An analysis of the Real Estate Investment Trust tax regime on the South African property sector

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DECLARATION

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H KANTILAL DATE

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ABSTRACT

Real Estate Investment Trusts (REITs) are used by individual investors to mitigate the risks relating to direct ownership. Prior to the implementation of the new REIT tax regime in South Africa, the regulatory framework and tax legislation that governed the former property investment vehicles, namely Property Unit Trusts and Property Loan Stock Companies, were fragmented and inconsistent. This caused uncertainty pertaining to the regulation and tax treatment of such investments and had a negative impact on the willingness of foreign investors to invest in South Africa. Consequently, a new REIT tax regime was introduced in South Africa to ensure simplicity, uniformity and consistency in the tax and regulatory environment of property investment vehicles while making it internationally comparable. The main objective of the study was to analyse and evaluate various aspects of the new REIT tax regime to determine, firstly, whether the taxation of the listed property sector in South Africa has improved in a fair and reasonable manner and, secondly, whether these amendments accommodate the needs of both the listed property sector and its investors. The study found that the new REIT regime ensures the application of substance over form and eliminates deficiencies in the previous tax treatment of property investment vehicles. From comparisons between the South African and US REIT structures, it became apparent that the South African REIT structure is still underdeveloped in terms of accommodating all types of organisations and stakeholders as the US REIT structure does. Despite the benefits associated with the new REIT structure, the study did identify scope for improvements like its extension to also include the unlisted property sector.

KEYWORDS:

Controlled company; listed property sector; property company; property investment vehicles; property loan stock company; property unit trust; qualifying distribution; real estate investment trust; tax conduit theory; tax dispensation; tax legislation.

TABLE OF CONTENTS

CHAPTER 1

PURPOSE, SCOPE AND CHAPTER OUTLINE

CHAPTER 2

LEGISLATION AND REGULATIONS GOVERNING THE SOUTH AFRICAN REAL ESTATE INVESTMENT TRUST REGIME

CHAPTER 4

A CRITICAL COMPARISON BETWEEN THE US AND SOUTH AFRICAN REIT SYSTEMS

LIST OF ABBREVIATIONS

Act	-	Income Tax Act (58 of 1962)
CISP	-	Collective Investment Scheme in Property
CIR	-	Commissioner for Inland Revenue
FSB	-	Financial Services Board
IFRS	-	International Financial Reporting Standards
JSE	-	Johannesburg Stock Exchange
NAREIT	-	National Association of Real Estate Investment Trusts
OECD	-	Organisation for Economic Co-operation and Development
PLS	-	Property Loan Stock
PNLR	-	Public Non-Listed REITs
PUT	-	Property Unit Trust
PWC	-	PricewaterhouseCoopers
REIT	-	Real Estate Investment Trust
SAICA	-	South African Institute of Chartered Accountants
SAPOA	-	South African Property Owners Association
SAREITA	-	South African Real Estate Investment Trust Association
SARS	-	South African Revenue Service
SEC	-	Securities and Exchange Commission
STC	-	Secondary Tax on Companies
UK	-	United Kingdom
US	-	United States

LIST OF FIGURES

LIST OF TABLES

CHAPTER 1: PURPOSE, SCOPE AND CHAPTER OUTLINE

1.1 INTRODUCTION AND BACKROUND

1.1.1 Introduction

Investment in immovable property remains an attractive investment opportunity due to the fact that investors can achieve gains from both rental streams and capital appreciation, through either direct or indirect investment. However, direct investment in immovable property requires significant amounts of financing and exposes buyers to risks of ownership such as the risk associated with variable and high interest rates, maintenance and management of the property, and underlying costs such as property insurance, levies, property rates and taxes. With indirect investments, the investor has the advantage of, firstly, investing collectively with other investors (low-cost trading market) into a fund which is managed on their behalf and, secondly, having a more diversified portfolio as opposed to having invested in one significant property for the same value. Furthermore, under indirect investment, investors are taxed in their own name as if ownership is direct. Such transparency and diversification are not present under direct investment in immovable property (Plaizier, 2008:4).

1.1.2 Background

Since the first democratic election in 1994, South African legislators have been reviewing tax legislation continuously and effecting amendments and introducing new legislation to improve legislation to a level which would not only be internationally accepted, but also be comparable to international legislation. Another aim has been to promote and attract foreign investors to South Africa in order to improve economic growth.

The introduction of the new Real Estate Investment Trust (REIT) structure to the listed property sector is no different and has been under discussion for a number of years before its implementation from 1 April 2013. Before this date, the listed property sector in South Africa mainly consisted of Property Loan Stock (PLS) companies and Property Unit Trusts (PUTs).

Not only were PUTs more strictly regulated than PLS companies, but inconsistencies also existed in the tax treatment between these two structures (National Treasury, 2012:66). Because they were classified as vesting trusts, PUTs were treated as a flow-through property vehicle where all income would retain its nature when distributed to their investors. Unlike with PLS companies, this ensured that income was taxed only at one level, namely in the hands of the investors. For income tax purposes, a PLS company qualified as a company as defined in terms of Section 1 of the Income Tax Act (58 of 1962) ("the Act") and, as a result, was taxed at a rate of 28%. All distributions were, firstly, taxed at a corporate level and thereafter at a shareholder level. The difference in the nature of the distributions made between a PUT and a PLS company was that distributions by a PLS company did not retain their nature as rental income, as with a PUT. A portion of the distribution was classified as interest with the remaining portion classified as dividends. This was because a PLS company consisted of linked units (equity and debenture portions). The investor was liable for dividends tax and was exempt from tax only for the interest portion up to a specific threshold in accordance with Section 10(1)(*i*) of the Act.

The REIT structure has been implemented in over 25 countries worldwide such as the United States (US), Australia, Belgium, France, Hong Kong, Japan, Singapore and the United Kingdom (UK) (SAREITA, 2013a). South Africa has also adopted the REIT structure whereby listed PLS companies and PUTs could be converted into REITs. This change in the structure of the South African listed property sector has necessitated changes not only in the Johannesburg Stock Exchange (JSE) Listing Requirements, but also in tax legislation to govern the tax treatment of the income and the distributions of REITs.

The introduction of the internationally recognised REIT structure, as well as the taxation of REITs in South Africa, was first announced and published by the National Treasury of South Africa in the Taxation Laws Amendment Act (22 of 2012) on 25 October 2012. The date of effective implementation of such legislation was from 1 April 2013. This implied that listed property investment vehicles would be taxed in the same way, in accordance with their common purpose (substance) and not their legal form. This resulted in a number of accompanying tax advantages such as the ability to deduct all distributions made from taxable income.

According to a report issued by the JSE during 2013 (see Appendix A), there have been over 20 listed entities operating as PLSs and under 10 listed entities operating as PUTs in South Africa since 10 December 2012 (National Treasury, 2012:66). In South Africa a PLS company was regulated by the Companies Act (71 of 2008), while a PUT was governed by a trust deed and managed by an external company. In addition, a PUT was regulated by the Financial Services Board (FSB) through the Collective Investment Scheme Control Act (45 of 2002). An investor in a PLS company held a unit that consisted of both equity and a debenture (a dual-linked unit), while an investor in a PUT acquired only an equity unit.

The differences between these two property investment vehicles, namely PLS companies and PUTs, resulted in inconsistent tax treatments. These inconsistencies created confusion among investors, in particular foreign investors, discouraging them from investing in South African property investment vehicles. For this reason, authorities reviewed the listed property sector as part of the proposals to the 2007/8 National Budget which acknowledged that the tax treatment of these entities was indeed fragmented because it was based on their legal form (i.e., trusts versus companies) rather than their common purpose. It was, furthermore, indicated that the regulatory and tax regime relating to property holding entities was to be reviewed during the course of 2007 (SARS, 2007:19).

In particular, the South African Revenue Service (SARS) expressed discomfort with the tax treatment of PLS companies on the basis that the excessive level of interest paid to linked unit holders arguably constituted a profit distribution (Wilson, 2013a:18). The National Treasury (2012:68) argued that the continued tax neutral treatment of these entities would not coincide with the overall tax policy of debt versus equity which follows a substance-over-form principle, as it regards interest to be more akin to a dividend which is not deductible for normal income tax purposes. PLS companies were, therefore, regarded to be the more popular and dominant structure, because they allowed an interest exemption for distributions received – this was not available for distributions received from PUTs, which constituted a taxable dividend (Lamprecht, 2013; National Treasury, 2012:67).

Industry executives in the property sector have long been campaigning for PUTs and PLS companies to be replaced with the internationally used REIT structure in order for the tax treatment of these entities to be aligned (Mashego, 2013:4). According to the publication in the Taxation Laws Amendment Act (22 of 2012), the REIT tax regime would treat a PUT as a company, therefore, placing the PUT on the same footing as the PLS companies. This is despite the fact that the South African REIT Association (SAREITA), previously known as The Property Loan Stock Association (PLSA), distinguished between two types of REITs, namely a company REIT and a trust REIT.

From 1 April 2013, the newly introduced tax legislation and tax dispensation were applied to all REITs, while the new JSE Listing Requirements took effect from 1 May 2013. Both PLS companies and PUTs had to apply at the JSE, showing that they complied with all requirements to qualify as a REIT by 1 July 2013. Entities who adhered to the necessary requirements on

1 July 2013 could officially qualify as REITs from the first day of their next financial year commencing after this date (Hedley, 2013a:13).

1.2 MOTIVATION FOR THE STUDY

The conversion of the former South African property investment vehicles such as PLS companies and PUTs into REITs has had the potential to impact the entire property sector, not only the listed property sector.

The listed property sector in South Africa has grown significantly with a market capitalisation of R41 billion at the end of March 2003, growing to approximately R300 billion at the end of 2014 (Rapp, 2014). Research conducted by Grindrod Asset Management on behalf of the PLSA indicated that the listed property sector was one of the most active sectors on the JSE for the 10 year period between October 2002 and October 2012 (before the introduction of the new REIT regime) in that it outperformed all other local asset classes (Property24, 2012). The latter two statements do not only highlight the importance of the listed property sector in the South African economy, but also justify the need to analyse the impact that the conversion of its tax structure has had on the sector itself.

PLS companies and PUTs were previously taxed in South Africa based on their legal form. The Taxation Laws Amendment Act (22 of 2012) introduced the new Section 25BB into the Act which encapsulates both these property investment vehicles under the new REIT regime. In this way, both PLS companies and PUTs can be classified as REITs (if they meet the requirements) and be treated in exactly the same manner for tax purposes.

The chairman of the SAREITA Committee, Mr Estienne De Klerk, contended that:

> the key benefit of the new REIT structure is that it will propel South Africa to being the eighth largest jurisdiction and will qualify us to be included in a whole lot of REIT indices, thus attracting foreign money onto our local market. (Mashego, 2013:4)

This statement was supported by JSE business development manager, Ms Patrycja Kula, who indicated that:

> [w]hen South African-listed property funds convert to this system, South Africa will be the eighth largest REIT market. (Radebe, 2013:15)

Therefore, the global nature of this structure allows, for example, a French retirement fund manager to compare Australian investments with Japanese, South African and American funds. The common rules and regulations of REITs make this international comparison possible.

The new REIT regime can be affected by different aspects such as the attractiveness of the listed property sector of South Africa to foreign investors (National Treasury, 2007:8), decisions pertaining to future management of property investment vehicles, impact on the unlisted property sector, REIT investments in offshore or foreign entities (Dachs & Du Plessis, 2012:1) and tax avoidance schemes through thin capitalisation (Anon., 2013).

The 2015 National Budget Speech (National Treasury, 2015:144) indicated that Section 25BB of the Act will be refined in order to remove anomalies. Therefore, research evaluating the taxation and economic impact of the new REIT regime since its inception in the South African property sector will be valuable when this refinement of the regime is to be reviewed by tax authorities. This study attempted to contribute to the current body of knowledge in this field by identifying areas for improvement, as well as areas which have experienced the unintended negative effects of the new REIT regime. Moreover, comparing the South African REIT regime to that of another country could highlight certain useful aspects for the South African context. Such a comparison could also serve to evaluate whether South Africa's new REIT regime would be sustainable in future with regard to its original purposes, such as attracting more foreign investors to the South African property sector.

1.3 RESEARCH QUESTIONS

In order to critically analyse the impact of the REIT tax regime on the South African property sector, the following two research questions were identified:

1.3.1 Does the new REIT tax regime improve the taxation of property companies in South Africa in a fair and reasonable manner?

1.3.2 Does the new REIT tax regime accommodate the needs of the South African property sector and its investors?

1.4 RESEARCH OBJECTIVES

The key research objectives of this study are as follows:

1.4.1 To explain how the new REIT tax regime is regulated in order to provide a basic understanding of the REIT provisions contained within the Act;

1.4.2 To determine which aspects of the new tax legislation governing the REIT regime have proven to have unintended implications and negative tax consequences for the listed property sector and to identify and analyse possible anomalies;

1.4.3 To determine whether the unlisted property sector has been negatively affected to such an extent that unlisted entities would attempt to be listed in future in order to take advantage of the tax benefits available to REITs;

1.4.4 To compare the aspects of the South African REIT regime identified in 1.4.1, 1.4.2 and 1.4.3 with those of another country's REIT structure. The country selected for this comparison is the US due to the following reasons:

- SAREITA is modelled according to the National Association of Real Estate Investment Trusts (NAREIT) in the US and the European Public Real Estate Association (EPRA) (SAREITA, 2013);
- The National Treasury collaborated with NAREIT to provide input and feedback on drafting the South African REIT structure in terms of the Draft Taxation Laws Amendment Bill of 2012. NAREIT is the worldwide representative voice for REITs, including REITs in the US which has more than 50 years' experience of implementing their REIT structure (Edwards, 2013:1);
- The US was the first country that introduced a REIT structure, which occurred in 1961. Thereafter, the structure has also been implemented by countries such as the UK, Australia, France, Canada, Japan, Singapore and the Netherlands (Property24, 2008). This serves as proof that the US has the most experience regarding the implementation of a REIT structure; and
- The REIT structure implemented in the US is the largest REIT structure in the world – it constituted 31% of the total market value of REIT structures in the world from the first quarter of 2009 (Vogel Jr., 2009:7).

1.5 LIMITATION OF SCOPE

This study reviewed existing legislation as at 31 October 2015 in terms of the Act and did not consider any proposed amendments released by the National Treasury in the Draft Taxation Laws Amendment Bill during the course of 2015 after this date.

It further included only a high level overview of the US REIT structure and did not include a review of the REIT structures implemented and regulated by the European Public Real Estate Association (EPRA). As differences do exist between the REIT structures implemented within European countries, such as between the UK and France, EPRA was not considered as part of the scope of this study. The sole focus in this study was placed on a comparison with US REITs.

1.6 RESEARCH METHODOLOGY

1.6.1 Research design

The selection of a research paradigm is influenced by the way in which the researcher views the world (ontology) and how the researcher perceives knowledge to be created (epistemology) (McKerchar, 2008). For the purposes of this study, research was conducted within the interpretivist paradigm. Interpretivism proposes to provide some clarity on social reality as it encapsulates the researcher's subjective interpretations to, ultimately, derive a better understanding of the research question at hand (McKerchar, 2008).

A methodology is a body of practices, procedures and rules used by researchers in an attempt to offer insight into the workings of the world. It is central to the scientific enterprise, because they enable researchers to gather empirical and measurable evidence and to analyse the evidence in an effort to expand knowledge (Lange, 2013:3).

When deciding on the research methodology to be followed, it is important to recognise that quantitative analysis is not the only or necessarily the best way to generate valid causal and descriptive inferences. To the contrary, for many research questions, the research results could be improved by way of comparative-historical methods (Mahoney, 2004:97).

Comparative research applies diverse methods to compare the characteristics of different cases and highlight similarities and differences between them. Comparative methods are usually followed to explore causes that are common to a set of cases (Lange, 2013:19).

Historical research is also known as historiography and it is the dominant method in the discipline of history. Such methods focus largely on finding data, judging the validity of the data and accurately presenting the data through narrative analysis (Lange, 2013:20). The current study aimed to gain insight into the previous provisions of the Act that regulated the former property investment vehicles in South Africa.

1.6.2 Research method

The research in this study attempted to provide a systematic exposition of the regulations governing REITs in South Africa. This was done by analysing the relationship between the rules governing the former property investment vehicles and those of the new REIT structure and by highlighting anomalies. Where applicable, future developments of the REIT regime in South Africa were envisaged.

Firstly, historical research was conducted on the previous provisions of the Act that regulated the former property investment vehicles applied in South Africa in the form of PUTs and PLS companies. This provided insight into previous legislation and regulations applicable to the former property investment vehicles. A background literature review was performed to obtain evidence which was then evaluated and organised to develop a general explanatory model. A critical theory paradigm approach was followed in the literature review of acts, law reports, newspaper articles, articles on websites, dissertations and journal articles with the aim to explain the historical developments and motives behind the implementation of the South African REIT structure.

Secondly, comparative research was conducted by comparing the regulation of the former property investment vehicles to that of the newly introduced REIT tax regime, which is mainly regulated in terms of Section 25BB of the Act but also by other regulations such as the JSE Listing Requirements. This provided an understanding of the significant principles, regulations, structure and objectives of the new REIT structure. In this way, the study was able to determine whether deficiencies in previous legislation have been rectified with the purpose of having property companies taxed in a fair and reasonable manner. Therefore, the study could establish whether there has been an improvement in the taxation of property companies.

By following a comparative-historical research method, the study was able to analyse the sequence of events that comprise the development of the REIT regime. In addition, it attempted to identify the stakeholders as well as the issues resulting from the implementation and further development of the new REIT structure together with the new tax regime applicable to it. The analysis sought to determine whether the principles of the old and new regime were related and resulted in the different inconsistencies, unintended implications and anomalies in the taxation of property investment vehicles.

Lastly, the South African REIT regime for the unlisted property sector was compared to another international REIT regime. This comparison focused on potential practical issues and solutions for the South African context with regard to principles and regulations for the unlisted property sector. Overall, the research endeavoured to add to the interpretation of the current tax regime and to contribute to the body of knowledge of the South African REIT structure.

1.7 CHAPTER OUTLINE

The chapter outline for the study is as follows:

Chapter 2: Legislation and regulations governing the South African REIT regime

The objective of this chapter is to explain and to provide a basic understanding of the working of the newly introduced REIT tax regime as opposed to the original property sector investment vehicles, namely PUTs and PLS companies. This chapter provides an overview of the income tax legislation and JSE Listing Requirements governing South African REITs.

Chapter 3: The impact of the new REIT tax system on the entire property sector of South Africa

This chapter aims to identify and analyse aspects of the new tax regime for REITs (listed property sector) that were unintended and not considered in the taxation of REITs. It also attempts to evaluate whether the new tax regime would affect unlisted property companies to such an extent that these companies would seek listing in order to take advantage of the tax benefits available to REITs. The chapter identifies possible anomalies arising from the implementation of the new REIT tax regime.

Chapter 4: A critical comparison between the REIT system of the US and the REIT system of South Africa

The focus of this chapter is to critically compare the REIT system in the US and the REIT system in South Africa. It, firstly, aims to give a general understanding of how these REIT structures are operated and regulated by providing an overview of the US REIT structure. The chapter identifies material differences and aspects of the US tax system that could be applied to improve the South African tax system for REITs. Lastly, the chapter evaluates the progress made on extending the REIT regime in South Africa to include the unlisted property sector.

Chapter 5: Summary of findings, conclusions and recommendations

The objective of this chapter is to summarise the pertinent findings regarding the REIT tax regime from chapters 2, 3 and 4. It further provides a conclusion to the findings in terms of the research questions. The chapter concludes by making final recommendations and identifying areas to be considered for future research.

CHAPTER 2: LEGISLATION AND REGULATIONS GOVERNING THE SOUTH AFRICAN REAL ESTATE INVESTMENT TRUST REGIME

2.1 INTRODUCTION

The purpose of this chapter is to explain how the new REIT tax regime is regulated in order to provide a basic understanding of the REIT provisions contained within the Act. This will be achieved by, firstly, describing the property investment vehicles that were formerly used in South Africa, namely the PUTs and PLS companies. Secondly, the chapter will take a closer look at the manner in which these former property investment vehicles were regulated and how these regulations affected their normal income tax consequences. This will support the explanation on how the new REIT regime is regulated and clarify how it differs from the normal income tax treatment of the former investment vehicles. Furthermore, this chapter will explain the concept of the new REIT tax regime, with specific reference to the requirements for qualifying as a REIT, the broader regulatory environment of a REIT, as well as its normal income tax consequences.

2.2 SOUTH AFRICAN PROPERTY INVESTMENT VEHICLES

Before REITs became a reality in South Africa, PUTs and PLS companies operated as the listed property investment vehicles in South Africa in a similar manner as the internationally recognised REITs (National Treasury, 2012:66). PUTs and PLS companies were, however, not internationally recognised property investment vehicles. The difference in legal form according to the National Treasury (2012:66,67) of South Africa is that a PUT constitutes a trust, while a PLS company constitutes a company. The differences in their legal form, as well as the differences in legislation that governed the two property investment vehicles, resulted in inconsistent tax treatment of PUTs and PLS companies.

Both these property investment vehicles are now convertible into a REIT provided that they meet all the requirements to be listed on the JSE REIT board. Investors elected to invest in these former property investment vehicles in order to invest indirectly in real estate and to receive constant distributions (in the form of tax exempt dividends) which acted as a substitute for taxable normal rental income. Another benefit for investors was the appreciation in the value of their investment in the property investment vehicle which acted as a substitute for the capital growth in the underlying property owned by the property investment vehicle.

2.3 KEY DEFINITIONS

In order to obtain a proper understanding of the concepts discussed in this chapter with regard to PLS companies and PUTs, it is important to take a closer look at the definitions as described below.

Section 1 of the Act defines the concept of a "company" by stating that a company will include the following:

> (e) any-
>
> (ii) portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interests; or
>
> (iii) portfolio of a collective investment scheme in property that qualifies as a REIT as defined in paragraph 13.1 (x) of the JSE Limited Listing Requirements.

Subsection (*e*)(*iii*) of the definition of a "company" was inserted particularly as a result of the introduction of REITs in South Africa.

Section 47(1) of the Collective Investment Schemes Act (45 of 2002) defines a "collective investment scheme in property" (CISP) as a portfolio that consists of property shares, immovable property, assets as determined by the registrar to be a CISP, as well as investments in foreign property, foreign property shares or foreign CISPs that are subject to further provisions contained in Section 49 of that act.

Also, Section 47(1) of the Collective Investment Schemes Act (45 of 2002), defines a "property share" as:

> shares of a fixed property company or a holding company with no subsidiaries except than that of fixed property companies that are wholly owned subsidiaries of that holding company.

2.4 PROPERTY UNIT TRUSTS

2.4.1 Description of a PUT

A PUT qualifies as a CISP in terms of Section 47(1) of the Collective Investment Schemes Control Act (45 of 2002) and takes on the legal form of a vesting trust (National Treasury, 2007:20) that is listed on the JSE and in which investors hold a participatory interest. A CISP is defined by the National Treasury (2007:31) as one of the two types of vehicles in which investors can invest to gain exposure to the property sector. A PUT, therefore, consisted of property shares of which the investor needed to have purchased to be able to invest in a PUT. A portfolio of investment grade properties was held by a PUT either through the direct investment in properties or indirectly through the holding of property shares. These properties were held for capital appreciation and rental income purposes.

The management of a PUT was undertaken by an external management company. This company made both the investment and operational decisions (either performed by the management company or outsourced to a separate property administrator) such as vacancy rates, quality of tenants, tenant retention and the number of new plans that are passed in relation to existing and potential new properties.

2.4.2 Regulation of PUTs

PUTs were regulated more stringently than PLS companies, which included regulation by the FSB in terms of the Collective Investment Schemes Control Act (National Treasury, 2012:66). A PUT was governed through a trust deed. The conditions in the trust deed, as determined by the FSB, regulated the way PUTs were to be managed, how decisions were to be made and how income was to be distributed. In addition, management companies that administered PUTs were regulated by a trust deed established between the management company and the trustee, and also by the JSE (Boshoff, 2012:49).

The FSB allowed PUTs to only invest in specific types of investments, including specified immovable property such as buildings, land or leaseholds (direct acquisition of real estate); shares in property companies (indirect acquisition of real estate); and liquid debt-related investments (National Treasury, 2012:66).

2.4.3 Tax legislation previously applicable to PUTs

PUTs were classified as vesting trusts. A vesting trust provided the beneficiaries of the trust a vested right to the income (including income of a capital nature) or assets of the trust (SARS, 2014). In terms of clause 34 of the model trust deed issued by the FSB, trustees were to pay to investors an amount that was available for distribution in proportion to the number of participatory interests held by each investor (FSB, n.d.:38). As a result, beneficiaries were able to obtain a vested right to the income available for distribution within a PUT.

According to the FSB and in terms of clause 32 of the model trust deed, the following was included in the amount available for distribution:

- Receipts from the issue of participatory interests;
- Dividends, interest and other receipts from the underlying assets;
- Commission received (directly or indirectly) from either insurance or the purchasing or disposal of immovable property on behalf of the PUT;
- Proceeds from capital gains, bonus or rights issued; and
- Receipts in terms of the disposal of the PUTs assets.

The conduit theory principle was applicable to PUTs due to the fact that they were viewed as vesting trusts. The conduit theory principle, established in terms of the Armstrong v Commissioner for Inland Revenue (CIR) 10 SATC 1 (1938) case, determined that income earned would retain its nature when flowing through the trust to the trust beneficiaries and would be taxed at an investor level rather than at a corporate level. Also, the judgement in SIR v Rosen (1971 A) determined that income flowing through a trust to a beneficiary would retain its identity. In substance, this provided the investor with an investment that had a more direct than an indirect nature. For the purposes of the discussion from an income tax perspective, the investor in a PUT will be referred to as the "beneficiary of a trust".

The section in the Act that supports the conduit theory principle is Section 25B(1), which determines the following:

> Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.

Therefore, it is evident that vesting trusts acted purely as conduits whereby income, such as rental income or dividends, was received by or accrued to a trust, but instead was deemed to have been received by or deemed to have accrued to the beneficiaries of such trust. It would be deemed as if income and capital would be received by or would have accrued to the beneficiaries and that they had a vested right to it, regardless of whether the income and capital were distributed by the trust. If the beneficiaries did not have any vested right to any income and capital received by or accrued to the trust, it would be the trust itself, and not the beneficiaries, that would be liable for the income tax on the taxable income retained by the trust at the corporate tax rate applicable to trusts (which is currently 41%) (Fourie, 2009:13). Any capital gains were also to be included in the taxable income of such a trust at the applicable capital gains tax inclusion rate in terms of paragraph 10 of the Eighth Schedule to the Act.

As a result of the conduit theory principle, the revenue of a PUT retained its nature when it was distributed by the PUT to its investors. This ensured, unlike with PLS companies, that the rental income was taxed only at one level, namely in the hands of the investor. According to proviso *(aa)* to Section 10(1)(*k*)(i) in terms of the Act, distributions made by PUTs did not qualify for the Section 10(1)(*k*)(i) exemption. This proviso determined that dividends received from property shares held by PUTs would not be exempt in the hands of the beneficiary of the trust, unless the initial distribution by the fixed property company to the PUT was of a capital nature. Thus, the various types of income, such as rental income or capital gains from disposals that were distributed, retained their nature and were to be taxed at an investor level.

Where a PUT disposed over a capital asset that was held by the PUT, the capital gain realised on that disposal would vest in the hands of the beneficiaries of that trust. However, Paragraph 67A of the Eighth Schedule to the Act (repealed and deleted from the Act as from 1 April 2013) would have prohibited the vesting of such capital gain in the hands of the beneficiaries of that trust. Thus, the conduit theory principle would have been overridden by Paragraph 67A of the Eighth Schedule to the Act.

Paragraph 67A(1) determined that:

> A holder of a participatory interest in a portfolio comprised in any collective investment scheme managed or carried on by any company registered as a manager under section 42 of the Collective Investment Schemes Control Act, 2002, for the purposes of Part V of that Act must determine a capital gain or capital loss in respect of any participatory interest in that portfolio only upon the disposal of that interest.

Therefore, any capital gains realised on the disposal of any assets held by the PUT would have been taxable only upon the disposal of such units in the PUT held by the beneficiaries of the trust, and the PUT would not have been liable for any capital gains tax.

Owing to the fact that it operated as a trust, a PUT could not benefit from the re-organisation corporate rollover relief as provided for in terms of Sections 41 to 47 of the Act (National Treasury, 2012:67).

2.5 PROPERTY LOAN STOCK COMPANY

2.5.1 Description of a PLS company

A PLS company was the other type of property investment vehicle, besides a PUT, that investors used for indirect investment in the South African property sector. A PLS company derived its income from the holding of a property portfolio in the legal form of a company, but the investment decisions of a PLS company were internally managed and not by an external management company as was the case with a PUT (refer to part 2.4.2) (National Treasury, 2007:3).

2.5.2 Regulation of PLS companies

PLS companies were regulated only in terms of the South African Companies Act (71 of 2008) and the JSE regulations. Because PLS companies did not fall under the jurisdiction of the Collective Investment Schemes Control Act, they were not restricted in respect of the type of investment and the manner in which they could invest in real estate and how they had to distribute income and capital gains to their investors. Therefore, a PLS company could own real estate either directly or indirectly through an interest in other entities. Owing to the limited regulation of PLS companies in comparison to PUTs, the PLS companies had the option of investing in joint ventures and other partially owned companies which did not consist of “property shares” as defined in Section 47 of the Collective Investment Schemes Control Act and with which PUTs had to comply when making other investments. Furthermore, PLS companies were regulated by their own memorandum and articles of association as required in terms of the Companies Act (71 of 2008).

2.5.3 Tax legislation previously applicable to PLS companies

PLS companies operated in the legal form of a company. Therefore, a PLS company fell within the scope of Paragraph (*a*) of the definition of a “company” as defined in terms of Section 1 of the Act and was liable for normal income tax at a corporate tax rate of 28%.

According to the National Treasury (2012:67), a PLS company, as a property investment vehicle, was the preferred choice for investors at a policy level. The holders of shares preferred to invest in linked units of a PLS company, because they did not represent “property shares” as defined in terms of Section 47 of the Collective Investment Schemes Control Act. A linked unit consisted of a debenture and an equity portion. When making distributions, the PLS company paid interest on the debenture portion and declared dividends on the equity portion. The dividends were exempt from normal income tax in terms of Section 10(1)(*k*)(i) for the holders of shares, and the interest was also exempt from normal income tax in terms of Section 10(1)(*i*)(xv) for the holders of shares (before amendments in 2015), which determined the following:

> any taxpayer who is a natural person, so much of the aggregate of any interest received by or accrued to him or her from a source in the Republic as does not during the year of assessment exceed.

The interest was exempt in the hands of the holder of shares in their capacity as natural persons up to the applicable threshold depending on their age (either below the age of 65 or 65 years and older).

The proviso to Section 10(1)(*k*)(i)(*aa*) previously determined that dividends received from property shares would not be exempt unless they were distributed by a fixed property company out of capital profits. Therefore, this proviso was applicable only to PUTs, because PUTs consisted of property shares. Owing to the fact that a holding in a PLS company constituted a linked unit, this proviso was not applicable to dividends distributed by a PLS company. Clearly, the investors in a PLS company enjoyed a tax benefit in respect of the dividend portion of the distributions made to them by the PLS company.

2.5.3.1 Tax legislation governing direct investment in real estate

Direct investment in real estate involves the direct acquisition of immovable property by a PLS company. Owing to the fact that a PLS company constituted a company as defined, the conduit theory principle could not be applied to a PLS company, because this principle is applicable only to trusts. Also, PLS companies could qualify for the re-organisation corporate rollover relief provided that they meet the requirements of Sections 41 to 47 in terms of the Act.

To determine the deductibility of interest distributed by a PLS company to its investors, consideration should, firstly, be given to Section 24J(2) of the Act which specifically provides guidelines on the deductibility of interest for income tax purposes. It is, however, noted that a deduction for interest was not available to PLS companies in terms of Section 24J(2) of the Act, because no specifically defined redemption date was attached to its linked units. The date of redemption was dependent on the intention of the unit holders with regard to when they wanted to realise the units held by them. The linked units, therefore, qualified as perpetual instruments. Perpetual instruments are instruments whose terms do not include or specify any date for the discharge or full redemption of the instrument and, in effect, constitute “perpetual debt” (Lewis &

Midgley, 2011). Without a specified accrual period attached to the instrument the yield to maturity formula cannot be applied effectively, in which case Section 24J(2) is not applicable.

Because no specific deduction for the payment of interest was available, the general deduction formula contained in Section 11*(a)* of the Act was thus considered. Section 11(*a*) of the Act states that, for the purposes of determining the taxable income derived by any person, the following deduction will be allowed:

> expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

The interest distributed by a PLS company to its investors was incurred in the production of income, because the interest expense was actually incurred in terms of the debenture portion of the linked units held by the investors. This is in accordance with the terms of the debenture's being incorporated in a debenture trust deed that provided for the distribution of most of the rental income of the PLS company in the form of interest. It is, therefore, evident that the debenture portions of the linked units were issued to obtain financing in order to earn rental income from property investments. The interest expense was not of a capital nature because, in terms of the debenture trust deed, the rental income was distributed in the form of interest, which confirms that the interest was paid for debentures used to earn gross income. Therefore, the interest expense qualified for a deduction in terms of Section 11(*a*) of the Act, because it was incurred in the production of income.

Owing to the fact that PLS companies distributed the majority of their profits in the form of interest to their investors, PLS companies were left with practically no taxable income seeing that these distributions qualified for a deduction in terms of Section 11(*a*) of the Act. Clearly, the distribution system of PLS companies was similar to that of the conduit theory principle applicable in the context of PUTs (National Treasury, 2012:67). This is due to the fact that, in both cases, the income tax liability rested with the investor rather than with the property investment vehicle, indicating a flow through of income from the property investment vehicle to the investor.

On the other hand, dividends declared and distributed on the equity portion of linked units used to be subject to Secondary Tax on Companies (STC) at a rate of 10% from 1 April 2007 in terms of Section 64B of the Act (Fourie, 2009:19). On 1 April 2012, the new dividends tax system was introduced, replacing STC in terms of Sections 64D to 64N of the Act. Any dividends declared on or after 1 April 2012 were subject to dividends tax at a rate of 15% in terms of Section 64E of the Act, unless they qualified for an exemption as provided for in terms of Section 64F (for cash dividends) and Section 64FA (for dividends *in specie*) of the Act.

Capital gains tax, as determined in terms of the Eighth Schedule to the Act, was payable by a PLS company when disposing of any real estate held directly at an effective rate of 18.66% (i.e., a capital gains tax inclusion rate of 66.6% for companies multiplied by the corporate tax rate of 28%).

2.5.3.2 Tax legislation governing indirect investment in real estate

A PLS company could invest indirectly in real estate through the investment of units in another property company (which could also include another PLS company) that would hold the underlying investments. Where a PLS company invested in real estate through another property company, the PLS company could receive either interest or dividends depending on the nature of the units held and whether they constituted linked units or not.

If invested in a linked unit of a supplementary PLS company, interest received by a PLS company did not qualify for an exemption from gross income in terms of Section 10(1)(*i*)(*xv*) of the Act, because this exemption was applicable only to a natural person, while a PLS company constituted a company (legal entity) as defined (refer to part 2.5.3). Dividends received from a supplementary PLS company were normally exempt from gross income in terms of Section 10(1)(*k*)(i) of the Act. However, the provision to this section, namely Section 10(1)(*k*)(i)(aa), which prohibits such an exemption, did not apply to a PLS company due to the fact that the PLS company did not receive the dividend from a property share as defined in Section 47 of the Collective Investment Schemes Control Act.

2.6 CONCLUSION

From the above discussion, it is clear that in South Africa PUTs were regulated much more stringently than PLS companies. Less stringent regulation of PLS companies provided more flexibility; hence, PLS companies became the more popular of the two property investment vehicles. This was evident in the South African listed property sector which originally comprised PUTs mainly and then shifted from a PUT/PLS company ratio of 34% : 66% in 1998 to a 74% : 26% in 2007 in terms of the overall market capitalisation of the South African listed property sector (National Treasury, 2007:4).

Section 11(*s*) of the Act (which was repealed from 1 April 2013) previously allowed fixed property companies to serve as a conduit for income in terms of dividends distributed to investors in PUTs by allowing dividends distributed from profits (excluding dividends distributed from capital profits) as a deduction from taxable income. Section 11(*s*) was, however, only applicable to fixed property companies that consisted of property shares as defined in Section 47 of the Collective Investment Schemes Control Act. This pertained to shares that were 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 Act for the purposes of Part V of that Act. (Fourie, 2009:15)

A fixed property company earned rental income as well as capital gains on the disposal of real estate, of which the fixed property company was then liable for normal tax at a corporate tax rate of 28%. Also included in the taxable income of fixed property companies were profits from rental income that were not allowed as deduction in terms of Section 11(*s*) due to the fact that they were not distributed to their holders of shares.

Section 11(*s*) was applicable only to companies that consisted of property shares (thus, 100% equity). Therefore, Section 11(*s*) applied to fixed property companies that were wholly owned by PUTs, because Section 47(1) allowed a PUT to invest in a portfolio of property shares and hold real estate indirectly through a fixed property company. However, Section 11(*s*) was not applicable to PLS companies that consisted of linked units (equity and debenture portion). This indicates that Section 11(*s*) was applicable to a company due to its legal form and not due its common purpose, namely being a property investment vehicle.

It could, therefore, be concluded that, even though PUTs and PLS companies had the same objective and common purpose in mind, namely to act as property investment vehicles, their tax treatments were different and inconsistent. The tax legislation governing these two investment vehicles was, therefore, based on their legal form, rather than their common purpose. This view was supported by SARS (2007:19) as stated as part of its proposals to the National Budget in 2007. Furthermore, SARS indicated concern about the high interest rates associated with the debenture portion of linked units in PLS companies due to the fact that it viewed the resulting interest from the high interest rates as dividends rather than interest (National Treasury, 2007:24). However, the newly introduced REIT structure now allows for a unified tax regime to be implemented which would align the tax regulation of PUTs and PLS companies so that both these former property investment vehicles would be taxed as REITs.

2.7 THE NEWLY INTRODUCED REIT STRUCTURE

"REIT" is the international term for a conventional property investment vehicle that is more regulated than normal companies involved in property management and development, with the added benefit of promoting tax efficiency in property investments with high liquidity potential. REITs give investors an opportunity to invest in diverse real estate portfolios and participate directly in the financing or ownership of real estate ventures by providing them with a tradable interest in a group of real estate-related assets. REITs own and operate income-producing real estate (National Treasury, 2007:32).

2.7.1 Key definitions

In order to obtain a proper understanding of the concepts discussed in this chapter relating to REITs, it is important to take a closer look at the definitions as described below.

A "controlled company" is defined in Section 25BB(1) of the Act as:

> a company that is a subsidiary, as defined in International Financial Reporting Standards (IFRS), of a REIT.

A "subsidiary" is defined in IFRS 10 of the IFRS as "an entity that is controlled by another entity".

The key relation between the IFRS definition of a "controlled company" and the definition of a "subsidiary" is the control of another company in case when a REIT would acquire another company.

"Control" is defined in IFRS 10 as the following:

> an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Many facts and circumstances must be considered when determining whether a company has control of another company, for example, percentage of voting rights or number of directors of the investee that can be appointed by the investor. This would be determined in accordance with IFRS 10.

A "property company" is defined in Section 25BB(1) of the Act as:

> a company—

a) in which 20 per cent or more of the equity shares or linked units are held by a REIT or a controlled company (whether alone or together with any other company forming part of the same group of companies as that REIT or that controlled company); and

b) of which at the end of the previous year of assessment 80 per cent or more of the value of the assets, reflected in the annual financial statements prepared in accordance with the Companies Act or IFRS for the previous year of assessment, is directly or indirectly attributable to immovable property.

A "qualifying distribution" is defined in the Act as:

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 REIT or a controlled company until the date of the declaration of that dividend consists of rental income where a REIT or a controlled company is incorporated, formed or established during that year of assessment; 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:

Provided that any amount that must be included in the income of the REIT or controlled company in terms of section 9D(2) must not be included in the gross income of the REIT or controlled company in respect of that year of assessment for the purposes of this definition.

"Rental income" is defined in Section 25BB(1) of the Act as:

any amount received or accrued—

a) in respect of the use of immovable property, including a penalty or interest in respect of late payment of any such amount;

b) as a dividend (other than a dividend contemplated in paragraph (b) of the definition of "dividend") from a company that is a REIT at the time of the distribution of that dividend;

c) as a qualifying distribution from a company that is a controlled company at the time of that distribution; or

d) as a dividend or foreign dividend from a company that is a property company at the time of that distribution.

A "dividend" (in section 1 of the Act) is defined as:

any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied—

a) by way of a distribution made by; or

b) as consideration for the acquisition of any share in, that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied—

i) results in a reduction of contributed tax capital of the company;

ii) constitutes shares in the company; or

iii) constitutes an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements.

2.7.2 Requirements to qualify as a REIT

For a property investment vehicle to qualify as a REIT, the entity must be a company that is a resident of which the shares must be listed on the JSE as securities in a REIT. Subsection (*e*)(iii) of the definition of a "company" was particularly inserted as a result of the introduction of REITs in South Africa (as also indicated in 2.3). Previously, PLS companies constituted companies due to their legal nature and PUTs used to constitute vesting trusts due to their being a CISP as defined. The inclusion of subsection (*e*)(iii) in the definition of a "company" eliminates the inconsistencies that existed due to the different legal forms of the former property investment vehicles, and all REITs are now classified as constituting companies. Owing to the fact that all REITs are now classified as a company for normal tax purposes, the investors in such REITs will be referred to as the "holders of shares" in the text to follow.

Any new listings in this sector will have to comply with the JSE REIT Listing Requirements. The JSE amended Section 13 of its listing requirements for property entities in March 2013, which was finalised and published in Bulletin 3 on 28 March 2013 (JSE Limited, 2013). To qualify as a REIT on the JSE REIT board, companies need to comply with the amended Sections 13.46 to 13.61 of the JSE Limited Listing Requirements. The following list highlights the most important requirements to be met by a REIT in terms of Section 13 of the JSE Listing Requirements contained in Bulletin 3 of 2013 (effective from 1 May 2013):

A REIT must have:

- A minimum of R300 million in assets [s13.46(b)];
- 75% of income from property rentals [s13.46(d)];
- A committee to monitor risk [s13.46(h)];
- A total debt-to-asset ratio of 60% [s13.46(g)(ii)]; and
- A distribution minimum of 75% of distributable profits (dividends) [s13.47(a)].

In terms of the new REIT regime, a PLS company is referred to as a “company REIT” and a PUT is referred to as a “trust REIT”. Existing PLS companies and PUTs are listed on the JSE. For a PLS company to qualify as a REIT, the holders of shares, firstly, have to vote for the company to convert to a REIT. Then, the company needs to apply to the JSE for approval to be listed on the JSE REIT board, after which the memorandum of incorporation needs to be amended with the approval of the holders of shares (SAREITA, 2013b).

For a PUT to qualify as a REIT, it needs to provide evidence of its compliance with the JSE Limited Listing Requirements and to register with the Registrar of Collective Investment Schemes upon application to the JSE (SAREITA, 2013b). PLS companies and PUTs that had qualified as a REIT by 1 July 2013 could only have commenced to trade as a REIT from the first day of its financial year following this date.

2.7.3 The regulation of REITs

Once qualified as a company REIT or a trust REIT, continued compliance with the requirements contained in Sections 13.49 to 13.53 of the JSE Limited Listing Requirements is necessary. For a company REIT, the responsibility to ensure continued compliance with the JSE Limited Listing Requirements and Companies Act rests upon the directors of such a company. A company REIT can be managed either internally or externally with a choice of having property administration or not. The holders of shares of such company will be active participants, will be allowed to vote on specific issues during general meetings and will be entitled to protection from the Takeovers Regulations Panel and Companies Act (SAREITA, 2013b).

Trust REITs need to satisfy all JSE Limited Listing Requirements, but are subject to neither the Takeover Regulations nor the Companies Act. Trustees have the responsibility to report to the Registrar and to ensure that all requirements of the Collective Investment Schemes Control Act are met. Trust REITs are managed externally and should, therefore, have an external asset and property manager in terms of the Collective Investment Schemes Control Act (SAREITA, 2013b). Investors in trust REITs are protected by a trust deed while the trustees are responsible for ensuring compliance with the Collective Investment Schemes Control Act and for safeguarding investors’ assets (SAREITA, 2013b).

2.7.4 REIT tax dispensation: Effect on the corporate entity

The newly introduced REIT structure allows for all newly listed entities that qualify as a REIT, as well as all pre-existing PLS companies and PUTs that qualify for conversion to a REIT, to obtain the tax benefits of the new REIT tax regime. This new REIT tax dispensation contained in Section 25BB of the Act will result in the following tax consequences for South African REITs (all section numbers refer to the Act, unless stated otherwise):

- In terms of Section 25BB(2)(a), REITs or a controlled company that is a resident are allowed to deduct all distributions made to their holders of shares from their gross income during a year of assessment on the condition that the distribution declared or incurred during that year of assessment is a "qualifying distribution" (refer to 2.7.1 for definition). The aggregate amount is, however, limited in terms of Section 25BB(2)(b) to the REITs taxable income for the year of assessment before: (i) the amount of taxable capital gain is included; and (ii) any distribution deduction in terms of Section 25BB(2) is taken into account. Therefore, it is not possible to create an assessed loss by way of the deduction of distributions made to the holders of shares, and no distributable deduction can be created from taxable capital gains.
- In terms of Section 25BB(5), where an SA REIT or a controlled company disposes of:
  (a) immovable property;
  (b) a share in a REIT; or
  (c) a share in a controlled company,
  any capital gain or loss as determined for the purposes of the Eighth Schedule to the Act must be disregarded.
- In terms of Section 25BB(3), amounts received (for disposals, as dividends or as interest) by REITs or controlled companies during a year of assessment relating to financial instruments held (excluding shares or linked units held in a REIT, a controlled company or a property company) must—
  (a) be deemed to be an amount that is not of a capital nature; and
  (b) be included in the income of the REIT or controlled company for that year of assessment.

  The National Treasury (2012:71) indicated that the purpose of Section 25BB(3) is to discourage REITs from holding other forms of investments (i.e., share portfolios, thereby coming into conflict with the mandate of a collective investment scheme in securities).
- In terms of Section 25BB(4), an SA REIT or a controlled company is not allowed to claim capital allowances in respect of immovable property (i.e., disallowed from claiming allowances in terms of Sections 11(*g*), 13, 13*bis*, 13*ter*, 13*quat*, 13*quin* or 13*sex*). This

disallowance also prevents recoupments arising from the disposal of immovable property, thereby giving rise to exempt capital gains in the event that immovable property is sold.

In addition to the above REIT tax dispensation relating to the operations of REITs, controlled companies and property companies, there are no entry charge taxes for converting from a PLS company or a PUT to a REIT (National Treasury, 2012:71). Thus, there are more tax benefits available to SA listed property companies during conversion as opposed to listed funds in the UK who had to pay a flat rate of 2% of their property value in order to convert (Fife, 2008). This means that both PLS companies and PUTs in South Africa can convert freely without any additional obligations. There is also rollover relief available to PLS companies on the condition that their property linked units be converted into 100% equity shares (National Treasury, 2012:71).

2.7.5 Conduit theory principle

The National Treasury (2012:68) indicated that real estate investment vehicles will satisfy the conduit theory principle established in the case of Armstrong v CIR 10 SATC 1 (1938). Income and capital gains are, therefore, to be taxed in the hands of the investor and not in the hands of the REIT. For investors, the investment is alike to direct ownership of the underlying property, because all distributions received from the REIT will not qualify for any dividend exemption in accordance with Section 10(1)(*k*) of the Act and will, therefore, be similar to receiving rental income.

2.7.6 REIT tax dispensation: Effect on the holder of shares

The newly introduced REIT tax regime contained in Section 25BB of the Act will result in the following tax consequences for the holders of shares (all section numbers mentioned in the section to follow are referring to the Act, unless stated otherwise):

- The following distributions will be included in the gross income of the holders of the shares in terms of special inclusion paragraph (*k*) of the definition of “gross income” as defined in Section 1 of the Act: distributions received from REITs, qualifying distributions from controlled property companies, and dividend distributions from property companies that are received by or accrue to the holders of the shares. This will apply irrespective of whether the distribution originates from an equity unit or a linked unit, because with a linked unit the interest on the debenture portion is treated as a deemed dividend in terms of paragraph (*k*) for normal income tax purposes.

- Owing to the conduit theory principle, all distributions received from a REIT (irrespective of whether they are qualifying distributions, in terms of Section 25BB) will be a taxable dividend, because no dividend exemption will be applicable in terms of Section 10(*k*)(i)(aa) of the Act. Taxpayers who receive distributions from REITs will, therefore, have to include these distributions in their income and will be taxed on these payments at their marginal tax rate. They will, however, be able to deduct costs in terms of Section 11(*a*), such as those costs incurred in acquiring the REIT shares, if the costs meet the requirements of the general deduction formula, as discussed under part 2.5.3.1.

- The same tax treatment as indicated in the previous paragraph would also apply to dividend distributions received from controlled companies (as defined under part 2.7.1) and property companies (as defined under part 2.7.1) with the exception that, for controlled companies only, the distribution made must be a “qualifying distribution” as defined in terms of Section 25BB (also refer to part 2.7.1).

- Owing to the fact that dividend distributions are subject to normal income tax, no dividends tax at the rate of 15% will be levied against the distribution received by the holders of shares, as long as it does not consist of a dividend *in specie*. The distribution will be exempt from dividends tax in terms of Section 64F(2) of the Act which states that:

  > any dividend paid by a REIT or a controlled company, as defined in section 25BB, and received or accrued before 1 January 2014 is exempt from the dividends tax to the extent that the dividend does not consist of a dividend in specie.

- However, all distributions made by an SA REIT to its foreign holders of shares were to be subject to dividends tax to be withheld at a rate of 15% from 1 January 2014 (subject to any possible double tax agreement which could indicate a different rate to be applied). Therefore, from 1 January 2014, the distribution was not treated as ordinary income (rental income), but as a dividend.

- The new REIT tax regime provides the holders of shares the opportunity to use debt effectively to fund the acquisition of REIT investments on a pre-tax basis. This will be achieved through the deduction obtained in terms of Section 24J(2) of the Act, because the financing will be incurred in the production of income due to the fact that income received or accrued from distributions retains its nature with the holders of shares. The deduction of interest in terms of Section 24J(2) would be allowed in this regard, because the debt incurred would not be perpetual debt as it would be for a PLS company (refer to 2.5.3.1). The financing obtained by the holders of shares would most likely be obtained from a financial institution and would have a date of redemption and a specified accrual period; therefore, the yield to maturity formula can be applied effectively.

- Owing to the fact that it is required to distribute the majority of its income to its holders of shares, a REIT would effectively pay no tax on dividends. For this reason, a REIT is an ideal investment vehicle for any retirement annuity fund, pension fund, provident fund, pension preservation fund or provident preservation fund (SAREITA, 2013c:5).

- If the investor originally invested in a PLS company that has since been converted into a REIT, the nature of distributions will change from “interest” to “rental income” in the form of a taxable dividend in terms of special inclusion paragraph (*k*) of the definition of “gross income” as defined in Section 1 of the Act.

- If the investor originally invested in a PUT, there will be no impact on the nature of the distribution after the conversion of such a PUT into a REIT.

- The acquisition of shares in a REIT will be exempt from Securities Transfer Tax in terms of Section 8(1)*(t)* of the Securities Transfer Tax Act (25 of 2007) which determines that:

> tax is not payable in respect of a transfer of a security—
>
> t) if that security constitutes a share in a REIT as defined in section 1 of the Income Tax Act.

The relief in respect of the Securities Transfer Tax provided is equivalent to the relief provided for acquisitions in a collective investment scheme in securities (National Treasury, 2012:72).

2.7.7 Conclusion

New tax legislation and tax dispensation, initially introduced by way of the 2012 Taxation Legislation Amendment Bill, became applicable to all REITs from 1 April 2013. This new tax regime includes many tax benefits. One benefit is exemption from paying capital gains tax on the disposal of any properties, which will assist in increasing trading activity and overall economic growth in the property sector in terms of acquisitions and disposals. Furthermore, REITs will be able to deduct all distributions made to their holders of shares provided that they are a “qualifying distribution” under the new REIT tax regime. This provides certainty to the holders of shares that at least 75% of all net income will be distributed and that tax exposure is determined by the tax status of the holders of shares. These benefits will entice most listed property companies classified as a PUT or PLS company and will serve as an incentive to convert to the new REIT structure. Initially, REITs focused on adjusting and implementing the new system effectively in order to make use of these benefits. However, because the legislation was new and untested, several economic and tax implications became apparent. Subsequently, existing legislation was amended to address uncertainties and anomalies that occurred.

2.8 OVERALL CONCLUSION

It is evident that the most prominent difference between the new REIT tax regime and the original property sector investment vehicles, namely PUTs and PLS companies, is the improved consistency in tax treatment. The REITs regime is aimed at ensuring consistent tax treatment when compared to the fragmented taxation that was present between PUTs and PLS companies. Both these types of companies had a common purpose, but were taxed differently based on their legal form. In addition, there were differences in the way in which these former investment vehicles were regulated. PUTs were regulated far more stringently than PLS companies. Trust REITs and company REITs are, on the other hand, subject to similar regulatory requirements with both having to comply with the JSE Limited Listing Requirements. The framework of the regulations applicable to REITs appears to be less complex than that applicable to the former PUTs and PLS companies.

It was also indicated that, from a tax perspective, the conduit theory principle (flow through principle) has a significant bearing on the REIT regime. When this principle is applied in the REIT regime, the tax liability of the net income of the REIT rests with the holders of shares.

In the next chapter, the impact of the new REIT tax system on the South African property sector will be evaluated. This impact will be discussed in the context of the anomalies and unintended implications of the newly introduced REIT tax regime on the South African listed property sector, as well as its influence on the decisions to be taken by unlisted property companies in future.

CHAPTER 3: THE IMPACT OF THE NEW REIT TAX REGIME ON THE SOUTH AFRICAN PROPERTY SECTOR

3.1 INTRODUCTION

The newly introduced tax regime for REITs became effective in South Africa from 1 April 2013. As could be expected from new legislation, and due to an ever changing tax environment, the initial legislation on REITs has been subject to changes since its inception. The latter was confirmed in the National Budget Speech of 2015 where the South African Minister of Finance indicated that Section 25BB of the Act will be refined in order to remove anomalies (National Treasury, 2015:144).

As the REIT tax regime is a fairly new and untested piece of legislation within the South African tax environment, uncertainties and anomalies have occurred in the application of the legislation and caused unintended tax consequences. New types of transactions or structures between REITs and companies have come to the fore due to the anomalies or unintended implications which have arisen from the initial tax regime as introduced in terms of Section 25BB of the Act. Refinement and changes to the provisions governing the tax treatment of REITs can, therefore, be expected in the near future.

The purpose of this chapter is to identify and analyse the unintended consequences of the new tax regime for REITs which have not been considered in the taxation of REITs, and of which changes to the applicable tax legislation can be expected. With the elimination of anomalies and unintended tax implications, the REIT tax regime would be at an appropriate and fair level to realise its purpose to not only provide a unified approach to the taxation and regulation of property investment vehicles, but also to make South Africa more attractive to international investors. In addition, this chapter attempts to evaluate whether the new REIT tax regime would influence the unlisted property companies to become listed in order to take advantage of the tax benefits available to REITs.

3.2 ANOMALIES

3.2.1 Pre-existing tax losses

In terms of the JSE Limited Listing Requirements, a REIT will be required to distribute at least 75% of its distributable profits. “Distributable profits” is defined in Section 13.47 (d) of the JSE Limited Listing Requirements as:

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

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

Property companies could have pre-existing tax losses as a result of property allowances or significant finance costs incurred in the financing of the property company's business activities. However, current REIT legislation does not provide guidance on whether such tax losses may be taken into account in determining the distributable profits of a REIT for a specific year of assessment. This would impact the tax position of a REIT and could negatively impact the tax treatment of a REIT, considering the 75% threshold of distributable profits. If the pre-existing tax losses are to be taken into account in determining the distributable profits of a REIT, this could result in a reduced amount available for distributions to be made, effectively meaning that lesser income would flow through to the holders of shares. This position would be in contradiction with one of the aims of the REIT structure, namely to have the REIT act as a flow through property investment vehicle where income needs to retain its nature after its distribution to the holders of shares who should, ultimately, be liable for the tax on such income.

3.2.2 Taxation in terms of hedging transactions

The business activities of REITs typically involve both local and foreign investments. Therefore, a REIT is exposed to the risk of currency fluctuations, as well as interest rate risk. In order to manage exposure against these risks, a REIT or property company may utilise certain hedging instruments such as interest rate swaps or foreign exchange contracts. In terms of Section 25BB (3)*(a)* of the Act, there could be significant tax implications for REITs to the extent that they enter into any hedging instruments. Gains earned relating to the realisation of such hedges will not usually be distributed, because such gains will be offset against the matching losses incurred on the realisation of the associated loan or funding instrument. REIT legislation, in terms of Section 25BB(3)*(a)* of the Act, currently determines that any hedging gains will be income for the REIT and, as such, might have to be distributed to comply with the requirement of having to distribute a minimum of 75% of distributable profits (Muller & Vogelman, 2013). Depending on the nature of the financial instrument and whether any gains are eliminated by any related matching losses, any excess gains might need to be distributed to comply with the definition of a "qualifying distribution" in Section 25BB(1) of the Act.

3.2.3 Effective double taxation of income from property companies

It seems as if current REIT legislation has the effect that income distributed from property companies will effectively be subject to double taxation on two levels. This is in accordance with the provisions contained within Section 25BB(1) and Section 25BB(2) of the Act. Firstly, Section 25BB(1) determines that income distributed by property companies (either in the form of a dividend or a foreign dividend) constitutes rental income in terms of paragraph (*d*) of the definition of "rental income". Furthermore, property companies are excluded from the definition of "qualifying distributions" for when dividends are distributed. This leads to the second level of taxation, which is contained within the exclusion of property companies in Section 25BB(2), thereby meaning that any dividends distributed by property companies will not be allowed as a deduction from their taxable income. This has the effect that such distributions made to the property company's holders of shares will be taxable, on the first level, in the hands of the property company. Possible holders of shares in a property company could include other REITs, controlled companies, and natural persons. Distributions made by property companies to natural persons will, furthermore, be subject to dividends tax, because dividends received from property companies are not exempt from dividends tax, which is the case with REITs and controlled companies (in terms of Section 64F(1)(a) of the Act). This is clear from Section 64F(2) which determines that:

> Any dividend paid by a REIT or a controlled company, as defined in section 25BB, and received or accrued before 1 January 2014 is exempt from the dividends tax to the extent that the dividend does not consist of a dividend in specie.

In order to avoid paying income tax on distributions received from property companies, REITs and controlled companies will have to distribute such amounts to their holders of shares. This will lead to the second level of taxation for which the holders of shares in REITs and controlled companies will be liable, except if they qualify for an exemption for dividends tax.

The effect discussed above is illustrated in Figure 3.1 below:

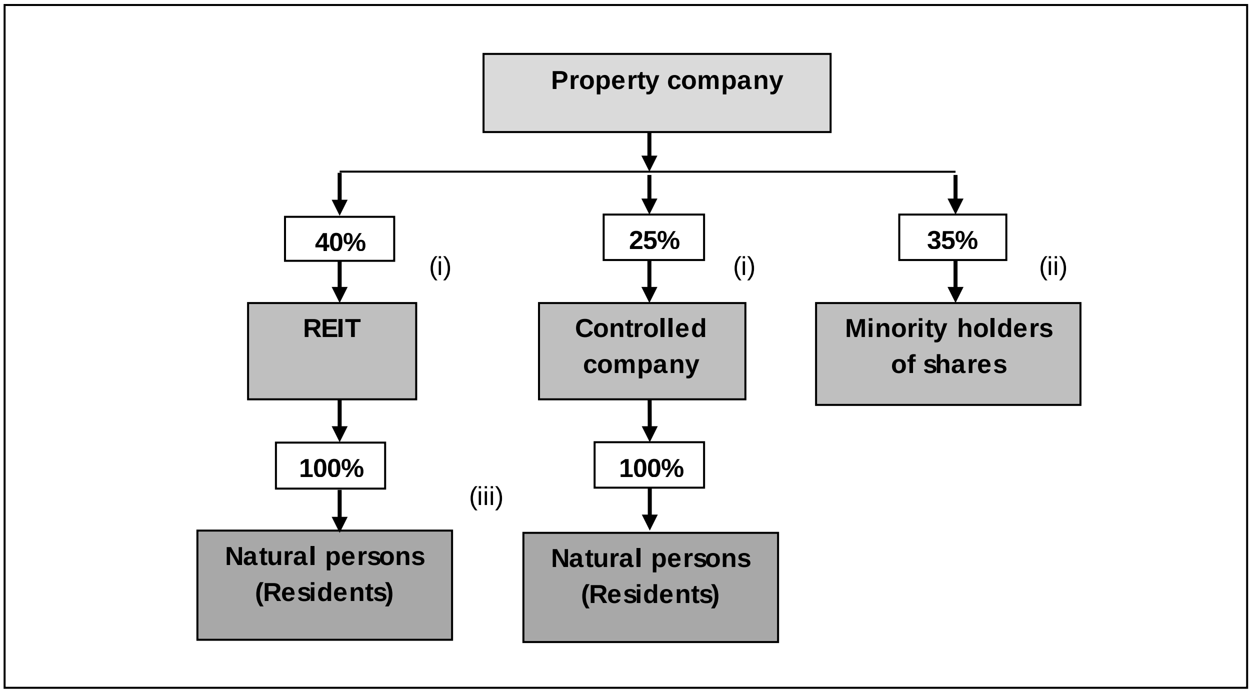

Figure 3.1: Effective double taxation of income

Source: Author

Tax implications of the various distributions [indicated on Figure 3.1 as (i) to (iii)]:

i. **Distributions from the property company to a REIT and a controlled company:**

   There will be no dividends tax, because the REIT and controlled company are exempt in terms of Section 64F(1)(*a*) of the Act. The distribution does not qualify as a "qualifying distribution" as defined in terms of Section 25BB(1) of the Act, because the definition of a "qualifying distribution" includes dividends paid by a REIT or controlled company and not a property company. Therefore, no deduction from the property company's income will be allowed in terms of Section 25BB(2). Thus, the property company will still be liable for income tax on the amounts distributed. This constitutes the first level of taxation.

ii. **Distributions from the property company to the minority holders of shares:**

   The minority holders of shares include natural persons. The distribution does not qualify as a qualifying distribution as defined in terms of Section 25BB(1) of the Act, because the definition of a "qualifying distribution" includes dividends paid by a REIT or controlled company and not a property company. Therefore, no deduction from the property company's income will be allowed in terms of Section 25BB(2) of the Act. The property company will still be liable for income tax on the amounts distributed. This is the first level of taxation.

The minority holders of shares will be subject to dividends tax on distributions from the property company at a rate of 15% in terms of Section 64EA(*a*) of the Act. This constitutes the second level of taxation on the distributed amount. However, the amount will be exempt from normal income tax, because the amount included in gross income in the hands of the natural person in terms of special inclusion paragraph (*k*) of the gross income definition will also qualify for the Section 10(1)(*k*) exemption for local dividends received.

iii. Distributions from a REIT and a controlled company to their holders of shares (natural persons):

The distribution received from the property company qualifies as rental income as defined in terms of paragraph (*d*) of the definition of "rental income" in Section 25BB(1) of the Act. If the requirements of the definition of a "qualifying distribution" in terms of Section 25BB(1) are met, the dividends received could be distributed and, therefore, deducted from the income of the REIT and the controlled company in terms of Section 25BB(2)(*a).* Therefore, both the REIT and the controlled company will not be liable for any normal income tax. As the REIT and controlled company act as a flow though property investment vehicle (due to the conduit theory principle), the income distributed retains its nature, and the holders of the shares will, ultimately, be liable for normal income tax up to a maximum rate of 41% on these distributions. This constitutes the second level of taxation.

3.2.4 Buy-back of shares

Qualifying distributions will fundamentally be limited as a tax deduction to the taxable income of the controlled company, yet the holders of shares that receive the qualifying distributions could be liable for tax for the total amount received. Therefore, the controlled company or REIT may attempt to purchase the shares back from the holders of shares such as from its parent company (REIT) by transferring the cash to this company. From the wording of the REIT legislation, a share buy-back is excluded from the definition of a "qualifying distribution" in terms of Section 25BB(1) of the Act. The repurchase price of the shares will, therefore, not be classified as a qualifying distribution and could lead to a possible deduction being denied when distributions are made to the holders of shares. This is because of the risk that the consideration from the buy-back would be so significant that it would cause the rental income of the REIT to fall below the 75% threshold. This will, in turn, reduce the ability of the REIT to satisfy the requirements of the definition of a “qualifying distribution” in terms of Section 25BB(1) (Miller, 2015).

A risk for the holders of the shares from the buy-back of shares arises from the fact that the consideration received is being taxed in the hands of the holders of shares. Paragraph *(b)(ii)* and *(iii)* of the definition of a “dividend” in Section 1 of the Act exclude consideration from a share buy-back being a dividend as defined and, therefore, the exemptions contained in Section 10(1)*(k)* will not be applicable. Consequently, the consideration received from a share buy-back will not be a “dividend” as defined in terms of Section 1 of the Act and will be taxed as income in the hands of the holders of shares.

3.2.5 Liquidation dividend distributed

The possibility exists that a REIT or controlled company could be liquidated either for restructuring purposes or in the event that the continuance of its business activities is not regarded to be in the best interest of the holders of shares.

If a REIT or a controlled company disposed of all of its assets in the process of liquidation and distributed the profits to its holders of shares, the capital gains that are usually disregarded for normal income tax purposes in a REIT would be subject to income tax in the hands of the holders of shares. To maintain tax transparency, a REIT or a controlled company would have to distribute any amounts received in terms of a liquidation distribution from another REIT or controlled company. If this was not done, the REIT or controlled company would be subject to normal income tax.

As such, minority holders of shares should carefully consider the implications of their joint venture holders of shares becoming a REIT (Muller & Vogelman, 2013).

The effect discussed above is illustrated in Figure 3.2 below:

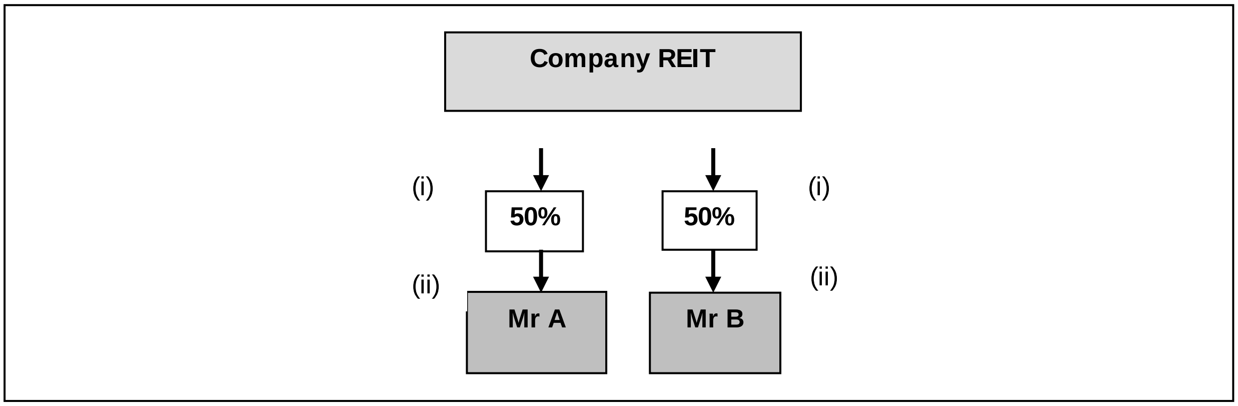

Figure 3.2: Distribution of liquidation dividends

Source: Author

Tax implications of various distributions [numbered on Figure 3.2 as (i) and (ii)]:

The company REIT is liquidated using the corporate rollover relief provided for in terms of Section 47 of the Act.

i. **Liquidation of the company REIT:** No capital gains tax implications for the company REIT in terms of Section 47 of the Act.
ii. **Distributions to holders of shares upon liquidation:** No dividends tax. Distributions to holders of shares will, however, be taxable dividends (not exempt) for normal income tax purposes up to a maximum rate of 41%. Included in the distribution could possibly be a return of capital if elected by the REIT, which could result in capital gains tax for the holders of shares.

3.2.6 Timing of dividend distributions

Timing differences between either the end of a financial year and the date of the distribution could prove to be problematic for REITs and controlled companies. Year-end distributions are, usually, determined by REITs or controlled companies after the end of the financial year once the accounting records have been finalised. This could lead to confusion for a REIT or controlled company, because the REIT might arguably only claim a qualifying distribution deduction against its income with regard to the year of assessment in which the qualifying distribution was made. The intention of REIT legislation, however, seems to be that the deduction against income should actually be deducted from the income in the year of the financial results to which the dividend relates (Miller, 2015).

In addition to the timing difference issue, a change in status of a property company could also be problematic for the holders of shares. This situation could arise from the acquisition of a property company by a REIT after distributing a dividend to the holders of shares of the property company. In this way, the property company will become a controlled company. The risk for the holders of shares is that the distributions received could be subject to normal income tax instead of only dividends tax, despite the fact that the dividend had been received before the change in status from a property company to a controlled company.

3.2.7 Making use of accounting definitions

This recent trend of referring to IFRS definitions within the definitions of newly introduced tax legislation has proven to be risky (Visser, 2013). The definition of a "controlled company" in terms of Section 25BB of the Act relies on and refers to the IFRS definition of "subsidiary". The risk associated with using IFRS definitions within South African tax legislation is attributable to the fact that possible amendments being made to IFRS definitions might not be keeping track with their impact on the South African tax effect. These amendments in the IFRS could occur without the administrators of South Africa tax legislation having any input to the changes made and without going through the proper legislative process required by the Constitution (Visser, 2013). If changes like these do occur in the future, it could place a burden on companies to keep track of and implement these changes.

3.3 UNINTENDED TAX IMPLICATIONS FOR REITs

The main purpose of introducing the new REIT tax regime in South Africa was to provide certainty in the tax treatment of transactions and to eliminate uneven regulation between PUTs and PLS companies as well as the different tax treatments due to the nature of the distributions made by the former PUTs and PLS companies (National Treasury, 2012:68). For this reason, it could reasonably be expected that, as with the introduction of any new legislation, some unintended tax implications could arise for property entities who have obtained REIT status and started to implement the new REIT tax regime. Some of these unintended tax implications are discussed below.

3.3.1 Foreign investors

Foreign investors will be exempt from normal income tax and dividends tax (but only up until 1 January 2014 for dividends tax) in respect of distributions received from REITs or controlled companies. However, such distributions would still constitute South African source income for normal income tax purposes in terms of Section 9(2)(*a*) of the Act which determines that:

> An amount is received by or accrues to a person from a source within the Republic if that amount—
>
> (a) constitutes a dividend received by or accrued to that person.

Therefore, the distributions received from REITs will constitute gross income as defined for foreign investors. According to Muller and Vogelman (2013), investment in South African REITs or controlled companies by foreign investors could result in unwanted compliance burdens in South Africa. These include additional administrative burdens such as registration as a taxpayer in South Africa, as well as the submission of annual tax returns in the country where the immovable property of the REIT is located.

3.3.2 Hotel companies

The new REIT tax regime was established mainly in order for PLS companies and PUTs to be taxed equally and to eliminate inconsistencies between their tax treatment. However, conversion to obtain the REIT status and, thereby, the concomitant favourable tax dispensations is not only limited to PUTs and PLS companies. Nothing in the current legislation prevents a company owning hotels from obtaining REIT status. Similar to a PUT or PLS company, a hotel company also owns properties, but the nature of its income is not in the form of rental income, but constitutes income derived from the provision of commercial accommodation services. Therefore, the nature of the income received by a hotel company will fall outside the scope of the definition of a "qualifying distribution" which states that a minimum of 75% of income must be rental income (refer to part 2.7.1).

However, listed hotel companies that wish to obtain these tax advantages could also convert to a REIT, but will face a complicated process in order to do so. This could be achieved by transferring the properties from which the hotel companies operate to a separate property vehicle. The operating company of the hotel group will need to enter into a rental agreement with the separate property vehicle after which the operating company will receive income from hotel residents and pay the rental expense in terms of the agreement to the property vehicle. This would enable the property vehicle owning the properties to adhere to the requirement of receiving a minimum of 75% of its income in the form of rental income. The aforementioned structure could be applied by companies owning hotels to obtain REIT status (Hedley, 2013b).

However, it needs to be determined whether this was the intention of the National Treasury, seeing that they have remained silent on issues relating to the nature of various companies that own properties but are not property investment vehicles and that could convert to a REIT. Other listed companies owning properties might potentially attempt to use similar schemes or structures to take advantage of the new REIT tax dispensations available in terms of Section 25BB of the Act. It is also possible that unlisted entities might attempt to apply such schemes and structures in the future when such REIT legislation for unlisted entities would be established.

This could lead to possible disputes between the SARS and hotel companies in the future, because such schemes and structures could then be claimed to be an “impermissible tax avoidance arrangement” in terms of Section 80A of the Act. If this is subsequently proven, SARS would be able to apply Section 80B and refuse such companies REIT status or the REIT dispensations.

3.3.3 Effective tax paid on taxable dividends

One of the big disadvantages of the high yield of REITs is that taxes are due on dividends received by the holders of shares. Local dividends from other listed shares would normally be exempt from normal income tax in terms of Section 10(1)(*k*) of the Act, but dividends tax would be withheld at a rate of 15% for which the holders of shares would be liable. Previously, private investors (natural persons) would have qualified for an interest exemption in terms of Section (10)(1)(*i*)(*xv*) when interest was received from PLS companies. This will not be the case anymore, because dividends will be paid out to investors based on shares held (100% equity) and not based on linked units (consisting of a portion of debt and a portion of equity). This has been one of the biggest criticisms against the new REIT tax regime (Lamprecht, 2014). However, this was necessary, because one of the anomalies identified from the previous tax legislation was the inconsistent tax treatment of distributions (dividends versus interest) made by the former PUTs and PLS companies.

Owing to the flow through nature of a REIT, the amount of tax charged will be dependent on the tax status of the holders of shares and not the tax status of the person declaring and distributing the dividend. Therefore, tax paid on dividends received will, effectively, be higher than the 15% dividends tax rate.

The nature of REITs is such that the initial holders of shares in REITs would probably be high net worth individuals who would, unsurprisingly, fall into the higher tax bracket. In this way, some individuals will pay up to 26% more tax on dividends from their investments than they would have had these been dividends received on other listed shares (i.e., 41% less 15%). This is an unintended consequence of the flow through nature of REITs as property investment vehicles, although it is a practice that is implemented within the REIT tax regimes of other countries. This could, however, lower the attractiveness of investment in the listed property sector for some individuals. Over a period of time, this could even draw funds away from REITs, resulting in a decrease of REIT share prices.

3.4 ISSUES FOR WHICH PROPOSED REIT LEGISLATION DID NOT PROVIDE FOR

Ungerer (2013a) noted that the income tax legislation after the initial introduction of Section 25BB did not provide a rule or guidance to regulate the income tax treatment of the cancellation by a REIT or a controlled company of the debenture part of a linked unit without compensation. Therefore, in terms of the accounting treatment (as regulated by IAS 32 of the IFRS), the REIT or the controlled company is considered to have capitalised the face value of the debenture to stated capital (i.e., as part of the conversion process from a PLS company to a REIT, the debentures are converted into shares). The proposed amendments specifically provide that the REIT or the controlled company will not be taxed in the case of such cancellation of a debenture.

According to the proposal from National Treasury (2013:118), the cancellation would not have any income tax or capital gains tax effect in terms of the rules relating to the reduction or cancellation of debt. Furthermore, it has been proposed that the cancellation of the debenture be disregarded by the debenture holder and that the base cost of the shares incurred by the holders of shares be equal to the amount of expenditure incurred for the acquisition of the linked unit. This effectively means that there will be no change in the base cost for the purposes of the conversion process of the linked units (originally acquired as an investment in a PLS company) to shares of a REIT or controlled company. This rule is contained within Section 25BB(8) of the Act.

The fact that there will be no tax implications for such transactions or conversions highlights the willingness of the National Treasury to simplify the process of the new REIT tax regime in an attempt to promote uniformity of tax treatment in the property sector. This clarification contributes in providing certainty to both the REIT and the investor in respect of the tax implications of such a transaction.

Income tax legislation also has not previously addressed the impact on a company should it cease to be a REIT or a controlled company. The proposals from the National Treasury (2013:118) indicate that the year of assessment of a REIT or a controlled company will end on the day that the company ceases to be a REIT or a controlled company where, for example, the REIT no longer abides to the JSE Listing Requirements to qualify as a REIT. Therefore, the following year of assessment will commence on the day immediately after the company ceases to be a REIT or a controlled company. Consequently, for this new year of assessment, the REIT dispensation will no longer apply to the company and the company will be taxed according to the normal tax regime. This rule is contained within Section 25BB(7) of the Act.

3.5 AMENDMENTS SINCE IMPLEMENTATION AFFECTING ANOMALIES OR UNINTENDED IMPLICATIONS

The National Treasury has provided clarification with regard to the anomaly identified under part 3.2.6, dealing with timing of distributions. It has been clarified that a dividend received or accrued from any company that is not a REIT or a controlled company at the time of the distribution must not be taken into account in determining the qualifying distribution. Prior to this, dividends declared by a property company before converting to a REIT or controlled company could have caused the holders of shares to be subjected to income tax as opposed to dividends tax, and in this way causing the distribution to be taxed at a higher corporate tax rate.

3.6 IMPACT ON THE UNLISTED PROPERTY SECTOR

3.6.1 Listed property sector versus unlisted property sector

REIT legislation is currently applicable only to the listed property sector, meaning that the unlisted property sector is not able to take advantage of the favourable tax dispensation in order to grow. The REIT status granted to qualifying listed property companies enables this sector to be more competitive internationally, which should result in a gradual inflow of foreign investment into listed property stocks, with which the unlisted property sector would not be able to compete. This could prove to be risky in future for the overall growth of the entire property sector, because it would allow well-established large property companies to expand, while smaller companies would struggle to keep up. Ultimately, the unlisted property sector could stagnate.

Unlisted property companies could, however, aim to list on the JSE in order to obtain the desired REIT status and take advantage of the favourable tax dispensations available. The property sector has had a number of new listings since the implementation of the REIT structure. Since 1 April 2013, the date of implementation of the REIT structure in South Africa, there has been a total of five new listings and a delisting of one company on the JSE, increasing the number of property companies on the JSE from 29 to 33. (Refer to Appendix B for a list of REITs on the JSE as at 8 October 2015.)

3.6.2 Incentives for unlisted property companies to list and convert to a REIT

The incentive for companies to list on the JSE is driven not only by the tax dispensations provided for by the new REIT tax regime, but also by the possible opportunity to eliminate deferred tax balances. Historically, property companies had to account for a deferred tax liability on their Statement of Financial Position as their properties increased in value over time. This deferred tax liability was recognised to account for capital gains tax that would be payable once the property had been sold eventually. This deferred tax liability had the effect of decreasing the net asset value of the company (Lamprecht, 2013). However, as soon as REIT status is obtained, property companies will be exempt from paying capital gains tax on the disposal of properties in terms of Section 25BB(5) of the Act and, therefore, would no longer have to account for the deferred tax liability. This could prove to be a major incentive for unlisted property companies to list on the JSE in order to improve their financial position, which could impact the acquisition of financing for future projects to help stimulate growth of such companies.

Alternatively, the REIT structure could be extended to the unlisted property sector, which would help provide access to the benefits of a REIT structure. However, this proposition could take quite some time, as was seen with the lengthy process of over seven years since 2006 to implement the REIT structure and tax regime in the listed property sector (Wilson, 2013b:18).

Since the implementation of the REIT regime, there has been an increase in the number of listings in the property sector on the JSE. As of 1 May 2013, when property companies could start converting to REIT status, there were 29 listed property companies in total (refer to

Appendix A for a list of these entities). As of 8 October 2015, there was a total of 33 companies listed as REITs in the REIT sector of the JSE.

3.6.3 Challenges for the unlisted property sector

Concerted efforts are being made to find a resolution to introduce the REIT structure to the unlisted property sector, with an on-going discussion regarding unlisted REITs between the South African Property Owners Association (SAPOA) and the National Treasury. The National Treasury (2015:144) has indicated their intention to extend the REIT dispensation to include unlisted qualifying entities. The process will, however, be tedious because, currently, listed REITs are governed by the JSE Limited Listing Requirements. In other words, there is a well-recognised, controlled and reputable governance and investor protection regime in place for the listed property sector. Similar regulation would have to be established for unlisted REITs.

SAPOA has ranked this issue as one of its key objectives for 2013/2014 (SAPOA, 2013:9). The president of SAPOA, Estienne de Klerk, is of the opinion that any extension of the REIT tax regime will be done in a two-phased approach. The first phase would be to regulate any institutional investors. This is regarded not to be a problem due to the fact that institutional investors are already being regulated by the FSB. The second, more tedious, phase would be the attempt to determine who would be responsible for regulating the unlisted property owners. The challenge here is that a regulator, such as the FSB, is unlikely to have the capacity to organise and deal with the high volumes of unlisted property owners involved (Hedley, 2013b).

The process to determine how the REIT structure and regime can be extended to the unlisted property sector is already underway. SAPOA is in discussion with the National Treasury regarding the different possibilities of how the REIT dispensation can be extended to qualified, unlisted REITs, as well as prospective governance and investor protective regimes that could be implemented.

3.7 CONCLUSION

With the REIT regime still in its early phases of implementation, it seems likely that different issues will arise as time progresses in the new phase of the South African property sector which is evolving into one of the largest REIT markets in the world.

With the introduction of REITs into the listed property sector, the expectation has been that investors would be encouraged to utilise their funds in the property sector. However, this could be hampered by the fact that certain tax matters require more clarity. For example, for a normal investor, the final return is the most important – and this is where the favourable tax treatment of REITs becomes attractive for investors. As time progresses, and should changes be applied to provide more transparency, an increased number of investors should be attracted towards investing in REITs. This, in turn, would help increase the value of the South African listed property sector.

The next chapter will provide an in-depth focus on the unlisted property sector in South Africa, evaluating developments in the extension of the REIT regime to this sector. A critical comparison will be performed between the REIT regime of the US and that of South Africa. Specific emphasis will be placed on the position of US unlisted property companies forming part of the US REIT regime in order to identify material aspects that could be useful for amending and improving the South African tax system for unlisted REITs.

CHAPTER 4: A CRITICAL COMPARISON BETWEEN THE US AND SOUTH AFRICAN REIT SYSTEMS

4.1 INTRODUCTION

The listed property sector in South Africa has grown significantly since the inception of the new REIT regime. This is evident from the large number of property companies that have listed on the JSE in order to obtain REIT status since the inception of the new REIT regime. Statistics indicate that since 1 April 2013, the date on which the REIT structure was implemented in South Africa, there has been a total of five new listings and one delisting of companies on the JSE. This increased the number of property companies on the JSE from 29 to 33 (refer to Appendix B for a list of REITs on the JSE as at 8 October 2015.) Further scope for overall growth in the property sector is still possible through the extension of the REIT status to include unlisted property companies.

The inclusion of unlisted property companies as part of the South African REIT regime would, however, create a number of challenges. This would include the challenge of establishing a regulatory body for unlisted REITs and also to introduce new tax legislation to govern and ensure fair taxation of unlisted REITs in comparison to listed REITs.

The purpose of Chapter 4 is to draw a critical comparison between the REITs system in the US and the REIT system in South Africa. An overview of the US REIT structure is provided first so as to obtain a general understanding of how this structure is operated and regulated, and to determine which aspects of this comparison could be useful within a South African context. Then the establishment requirements for a REIT in the US are compared to those in South Africa. This chapter further discusses the current position of the unlisted property sector within the REIT regime of the US compared to that of South Africa. Lastly, it takes a closer look at the proposed future developments of extending the South African REIT regime to include the unlisted property sector and highlights the possible benefits that could be derived from such an extension.

4.2 MOTIVATING FACTORS FOR COMPARING THE US AND SOUTH AFRICAN REIT STRUCTURES

The REIT structure adopted by South Africa is largely based on the REIT structure used in the US. The National Treasury of South Africa largely collaborated with role-players from the US before the South African REIT regime was enacted (Ungerer, 2013b:9). Motivating factors that support the comparison between the REIT structure of the US to that of South Africa include the following:

- The South African REIT Association (SAREITA) is modelled according to NAREIT in the US, as well as EPRA in Europe (SAREITA, 2013c:2). It must be noted that this study focused on the US REIT model, while the European REIT model was excluded from the scope, as discussed under section 1.5;
- The National Treasury collaborated with NAREIT to provide input and feedback on drafting the South African REIT structure in terms of the Draft Taxation Laws Amendment Bill of 2012. NAREIT is the worldwide representative voice for REITs, including REITs in the US which has over 50 years' experience of implementing their REIT structure (Edwards, 2013:1);
- The US was the first country that introduced a REIT structure, which occurred in 1960. Thereafter, the structure has also been implemented by countries such as the UK, Australia, France, Canada, Japan, Singapore and the Netherlands (Property24, 2008). This serves as proof that the US has the most experience regarding the implementation of a REIT structure; and
- The REIT structure implemented in the US is the largest REIT structure in the world – it constituted 31% of the total market value of REIT structures in the world from the first quarter of 2009 (Vogel Jr., 2009:7).

4.3 AN OVERVIEW OF THE US REIT STRUCTURE

In 1960 the US became the first country in the world to establish a REIT regime (NAREIT, n.d.). In order to critically compare the South African REIT structure to that applied in the US, it is first necessary to obtain a better understanding of how the US REIT regime operates and how it is regulated. For this to be achieved, the next section provides a brief overview of aspects which include: the legal form of entities forming part of the US REIT structure; the capital requirements of US REITs; the listing requirements of US REITs; and an indication of its overall regulation.

4.3.1 Legal form

A REIT in the US can take on the legal form of a corporation, a trust or an association which is taxable as a corporation, such as a limited partnership or a limited liability company (PwC, 2013:60). In contrast, a South African REIT can take on only the legal form of a company REIT (previously referred to as a PLS company) or a trust REIT (previously referred to as a PUT). It is, therefore, evident that the US REIT system allows for a wider range of legal forms of entities allowed to be part of the REIT structure. This is a further indicator that the US REIT structure is much more matured than the South African REIT structure. With experience of more than 55 years in the REIT sector, the US has developed a REIT structure which is aimed at accommodating as many participants in the real estate sector as possible in an effort to expand the sector to its full potential. Thus, consideration should be given to the expansion of the South African REIT regime by including unlisted entities to qualify as REITs and to determine its potential impact on the overall growth of the South African property sector.

4.3.2 Capital requirements

There is no limitation placed on the amount of borrowings that a REIT in the US is allowed to acquire. However, a deduction of interest in relation to any borrowings from related persons such as companies that form part of the same group of companies is subject to similar earnings stripping and debt-to-equity considerations as other entities within the same jurisdiction (PWC, 2013:60)

The earnings stripping approach focuses on the amount of interest paid or payable in relation to the amount of income on which the interest is paid (OECD, 2012). These considerations relate to the limitations placed on the amount of interest that are allowed to be deducted from certain borrowings, such as a thin capitalisation loan where a foreign funded loan is acquired at a high interest rate in order to enable excessive interest deductions. Therefore, debt-to-equity ratios need to be considered. In South Africa a debt-to-equity ratio of 3 : 1 is considered to be the standard acceptable maximum (SAICA, 1996). This ratio is applied where a foreign person provides a loan in order to prevent excessive funding by way of low equity and high debt subject to high rates of interest. Thus, the regulation of the debt-to-equity ratio will prevent interest deductions (if tax deductible) from effectively draining out profits of a specific jurisdiction's tax net (SAICA, 1996).

The only indication of a limitation being placed on the borrowings permitted for a REIT in South Africa is the requirement contained within Section 13.46(g)(ii) of the JSE Limited Listing Requirements, which stipulates that a REIT must have a total debt-to-asset ratio of at least 60%. In addition, similar equity stripping and debt-to-equity considerations are applicable to the deduction of interest form borrowings. This is identified as an aspect for improvement in the future. Further research needs to be conducted to determine the advantages and disadvantages associated with a limitation being placed on the borrowings of a REIT. It needs to be considered whether the current limitation of a debt-to-asset ratio of at least 60% is sufficient and effective. Establishing effective debt limits will contribute in protecting REITs, because they will limit the exposure to negative equity risk. To achieve this, the value of assets that are used to secure debt should not be less than the outstanding balance of debt. A limitation placed on borrowings will also protect the income stream to be distributed to investors by ensuring that available income is not wholly allocated to debt repayments.

4.3.3 Listing requirements

In the US there is no requirement to be listed in order to qualify as a REIT. Both public and private REITs exist in the US without their having to be listed on a specific stock exchange (PWC, 2013:60).

On the contrary, a REIT needs to be listed on the JSE in order to qualify as a REIT under the South African REIT regime as stated in the definition of a REIT in Section 1 of the Act. This is regarded to be one of the deficiencies of the South African REIT structure when compared to the REIT structure of the US. In the US no distinction is drawn between REITs based on their status as being listed or not.

4.3.4 Overall regulation

There are two main types of REITs in the US, namely equity REITs and mortgage REITs. Equity REITs generate income through the collection of rental income and the disposal of properties. Mortgage REITs, on the other hand, invest in mortgages or mortgage securities that are linked to properties (NAREIT, n.d.). US REITs are regulated in terms of the tax regulatory laws of the Internal Revenue Service, NAREIT, the Real Estate Investment Trust Act of 1960 (Public Law 86 – 779 – Federal Internal Revenue Code of 1954 Section 856 *et seq.*), the REIT Modernization Act of 1999 and the Tax Reform Act of 1986 (Fourie, 2009:64). In addition, REITs in the US which trade publicly need to be registered with and are subject to the regulations of the Securities and Exchange Commission (SEC).

Even though the current regulation of REITs in South Africa is more simplified than the former regulation of PLS companies and PUTs, the current regime is still underdeveloped when compared to the regulation of the US regime. South African company REITs are regulated only by the Companies Act (71 of 2008), the JSE Limited Listings Requirements, the Act and the Takeover Regulations Panel. Trust REITs are regulated by only the JSE Limited Listings Requirements, a trust deed, the Act, the Registrar and the Collective Investment Schemes Control Act (45 of 2002).

It is evident from the various regulators and legislation that are applicable to US REITs that the nature and volume of regulation for US REITs are more comprehensive and much more stringent than those of the South African REITs. This is indicative of the fact that administrative participants in the regulation of REITs have continuously, since its inception in the US, identified deficiencies which necessitate further regulation.

4.4 COMPARING THE US AND SOUTH AFRICAN ESTABLISHMENT REQUIREMENTS OF A REIT

In order for it to be established as a REIT, an entity must meet a number of requirements which could be divided into the following categories: organisational; operational; distribution; and compliance requirements. These requirements, which are tax related to the REIT system in each jurisdiction, are compared by discussing them first in the context of the US and then in the South African context.

4.4.1 United States

4.4.1.1 Organisational requirements

In respect of the organisational requirements, a US REIT needs to be formed as an entity taxable for federal purposes as a corporation. A US REIT needs to be managed by a board of directors or trustees. After its first year qualifying as a REIT, a US REIT would need to have a minimum of 100 holders of shares, where five or fewer individuals are not able to own more than 50% of the value of the US REIT’s stock during the previous half of its taxable year (US SEC, 2011).

4.4.1.2 Operational requirements

In order to meet the operational requirements, there are two annual income tests and a number of quarterly asset tests that need to be satisfied. These tests are performed in order to ensure that the majority of the US REIT's income and assets are obtained from real estate sources. In respect of the first annual income tests, a minimum of 75% of the US REIT's annual gross income must be derived from real estate-related income such as rental income and interest on obligations secured by mortgages. In addition, 20% of a US REIT's gross income must be attained from sources such as dividends, interest income and gains on securities. Therefore, no more than 5% of a US REIT's income may be derived from non-qualifying sources relating to non-real estate business operations (NAREIT, n.d.).

In terms of the quarterly asset tests, a minimum of 75% of a US REIT's assets must consist of real estate assets such as immovable property or loans that are secured by immovable property. During each quarter, a US REIT may not hold more than 10% of another entity that is not a REIT. With these holdings, a US REIT may not own securities in another entity of which the value of the securities is more than 5% of the REIT's assets. With regard to a REIT's holding in another REIT, specifically a taxable REIT subsidiary (which can undertake activities that the REIT cannot and whose status is obtained by filing a tax election), the value of shares held by a US REIT in a taxable REIT subsidiary may not exceed 25% of the value of the REIT's assets (NAREIT, n.d.).

4.4.1.3 Distribution requirements

In terms of the distribution requirements, a minimum of 90% of a US REIT's taxable income needs to be distributed in order to qualify as a REIT. Similar to the taxation of other entities, the REIT would be liable for taxes on any income retained within the REIT which is not distributed in any manner (NAREIT, n.d.).

4.4.1.4 Compliance requirements

Finally, for the compliance requirements, a US REIT is required to file an income tax return that is due in March every year. In addition, a US REIT is obliged to distribute letters to its holders of shares in order to request details of beneficial ownership in respect of the shares that are held by them (NAREIT, n.d.).

4.4.2 South Africa

The following is a summarised version of the fundamental aspects of the organisational, operational, distribution and compliance requirements of REITs in South Africa. For more detail, please refer to part 2.7 where a basic understanding of the working of the newly introduced REIT tax regime is discussed.

4.4.2.1 Organisational requirements

For South African organisational requirements, a company REIT can either be internally or externally managed with a choice of having property administration or not. The holders of shares of such company are active participants and are allowed to vote on specific issues during general meetings (SAREITA, 2013b). There is no limitation placed on the number of holders of shares that a South African REIT is allowed to have.

4.4.2.2 Operational requirements

In respect of the operational requirements, a South African REIT must satisfy an income test annually. This income test determines that a minimum of 75% of income must be derived from property rentals.

4.4.2.3 Distribution requirements

In terms of Section 13.47(a) of the JSE Limited Listing Requirements, as well as the definition of a “qualifying distribution” in Section 25BB(1) of the Act, a South African REIT must distribute a minimum of 75% of distributable profits. This provides certainty to the holders of shares that at least 75% of distributable profits will be distributed and that tax exposure is determined by the tax status of the holders of shares.

4.4.2.4 Compliance requirements

A South African REIT needs, firstly, to comply with the regulations of the Tax Administration Act (28 of 2011) in terms of filing an income tax return annually. Secondly, it needs to continuously comply with the JSE Limited Listings Requirements.

4.5 POSITION OF THE UNLISTED PROPERTY SECTOR WITHIN THE REIT REGIME

The section to follow provides an overview of the position of the unlisted property sector within the REIT regime of the US compared to the current position in South Africa. The discussion is not limited to the current position of the unlisted sector prevailing in South Africa, but extends to the consideration of proposed future developments and highlights possible benefits that could arise from the extension of the South African REITs structure to include the unlisted property sector.

4.5.1 Position in the US

In the US there are two types of REITs that are not listed, namely public non-listed REITs (PNLRs) and private REITs.

As mentioned under part 4.3.4, US REITs that are publicly traded on the national stock exchange are registered with the SEC. However, some US REITs are registered with the SEC, but do not trade on major securities. These types of REITs are referred to as PNLRs. PNLRs are subject to the same Internal Revenue Service rules which require all PNLRs to distribute all of their taxable income to their holders of shares in order to avoid paying any taxes at a corporate level. PNLRs are also required to make regular SEC disclosures, which include both quarterly and annual financial reports. New issues and problems arising within the PNLRs environment are monitored and managed by both NAREIT and the PNLR Council (NAREIT, n.d.).

Private REITs have been designed for institutional investors which require a much higher amount for an investment than listed REITs and PNLRs. Private REITs do not trade on the national stock exchange, nor do they need to be registered with the SEC. Consequently, private REITs would not be subject to the same regulatory or disclosure requirements as listed REITs and PNLRs.

The shares issued by private REITs do not need to be registered with the SEC. These share issues are subject to several exemptions regulated and enforced by the SEC. These exemptions include rules that are contained within Regulation D which enables private REITs to sell securities to accredited investors, without having to register the securities with the SEC. In addition, Rule 144A of the Securities Act of 1933 exempts the securities that are issued to qualified institutional buyers from adhering to the registration requirements of the SEC (NAREIT, n.d.). Rule 144A increases the liquidity of these securities as they can be freely traded whereas, previously, the trading of these securities was restricted due to the registration requirements of the Securities Act of 1933.

In the US, publicly traded REITs, PNLRs and private REITs are all subject to the same tax legislation. However, distinction between these entities is drawn based on different corporate regulations applicable to the different types of US REITs operating in different legal environments.

4.5.2 Position in South Africa

The current position in South Africa is that the unlisted property sector does not form part of the REIT regime. Further developments are, however, in process to investigate the possibility of extending the REIT regime to include the unlisted property sector. It is still uncertain as to whether South Africa will follow the US REIT structure in terms of the development of the unlisted REIT structure. There has, however, been a clear indication that once unlisted property companies can attain the REIT status, the same tax legislation will be applicable to both listed and unlisted REITs. The latter was stated by the Minister of Finance, Mr Nhlanhla Nene, who announced during his 2015 Budget Speech that provisions contained in Section 25BB of the Act should also apply to unlisted property companies (National Treasury, 2015:144).

Considering it from a tax perspective, the position should be stretched so that current South African tax legislation pertaining to REITs requires all property companies to be listed. It is, however, not general practice for governments to differentiate between listed and unlisted companies at a tax level. The decision as to whether to list should be based on obtaining access to capital markets and the opportunity to raise capital in order to finance business operations and to stimulate growth, rather than to purely obtain a tax benefit.

4.5.3 Possible benefits of extending the South African REIT regime to include unlisted entities

It should be noted that different benefits are attached to the status of being listed as opposed to not being listed. One of the benefits of unlisted REITs is the fact that they are not exposed to the price volatility attached to the listed market. The capital value of an unlisted REIT is determined with reference to its net asset value and not by the share price as in the case with listed REITs. Therefore, by extending the South African REIT structure to include unlisted entities, South Africa could create a justifiable fourth asset class which behaves differently to equity, bonds and cash, because its correlations to the former are regarded to be insignificant.

According to Jess Cleland, a South African research director at Investment Property Databank (IPD), it is estimated that approximately 54% of South African professionally managed investment property (property that is held to receive rental income) is listed (Hedley, 2013c).

The majority of the large corporate companies that are involved in the unlisted property sector are insurance companies or pension funds, such as Old Mutual Property, Sanlam Properties, Momentum Property Fund and Liberty Properties (Hedley, 2013c). The decision to list in order to obtain the tax benefits of the REIT regime might not be an option for these corporates due to other key factors such as the vision and competitive strategy in terms of the strategic direction of the company that would need to be considered by the board of directors before listing. However, some private corporates might seriously consider listing on the JSE in order to remain competitive due to the ever changing dynamics of the type of sector in which they operate. Furthermore, by extending the REIT dispensation to the unlisted property sector, tax leakage from pension and savings vehicles will be prevented.

Private property companies in the unlisted property sector remain substantial, holding some of the country's most important properties and are critical to the overall growth of the South African property sector (Hedley, 2013c). It is, therefore, imperative that a solution is actively sought that will ensure fairness across the entire property sector (including listed and unlisted entities). Smaller unlisted funds will be an important catalyst for the development of new listed funds, governance, increased competition and the diversification of industry corporates.

The current state of the property sector could, furthermore, influence the manner in which unlisted property companies conduct their business until a solution is found to extend the REIT regime to include the unlisted sector. Owing to the tax advantages in the form of the removal of capital gains tax for REITs, listed property companies (REIT) could be more willing to pay more for a portfolio. Consequently, unlisted companies would be more likely to sell their assets or portfolios to listed companies rather than to unlisted companies.

4.5.4 Proposed future developments

Before 1 March 2015, the provisions of Section 25BB of the Act did not apply to unlisted property companies. However, the Minister of Finance, Mr Nhlanhla Nene, announced during his 2015 Budget Speech that provisions contained in Section 25BB of the Act should also apply to unlisted property companies, provided that they become regulated. These regulations that will govern the unlisted property companies still need to be developed, however (National Treasury, 2015:144).

The regulations to be developed can be expected to be strict and similar to those of the JSE Limited Listing Requirements, which could discourage unlisted property companies to list due to the compliance burden. These expected regulations and requirements could comprise obligations such as substantial reporting requirements, specific debt gearing ratios and making minimum distributions annually. These types of obligations might not be suitable and attractive to all types of unlisted property companies (Lewis, A: 2015).

Mr Estienne de Klerk, the chairman of SAREITA's Taxation and Regulation Committee, has indicated that the extension of the REIT status to the unlisted property sector will provide unlisted property-owning vehicles (such as pension and insurance funds and private investment companies) access to the same benefits available to the listed property sector. One of these benefits will be the fact that net property income will retain its nature in the hands of the holders of shares due to the conduit theory and flow through principle. The issue in respect of extending the REIT regime seems to be not one of taxation, but rather of regulation and controls within property companies. This is evident from the fact that South Africa – should the scope of section 25BB of the Act be extended to include unlisted REITs – follows a similar principle than that of the US in that both listed and unlisted REITs are being taxed similarly. This is further emphasised by comments from leaders in the property industry such as Mr Mark Stevens, the Chief Executive Officer of JSE-listed Fortress Income Fund, who stated the following:

> I'm still very wary of property syndicates. (They) currently don't have the same auditing and other risk-preventative measures in place that listed property companies do. REIT status has enhanced the reputation of these listed funds. (Anderson, 2015a)

There is additional pressure for the REIT status for unlisted property-owning vehicles to be finalised as soon as possible, because Sections 8F and 8FA of the Act, which both relate to dual linked debentures, will expire on 31 December 2015 (Mazansky, 2013). These sections are important to the regulation of unlisted property companies that contain linked units with both a debenture and equity portion.

4.6 FINDINGS AND CONCLUSIONS

Based on the critical comparison performed in Chapter 4, it is clear that the US REIT structure is much more developed, especially because of its experience in dealing with various types of entities.

4.6.1 Organisational requirements

The following table looks to conclude on the similarities and differences between the REIT systems in South Africa and the US in terms of their organisational requirements.

Table 4.1: Similarities and differences – Organisational requirements

Similarities	*Differences*
Both are taxable entities in their respective jurisdictions.	US REITs are required to have a minimum of 100 holders of shares at the end of its second taxable year. South African REITs, as pre-requisite, should be listed. Therefore, once the REIT is in existence, there will be multiple holders of shares. The minimum number of holders of shares for a public company as per the Companies Act (71 of 2008) is one.
Both can be managed either internally or externally, either by the board of directors or trustees for US REITs and with South African REITs by having the option of having property administration.	
There are no limitations on the number of holders of shares that a US or South African REIT are allowed to have.	

In terms of organisational requirements, US and South African REITs have similarities in terms of how they are managed, as well as the nature of their shareholders. Once unlisted property companies in South Africa are allowed to obtain REIT status, consideration should be given to whether to follow the US approach with regard to the minimum number of holders of shares required. It should be determined whether a specific rule should be set for REITs or whether the minimum number of holders of shares should be in line with the Companies Act (71 of 2008), which sets no limit for a private company. By not having a minimum number of holders of shares, it might be defeating one of the purposes of REITs in South Africa which is to provide a way for potential investors to invest in property indirectly without having to outlay large sums of capital to gain access to large-scale, income-producing real estate properties.

4.6.2 Operational requirements

The following table looks to conclude on the similarities and differences between the REIT systems in South Africa and the US in terms of their operational requirements.

Table 4.2: Similarities and differences – Operational requirements

Similarities	*Differences*
Annual income tests are conducted for both US and South African REITs to satisfy legislative REIT requirements.	Two annual income tests are conducted for US REITs in contrast to only one annual income test for South African REITs.
	The annual income tests for US and South African REITs have a threshold of 75% of gross income that should be derived from real estate-related income such as rental income. There are, however, differences between US and South African legislation of what is classified as real estate-related income, as discussed below. US REITs, in addition, have to obtain a further 20% of gross income from sources such as dividends, interest income and gains and securities.
	For the purposes of determining whether the 75% thresholds for South African REITs are satisfied, “rental income” as discussed in part 2.7.1, consists of rental income, dividends and interest income. For the purposes of determining whether the 75% threshold for US REITs are satisfied, “real estate-related income” consists of rental income and interest on obligations secured by mortgages.

By comparing the operational requirements of the US REIT (refer to 4.4.1.2) to those of South Africa (refer 4.4.2.2), it is evident that US REITs are subject to much more stringent requirements pertaining to their operations. In this way, US REITs remain focused on growth and income-generating activities encapsulated within the real estate sector.

4.6.3 Distribution requirements

The following table looks to conclude on the similarities and differences between the REIT systems in South Africa and the US in terms of their requirements for distributions.

Table 4.3: Similarities and differences – Distribution requirements

Similarities	*Differences*
	US REITs have to distribute 90% of their taxable income, while South African REITs have to distribute a minimum of 75% of their distributable profits.
	The threshold for US REITs is based on their taxable income, while the threshold for South African REITs is based on their gross income as determined by tax principles in the Act.

While the threshold for distributions of US REITs would appear more excessive, it is important to identify that the threshold is based on the REITs' taxable income and not their gross income, as is the case for South African REITs. Therefore, the US REITs base for calculating satisfaction of the threshold will be lower than that of the base for South African REITs.

4.6.4 Compliance and legal requirements

The following table looks to conclude on the similarities and differences between the REIT systems in South Africa and the US in terms of the compliance and legal requirements applicable to them.

Table 4.4: Similarities and differences – Compliance and legal requirements

Similarities	*Differences*
Both US and South African REITs are required to file income tax returns in their respective jurisdictions.	South African REITs are not obliged to distribute letters to their holders of shares in order to request details of beneficial ownership in respect of the shares that are held by them, which is a requirement of US REITs to perform.
	US REITs can take on the form of a corporation, a trust or an association which is taxable as a corporation such as a limited partnership or a limited liability company, whereas South African REITs can only take on the form of a company or trust REIT.

There is more legal form variety present in the US REIT structure, seeing that both listed and unlisted companies can attain REIT status in the US. It also seems as if the requirements in terms of both regulation and distribution are stricter in the US than in South Africa. This is indicative of a more mature REIT structure in the US when compared to that of South Africa. With experience of more than 55 years in the REIT sector, the US has developed a REIT structure that seeks to accommodate as many participants in the real estate sector as possible in an effort to enhance the growth of the sector to its full potential.

4.6.5 Unlisted property sector

Unlisted property-owning vehicles, as well as many JSE-listed REIT companies, would welcome the expansion of the REIT regime to include the unlisted property sector, because many of the JSE-listed REITs have associate companies and investments held in unlisted property companies.

Once a country has implemented and established its own REIT structure for its property sector, it has the advantage of being able to attract both local and international investors. Owing to the global nature and transparency of REITs, international investors would be more willing to invest offshore in REITs. As international investors would have a basic understanding of the standardised processes of the worldwide REIT structure, it would be beneficial for the South African economy to include the unlisted property sector as part of its REIT regime, because it would be internationally comparable to countries such as the US. Consequently, the South African REIT structure would be more standardised and, in turn, more user-friendly to international investors.

CHAPTER 5: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

Any new legislation is always analysed critically by market leaders and stakeholders in order for it to be improved and to clarify possible deficiencies. Therefore, with the introduction of the new REIT tax regime in South Africa, it was important to distinguish between aspects that have improved the taxation of property companies and possible deficiencies that need to be modified in future. The needs of the South African property sector and its investors had to be analysed to determine whether the amendments have significant commercial substance to such an extent as to influence the sector to improving not only economically, but also qualitatively for its investors.

The overall purpose of this study was to determine whether the new REIT regime in South Africa has been improving the taxation of property companies in a fair and reasonable manner and whether it accommodates the needs of the South African property sector and its investors. In order to answer these two research questions, various research objectives were set (refer to part 1.4) of which the results and findings are summarised in this chapter.

5.2 FINDINGS ON LEGISLATION AND REGULATIONS GOVERNING THE SOUTH AFRICAN REIT REGIME

The first research objective (refer to 1.4.1) was to provide an overview and obtain a basic understanding of the provisions in the Act and the JSE Listing Requirements which regulate the REIT structure. This was achieved in Chapter 2, which contains a detailed explanation of the working of the newly introduced REIT tax regime as opposed to the original regulation of property investment vehicles in South Africa comprising PUTs and PLS companies. From this overview, it was found that the main reason for the introduction of a new REIT structure, from a tax perspective, was the attempt to improve the consistency of the tax treatment of property investment vehicles in South Africa.

It was further established that the greatest concern associated with the original property sector investment vehicles, namely PUTs and PLS companies, was not only the fact that they were regulated differently, but also that their tax treatment was based on the classification of their legal form and, therefore, differed as well. A PUT took on the legal form of a vested trust, while a PLS company was treated as a company for tax purposes as defined. Not only did the legal forms differ, but also the units to be acquired by investors in these investment vehicles. The acquisition of units in PUTs consisted purely of equity, while units acquired in PLS companies constituted linked units comprising both a debt and equity portion. This eventually caused differences in the tax treatment of the two property investment vehicles and resulted in PLS companies' being the more popular option of the two investments.

From the basic understanding obtained of the working of the REIT tax regime as opposed to the original property sector investment vehicles, it became apparent that the amendments made to the regulation resulted in more consistent tax treatment of investment vehicles within the listed property sector of South Africa. The tax treatment of REITs is not as fragmented as was the case when different tax implications applied to PUTs and PLS companies, even though they had a common purpose. An improvement in the overall regulation has also taken place, because REITs now have to comply with JSE Limited Listing Requirements. The new regulations appear to be less complex compared to those applicable to the former regulation of PUTs and PLS companies.

The market capitalisation has increased to approximately R340 billion, an increase of approximately 43% over the 12 month period ending July 2015 (Anderson, 2015b). Together with the number of additional property companies (five new property companies listed on the JSE, as discussed under section 3.6.2), it is evident that the new REIT tax regime has impacted the South African listed property sector positively. The amendments have simplified the property sector for the holders of shares by simplifying the different terms, provisions and regulations applicable to REITs. The adoption of the REIT structure has aligned the South African listed property sector with over 25 countries worldwide which have a REIT structure in place. The consistent tax treatment of REITs within South Africa, as well as the fact that it is a global structure, will encourage and promote investment from foreign investors who have been previously discouraged from investing in the South African property sector due to the confusion and inconsistencies that existed between PUTs and PLS companies.

5.3 FINDINGS ON THE IMPACT OF THE NEW REIT TAX SYSTEM ON THE ENTIRE SOUTH AFRICAN PROPERTY SECTOR

The second research objective (refer 1.4.2) was to determine which aspects of the new tax legislation governing the REIT regime have proven to have unintended implications and negative tax consequences for the listed property sector as well as to identify and analyse possible anomalies. From the analysis of the new tax regime for REITs in Chapter 3, various anomalies were identified, such as issues relating to pre-existing tax losses, taxation in hedging transactions, the effective double taxation of income from property companies, the buy-back shares, the distribution of a liquidation dividend, the timing of a dividend distributed and the use of accounting definitions. In addition, unintended tax implications were identified with regard to unwanted compliance burdens for foreign investors, hotel companies looking to obtain REIT status and effective tax paid on taxable dividends. These findings indicate the areas of the REIT regime that need rectification in order to improve the taxation of property companies in South Africa and to accommodate the needs of the South African property sector and its investors. Although the analysis included only the listed property sector, it is inevitable that the significant changes in the listed property sector would eventually have an impact on the unlisted property sector. It is, therefore, submitted that unlisted property companies would be encouraged to list on the JSE in order to take advantage of the tax benefits available in terms of the REITs structure.

The National Treasury has indicated their commitment to improving the taxation of property companies in South Africa by not only implementing the REIT tax regime in South Africa, but also making amendments to existing tax legislation regarding REITs. This would ensure that the taxation of property companies is improved and that the holders of shares are accommodated in terms of the fairness of taxation from the various cash flows from the REIT. Moreover, this would ensure clarity for the investors in terms of their investment in the REIT.

For the anomaly in respect of the timing of distributions, clarification has been provided by the National Treasury in terms of the Taxation Laws Amendment Bill in 2014. The confusion resulted from the question on whether dividends received by a holder of shares holding an interest in a property company, which subsequently becomes a controlled company, would be subject to income tax instead of dividends tax. It has been clarified that any dividend received or accrued from any company that is not a REIT or a controlled company at the time of the distribution must not be taken into account in determining the qualifying distribution.

In 2014, the National Treasury introduced regulations in respect of the cancellation of the debenture portion of a linked unit held in a PLS company. In terms of the Taxation Laws Amendment Act (43 of 2014), there will be no income tax or capital gains tax implications from the cancellation of the debenture portion of such a linked unit. This has further highlighted the National Treasury’s willingness to simplify the process of the REIT tax regime in an attempt to promote uniformity of tax treatment in the property sector. Thus, the needs of holders of shares are accommodated while the taxation of the listed property sector is simultaneously improved.

The third research objective (refer 1.4.3) was to determine whether the unlisted property sector has been affected to such an extent that unlisted entities would seek listing in future in order to take advantage of the tax benefits available to REITs.

With regard to the unlisted property sector, SAPOA is investigating the possibility to further develop and include the unlisted property sector in the scope of the South African REIT regime. This would enable growth in the sector and provide more variety to potential holders of shares in terms of investment options. The advantages and disadvantages associated with investment in an unlisted property REIT as opposed to a listed REIT are still unknown. The same process would need to be followed in order to identify any anomalies and possible amendments to be made to the taxation and legal legislation that would govern the unlisted REITs.

It was indicated that a two-phased approach be considered. The first phase would look at the regulation of any institutional investors, while the more tedious second phase would need to determine who would be responsible for the regulation of unlisted property owners. Discussions between SAPOA and the National Treasury are in progress to determine a strategy to integrate and extend the REIT structure to the unlisted property sector. This process commenced during the 2013/2014 period when SAPOA (2013:9) ranked this issue as one of its key objectives for this period.

5.4 FINDINGS FROM THE CRITICAL COMPARISON BETWEEN THE US AND SOUTH AFRICAN REIT SYSTEMS

The fourth and final research objective (refer 1.4.4) was to compare the South African REIT system with that of another country in order to determine and identify aspects that could be useful for implementation within a South African context.

From the comparison of different elements of the US REIT structure, definite similarities between the two REIT structures were identified. The regulatory requirements of both South African and US REITs are governed by different Acts and regulatory bodies to ensure that REITs are established for their primary purposes and are fulfilling their responsibilities. Further similarities were found in terms of the operational requirements in that REITs in both South Africa and the US are subject to annual income tests, even though the percentage thresholds differ between the two systems.

However, it was found that US REITs are subject to much more stringent requirements in terms of their regulation and distribution. This could have been expected considering the fact that the

South African REIT structure has been developed recently, while the US REIT structure has been in existence for over 55 years. Therefore, both administrators and stakeholders of the US REIT structure have had the opportunity to identify deficiencies over the years of its operation. Subsequent amendments, additional requirements and the development of various Acts have since taken place in an effort to improve the US REIT structure.

The South African REIT structure would need to operate for an extended period before the structure could be reliably said to accommodate all types of organisations and stakeholders that have an interest in the South African property sector. One consideration in this regard is the development and extension of the REIT structure to include unlisted property companies. The US REIT structure accommodates unlisted REITs where the holders of shares might be individuals, as well as REITs where the holders of shares are institutional investors such as pension funds and insurance companies. Currently, it is unknown whether there is a demand in South Africa for one of the types of holders of shares. The first step would be to implement the REIT structure in the unlisted property sector and follow the same process in the identification of anomalies and amendments to the taxation and legal legislation that would govern the unlisted REITs in a South African context.

5.5 OVERALL CONCLUSION

In an effort to align the South African listed property sector with international standards, the REIT structure for listed property companies was implemented in South Africa. The new structure has resulted in uniformity and consistency between listed property companies in terms of their respective taxation and regulation. Two main problems previously persisted: firstly, the listed property sector environment was fragmented with regard to the different regulations applicable to PUTs and PLS companies, while this regulatory framework was also considered to be too restrictive and not internationally comparable. Secondly, there were inconsistencies in the tax treatment between PUTs and PLS companies.

The implementation of the new REIT tax regime has provided clear direction to listed property companies in terms of its regulation through the JSE Limited Listing Requirements, the Companies Act and the Collective Schemes Control Act. The new regime also ensured that all types of listed property companies are subject to the same taxation provisions and are not influenced by technicalities, in accordance with the substance-over-form principle. Thus, fair and reasonable tax treatment of property companies has been achieved. Previously, there was no simple uniform tax dispensation available for property investment vehicles and, therefore, the legislation applied was dependent on the legal form of such investment vehicles. The differences in the tax treatment between PUTs and PLS companies, together with the difference in regulatory framework, caused uncertainty among investors and discouraged both potential local and foreign investors from investing in the South African property sector.

With the introduction of an internationally recognised REIT structure into South Africa the purpose of a property investment vehicle was realised, namely to generate rental income and to create capital appreciation for the holders of shares while having certainty on the regulations and taxation of their investments relating to REITs. It is, therefore, concluded that the new REIT tax structure does, in fact, accommodate the needs of the South African listed property sector and its investors. Investors are taxed on distributions received from REITs as if they were rental income from an investment in property, and the REITs are allowed deductions from their taxable income for distributions made in transferring the tax liability for rental income to the holders of shares. In substance, the purpose of a property investment vehicle is to distribute rental income to the holders of shares from the underlying income-producing properties invested in on behalf of the holders of shares of which a REIT achieves in a fair and reasonable way.

However, the REIT structure is currently available only to listed property companies. Thus, the needs of the entire property sector are not being met and development is required with regard to the extension of REITs to the unlisted property sector. Unlisted property companies are at a disadvantage currently, because the REIT dispensations are not available to them, making the listed property companies a more attractive option for investment for potential investors.

5.6 RECOMMENDATIONS

From the analysis of the REIT tax regime followed in the South African property sector performed in this study, the following recommendations are proposed:

- Further consideration needs to be given to the extension of the REIT tax legislation to unlisted property companies to enable the unlisted property sector to take advantage of the favourable tax dispensation available and experience growth. It seems as if the main issue at the moment is not one of unwillingness to extend the REIT structure to the unlisted property sector, because there have been several indications that the National Treasury and SAPOA are keen to do so. The main issue is to determine who will regulate the unlisted property sector in a similar way as the JSE Limited Listings Requirements regulate the listed property sector. The National Treasury and SAPOA could choose to follow a similar route to that of the US REIT structure, namely that unlisted property companies acquiring the REIT status are to be registered with the JSE for regulatory purposes;

- As discussed under 3.2.1, it is recommended that the National Treasury set specific rules with regard to pre-existing tax losses to establish whether these losses should be taken into account in determining distributable profits of a REIT for a specific year of assessment;
- As discussed under 3.2.3, it is recommended that the National Treasury consider amending the definition of a "qualifying distribution" to include property companies in order to avoid the effective double taxation of income from property companies; and
- The use of accounting definitions, as discussed under 3.2.7, should be reconsidered, because the National Treasury will have no control over any changes made to these definitions contained in the IFRS. Therefore, the National Treasury should perhaps consider including further definitions in the Act to replace the definitions used as per the IFRS.

5.7 AREAS OF FUTURE RESEARCH

Some additional areas have been identified for future research. This research will assist in changing economic and commercial requirements which will, in turn, improve the REIT tax regime and the taxation of property companies in South Africa to continue to accommodate the needs of the South African property sector and its investors:

- Once the REIT tax regime has been extended to the unlisted property sector, a significant amount of research will need to be conducted to determine the anomalies and unintended tax implications that will arise. Research will also be needed to determine whether the chosen regulatory body for the unlisted property sector is effective and protects investors in a similar manner than the JSE does currently for listed REITs.
- As discussed under 3.3.1, unwanted compliance and administrative burdens infringed upon foreign investors could deter foreign investors from investment into South African REITs. Research in this area could determine the effect of these compliance and administrative aspects on the investment behaviour of foreign investors, because the primary objective of introducing the REIT structure in South Africa was to increase the amount of foreign investment in the South African property sector.
- When a REIT has been liquidated, regardless of the reason, research can be conducted to determine the tax effect and impact on the holders of shares, because all income from

liquidation will effectively be taxed in the hands of the holders of shares. The intention of the REIT tax regime was not to place such a large burden on the holders of shares. Once research has been conducted on this, possible further provisions could be added to Section 25BB of the Act to ensure that holders of shares do not obtain large tax liabilities at the time of liquidation of a REIT.

- As discussed under 3.2.4, it should be determined whether share buy-backs by controlled companies from their parent companies (REIT) constitute the abuse of the provisions of Section 25BB of the Act and whether it should be general practice for REITs to enter into such transactions. Thereafter, it should be considered whether the consideration received from a share buy-back should form part of the definition of a "qualifying distribution".

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Appendix A:

Listed property entities on JSE as at 1 May 2013

Alpha	LongName	Type	Sector
ACP	Acucap Properties Ltd	LU	Real Estate
ANP	Annuity Properties	LU	Real Estate
AWA	Arrowhead Properties	LU	Real Estate
AIA	Ascension Properties	LU	Real Estate
DLT	Delta Property	LU	Real Estate
DIA	Dipula Income Fund	LU	Real Estate
FVT	Fairvest Property Hldgs	LU	Real Estate
FFA	Fortress Inc Fund	LU	Real Estate
GRT	Growthpoint Prop Ltd	LU	Real Estate
HPA	Hospitality Prop Fund	LU	Real Estate
HYP	Hyprop Inv Ltd	LU	Real Estate
IPF	Investec Property Fund	LU	Real Estate
OCT	Octodec Invest Ltd	LU	Real Estate
ORE	Orion Real Estate	LU	Real Estate
PMM	Premium Properties Ltd	LU	Real Estate
REB	Rebosis Property Fund	LU	Real Estate
RIN	Redefine Prop Int	LU	Real Estate
RDF	Redefine Properties Ltd	LU	Real Estate
RES	Resilient Prop Inc Fund	LU	Real Estate
SGA	Synergy Inc Fund Ltd	LU	Real Estate
VIF	Vividend Income Fund	LU	Real Estate
VKE	Vukile Property Fund	LU	Real Estate
VPF	Vunani Prop Inv Fund	LU	Real Estate
CPL	Capital Property Fund	PL	Real Estate
EMI	Emira Property Fund	PL	Real Estate
FPT	Fountainhead Prop Trust	PL	Real Estate
OAS	Oasis Crescent Prop Fund	PL	Real Estate
SAC	SA Corp Real Estate Fund	PL	Real Estate
SYC	Sycom Property Fund	PL	Real Estate

LU: Property Loan Stock (PLS) company

PL: Property Unit Trust (PUT)

From JSE (Wimberley, 2013)

Appendix B:

Listed REITs on JSE as at 8 October 2015

Alpha	LongName
APF	Accelerate Prop Fund Ltd (New Listing)
ACP	Acucap Properties Ltd
ANP	Annuity Properties
AWA	Arrowhead Properties
AIA	Ascension Properties
CPL	Capital Property Fund
DLT	Delta Property
DIA	Dipula Income Fund
EMI	Emira Property Fund
EQU	Equites Prop Fund Ltd (New listing)
FVT	Fairvest Property Hldgs
FFA	Fortress Inc Fund
FPT	Fountainhead Prop Trust
GRT	Growthpoint Prop Ltd
HPA	Hospitality Prop Fund
HYP	Hyprop Inv Ltd
IPF	Investec Property Fund
LDO	Lodestone REIT Limited (New listing)
OAS	Oasis Crescent Prop Fund
OCT	Octodec Invest Ltd
ORE	Orion Real Estate
PMM	Premium Properties Ltd
REB	Rebosis Property Fund
RDF	Redefine Properties Ltd
RES	Resilient Prop Inc Fund
SAC	SA Corp Real Estate Fund
SAR	Safari Investments RSA Ltd (New listing)
SYC	Sycom Property Fund
SGA	Synergy Inc Fund Ltd
TEX	Texton Property Fund Ltd (New listing)
TWR	Tower Property Fund Ltd (Formerly Vunani Prop Inv Fund)
VIF	Vividend Income Fund
VKE	Vukile Property Fund

From JSE (Wimberley, 2015)