the tax saving generated by the building allowances will be accounted for in the future when the building is disposed of and the allowance is recouped. The R4.2m (R15m x 28%) deferred tax represents 17%(rounded) as a percentage of profit before building allowances which, if added to the income tax which represent 16% of the tax as a percentage of profit before tax, increase to 33% for the REIT with the building allowance compared to the REIT without building allowances percentage of 41% tax as a percentage of profit before tax. The difference is that the 41% tax of the REIT without the building allowances is payable in the current year compared to only 16% for the REIT with the building allowance.

2.3.5 An analysis of basing the REITs distribution criteria on available cash flow

The problem for the REIT regime (identified in 2.3.4) is that the tax saving created by the building allowance reduces the taxable income considerably and the qualifying distribution allowed is limited to the taxable income. However, there is much more cash

available to distribute. Therefore, a possible solution would be to rather use the available cash flow as the limitation for a distribution to shareholders instead of taxable income.

The fact that the depreciation allowance is also available to US REITs leads to greater flexibility in the US REIT regime's distribution policies and yields higher distribution returns as a result. The US REIT regime requires a REIT to distribute 90% of the net profit. The net profit is the rental income less general operating expenses, finance charges and depreciation. This results in many cases that US REITs declare dividends to shareholders which is in excess of the taxable profits (i.e. dividend more than 100% of taxable profit). The US REITs can do this by having greater net cash flow compared to taxable income (Baum & Devaney, 2008).

The following scenario will compare the US style REIT property company (which can deduct the building allowance and distribute all the company's available cash flow) to the REIT property company which is not allowed to deduct the building allowances and is bound by the distribution limitations (i.e. maximum deduction distribution is the company's taxable income). The effect of a REIT property company that is able to deduct a non-cash-flow deduction from income taxation and distribute all the available cash flow, is analysed.

There is an assumption made with this case study that 25% of the after-tax profits (R4.5m) is required to be retained by the company for cash flow purposes and therefore cannot be distributed to the shareholders. The cash flow requirements are based on the company needing to service the capital expenditure (i.e. the capital portion of the mortgage bond and improvements to buildings (non-income statement cash outflows)). Therefore, the assumption is made that both companies in the case study will need R4.5m positive cash flow after the distribution and the payment of tax (the amount is not important, but rather the illustration of the principle). The REIT which can use the building allowance deduction will be able to distribute 205% (R20.5m qualifying distribution / R10m profit before building allowance x 100 = 205%) of the distributable profit (i.e. profit after building allowance) (R25m positive cash flow – R21,5m qualifying distribution = R4.5m remaining cash flow)

This case study will disregard section 25BB(4) of the Act's disallowance of building allowances. This case study will also disregard section 25BB(2) of the Act by not limiting the deduction of the distribution to 100% of the company's taxable income.

Table 4: Distribution based on maximum available cash flow (all REIT companies)

<u>REIT allowed to utilise building allowances</u>		<u>REIT not allowed to utilise building allowances</u>	
<u>Deduction (distribution) of available cash flow (205% of profit)</u>		<u>Deduction (distribution) of 75% profit (using the excess for cash flow)</u>	
	20 years		20 years
	Rm		Rm
Rental income	800	Rental income	800
Operating expenses	(200)	Operating expenses	(200)
Finance cost	(100)	Finance cost	(100)
Profit before building allowance	500	Profit before building allowance	500
Building allowance @ R300m x 5% x 20 years	(300)	Building allowance not allowed	-
Profit after building allowance	200	Profit after building allowance	500
Qualifying distribution @ 205%	(410,00)	Qualifying distribution @ 75%	(375,00)
Profit before tax	-	Profit before tax	125,00
Tax @ 28%	-	Tax @ 28%	(35,00)
Deferred tax on building allowance (R15m x 28%)	(4,20)		
(After Tax) income @ property company level	-	(After Tax) income @ property company level	90,00
Individual investor (205% dividend declared)	410,00	Individual investor	375,00
Tax @ 45%	(184,50)	Tax @ 45%	(168,75)
Income after tax	225,50	Income after tax	206,25
Total tax paid (0 + 184,50)	184,50	Total tax paid (35 + 168,75)	203,75
Total tax as % of Profit before building allowance	37%	Total tax as % of Profit before building allowance	41%
% at property company level	0%	% at property company level	7%
% at individual shareholder level	37%	% at individual shareholder level	34%

Source: Author`s compilation

If we assume that the R4.5 million after tax profit is used to service the capital expenditure (i.e. the capital portion of the mortgage bond, improvements and upgrades to buildings) and that this amount cannot be distributed to the shareholders, then the REIT which can utilise the building allowance deduction and has no distribution limitations, can distribute up to 205% of the profit before tax (leaving R4.5m cash flow in the REIT) and the REIT which cannot utilise the building allowances deduction and is subject to the distribution limitations can only distribute 75% (leaving R4.5m cash flow in the REIT).

Noteworthy is the R20.5 million income before tax for the shareholders under the REIT regime, which includes the building allowances deduction and no limitations on distributions, compared to the R18.75 million income before tax for the shareholders under the current South African REIT regime, which excludes building allowances deduction and applies limitations on distributions. Therefore, the shareholder will

receive more income from the property company's rental income under the REIT regime with the US style distribution policy.

The total tax generated by SARS for the REIT which can utilise the building allowance deduction and adopt the US style distribution policy, amounts to 37% of the income before building allowance, compared to the REIT which cannot claim the building allowance and only distribute the taxable income that amounts to 41% of the income before the building allowance. The taxpayers will save 4% of tax as a percentage of income. The shareholders of the REIT which has no distribution limit and can utilise the building allowance deduction, will bear 100% of the tax liability, compared to the 81% for the shareholders of the REIT that has the distribution limitation and can claim no building allowances.

The results indicate that if the REIT listed property company was allowed to claim building allowance deductions and distribute all the available cash flow (retaining similar cash flow as when 75% of the accounting profit was distributed and no building allowances deduction were available), then the REIT could distribute far more than 100% of the accounting profit (205% in our case study example). This results in the taxpayers receiving slightly more income (10%) and SARS earning slightly less tax revenue (4%) than with the current South African REIT listed property company, which is not allowed to claim the building allowance deduction and is limited to only distributing the total taxable income.

The aforementioned indicates that the problem, identified in 2.3.4 could be overcome. The problem which the inclusion of the building allowance deduction to the REIT regime created was that the taxable income of the REIT was reduced considerably and the limitation on the distribution to not exceed the taxable income, resulted in a low percentage of the rental income flowing through to the shareholders. The case study in 2.3.5 indicates that the problem can be overcome by amending section 25BB(2) of the Act. Essentially changing the distribution rules by not limiting the qualifying distribution to the available taxable income, but rather using the available cash flow to determine the distribution limited.

What should not be forgotten is the deferred tax of R4.2m which implies that the tax saving generated by the building allowances will be accounted for in the future when the building is disposed of and the allowance is recouped. The R4.2m deferred tax represents 17%(rounded) as a percentage of profit before building allowances which if added to the income tax which represent 37% of the tax as a percentage of profit

before tax increase to 54% for the REIT with the building allowance and maximum cash flow distribution compared to the REIT without the building allowances percentage of 41% tax as a percentage of profit before tax. The difference is that the 41% tax of the REIT without the building allowances is payable in the current year compared to only 37% for the REIT with the building allowance and maximum cash flow distribution.

It has now been established that the building allowance deduction in a single year can suffice under the REIT regime and benefit the taxpayer, subject to the amendment of the distribution limits. The next step will be to analyse the recoupment consideration of building allowances under the REIT regime.

2.3.6 Considerations of recoupment of building allowances

If the allowance is considered for the REIT regime, then it will only be fair to consider the recoupment of the allowance. Section 8(4)(a) of the Act provides that where allowances were previously allowed and the asset is subsequently sold for a price in excess of its tax value, that difference between the selling price (limited to the initial cost price) will be a taxable recoupment of the deductions previously claimed (Haupt, 2017).

The recoupment of allowances claimed before gaining REIT status form part of the definition of rental income under the REIT regime. This was affected by the introduction of paragraph (e) to section 25BB(1)'s definition of rental income. The reason for including the recoupment to the definition of rental income was to prevent the recoupment income to impact the rental income threshold (75%) requirement of a REIT negatively. Before the amendment to legislation the recoupment of allowances increased the REIT company's non -rental income and therefore decreased the rental income percentage of the total income.

Studies indicated that real estate investment is viewed globally, as long-term investments (10 to 20 years and even more) and that South Africa is perceived as a pro-landlord real estate market (Wilfred, 2016). Most property companies and specifically REITs, develop the properties to lease and not necessarily to sell them (Visser, 2016). Therefore, the REIT and the shareholders can enjoy a considerable tax advantage over time, by claiming the annual building allowance tax deduction for several years and not necessarily dispose of the building and trigger the recoupment. Furthermore, the shareholder will not necessarily hold shares in the REIT when a disposal of a building takes place. However, the share price will be affected

by the eventual recoupment in advance as a result of the deferred tax on the balance sheet factored into the valuation of the company.

The concern with the recoupment of the building allowance is the increase the income will result in an increase in the distributable profits (JSE requirements of the 75% distribution of the distributable profits). This will have a negative impact on the cash reserves and a similar reinvestment in property will also be impacted negatively as the majority of the income generated from the sale of the building will be distributed to the shareholders (see table below). This is not what Treasury envisaged for a REIT. Treasury aimed for reinvestment and no capital distributions (Treasury, 2007). Therefore, if the recoupment component is required, in its current form, the building allowance consideration should not suffice under the REIT regime.

A possible solution would be to use section 8(4)(e) of the Act which will defer the recoupment over the allowance period of the replacement asset. The amended version of section 8(4)(e) came into effect on 22 December 2003 which resulted in a recoupment not always needed to be included as income in the year when it arises. The recoupment is included in the taxpayer's income in subsequent years of assessment (i.e. the deferment of the recoupment) (Haupt, 2017).

The application of section 8(4)(e) will counter the large recoupment in the year of the disposal. It would also encourage reinvestment. The REIT will then have annual recoupment of the old building and an annual allowance for the new building. If the new building has a higher value than the old building it will still result in a net deduction for income tax and provide a benefit for the taxpayers.

The following table will have 3 sections: The first section will illustrate the REIT allowed to utilise the building allowance in year one (Year 1). The second section will illustrate the REIT allowed to utilise the building allowance and in year 20 and dispose the buildings with the full recoupment of the allowances claimed and no reinvestment in the replacement buildings and therefore no future allowances can be claimed (Year 20 full recoupment). The third scenario will illustrate the REIT allowed to utilise the building allowance in year 20 with the deferred recoupment over the lifespan of the new buildings. The R30 million worth of buildings are replaced with R40 million worth of buildings. All other background information and assumptions are the same as with the previous tables (Year 20 deferred recoupment). No capital gains tax considerations are applicable (CGT will be discussed in 2.3.7).

Table 5: Recoupment deferred over the lifetime of replacement buildings

REIT allowed to utilise building allowances & deferred recoupment of replacement asset			
	Year 1	Year 20 full recoupment	Year 20 deferred recoupment
	Rm	Rm	Rm
Rental income	40	40	40
Operating expenses	(10)	(10)	(10)
Finance cost	(5)	(5)	(5)
Profit before building allowance	25	25	25
Building allowance @ R300m x 5%	(15)	(15)	(15)
100% recoupment of building allowance (R300m x 5% x 20 years)		300	
Deferred recoupment of old building allowance @ R300m x 5%			15
New building allowance of @ R400m x 5%	-	No replacement	(20)
Profit after building allowance	10	310	5
Qualifying distribution @ 75%	(7,50)	(232,50)	(3,75)
Profit before tax	2,50	77,50	1,25
Tax @ 28%	(0,70)	(21,70)	(0,35)
(After Tax) income @ property company level	1,80	55,80	0,90
Individual investor	7,50	232,50	3,75
Tax @ 45%	(3,38)	(104,63)	(1,69)
Income after tax	4,13	127,88	2,06
Total tax paid (0,70 +3,38) & (21,70 + 104,63) & (0,35 + 1,69)	4,08	126,33	2,04

Source: Author`s compilation

The table illustrates that the deferral of the recoupment combined with the new building allowance will streamline the process and address the problem created by the recoupment. The problem with the full recoupment in year 20 is the effect it creates with the increase in the distributable income. The significant increase in distributable profits and the 75% distribution rule will result in the majority of the REIT`s funds to be distributed and prohibit the reinvestment in a replacement asset (i.e. building). However, the deferral of the recoupment over the lifespan of the replacement asset will result in no excessive income on the income statement and the cash reserves will be able to be reinvested and not forced to be distributed and by doing so deplete the REIT`s funds. Therefore, the REIT regime will be able to accommodate the disposal of a building in a single year, subject to the recoupment being deferred over the lifespan of the replacement asset.

Based on the aforementioned, the building allowance and the recoupment of the building allowance can suffice under the REIT regime, subject to certain adjustments to legislation. The next consideration will be capital gains tax.

2.3.7 Capital gains considerations

Section 25BB(5) of the Act exempts the receipt of capital gain of a REIT. National Treasury's aim with the exemption of capital gain was that the proceeds realised from the sale of buildings be reinvested and not distributed to the shareholders. Therefore, not inflating the short term returns of the REIT and preserve the REITs long term value. Furthermore, the practical implications of a capital distribution were a problem for Treasury as the distribution will not necessarily go to the correct shareholder. Resulting in a timing problem (Treasury, 2016).

The US REITs can elect to distribute capital gains to shareholders and the capital distribution is also a deductible from the REITs taxable income (Baum & Devaney, 2008). This in contrast to the views of Treasury in South Africa. The distribution of capital gains will always have the practical problems and will be difficult to overcome. Therefore, capital gains will struggle to suffice under the REIT regime and I am in agreement with section 25BB(5) which exempts the REIT of capital gains and that the shareholders should be liable for capital gains tax with the disposal of their shares in a REIT company. Therefore, the investor in REIT shares will have to factor the potential capital gains tax on the capital growth of the shares and the fact that no deferred capital gains tax will be provided for on the REIT company's balance sheet and therefore impact the valuation of the share price.

2.3.8 An analysis of investor income and tax collection by the SARS

In 2.3.4 – 2.3.7 we analysed the feasibility of building allowances under the REIT regime from a mechanical point of view. In this section the consideration shifts to an analysis of investor income and revenue collection of the SARS when the building allowance deduction is introduced to the REIT regime.

The following table summarises the investor income and SARS tax collection on a single year basis. The building allowance does not materially impact the investor income of the shareholders of the non-REIT companies, but it does impact the tax collection by SARS considerably (Table 6.1 and 6.2).

The standard REIT's investor income and SARS tax collection (Table 6.3) are at similar levels to the non-REIT without building allowances (Table 6.1). The introduction of the building allowances to the REIT regime (Table 6.4) reduces the tax to similar levels to the non-REIT regime with building allowances (Table 7.2). However, due to the dividends taxed as gross

income in the hands of the shareholder, the investor income after tax is reduced considerably. Therefore, the building allowances yield better results outside the REIT regime.

The REIT with the building allowances and no distribution limitations (Table 6.5) yield the highest investor income after tax, but is at the same level as the REIT regime without the building allowances (Table 6.3). The same applies to the tax collection by SARS. Tax collection are at the same level as the non-REIT not using building allowance and the REIT regime without building allowance.

Based on the aforementioned the REIT with the building allowances and no distribution limitations (Table 6.5) yields the best results. The investors will receive the most income and SARS will earn slightly less revenue than under the other regimes.

Table 6: Investor income and SARS tax collection (annual basis)								
No	Type of regime	Investors income after tax (Rm)	Investor level	Total tax collected by SARS (Rm)		Previous table reference	Section reference	
				Property company level	Total tax collected by SARS			
1	Non-REIT not qualifying for building allowances, distributing 75% of profit	10,80	2,70	7,00	9,70	1	2.3.2	
2	Non-REIT qualifying for building allowances, distributing 75% of profit	10,80	2,70	2,80	5,50	1 & 2	2.3.2 & 2.3.3	
3	REIT not allowed to utilise building allowances, distributing 75% of profit	10,31	8,44	1,75	10,19	2 & 3 & 4	2.3.3 & 2.3.4 & 2.3.5	
4	REIT allowed to utilise building allowances, distributing 75% of profit	4,13	3,38	0,70	4,08	3	2.3.4	
5	REIT allowed to utilise building allowances, distributing the available cash flow (205% of profit)	11,28	9,23	-	9,23	4	2.3.5	
6	100% Recoupment after 20 years	127,82	104,63	21,70	126,33	6	2.3.6	
7	Deferred recoupment after 20 years	2,06	1,69	0,35	2,04	6	2.3.6	
Source: Author's compilation								

2.3.9 An analysis of investor income and tax collection by the SARS over the full lifespan of the building allowance

The previous sections focussed on the mechanical functionality of the building allowance under the REIT regime and the investor income and tax collection in single years of assessment. This section will analyse the full life cycle of a building allowance under the REIT regime. The following table will incorporate all the proposed amendments to legislation (claiming building allowances, distributing the available cash flow, deferring the recoupment of the building allowances over the lifespan of the replacement asset) and comparing the regime to the current REIT regime (no allowances, distribution less than the taxable income and no recoupments) over the 20 years lifespan of the proposed building allowance deduction. The qualifying distribution will be 75% of the distributable profits, unless the qualifying distribution is based on available cash flow. The available cash flow will be 25% of the profit less the tax paid at company level so that the cash flow is similar to the after-tax income at property company level of the REIT company which is not allowed to utilise the building allowances (R90m).

Table 8: Comparison between the proposed REIT regime v current regime over the lifespan of the building allowance

<u>REIT allowed to utilise building allowances & deferred recoupment of replacement asset (distribution of all available cash flow)</u>	<u>REIT allowed to utilise building allowances & deferred recoupment of replacement asset (distribution of 75% of the profit)</u>	<u>REIT not allowed to utilise building allowances & no recoupment applicable (distribution of 75% of the profits)</u>
20 Years	20 Years	20 Years
Rm	Rm	Rm
Rental income	Rental income	Rental income
800	800	800
Operating expenses	Operating expenses	Operating expenses
(200)	(200)	(200)
Finance cost	Finance cost	Finance cost
(100)	(100)	(100)
Profit before building allowance	Profit before building allowance	Profit before building allowance
500	500	500
Building allowance @ R300m x 5% x 20 years	Building allowance @ R300m x 5% x 20 years	Building allowance not allowed
(300)	(300)	-
Deferred Recoupment of building allowance @ R300m x 5% x 1 year	Deferred Recoupment of building allowance @ R300m x 5% x 1 year	No recoupment
15	15	
New building allowance of @ R400m x 5%	New building allowance of @ R400m x 5%	No new building allowance
(20)	(20)	
Profit after building allowance	Profit after building allowance	Profit after building allowance
195	195	500
Qualifying distribution @ available cash flow (500 - 90)	Qualifying distribution @ 75%	Qualifying distribution @ 75%
(410)	(410)	(375)
(Maintain the same level cash as the REIT with no allowances & recoupments)		
Profit before tax	Profit before tax	Profit before tax
-	-	125,00
Tax @ 28%	Tax @ 28%	Tax @ 28%
-	(25,20)	(35)
(After Tax) income @ property company level	(After Tax) income @ property company level	(After Tax) income @ property company level
-	64,80	90,00
Individual investor	Individual investor	Individual investor
410,00	105,00	375,00
Tax @ 45%	Tax @ 45%	Tax @ 45%
(184,50)	(47,25)	(168,75)
Income after tax	Income after tax	Income after tax
225,50	57,75	206,25
Total tax paid (0 + 184,50)	Total tax paid (25,20+ 47,25)	Total tax paid (35 + 168,75)
184,50	72,45	203,75
Total tax as % of Profit before building allowance	Total tax as % of Profit before building allowance	Total tax as % of Profit before building allowance
37%	14%	41%
% at property company level	% at property company level	% at property company level
0%	5%	7%
% at individual shareholder level	% at individual shareholder level	% at individual shareholder level
37%	9%	34%

Source: Author's compilation

The table illustrates that the individual investor will receive R410m before tax in the REIT regime with building allowances and no distribution limitations compared to the R105m before tax in REIT regime with building allowances and distribution limitations compared to the R375m before tax of the current REIT regime without the building allowances. The total tax liable to SARS with the building allowances and no distribution limitations are R184,50m compared to the REIT regime with building allowances and distribution limitations are R72.50m compared to R203,75m without the building allowances and distribution limitations.

The investor income and the SARS tax collection over the full lifespan comparison is similar to the comparison over one year. The REIT regime with the building allowance and distribution limitation will result in a low percentage of income flowing through to the investors and a very low percentage of tax collection for the revenue authorities. Which yields an undesirable outcome for taxpayer and state. Which proves that the building allowances cannot suffice under the REIT regime with distribution limitations.

The REIT regime with all the proposed amendments to legislation will be able to accommodate the building allowance. Therefore, the REIT regime with building allowances and no distribution limitation should be compared to the current REIT regime (no building allowances and distribution limitations).

The REIT regime with both the building allowance and the unlimited deduction for distribution of the maximum available cash flow will yield a slightly higher after-tax income for the investor (R225.50m v R206.25m) and provides a slightly less tax collection for SARS (184.50 v 203.75) & 37% v 41%).The tax reduction for SARS is 9%. However the increase in income to the shareholders can lead to further investor incentive and subsequent future tax collection.

2.4 CONCLUSION AND RECOMMENDATIONS

2.4.3 Conclusion

The study proves that the building allowances tax deductions cannot add value to listed property companies and SARS under the current REIT tax legislation. The REIT regime cannot accommodate the building allowance without amendments to the current REIT tax legislation. In its current form the building allowance will reduce the taxable income and the distributable profits of the REIT considerably. Which will result in the REIT distributing a low percentage of the company's cash flow to the shareholders and will lead to a very low tax collection by SARS. The subsequent recoupment of the building allowance will also be impact

the re-investment in a new property negatively. The proceeds from the building will be distributed to the shareholders and no re-investment in properties will be possible. But if the limitation on the deduction of the distribution is based on available cash flow instead of distributable profits and the recoupment is allowed to be deferred over the lifespan of the replacement asset (i.e. building) the building allowance will be able to suffice in the REIT regime and provide sufficient investor income and tax revenue for SARS. Both of these amendments will need to be affected to make the building allowances a feasible option in the REIT regime. These amendments will lead to a small reduction in taxation for SARS (9% according to the case study in 2.3.8).

2.4.4 Recommendations

Based on the aforementioned, the best outcome for the investors in REITs will be if the building allowances be included in the REIT regime and the maximum available cash flow can and is distributed (i.e. more than 100% of the distributable profit). This would mean amending section 25BB(2) and scrapping section 25BB(4) of the Act. The building allowance deduction will not add value to the regime without increasing the deduction of the qualifying distribution's maximum amount.

The effect of the amendments will be more income for the taxpayer, more revenue for the SARS and more cash flow ploughed back into the company for maintenance and future expansion. This would mean adopting the US style REIT regime of claiming depreciation of rental property income and distributing 100% or even more of the taxable profit.

The consequence of including the building allowance deduction will be the possible future recoupment which can prove to be problematic for the REIT regime and Treasury's goals of reinvestment in capital assets. The deferment of the recoupment with a replacement asset will however be a workable solution. The capital gain exemption considerations should not impact the allowance consideration as the US REIT regime function with both and the study indicate that the exemption will not impact the allowance consideration.

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CHAPTER 3: SUMMARY OF FINDINGS, OVERALL CONCLUSION AND RECOMMENDATIONS

3.1 OBJECTIVES OF RESEARCH

The main objective of this study was to critically analyse the South African REIT listed property company's inability to claim building allowances from income tax, and to evaluate whether the policy is appropriate for the taxpayer and the South African government.

To achieve the above-mentioned objective, it was required to determine:

1. To gain a basic understanding of the South African non-REIT property company tax treatment of building allowances, and the impact it has on the property company's taxation and financial circumstances.
2. To gain a basic understanding of the South African REIT landscape and the associated tax treatment thereof. With the aim of establishing whether the building allowances tax deduction can suffice under the REIT taxation policy.
3. To consider the capital gains and recoupments of allowances under the REIT regime and how that links with building allowances under the REIT regime.

3.2 FINDINGS AND OVERALL CONCLUSION OF RESEARCH

Building allowances do provide a considerable tax saving for non-REIT property companies. It is therefore an extremely useful tax concession and a noticeable omission from the REIT regime. The current REIT regimes generates an excellent before tax income for the investors, but the after -tax income is in line with the non-REIT property company investors utilising the

building allowance deduction. This is due to the income tax rate of 45% compared to the dividend tax rate of 20% (at investor taxation level). The current REIT regime is extremely beneficial to SARS. The structure of the current REIT legislation does not accommodate building allowances. The allowance will reduce the available distribution from the property company to the investor to an unattractive level. This problem will however be addressed by basing the distribution deduction on available cash flow and remove the limitations on the amount which can be distributed. The REIT regime will then yield sufficient income and tax levels which can compare and even beat the non-REIT regime with the building allowances. The possible future recoupment of building allowance will be a problem for the REIT regime, but the deferral provision, which is already in the tax legislation will solve the problem. Capital gains should still be exempt under the REIT regime and the REIT investor should remain liable for capital gains when the share in the REIT is disposed of. The proposed amendments will result in the REIT regime effectively adopting the building allowances and will reduce the tax collection by SARS slightly on a one-year basis as well as over the full lifespan of the building. The building allowance will however not suffice in the REIT regime unless both the deduction limitations be amended and the recoupment of the building allowance are deferred over the lifetime of the replacement asset.

3.3 RECOMMENDATIONS

The building allowances deduction should be incorporated in the REIT regime taxation and the maximum available cash flow should be allowed to be distributed (i.e. more than 100% of the taxable profit). This would mean amending section 25BB(2) and scrapping section 25BB(4) of the Act. Remembering that the building allowance deduction will not add value to the regime without increasing the qualifying distribution`s maximum amount.

The consequence of including the building allowance deduction will be the possible future recoupment which can be problematic for the REIT regime and Treasury`s goals of reinvestment in capital assets. The deferment of the recoupment with a replacement asset will however be a workable solution. The capital gain exemption considerations should not impact the allowance consideration as the US REIT regime function with both and the study indicate that the exemption will not impact the allowance consideration.

3.4 LIMITATIONS OF RESEARCH

The research is limited to the South African resident individual taxpayer with a marginal income tax rate of 45%.

The section 13quin building allowance was the only allowance used in this study (i.e. 5% of the commercial building value).

The study did not consider International Financial Reporting Standards.

The study did not consider Company Law provisions and requirements.

3.5 FURTHER RESEARCH OPPORTUNITIES

Research could be expanded by comparing and analysing the different types of building allowances to the REIT regime.

Research could also be expanded in the future by using different marginal tax rates for the individual investor and even establishing at which marginal rate the taxpayer can gain the ultimate advantage.

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