REVIEW OF THE TAX CHALLENGES FACED BY THE SOUTH AFRICAN REAL ESTATE INVESTMENT TRUSTS ON THE APPLICATION OF THE TAX LAWS AND REGULATIONS

Harrieth Mcondisi Mabuza

A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, in partial fulfilment of the requirements for the degree of Master of Commerce (Taxation)

Johannesburg, 2023

ABSTRACT

The introduction of the Real Estate Investment Trust (REIT) regime in South Africa in 2013 has created a substantial world-class real estate industry which has contributed significantly to the country's economic growth and prosperity over the long term. The REIT regime replaced the Property Unit Trusts and the Property Loan Stock property investments, which were in existence before the REIT regime was enacted in 2013.

The REIT regime came with special tax dispensation for the South African REITs, and as a result, the investors of a REIT are taxed on the income generated by a REIT instead of the REIT itself; the REIT operates as a conduit for income derived from the immovable properties. Although most aspects of the SA REIT laws and regulations and taxation were confirmed, a few unresolved matters still require attention regarding the taxation of South African REITs.

The 2019 budget review documents indicated that amendments are still required to the South African REIT tax laws and regulations to iron out current inconsistencies and challenges identified in applying the REIT tax laws and regulations. Currently, many other REIT markets, especially in underdeveloped countries, are looking to change their REIT tax regime to make it more attractive to foreign investors and to compete in global REIT markets. The study investigated the current tax challenges faced by SA REITs on the application of the SA REIT tax laws and regulations and made recommendations for necessary amendments to ensure the attractiveness of the SA REIT regime.

The study made use of the qualitative and interpretive approach through the examination of existing discussion papers, both locally and internationally, legislation, reports, guiding memoranda, journals, books, case laws, website documents, and other material to understand the taxation of REITs. Interpretation notes and current discussions are looked at to understand the challenges faced by REITs relating to the Income Tax Act, value-added tax, Tax Administration Act, and tax treaty issues relating to REITs. The study provided a detailed understanding of the key tax design elements that underpin the SA REIT industry by comparing the SA REIT regime to the United States and United Kingdom REIT regimes.

The study identified challenges that expose the REIT to double taxation, challenges that are violating the REIT conduit principle; issues that threaten the REITs to failure in meeting the 75% income test, possible exposure to fines and penalties, and threats to the loss of the REIT status. Furthermore, we have identified administration issues that cause unnecessary delays in the REIT tax administration process and tax treaty issues that affect the taxation of REITs. Further, the study made suggestions for amendments that can be made to REIT tax laws and regulations to address each of the identified tax challenges affecting SA REITs.

DECLARATION

I, Harrieth Mcondisi Mabuza, declare that this research report is my work except as indicated in the references and acknowledgements. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university.

(Harrieth Mcondisi Mabuza)

Signed at …………………………………………………

On the …………………………….. day of ………………………… 2023…..

DEDICATION

I dedicate my dissertation work to my family and friends who supported me through this journey, including my mom, whose no longer with us; I hope she is celebrating with me from heaven. My beautiful daughter Charisma, thank you for being patient with me.

ACKNOWLEDGEMENTS

I would like to thank God, the lord Jesus Christ, for giving me the strength, courage, and grace to complete this research paper; it was not an easy journey, but he made it possible.

I am deeply grateful to my supervisor Faeeza Soni for all the sacrifices she made to provide me with guidance, prompt feedback, and reviews of my work. Her patience, skills, and extensive knowledge made the research process easy.

I am thankful to my family for the prayers, the support, the words of encouragement, and for believing in me. My beautiful Charisma, thank you for being by my side every day during this journey and for your patience, my love.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

Abbreviations and Glossary

the Act	Income Tax Act No 58 of 1962, as amended
Carbon Tax Act	Carbon Tax Act No 15 of 2019
The Companies Act	Companies Act 71 of 2008, as amended
CFC	Controlled Foreign Company
CGT	Capital Gains Tax
Controlled company	Controlled Property Company as defined in section 25BB(1)
DTA	Double Tax Agreement
DWT	Dividends Withholding Tax
Exchange	An exchange as defined in section 1 of the Financial Markets Act and licensed under section 9 of that act
FBE	Foreign Business Establishment
JSE	Johannesburg Stock Exchange Limited
NAREIT	National Association of Real Estate Investment Trusts

OECD	Organisation for Economic Co-operation and Development
Property Company	Property company as defined in section 25BB(1)
PLS	Property Loan Stock
PUT	Property Unit Trust
REIT	Real Estate Investment Trust
SARS	South African Revenue Services
SAREIT	South African Real Estate Investment Trust
Schedule	Schedule to the Act
Section	Section of the Act
SASRIA	South African Special Risk Insurance Association
Tax treaty	An agreement for the avoidance of double taxation entered into between South Africa and another country
TAA	Tax Administration Act
UK	United Kingdom
US	United States

VAT Act	Value Added Tax Act 89 of 1991

CHAPTER 1. INTRODUCTION

1.1 Purpose of the study

The study examines the current tax challenges faced by South African Real Estate Investment (SA REIT) Trusts on the application of the current SA REIT tax laws and regulations and proposes possible solutions to the identified challenges.

1.2 Context of the study

Prior to the REIT regime implementation in 2013, the South African tax and regulatory environment did not accommodate REITs. South Africa had two types of listed property vehicles, being the Property Loan Stock (PLS) and Property Unit Trust (PUT), known as Collective Investment Schemes in Property (CISPs). The two property vehicles had different governing regulatory legislations, which resulted in the inconsistency of tax treatment and confusion for foreign investors, which triggered the need for the implementation of the REIT regime (Bredell & Boshoff, 2013). The REIT framework was then enacted to cater to the fragmented property industry, which was partly regulated, and to do so; the treasury had to redesign some of the regulatory requirements that were too restrictive and not aligned with international standards for competition purposes (National Treasury, 2007).

REITs have been generally regarded as financial assets that offer good growth potential (Botha et al., 2017). Real Estate Investment Trusts are an alternative investment that can provide periodic income in the form of rentals and capital appreciation in the long term. This type of alternative investment option further provides diversification benefits to an investment portfolio and serves as a hedge against inflation risk, as rents and property value tends to increase with inflation (Baker et al., 2018).

The benefits of investing in a REIT include the following:

- Tax efficiency as REITs is treated as a conduit that avoids the double tax usually occurring when investing in normal shares.
- Diversification benefits as they allow investors to easily access different kinds of properties in different locations.
- Liquidity benefits as listed REIT shares are traded daily compared to indirect investments in property, which are highly illiquid.
- Provider of income since REITs have to pay out the majority of their income to investors (National Treasury, 2007)

SA REITs hold different types of commercial property, including shopping centres and malls, offices, factories, warehouses, hotels, hospitals and healthcare centres, and residential properties in South Africa and in other countries. SA REITs are permitted to invest in property from other jurisdictions with an aim to ensure steady rental income and capital appreciation for its investors from all the different properties (SARS, 2022).

REITs are known for their tax efficiency, as well as their ability to aggregate different sources of funding and channel them toward real estate investment which overcomes any financial hindrances associated with individual projects (Kruger-Levy et al., 2017)

The National Association of Real Estate Investment Trusts (2018) defines a Real Estate Investment Trust as “a company that owns or finances income-producing real estate." A REIT is a professionally managed investment vehicle specializing in investing in properties and the management of real estate portfolios on behalf of investors in return for a fee (Wong & Reddy, 2018). Beracha et al. (2019) opine that REITs are modelled after mutual funds, as they offer investors periodic income in the form of dividends, diversification, and long-lasting capital gains through exposures to efficiently managed real estate properties. At least 75% of the income generated by SA REITs must be distributed to shareholders to comply with the REIT requirements (SARS, 2022). In reality, REITs are internationally recognised investment vehicles that allow an investor to invest in immovable properties and receive period income streams (Botha et al., 2017).

SA REITs and their controlled companies are subject to specific tax dispensations in line with section 25BB of the Income Tax Act, where they are granted a deduction for distributions made to shareholders of the REIT, subject to certain limitations. REITs are treated as a conduit that avoids the double taxation that occurs on the investment made on ordinary shares as the income generated by the REIT is taxed in the investor's hands, not on the REIT (National Treasury, 2007). South African resident investors are taxed normal tax on the dividends received from the REIT or the controlled company whereas a foreign investor is subject to dividends tax instead of a normal tax on those dividends (SARS, 2022).

Tax legislation evolves continuously across all global REIT markets, especially in under-developed countries where the overall REIT framework has not been favourable sufficiently to encourage property companies to adopt the REIT structure. REIT associations from different jurisdictions are currently looking for ways to improve the existing REIT legislation to make it more desirable to investors and property companies and provide additional tax benefits that will promote the use of the REIT structure (Ernst & Young, 2018).

A REIT is one investment vehicle that enables investors to receive income safely, easily, and affordably. The REITs tax legislation was introduced to ensure that qualifying REITs operate as a channel through which the rental income flows to the shareholders, which ultimately results in the shareholder being responsible for income tax on the rental earnings generated by the REIT (KPMG, 2022).

REITs usually pay less tax or no income tax due to a special deduction contained in S25BB which means that the investor will pay the tax on the dividends received from the REIT. Furthermore, REITs are not taxed capital gains tax on the sale of their immovable properties or subsidiary property companies, whereas the dividends declared by REITs are not exempt from income tax in terms of section 10(1)(k)(i)(aa) of the Act in the shareholder’s hands. Section 64F(1)(I) provides an exemption from dividends tax for REITs, however (CDH, 2019a).

Technical issues have been identified during the application of the REIT tax laws, especially with the SA REITs growing their international presence (de Klerk, 2019). Identified technical challenges with the application of the South African REIT laws and regulations were also highlighted in the 2019 budget review, which means ongoing refinement is necessary on the SA REIT regime, since it is still in the development phase (CDH, 2019a).

Some of the challenges encountered by SA REIT companies include the matters highlighted below.

Listed vs. Unlisted REITs:

Section 25BB of the Act is only for REITs that are registered on the stock exchange; this includes any of the South African stock exchange platforms (The JSE Limited, Cape Town Stock Exchange, A2X Markets, and the Equity Express Securities Exchange) in terms of section 1 of the Financial Markets Act and licenced under section 9 of that Act (SARS, 2022).

The stock exchange listing conditions can be narrow and burdensome to administer, coupled with the resultant compliance requirements that come with being listed on an exchange (Ungerer, 2013). These requirements and the additional costs are likely to discourage unlisted REITs from listing, which means that unlisted REITs will not be able to enjoy the tax benefits available to listed REITs. Furthermore, unlisted REITs are not given global recognition by overseas investors, which is currently enjoyed by listed REITs (Ungerer, 2013). This results in inconsistencies in tax treatment for companies within the same property industry (CDH, 2019a). Countries, such as the United States of America (USA) and Australia, have a combination of listed and unlisted REITs which both enjoy the same tax privileges available to REITs. There have been promises to regulate unlisted REITs to enable them to enjoy the same tax dispensation available to listed REITs; however, there has been no progress to date in that regard (de Klerk, 2019).

The challenges stated below need to be resolved to ensure further growth and development of the South African REIT industry. (NAREIT, 2022) emphasised that the original intent of REITs was inclusivity, and to date, that stays at the heart of the global REIT model. Therefore, the SA REIT model should be aligned with the core of the REIT model through the inclusion of unlisted REITs. It was also noted that several challenges would have to be addressed before the amendment of the REIT legislation to cater for unlisted REITs, such as the regulation of the unlisted REITs, as well as modeling the tax legislation to be beneficial to the unlisted REITs without discouraging the listed REITs from listing (Kantilal, 2016).

Economic double taxation:

Careful attention should be given to the REIT design features and the special tax dispensation to ensure that it does not undermine the general tax principles and tax rules applicable to a normal company (National Treasury, 2007); however, some circumstances expose the REITs to double taxation such as the following:

- If a REIT is in a taxable income position and pays the relevant tax liability, there will be double taxation if the REIT subsequently makes a distribution from the amount that has already been taxed because Section 10(1)(k)(i) proviso (aa) of the Act excludes dividends received from a REIT from the dividend exemption. This means that the REIT shareholders will be taxed on the same amount that has already been subject to tax on the shareholder's hands (Kantilal, 2016).
- The same issue also occurs when a controlled company disposes of a property that is exempt from capital gains tax in terms of S25BB(5)(a) of the Act. If the controlled company distributed those proceeds to its parent company for re-

investment or settlement of the property debt, that distribution becomes taxable in the parent's hands irrespective of the distribution being exempt in nature (Section 25BB(5)(a) of the Act) (SARS, 2022).

Impact of building insurance claims and pay-outs on rental income requirement for REITs:

The South African property sector experienced significant damages to their properties due to the riots that took place in July 2021 in KwaZulu Natal and Gauteng. Property companies, including REITs that suffered damage, applied for compensation from their respective insurance companies to rebuild the properties and also for the loss of revenue during that period (Staff, 2021). Should the loss of revenue not be classified as rental income, those companies might not meet the 75% rental income threshold and may not be able to pay a tax-deductible dividend to their shareholder (section 25BB(1) of the Act) (SARS, 2022).

Definition of property company:

The definition of a "property company" in section 25BB(1) of the Act means a company in which 20% 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 of which at the end of the previous year of assessment, 80% or more of the value of the assets, reflected in the annual financial statements, is directly or indirectly attributable to immovable property (Section 25BB (1)) (SARS, 2022).

REITs with multiple structures end up being assessed at each company level to confirm if the 80% immovable property asset test is passed. REITs usually have multi-group structures where the individual company financial statements include intergroup loans where the company is financed through debt, and as a result, that company might not meet the 80% or more of the assets attributable to immovable property test due to the intergroup loans. Any dividend from that company would not form part of the rental income despite the company being directly or indirectly exposed to immovable property. This position exposes the REIT to failing the 75% rental income requirement, which might result in the REIT paying non-deductible distributions to its shareholders. The assessment must be done at an individual financial statement level, not at a consolidated financial statement level which leaves the above highlighted problem unresolved (SARS, 2022).

Calculation of taxable income for provisional tax submissions:

Due to the uncertainty around the dividends to be declared and whether or not provisional taxes should be paid, the REIT needs to finalise its financial results first to confirm the final dividend it will be able to distribute, which exposes the REIT to understatement penalties if provisional taxes are not paid where they need to be paid (Britz & Jayes, 2019).

The reduced corporate income tax rate impact for REITs:

Due to the tax-neutral nature of REITs through the conduit principle, the corporate tax rate change may negatively affect REIT investors, such as individual investors. Individuals are taxed on a sliding scale of up to 45% on taxable income earned. Individuals do not receive an exemption on dividends received from a REIT in line with Section 10(1)(k)(i) proviso (aa) of the Act, which means dividend income from REITs will be taxable at the marginal rate for individual investors which is more compared to dividend income received from non-REIT companies which would have been taxed dividends tax at 20% after the 27% corporate tax paid by the company (KPMG, 2022).

Interest limitation:

Interpretation Note 97 was updated on 5 July 2022 to refer to the new interest limitation rules, which limit interest deduction under certain circumstances. Section 23M stipulates that the deduction of interest incurred by the borrowing company on debt is limited to a percentage of adjusted taxable income (SARS, 2022).

REITs, especially multinational REITs, may be equally impacted by these changes, which might require the REIT to distribute more cash to remain tax neutral. This might not be possible, and it might end up resulting in potential adverse tax implications for the REITs (KPMG, 2020b).

Unrealised gains on foreign currency hedges:

Section 25BB(1) defines Rental Income with the formula:

RI = PI + EG

The symbol EG signifies the total foreign exchange gains as defined in section 24I(1) of the Act determined with respect to the amounts referred to under the "PI" part of the rental income formula. Foreign exchange losses are excluded in the symbol EG of the rental income. The foreign gains or losses can be realised or unrealised (SARS, 2022). Section 25BB(1) requires that any hedge gains be considered as part of income, which has to be distributed by the REIT to ensure compliance with the 75% distribution requirement (KPMG, 2020b).

The issue begins where the unrealised gains have to be included in the REIT's taxable income while a cash event only occurs upon settlement of the forward exchange contracts, which creates a cashflow problem because the REIT might not be able to make large enough qualifying distributions to reduce its taxable income to zero as the cash event on the unrealised gains have not yet occurred (CDH, 2019a).

Furthermore, the REIT might have surplus cash the following year when the forward exchange contract is realised, which is not beneficial to the REIT as the qualifying distributions might be in excess of its taxable income, considering that section 25BB(2)(b) limits the qualifying distributions deduction to the company's taxable income (SAREIT, 2017).

REITs and corporate restructure:

Unbundling and liquidation distributions on the REIT group structure.

- The REIT framework has an impact on tax considerations relating to the above corporate restructuring transactions.
- Where a REIT is part of a merger and acquisition transaction, and Section 46(6A) of the Act excludes REITs or controlled companies from receiving any tax relief under S 46 when unbundling shares held in another company which means the REIT or controlled company is taxed on this type of transactions. This issue will likely affect non-qualifying assets since in specie distributions from the unbundling transaction would be immovable property or share in a property company which will not trigger capital gains tax in line with section 25BB(5) of the Act (CDH, 2019a).
- S47 of the Act further states that although liquidation distributions are exempt from income tax in terms of section 10(1)(k) of the Act, if the distribution is from a REIT or a controlled company, the exemption will not apply in the recipient's hands and those distributions will be subject to, tax due to proviso (aa) to the dividend exemption under section 10(1)(k) of the Act (SAREIT, 2017).
- The above-mentioned scenarios will lead to REIT shareholders being taxed on profits that were already taxed at 27% on the REITs or controlled companies on distributing any amounts received from other REITs or controlled companies relating to liquidation distribution or an unbundling transaction (CDH, 2019a).

Section 18D of the VAT Act on residential property:

Property developers, which often include REITs because they are VAT registered, must deduct input tax from the VAT incurred on development costs and pay output VAT at the standard rate of 15% on the property when it is sold. Letting of a residential dwelling is exempt from VAT; however, due to unfavourable market conditions, the REIT might decide to temporarily let the unit while looking for a prospective buyer, which triggers a change in use adjustment requiring VAT output equal to the open market value of the property to be paid over to SARS when the property is first let out (section 18(1) of the VAT Act) (Core Tax, 2022).

Section 18B(1) of the VAT Act, which has no longer been applicable since 1 January 2018, relieved developers by a period of 36 months before a change in use adjustment was triggered. Section 18D(1) of the VAT Act was enacted on 1 April 2022, which provides for an output tax to be paid equivalent to the tax fraction of the adjusted cost of construction when the developer temporarily lets the unit for a period not longer than 12 months (CDH, 2022).

It is not clear what the consequences will be if the lease period extends beyond 12 months, especially with the dire economic conditions that South Africa is undergoing. This issue will put the REITs out of pocket as they will have to pay output Vat without having received cash from the sale of the property (CDH, 2022).

Carbon tax efficiency savings:

Technology will help REITs to design advanced and sustainable properties, resulting in efficient use of water and energy resources which will result in reduced operational costs and possibly carbon emissions (Ho et al., 2013). The Carbon Tax Act has been amended with effect from 1 January 2023 to extend the Energy efficiency savings tax incentive in terms of section 12L of the Act until 31 December 2025. This change encourages taxpayers to invest in energy-saving measures for companies to reduce greenhouse gas emissions and to stimulate energy-efficient practices. If this allowance ceases in 2025, it is not clear what will motivate SA REITs to enhance their building designs with energy solutions that will reduce carbon emissions and compete with other REIT markets (National Treasury, 2023).

Tax treaty issues relating to REITs:

The OECD model tax convention further stated that due to the growth and globalisation of REITs investments, cross-border tax treaty issues have emerged as a result (OECD, 2017). The identified issues include but are not limited to:

- Treaty entitlement of a REIT: There is difficulty with the understanding of the REIT's own treaty right to both the income and the distributions of a REIT.
- Treaty entitlement of the REIT investors: REITs are eligible to enjoy the tax treaty benefits concluded by country of residence; part of REITs' investments comes from pension funds which, in some countries, are not entitled to treaty benefits.
- Who is the taxpayer for treaty purposes: The understanding of whether the tax treaty terms and conditions should be applied at the REIT level or at the shareholder level is not the same across many jurisdictions.
- How should distributions from REITs to foreign investors be treated: whether such distributions should be dealt with as rental of property income or income from investing in shares is not yet clear from the different states.

Other administrative issues:

Other tax administrative challenges faced by REITs include the delays in VAT refunds from SARS during the development of the REIT properties. Delays on VAT refunds can be prolonged over six months, which creates cashflow problems on REIT projects (Mazars, 2018). There are delays concerning the carbon tax registration process, which results in non-compliance by the REITs required to register for the carbon tax filing.

1.3 Problem statement

Given the tax challenges identified above, the study aims to identify the tax challenges faced by South African REITs on the application of the SA REIT tax laws and regulations.

Firstly, the study focuses on the key tax elements that underpin the South African REIT industry, which provides more background to the tax challenges faced by SA REITs.

Secondly, the study focuses on understanding the challenges faced by SA REITs in applying the SA REIT tax laws and regulations and provides recommendations for improvements that can be made to resolve the identified challenges.

1.4 Research Objectives

The study determines the following objectives that are necessary for the actualisation of the overall aim of the study. The research objectives are as follows:

1. To understand the key tax design elements that underpin the South African REIT industry.
2. To understand and propose solutions to the challenges in applying the South African REIT tax laws and Regulations.
   2.1 Challenges relating to the Income Tax Act.
   2.2 Challenges relating to the Value Added Tax Act.
   2.3 Challenges relating to the Tax Administration Act.
   2.4 Tax treaty issues relating to REITs.

1.5 Significance of the study

By achieving the aim and objectives of this study, the research provides significant novel insights and evidence in understanding REITs operations, tax efficiency, and challenges encountered by the REITs on the application of the SA REIT tax laws and regulations, as well as makes recommendations to the identified challenges for possible South African tax amendments. Notable contributions include:

- Understanding the key tax design elements that underpin the South African REIT industry.
- Understanding the current tax challenges with the application of the SA REIT tax laws and regulations and recommendations to the identified challenges.

Hence, the findings of this study are useful for REIT management companies, REIT valuation experts, portfolio managers, and tax consultancies, which are necessary for investment decisions. Also, this information provides REIT practitioners, portfolio managers, pension fund administrators, regulatory agencies, as well as the general public with better information for decision-making and regulation of South African REITs.

1.6 Delimitations of the study

The study focuses on the tax challenges encountered by REITs with regard to the implementation of the SA REIT tax laws and regulations. It excludes challenges unlisted REITs face in applying their tax laws and regulations, challenges regarding the exchange listing requirements, or any accounting treatment and disclosure requirements affecting REITs.

The study looks at existing legislation as of 31 May 2023 in terms of the Income Tax Act, and it touches on relevant proposed amendments affecting REITs released by the National Treasury on the Tax Laws Amendments Bill 2023 and from the National Budget Speech 2023.

The study includes a high-level view of the US and the United Kingdom (UK) REIT regime tax treatment, but it does not include a review of all the other countries with the REIT regime in place.

1.7 Research Methodology

The above objectives are achieved through an analysis of both local and international discussion papers, legislation, interpretive memoranda, journals, books, and material available on the taxation of REITs and the interpretation and current discussion of the practical issues faced by REITs with the applicable tax laws and regulations. The research is of a qualitative and interpretive nature through the review of case studies, conceptual studies, content analysis and historical research on REITs that is used (Peters et al., 2020). Greater weight is given to legislation and case laws from the following institutions:

- National Treasury of South Africa
- South African Revenue Services (SARS)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts (NAREIT)
- Lawyers and Tax advisors
- Academic institutions

Detailed comparison of the US and the UK REIT regime was chosen as the appropriate means of understanding the key tax designs that underpin the SA REIT regime because the SA REIT regime is based on the US and the UK REIT regime, according to PWC (2021) and National Treasury (2007).

1.8 Structure

The study is structured as follows:

Chapter Two – Literature Review

This chapter of the research study covers both the theoretical, empirical, and conceptual review. Herein, the study focuses on the evolution of REITs as well as the core requirements under the REIT regime. The study empirically reviews relevant pieces of literature, publications, and reports relating to REIT tax laws and regulations.

Chapter Three – Key tax design elements for the SA REIT Industry

This section compares the worldwide REIT regimes, the US, the UK REITs, to fully understand from where the SA REIT regime originated, which provides a base for understanding some of the challenges currently faced by the SA REITs.

Chapter Four – Tax Challenges with the SA REIT Regime

This chapter focuses on the tax challenges faced by the SA REITs with the current REIT tax laws and regulations and make recommendations for possible amendments that can be made to resolve the identified challenges.

Chapter Five – Conclusion and recommendations

Provides the conclusion and recommendations of the study and also highlights areas of further research.

CHAPTER 2. LITERATURE REVIEW

2.1 Introduction

This chapter gives a thorough background to REITs and a detailed understanding of the REIT regime and is broken down into two parts. The first part examines the evolution of REITs globally, including the evolution of South African REITs. The second part covers the essential requirements for a REIT regime globally, as well as requirements for the South African REIT regime. Understanding the history and background of REITs is vital for understanding the tax challenges faced by South African REITs; hence a detailed view of the REIT regime worldwide and in South Africa is provided.

2.2 Background Discussion

Different countries in the world have implemented the Real Estate Investment Trusts structure as part of their economic growth and development strategies (NAREIT, 2022). Over 40 countries have adopted the REIT regime, which is known for bringing assurance and solidity to shareholders and markets worldwide (EPRA, 2022). Since the introduction of the REIT framework in the United States in 1960, over 40 countries have adopted the model, with nearly five billion people, comprising 85% of the global GDP. Today, over 865 listed REITs are in operation worldwide, with a total equity market capitalisation of $2.5 trillion for listed REITs as of December 2021 (NAREIT, 2022).

REITs are well known for the number of incentives they offer investors, including their ability to provide low entrance fees to real estate investment and to serve as a diversification tool (Ijasan et al., 2021). South Africa introduced the REIT regime in 2013 to enable the SA-listed property sector to compete globally, attracting more foreign investments to the SA-listed property sector (Rampersad, 2010).

NAREIT (2022) defines REITs as "companies that own, operate, or finance income-producing real estate."

The OECD (2017) defines a REIT as

> " a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property. distributes most of that income annually and does not pay income tax on the income related to the immovable property that is so distributed."

The EPRA (2022) defines REITs as

> " Publicly listed property investment companies that own, operate, develop, and manage real estate assets for obtaining returns from rental income and capital appreciation."

The SAREIT (2023) defines a REIT as

> "a company that derives income from the ownership, trading, and development of income-producing real estate assets."

According to the NAREIT (2022),

> "REITs own, operate, and finance apartment buildings, data centers, health care facilities, logistics facilities, office buildings, rental housing, retail and shopping malls, and self-storage centres. Communication towers, timber lands, and many other types of properties".

REIT regimes contain different definitions per country, with the common feature being tax dispensation, real estate, and pay-out requirements for which there are minor differences between countries (Parker, 2018). Other benefits that make REITs different from other non-REIT property companies include the geographical and functional diversification of their portfolio, allowing individuals to enjoy profits even from international property companies from all around the world, the low contract costs, low entrance costs, steady income from dividends, tax exemptions, high asset liquidity as well as investment protection (Mazurczak, 2011). Compared to other commercial real estate, REITs are easy to buy and sell and are accessible to people with different income streams (NAREIT, 2022).

REITs are immune to hostile takeovers and they are prohibited from reinvesting their profits through the mandatory distribution requirements (Oh & Verstein, 2023).

Bredell and Boshoff (2013) further stated that the benefits of adopting a REIT structure extends even to the neighbouring countries because if one country establishes a REIT regime, it pressures the neighbouring countries to do the same which we have seen in Africa. Since the implementation of the REIT regime in SA, other African countries, such as Kenya and Morocco, have adopted the regime as well.

REITs provide significant dividend yields, which usually exceeds the yields of most publicly traded stocks, making them an ultimate investment for an individual or retirement fund entity (Block, 2011).

Other advantages of REITs include affordability and ease of handling concerning lower transaction costs for most investors, greater investor access, liquidity, corporate governance, and real-time pricing in listed markets (Naidoo, 2014). REITs are also identified as a way to safeguard investment from inflation through capital appreciation and income distribution. The average REIT investment grows by 8% annually, almost equivalent to global inflation rates (Makatsane, 2018).

Many individuals are not as familiar with REITs even though they are an attractive investment. REITs must pay at least 70% to 100% (range worldwide depending on each country's distribution requirement) of their income in dividends (White & Howell, 2020).

2.3 Evolution of Real Estate Investment Trusts

This section looks into the evolution of REITs from the US perspective to the global spread reaching over 40 countries worldwide, including South Africa.

2.3.1 *The global history of REITs*

On 14 September 2010, the REIT sector celebrated its 50 years since the origin of the REITs in 1960 when the US Congress introduced the Real Estate Investment Trust Act intending to allow individual investors to participate efficiently in commercial real estate, leading to the current standing of the US REIT being one of the key wealth providers of real estate in the United States (White & Howell, 2020). The Tax Reform Act of 1986 loosened some restrictions preventing REITs from growing into a significant industry. The Tax Reform Act formed a basis for the REITs boom in the 1990s, which placed the REIT industry as the third most crucial vehicle next to stocks and bonds (Brounen & De Koning, 2012).

Prior to the enaction of the SA REIT regime, Rampersad (2010) studied the proposed SA REIT structure and the potential impact of the structure on listed companies and noted the United States as the leader in REIT thinking because they have tried and tested different rules and structures to get where they are today. The Netherlands was the second country to introduce the REIT structure in their listed property system in 1969 after the USA, together with New Zealand and Taiwan, followed by Australia in 1971 and Brazil in 1993. Though the United Kingdom is a "major powerhouse in the world economy," it only introduced its REIT regime in 2007. The US REIT remains the most significant market globally, with over 200 listed REITs representing 64% of the global REIT market capitalisation, followed by Australia, Canada, France, Japan, Singapore, and the UK (Simontacchi & Stoschek, 2019).

According to Simontacchi and Stoschek (2019), the oldest REIT regimes in a geographical area are as follows:

a) America: United States (1960).
b) Europe: Netherlands (1969).
c) Oceania: Australia (1971).
d) Asia: Singapore (1999).
e) Africa: Nigeria (2007).

The US REIT model has encouraged domestic real estate investment, with over 44% of American households holding REIT investments. Market capitalisation for REITs has increased significantly around the globe, though the most significant development was in North America from $8.7 billion in 1990 to $1.7 trillion in 2021, which is a evidence to the success and resilience of the REIT model (NAREIT, 2022). In 1990, REIT countries only represented about 6% of the world's population which grew to 67% of the world's population as of 2021, which was mainly driven by the introduction of REITs in India in 2014 as well as China in 2021, which have large populations (NAREIT, 2022).

Below is a table showing the different countries that have adopted the REIT framework since 1960 and the year of adoption:

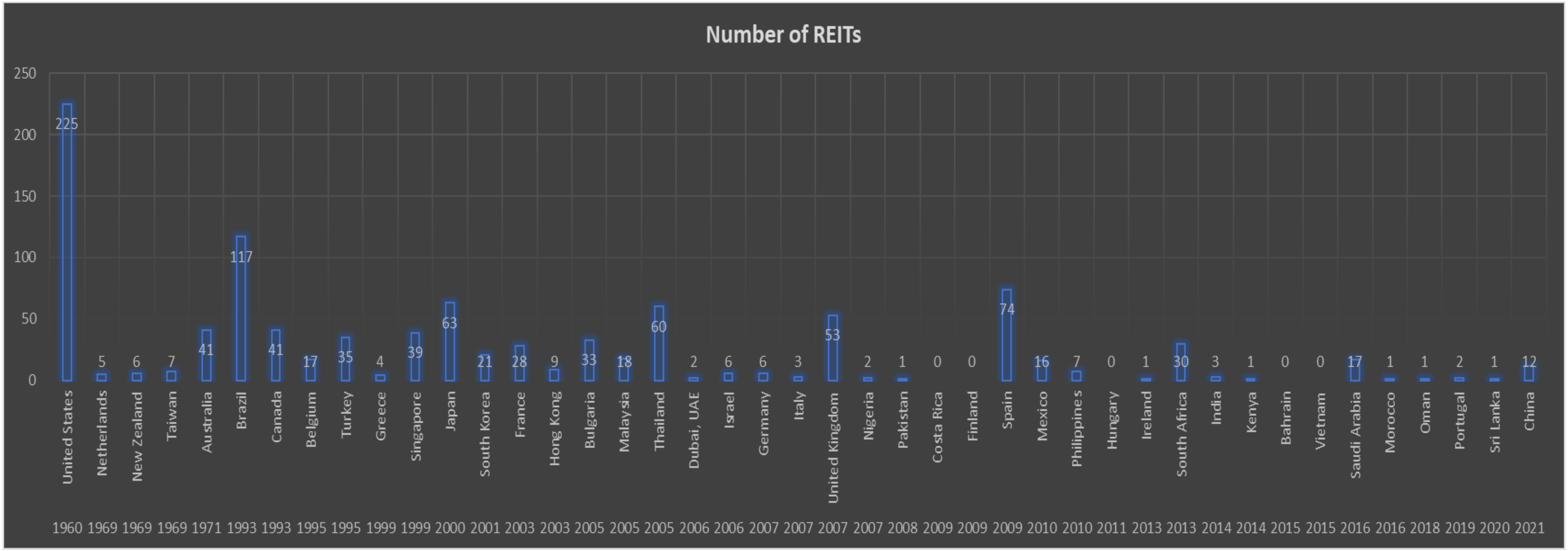

Figure 1.1: Compiled by author, source: Global approach to real estate investing (NAREIT, 2022); Global REIT survey (NAREIT, 2022).

The following shows the global REITs by numbers:

Global REITs by numbers	
Number of countries and regions with REITs	41
Total number of listed REITs globally	**1989**: 120 **2021**: 865
Equity market cap for listed REITs	**1989**: $11.7B **2021**: $2,5T
Capital raising	$174B

Figure 1.2: Source: Global REIT approach to real estate investing (NAREIT, 2022).

The following shows the global performance of REITs to stocks and bonds:

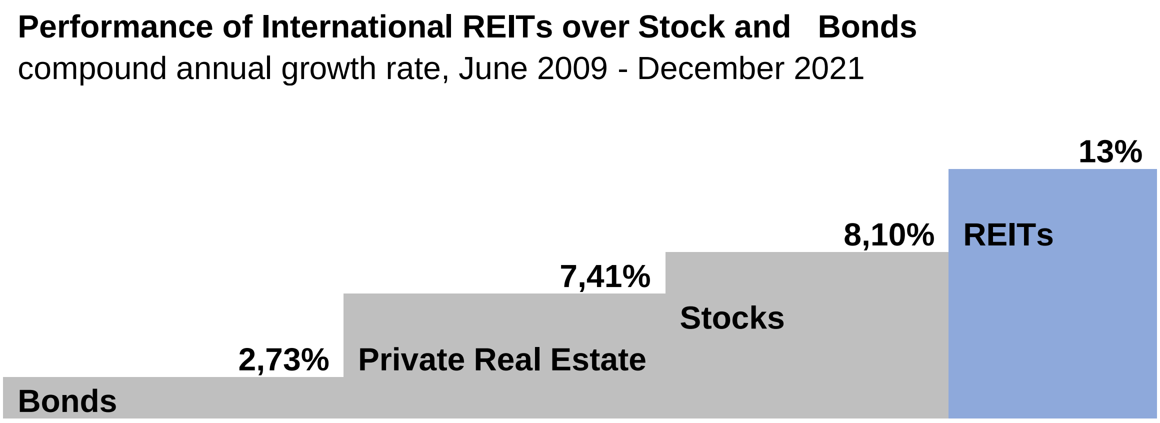

Figure 1.3: Source - Global REIT approach to real estate investing (NAREIT, 2022).

According to Simontacchi and Stoschek (2019), REITs are all about the quality of management, real estate cash flow converted into regular dividends for its shareholders, and governance at the highest standards.

REITs also assist with the enhancement of communities by making available real estate for people to live, work, play, and interact with one another, job creation, increased economic activity, encouraging admission to international investment capital and national ownership of the real estate and critical infrastructure (NAREIT, 2022).

Despite the poor performance of REITs as a market during the recent economic downturn, REITs are still perceived as safe and robust investment choices by investors (Simontacchi & Stoschek, 2019). Mazurczak (2011) says the future success of REITs will be determined by the effectiveness of the REIT managers in adapting to the fluctuating investment markets as well as identifying new strategies to advance profitability but most importantly, the government and authorities, through creating distinct tax structures, to ensure adequate growth of REITs.

2.3.2 *Evolution of REITs in South Africa*

Prior to the REIT regime implementation in 2013, South Africa had two types of listed property vehicles, namely, the Property Loan Stock and Property Unit Trust (also known as Collective Investment Schemes in Property) (National Treasury, 2007). The two vehicles had different governing regulatory legislations, which resulted in the inconsistency of tax and regulatory treatment of the two property entities and that created confusion for foreign investors; as a result, the National Treasury introduced the REIT framework in South Africa to iron out these differences (Bredell & Boshoff, 2013). The disadvantage of the above property vehicles was that foreign investors were unfamiliar with them, which created a reluctance to invest on their side, mainly due to the differing legal forms and the legislation governing both vehicles (Ungerer, 2013). Both vehicles were criticised for the double taxation they imposed on investors (Ntuli & Akinsomi, 2017).

The fundamental differences between the taxation of PLS and PUT were as follows:

- PLS paid capital gains tax on profits made from the disposal of assets, while PUT did not pay capital gains tax where those profits were distributed to shareholders.
- PUTs were not allowed to invest in other listed companies, while PLSs were allowed.
- There were two distinct debt gearing limits for both vehicles: the amount stated on the company's memorandum of incorporation for PLSs and 30% of the total assets value for PUTs.
- Both vehicles were governed by two separate acts, the Companies Act for PLS and the Collective Investment Schemes Act for the PUT (Bredell & Boshoff, 2013).

The National Treasury's aim with the introduction of the REIT regime was to ensure that there is a unified system that caters to both vehicles, eliminating the inconsistencies of taxation in the property industry through the REIT regime, which is aligned with international standards while ensuring the protection of investors and safeguarding the industry's reputation (National Treasury, 2007).

South Africa has two types of REITs currently, namely, the company REIT and the Trust REIT, according to the SA REIT (2013). Below is a table that shows the key differentiating characteristics of company REITs and Trust REITs:

Company REIT	**Trust REIT**
Investors are active members, and they benefit from the complete safeguard of the Companies Act and Takeovers Regulations Panel and can vote on general meeting on specific issues. Investors vote for the company to be a REIT.	An existing PUT will become a SA REIT upon application to the JSE and after providing evidence of its compliance with the JSE Listing Requirements and that it is registered with the Registrar of Collective Investment Schemes.
The company memorandum of incorporation should record the REIT structure.	Investors' interests are protected by both the trust deed and the trustee, who ensures that there is compliance with the Collective Investment Schemes Control Act and safeguards shareholders' assets.
Directors are responsible for ensuring compliance with the JSE's listing requirements and the Companies Act.	The Trust REIT must meet all JSE listing requirements but is not subject to the Takeovers Regulations.
Companies can have external or internal management or property administration.	Trustees report to the Registrar of Collective Investment Schemes and must comply with all the Collective Investment Schemes Control Act requirements.
	Must be externally managed per the Collective Investment Schemes Control Act.

Table 1.1 Source: *http://www.sareit.com/docs/SA_REIT_brochure.pdf* (SAREIT, 2013).

The listed company REITs and the Trust REITs qualify for the REIT tax dispensation and should all be registered on a recognised stock exchange as REITs (CDH, 2019a).

The following are the requirements for a company or trust to have REIT status:

- Assets owned must at least be R300 million.
- It must be a property entity.
- Debt must be limited to 60% of the REIT's gross asset value.
- Minimum of 75% of the REIT's income must be from property rental business or investment income from indirect property ownership.
- Must have a risk committee for risk monitoring.
- The REIT must not enter into derivatives that are not in the ordinary course of business.
- Distribute at least 75% of its taxable income each year ((SAREIT, 2013;) (JSE Limited, 2013)).

Only after the stock exchange awards a listed SA REIT status can the REIT apply section 25BB of the Income Tax Act (de Klerk, 2019).

Initially, when the REIT regime was introduced in May 2013, there were only 24 REITs that the JSE approved in 2013. The number grew to 33 in 2019, and currently, there are 29 REITs in South Africa as others have lost their REIT status along the way ((de Klerk, 2019) & (SAREIT, 2023)).

Below is the SA REIT market capitalisation, showing the pre- and post-REIT regime:

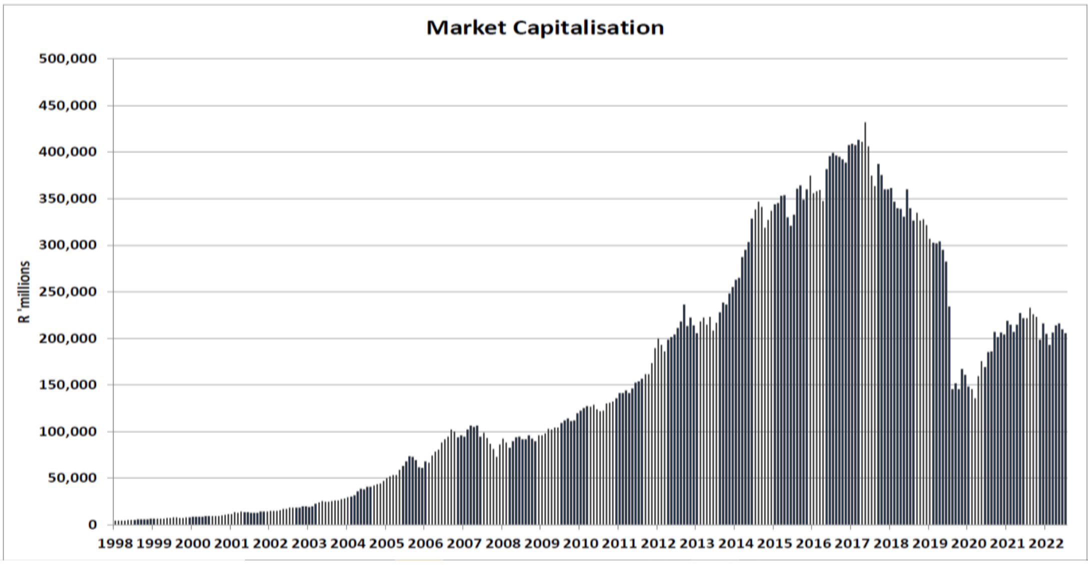

Figure 1.4: Source – (SAREIT, 2023) [Research - SA REIT]

The SA-REIT regime currently has 29 companies with market capitalisation of over R200 billion (SAREIT, 2023). According to the JSE REIT industry analysis report, SA REIT earnings are expected to raise by 24% per annum in the following few years (Simply Wall St, 2022).

Prior to the enactment of the REIT regime, evidence suggested that the South African listed property sector was adequately positioned to compete internationally in terms of both risk and returns (National Treasury, 2007). Bredell and Boshoff (2013) also predicted the possibility of SA REITs to be participating in the global market of real estate. Both predictions have proven accurate because the SA REITs now play a crucial part in the Standard and Poor global REIT index (Ijasan et al., 2021).

2.3.3 *Literature review on SA REITs*

According to Strauss (2018), the existence of a REIT structure is dependent upon the tax regulations of a particular country. The author examined the availability of literature on the taxation of REITs and found that less than 20% of research directly relates to the taxation of REITs, which indicated that more research still needed to be done to establish the appropriateness of the current REIT regulations.

Ijasan et al. (2021) studied the link between the SA REIT regime and 10 of the most developed REITs in the world from Europe, Asia, North America, and Oceania and found that the US leads South Africa, which is credited to the difference in the share of global REIT index; however, the SA REIT was attractive for inclusion on an investment portfolio for their diversification benefits.

Ntuli and Akinsomi (2017), on the overview of SA REITs' initial performance, found that stocks are the best performing assets, risk-adjusted, while SA REITs enhance the return when included in a mixed portfolio as they contribute at a higher end of the risk scale.

Part of the REIT's unique tax treatments included the non-deduction of building allowances relating to immovable property. Some researchers wondered if REITs were not missing out on the building allowances, and Coetzee (2019) studied the implications of the non-deduction of building allowances for REITs and concluded that the REIT regime would not function effectively with the deduction of building allowances as shareholders would have less income distributed to them. SARS would receive less tax from the REIT structure, making it less appealing to investors and thus detracting from the REIT flow-through principle. SA REITs also do not qualify for participation exemption on foreign dividends received (PWC, 2021).

The REIT regime has been extended further to cater to the other exchanges in South Africa; this led to the definition of REITs being updated to include another recognised exchange instead of the JSE limited only. This amendment meant that REITs could choose any exchange suitable for their budget and needs accordingly (CDH, 2019a).

Carstens and Freybote (2018) studied the effects of the introduction of the SA REIT regime on foreign investment and liquidity. They found that introducing REITs in SA enhances the liquidity of listed property companies and that the regime positively impacted measures such as turnover and trading volumes. Wesson and Carstens (2019) investigated the impact of SA REITs legislation on firm growth and firm value. They found a significant change in growth components, including high average profitability and sustainable growth in the REIT industry, suggesting that the property industry responded positively to the introduction of the REIT regimes.

The legal requirements of a REIT represent an essential determinant of the market's performance and risk-adjusted returns. Items, such as pay-out requirements and the taxation of undistributed ordinary income, are consistently related to future risk-adjusted performance (Ghosh & Petrova, 2021). Xu and Yiu (2010) also indicated the effects of tax reforms on REITs and concluded that tax reforms truly affect the REIT's performance.

Kantilal (2016) reviewed the SA REIT legislation against the US REIT framework and concluded that the SA REIT framework is still underdeveloped; thus, more work still needs to be done to align with some of the most developed REITs in the world.

Ungerer (2013) studied the practical issues relating to the SA REIT tax dispensation by discussing the US and UK REIT regimes as a basis for the SA REIT regime. He identified the listing requirements, possible double taxation of amounts received from financial instruments, amounts received from property companies, liquidation distributions, and issues around REITs' failure to meet the 75% rental income requirement annually as practical issues relating to the SA REIT regulations and made recommendations to resolve those issues accordingly.

Breetzke (2014) studied the taxation of SA REITs, where he compared the SA REIT regime to the Australian REIT regime and identified gaps and areas of improvement to the SA REIT regime based on the analysis of the Australian REIT regime.

2.3.4 *Requirements of a Real Estate Investment Trusts Regime*

The country's tax reforms determine vital structural aspects of a REIT; however, the majority of countries adopted the US REIT framework with minor adjustments, which makes the US REIT regime a reasonable basis for testing if a country's regime is in line with international standards (Mazurczak, 2011). The critical structural aspect of a REIT regime includes corporate structure, investment focus, time horizon, profit distribution, and tax treatments (Parker, 2018). Simontacchi and Stoschek (2019) identified the following: entity form, capital, investor, listing, distribution requirements, as well as investment restrictions, as the main requirements for REIT regimes. Failure to meet these requirements usually results in financial penalties or the loss of REIT status, depending on the jurisdiction.

2.3.5 *Global Requirements for a REIT Regime*

The entity form and corporate structure

The required legal form for a REIT framework varies from unit trusts for countries such as the US, Australia, and Canada. Corporations are also considered in the US, the UK, and the Netherlands. Partnerships are an acceptable legal form for the US and France, and funds are the required legal form for Brazil and the Netherlands, while South Africa requires the legal form for their REITs to be either a trust or a company (Simontacchi & Stoschek, 2019). Most jurisdictions, including South Africa, require listing on a public stock exchange, which is not required in the US and the Asian-Pacific regions. There is still an ongoing debate regarding the management of REITs; some countries, such as South Africa, are silent concerning the management, while jurisdictions, such as the US, previously adopted the internally managed REIT model. The rest of the Asian-Pacific regions are focused on externally managed REITs (Parker, 2018).

Capital requirements.

The REIT regime may also require that the company holds assets worth a particular amount, depending on the jurisdiction to ensure sufficient investor protection. These requirements include minimum capital and maximum debt level. The South African REIT regime requires a minimum asset value of R300 million and maximum debt of 60% of the gross asset values (Kantilal, 2016). In other jurisdictions, the minimum requirement depends on the REIT's legal form or the status granted by the stock exchange, and it can also be set by the relevant company law (Simontacchi & Stoschek, 2019). Jurisdictions with debt limits usually range between 40% and 75%, while some jurisdictions apply a specific debt ratio that should be maintained by the REIT company, especially in European countries. Some jurisdictions have no debt limits, such as the US (Parker, 2018).

Investor requirements

REITs were intended to be collective investment vehicles, hence most REIT legislation includes investor requirements. Investor requirements can be grouped into the minimum number of investors in countries such as the US, Canada, and Singapore. At the same time, some jurisdictions base it on the minimum interest owned by institutional investors (Simontacchi & Stoschek, 2019). South Africa has no requirement regarding a minimum number of investors for REITs.

Investment Restrictions

REIT Activity

The primary investment focus of a REIT is real estate assets. Initially, REITs started with commercial properties but have broadened their focus to include hotels, residential, and bulk retail centres and recently, ventured to include self-storage and prisons (Parker, 2018).

Some jurisdictions restrict the scope of REITs' investment activities to immovable property. Other countries allow their REITs to undertake certain activities only if they are supplementary to the core business, which is determined through the following tests:

- The Income test: requires most of the REIT's income to be generated from its core activity, i.e., the rental income from immovable property. Proceeds are used to measure this test – usually, more than 75% must be from immovable property, South African REITs are also subject to this test.
- The asset test requires that REITs invest most of their funds, mainly in immovable property (Simontacchi & Stoschek, 2019). For South African REITs, for a property company to be recognised as such, 80% of its assets should be immovable property (SARS, 2022).

REIT Investments

Certain countries put restrictions on the type of immovable property investments that a REIT can invest in, such as the following:

- Minimum diversification levels to minimise the overall risk, such as a limit on a single investment compared to total assets and a minimum number of immovable assets in which a REIT can invest.
- Limitation on foreign immovable property. Some countries, such as India, prohibit investment in foreign immovable property by REITs, while Greece and Turkey set a maximum amount for investment in foreign immovable property.
- Limitations of investment on particular immovable property. Countries like Germany do not allow their REITs to invest in residential accommodation.
- Limitation on investment in subsidiaries: Countries like Mexico do not allow their REITs to own subsidiaries, while other countries set a minimum holding percentage in a subsidiary (Simontacchi & Stoschek, 2019).

Distribution Requirements

Most developed countries have opted for a REIT regime with a profit distribution requirement between 70% to 100% as a pre-requirement for favourable tax treatment. South Africa requires a minimum distribution of 75%, whereas countries, such as Turkey, have elected a discretionary distribution requirement. Some countries apply the distribution threshold to the net income, while others apply it to the rental income (Parker, 2018).

Other distinct factors for REITs include the election for authorisation of REIT status, whereas, in countries such as the Netherlands and the US, an election for REIT status is made during the submission of the tax return. In contrast, countries like South Africa require written approval from the tax authorities or the stock exchange before favourable tax benefits can be enjoyed by the REIT (Simontacchi & Stoschek, 2019).

The above requirements limit managerial discretion on the use of cashflow and reduce information asymmetry which further reduces the investment risk and increases transparency compared to non-REIT companies (Gogineni et al., 2021).

2.3.6 *Tax issues encountered by Other REIT jurisdictions.*

Different tax regimes for REITs worldwide are diverse, complex, and variable, with many fixed dates, terms, and timelines. These timelines and conditions need to be observed by each taxpayer to avoid penalties and to take advantage of tax relief or exemptions (PWC, 2022a). Tax issues are encountered year on year by real estate companies which threaten the REIT's tax relief, ranging from the corporate tax related issues, withholding taxes, dividends and capital gains tax payment, VAT, and other tax treaty problems (Cassanos et al., 2020).

Tax issues were encountered by some of the REITs around the world during the Covid-19 pandemic, which threatened the REIT status when the minimum requirements were not met. Below are some of the issues that were encountered by some of the countries during the pandemic:

<u>The income test:</u> The required minimum income from the rental of immovable property is usually at least 75% of the income, and the minimum distribution from that rental income ranges from 70% to 100%, depending on the country's tax reforms. The required income from the rental of immovable property was not attained due to struggles caused by the financial distress that came with the Covid 19 Pandemic; tenants were not able to keep up with their rental obligations, leases were cancelled, and lease concessions were made with tenants which, in most instances, was not classified as qualifying income. Any lease amendment could have easily resulted in qualifying income being classified as non-qualifying income (Cassanos et al., 2020).

<u>The assets test:</u> REITs are usually required to hold at least a certain percentage of immovable assets, with the loss of value experienced on REIT assets due to the Covid 19 Pandemic; if the REIT acquired other types of assets that were not immovable, the loss of value on immovable assets could easily result in the asset test not being met. This could also be coupled with the balance sheet value increasing due to deferred lease payments (Cassanos et al., 2020).

<u>Satisfying the distribution requirement:</u>

The trade-off for REITs to be allowed to deduct their dividends is the general requirement to annually distribute a certain percentage of their net taxable income (ranging from 70% to 100% globally, depending on each jurisdiction's requirement). During the difficult times that REITs encountered during the Covid–19 pandemic, some companies were not able to make distributions, and the most important thing was to conserve cash, so the distribution requirements became more burdensome than the corporate income tax that would have been due if the company was not a REIT. Other REIT associations, such as the NAREIT, requested the US government to reduce cash limitation rules with regard to distributions in 2020 and 2021 as a relief measure for their REITs distribution requirements (Cassanos et al., 2020).

Some REITs found themselves engaging in unusual transactions with uncertain tax consequences, which might have resulted in the REIT losing out on the favourable tax benefits of a REIT. The saving provisions in the US allow a REIT to save its status by paying a penalty tax if it proves that it acted with reasonable cause and not negligence (Cassanos et al., 2020). The JSE also permitted the SA-REITs to extend their distribution period from four months after the year end to six months in 2021 which enabled the REITs to resolve any cash constraints they could have encountered as a result of the Covid 19 pandemic (JSE Limited, 2020).

2.4 Conclusion of Literature Review

Globally, REITs have progressed significantly since their introduction in the US in 1960, with over 40 countries and regions adopting the REIT framework as part of their economic development strategy. The OECD noticed the growth of the REIT regime among different countries and updated the Model Tax Convention in 2008 to address certain inconsistencies arising from the global transactions relating to REITs to resolve double taxation issues that arise (Ungerer, 2013).

Tax legislation issues affecting REITs continue to advance across the different REIT markets, especially in less developed states where a REIT regime is in place but in some countries, it has not proven to be favourable enough to enable other property companies to convert to a REIT (Ernst & Young, 2018).

With increasing international transactions and the cross-border flow of capital, more cross-border investments will likely be made in REITs and by other foreign REITs, despite the insufficient attention dedicated to the tax literature analysing investments in REITs, as well as investment made by REITs with regards to tax treaties (Simontacchi & Stoschek, 2019).

2.4.1 *Tax elements that underpin the SA REIT Regime:*

Section 25BB of the Act brought the following key tax elements to the REIT industry:

- Distributions by a REIT were reclassified as taxable dividends for resident investors while dividends paid to foreign investors remained exempt from income tax in the foreign investor's hands; however, those distributions to foreign investors attract dividends tax.
- REITs are allowed a deduction of the qualifying distribution, which aligns with the conduit principle for REITs.
- No capital allowances deduction on the immovable property is allowed.
- The REIT is not subject to capital gains tax on the sale of immovable property (Ungerer, 2013).

Chapter three looks at the vital tax elements that underpin the South African REIT industry, which according to Ungerer (2013), were taken from the UK and the US based on the individuals who participated in developing the SA-REIT regime.

2.4.2 *Tax challenges faced by SA REITs on the application of the tax laws:*

It was highlighted in the 2019 Budget Speech that further amendments were required to the SA REIT regime to cater for issues that SA REITs currently face on the application of the tax laws and regulations as well as to ensure the same tax advantages for the unlisted property companies (CDH, 2019a). Most elements of the SA REIT regulations were concluded when section 25BB of the Income Tax Act was enacted in 2013; however, a handful of outstanding matters still require consideration to enhance the attractiveness of the SA REIT regime (de Klerk, 2019). Chapter four focuses on the current tax challenges SA REITs face in applying the REIT laws and regulations and propose solutions accordingly.

CHAPTER 3. Key tax design elements that underpin the SA REIT industry

This chapter examines the critical tax design elements underpinning the SA REIT regime. It provides a detailed understanding of how the SA REIT framework was modelled and highlights the respective jurisdictions from which parts of the SA REIT framework were established. A detailed comparison of the tax elements from the US, the UK, and South Africa is provided in this chapter.

Introduction

Special dispensations for REIT regimes and frameworks depend on the REIT's jurisdiction. REIT regimes are constantly changing around the globe as a responsive measure to the constantly fluctuating market environments and are consistently progressing (Mazurczak, 2011). According to Ungerer (2013), South Africa borrowed its REIT regime from the US and the UK as the National Treasury engaged with the key role players from the US and the UK REIT associations on the development of the SA REIT regime. The SA REIT Association is modelled according to the NAREIT in the US and the EPRA in Europe, according to Kantilal (2016) and PWC (2021). The idea of a REIT is not meant to be the same among the different jurisdictions; however, it should be based on similar broad principles. While there could be differences among the jurisdictions, the broad idea stays the same (Mazurczak, 2011).

3.1 US REIT Legislation

Bredell and Boshoff (2013) listed the United States as one of the leading countries of the REIT structure as they established the REIT framework in the 1960s. They are recognised as leaders with regard to REIT thinking, and much can be learned from them (Rampersad, 2010). The US REIT industry has a solid foundation of tax laws that work efficiently and has been identified as the only matured REIT regime in the world with over 200 listed REITs (Ernst & Young, 2018). Most countries adopt the US REIT model with a few modifications. The

US regime is the oldest and most successful REIT structure, making it an appropriate base for confirming that a country's REIT regime is internationally competitive (Mazurczak, 2011).

The US has the following classifications for its REITs:

- Equity REITs own and manage income-generating real estate assets, including buildings and storage centres.
- Mortgage REITs - loan money to real estate owners and their managers or via loan purchase and mortgage-backed securities.
- Hybrid REITs own real estate assets and lend money to owners and operators (Mazurczak, 2011).

The US REIT market is twice the size of all the other global REITs combined with a total market capitalisation of $1.7 trillion in 2021 compared to the global equity market capitalisation for listed REITs of $2.5 trillion (NAREIT, 2022; Statista, 2023).

The US REIT received a significant helping hand from the inclusion of REITs in the Standard and Poor global REIT index. The unswerving out-performance by US REITs on major targets has also encouraged the growth of the US REITs. The US has another type of REIT called UPREIT which does not own properties directly but instead owns shares of the underlying properties in a partnership (Bredell & Boshoff, 2013).

3.2 UK REIT Legislation

The United Kingdom contributes significantly to the world economy, though it only introduced its REIT regime in 2007. The UK government aimed to introduce a regime where investors are taxed as if they have direct ownership of the properties. This differs from prior treatment, where the REIT was liable for corporate taxes and the shareholders for tax on dividends received (Ungerer, 2013). Much can be learned from their latest regime instead of learning only from the old regimes such as the US or Australia (Bredell & Boshoff, 2013). The UK regime continued to evolve with amendments that made it more attractive to investors and other capital providers; the latest amendment was enacted on 1 April 2022 (Deloitte, 2022). The recent announcement of corporate tax rate increases from 19% to 25% has created a renewed buzz in the UK REIT industry, as many investors could benefit from the 20% effective tax rate if they have tax treaty rates or exemptions (PWC, 2022). Entry to the REIT regime is now cheaper as the entry charge has been abolished, and institutional investors now own substantial shareholdings in a REIT without any breaches to the held/not 'close' test (PWC, 2022).

The Ernst and Young Global REIT market report 2018 indicated that the UK is one of the well-established REIT regimes and currently holds 4.85% of market capitalisation on the global REIT index, with 53 listed REITs. Total market capitalisation is roughly €76 billion as of December 2021 (EPRA, 2022).

3.3 Comparison of the SA-REIT Regime to the US and the UK REIT Regimes

Regulatory Aspects	United States	United Kingdom	South Africa
Legal Form	- Company, trust or partnership taxable as domestic company (EPRA, 2022). - No listing requirement (KPMG, 2013) - Governed by one or more trustees or directors (Internal Revenue Code, 2011).	- Must be a company with tax residence in the UK (Corporation tax act, 2010:693). - Is not a close company – must not be controlled by five or fewer participators or it can be a close company if it has one or more institutional investors as participator (Deloitte, 2022). - Management may be internal or external (EPRA, 2022) . - Single class of ordinary shares: only ordinary shares or non-participating preference shares (Macfarlanes, 2022). - No entry charge (EPRA, 2022)	- Corporation or collective investment scheme in property (trust REIT) (SARS, 2022:6). - REIT shares have to be registered on a stock exchange (SARS, 2022:6). - Managed internally or externally (EPRA, 2022). - No conversion/ entry charge (National Treasury, 2007).
Capital requirements	No minimum share capital requirement (Simontacchi & Stoschek, 2019).	No Specific capital requirement (PWC, 2021), but if the listing requirements apply, share capital of GBP 50 000 ("Market capitalisation of GBP 30 million if registered in the UK	At least R300 million worth of property assets (JSE Limited, 2013:218).

		on London Stock Exchange") (EPRA, 2022). Not be party to a non-commercial loan or profit linked loan (KPMG, 2013)	
Shareholding requirements	- Minimum of 100 shareholders (Internal Revenue Code, 2011:1762). - Few persons or organisations may not own over 50% of the shares (Oh and Verstein, 2023:10). - No restrictions on foreign investors (EPRA, 2022).	- Possible penalties if one corporate investor owns more than 10% of the shares (KPMG, 2013). - Listed company will not be a close company if minimum of 35% of the REIT shares owned by the public (Deloitte, 2022) . - No restrictions on foreign shareholders (EPRA, 2022).	No shareholder requirement (EPRA, 2022).
Listing requirements	No listing requirements (KPMG, 2013).	- Have to be registered to be trading on a recognised stock exchange, and either registered on a stock exchange" or trading on a stock exchange in each accounting period except the first three accounting periods (Deloitte, 2022); or - If more than 70% of the ordinary share capital is owned by institutional investors (Corporation tax act, 2010:693).	The REIT must be listed on any approved SA exchange (The JSE, A2X, CTSE & EESE) (SARS, 2022:6).

Asset/income/financing/Activity test	- Quarterly, at least 75% of the assets have to be real estate assets, government securities, or cash (Oh & Verstein, 2023:9). - Securities of taxable REIT subsidiaries cannot be more than 20% of the REIT's total assets value (PWC, 2021). - Annually, a minimum of 75% of gross earnings have to be acquired from real estate rental or interest on mortgages on real estate, gain on disposal of real estate property (PWC, 2021). - Annually, a minimum of 95% of gross income must be from sources including those qualifying for 75% income test above, other interest & dividend income and gains on securities (PWC, 2021). - REIT may not have more than 5% of its total assets characterised by securities any issuer who is not an alternative REIT (EPRA, 2022). - Securities of any issuer other than another REIT cannot represent more than 10% of the shares (EPRA, 2022). - They are permitted to invest in non-US real estate assets (KPMG, 2013).	- Property rental business must comprise at least three properties (Macfarlanes, 2022). - A minimum of 75% of a REIT's net profit have to be earned from the property rental business (Corporation tax act, 2010:702). - At least 75% of the total value of REIT’s assets must be from the property rental business and cash or cash equivalent or the UK REIT shares (Corporation tax act, 2010:703). - One property asset may not exceed 40% of the total value of assets (Corporation tax act, 2010:699). - The REIT can invest in other countries outside the UK in real estate (EPRA, 2022). - Owner-occupied properties are excluded from the property rental (KPMG, 2013).	Rental income includes sums from (SARS, 2022:17): - Use of real estate property plus penalties or gains resulting from late payment of the rental. - Qualifying distributions from the controlled company. - Dividends from a property company (Local &Foreign). - Exchange gains from foreign exchange contracts result from an exchange item. Rental income excludes (EPRA, 2022): - Asset management fees, deal fees, underwriting fees, interest received, and distribution from non-property companies. To a property company, 80% of the company assets must be attributable to immovable property (SARS, 2022:18).

Leverage	No legal restrictions, but tax authorities may impose a limit on an amount (EPRA, 2022).	REITs must maintain a profit to finance cost ration of at least 1.25:1 otherwise a penalty might result (Deloitte, 2022).	- Debt must be limited to 60% of the gross value of the REIT's assets (SAREIT, 2013).
Profit distribution requirements	- At least 90% of the REIT's taxable income must be distributed for the tax year within 12 months following the close of taxable year (Internal Revenue Code, 2011:1782). - The undistributed amount will be taxed at 21% (KPMG, 2013). - No requirement to distribute capital gains (EPRA, 2022). - The REIT may deduct distributions paid to shareholders (Internal Revenue Code, 2011).	- 90% of tax-property rental profits must be distributed (Gogineni et al., 2021:29). - If a REIT invests in another REIT, 100% of property income distribution received from that other REIT have to be dispersed (EPRA, 2022). - No distribution is required from capital gains resulting from the sale of real estate property or shares in a UK property company (EPRA, 2022). - Distributions must be made within 12 months after year end (PWC, 2022) .	- At least 75% of its income from rental income, investing income from indirect ownership of property have to be dispersed to shareholders (EPRA, 2022). - Distributions have to be made annually within four months after year end (SARS, 2022).
Sanctions: penalties/loss of status rules	- 4% excise tax on failure to distribute 85% of ordinary income and 95% of its net capital gain within the tax year (PWC, 2021). - 100% penalty on net income derived from prohibited transaction by a REIT (Internal Revenue Code, 2011:1784). - Possible loss of REIT status on intentional disregard (Internal Revenue Code, 2011:1788).	- Penalties or loss of REIT status if specific requirements are breached. - A tax charge of 19% applies on failure to make the required distributions (Corporation tax act, 2010:736). - A 20% tax charge applies if property income distribution is paid to corporate investors who owns more than 10% of	- Penalties or loss of REIT status for non-compliance with any REIT applicable legislation (JSE Limited, 2013:218).

		the stocks in the UK REIT (EPRA, 2022).	
Tax treatment at the REIT level:			
Current income	- Distributions are tax-exempt to the extent distributed (EPRA, 2022); undistributed income will be taxed (KPMG, 2013). - Dependent on the US alternative minimum tax (KPMG, 2013). - Net income from inventory sales or property held for sale in the ordinary course of business will be taxed (KPMG, 2013). - Tax on non-arm's length transactions in dealing with the REIT subsidiaries may arise (EPRA, 2022).	- Earnings from property rental business is exempted from corporate taxation (Corporation tax act, 2010:707). - Remaining business income is taxed at the existing corporate tax rate of 25% (PWC, 2022). - Cannot offset profits or losses from property rental business against those of residual activities (Corporation tax act, 2010:713).	- Tax on dividend income from other financial instruments (EPRA, 2022). - Deduction for qualifying distributions paid to shareholders (The Income Tax Act, 2023). - The residual taxable income is subject to tax at 27% (SARS, 2022). - They are not allowed to claim building tax allowances (Coetzee, 2019).
Capital gains	- Tax exempt to the extent distributed (EPRA, 2022).	- Gains realised on disposal of immovable property assets that was exclusively used for the property rental business are not taxed (Corporation tax act, 2010:708). - REITs are exempted from corporation tax on the sale of stocks in a UK property rich company (Deloitte, 2022).	- REITs are not taxed capital gains tax on the sale of immovable property assets (EPRA, 2022).
Building allowances deduction	- Allowed depreciation claim in determination of their taxable income (Barrus & Munuhe, 2018).	- No allowance for depreciation is made to offset against taxable income (Baum & Devaney, 2008).	- May not deduct building allowance relating to the immovable property (Coetzee, 2019:13).

Withholding tax	- No withholding tax on distribution to US investors (KPMG, 2013). - No refund of foreign withholding tax; and - Foreign taxes can be deducted (EPRA, 2022).	- No withholding tax is charged on the dividends paid out of remaining business income (EPRA, 2022). - Property Income Distributions are subject to 20% withholding taxes for non-corporate recipients (Pinsent Masons, 2023). - Payments can be made gross to UK corporates, pension funds and charities (PWC, 2021).	- No withholding taxes on dividends received by SA REIT from another SA REIT or controlled company (SARS, 2022).
Other taxes	REITs are subject to all other federal income taxes, such as franchise taxes (EPRA, 2022).	- All other taxes apply to UK REITs as they do to other ordinary companies (EPRA, 2022).	- No securities transfer tax on the transfer of a share in a REIT, but it may be applicable on the transfer of shares in a controlled company. - All other taxes are applicable the same way as ordinary companies (EPRA, 2022).
Transition regulations	- Accumulated gains are taxable (EPRA, 2022). - An exemption is likely if assets are retained for over five years (EPRA, 2022). - Accumulated profits before conversion to REIT must be distributed to shareholders within the first year of becoming a REIT (KPMG, 2013).	- No conversion charges; - New accounting period at conversion to REIT (Corporation tax act, 2010:712).	- No conversion charge (National Treasury, 2007)& (EPRA, 2022).

Registration duties	- Transfer tax on acquisition of real estate or controlling interest in a real estate entity (EPRA, 2022).	- N/A	- N/A
Tax treatment at the Investor level			
Domestic Investors:			
Corporate Investor	Earnings, capital gains, and return of capital distributions are subject to tax at 21% (EPRA, 2022).	- Dividends paid out of property rental earnings are regarded as rental profits and taxed at the current corporate tax rate of 19% (Pinsent Masons, 2023). - Distributions from other business profits could be exempt (EPRA, 2022). - Capital gains on the sale of UK REIT stocks are subject to normal capital gains requirements (Pinsent Masons, 2023).	- Distributions are taxed at 27% (SARS, 2022). - Taxation of non-immovable property capital gains on disposal, 80% of those are part of taxable income resulting in the effective tax rate of 21.6% (EPRA, 2022). - Shareholders that are trusts are taxed at 45% (The Income Tax Act, 2023). - Institutional investors such as pension funds are exempt from tax and will not be taxed on dividends received (PWC, 2021).
Individual shareholder	- Capital gain dividends are subject to tax at a maximum of 23.8%. - Return of capital tax is postponed. - 20% deduction on ordinary REIT dividends (EPRA, 2022).	- 20% tax on property income distributions as withholding tax (Pinsent Masons, 2023). - Additional tax is paid by higher rate taxpayers via their annual returns (KPMG, 2013).	- Distributions received by individuals are subject to tax at a marginal tax rate ranging from 18% to 45%. - Capital gains derived by individuals on the disposal of REIT shares result in only

		- Capital gains tax on disposal of REIT shares(EPRA, 2022).	40% inclusion on taxable earnings resulting in an effective rate ranging from 7.2% to 18%(EPRA, 2022).
Withholding tax	- No withholding tax on distributions made to domestic shareholders (KPMG, 2013).	- Withholding tax is deducted at 20% on property income distributions for individual shareholders (Macfarlanes, 2022). - Withholding tax exemption applies to distributions made to corporate recipients (EPRA, 2022).	- Dividends withholding tax is not applicable as the REIT distributions to resident taxpayers are subject to income tax (SARS, 2022:5). - However, distributions to non-resident shareholders do attract a 20% dividends tax but which may be reduced under an applicable DTA (EPRA, 2022).
Non-resident investors			
- Corporate investors	- 30% withholding tax on income dividends unless a lower treaty rate is applied. - REIT capital gains distributions at 21%. - Return of capital taxed at 10% of the distributions made (EPRA, 2022).	- 20% withholding tax for property income distributions (Macfarlanes, 2022). - The sale of shares in UK REITs are taxed on capital gains in the UK subject to the terms of DTA (EPRA, 2022).	- Distributions are subject to dividends tax at 20% unless reduced by a double tax agreement. - Taxation of capital gains on disposal, 80% of gains are added to the taxable income resulting in a 21.6% effective rate if the unitholder holds more than 20% of the shares in a REIT

			for a property-rich type of REIT (EPRA, 2022).
- Individual shareholders	- Dividends income is taxed at 30% - Capital gain distributions are taxed at 21% - Return of capital is taxed at 10% (EPRA, 2022).	- 20% withholding tax for property income distributions (Macfarlanes, 2022). - The sale shares in UK REITs are taxed capital gains tax in the UK subject to the terms of DTA (EPRA, 2022).	- Distributions are subject to tax at a marginal tax rate of 18% to 45% (The Income Tax Act, 2023). - Capital gains only 40% of them are taxed, bringing about an effective rate of 7.2% to 18% (EPRA, 2022).
- Withholding tax	Tax treaty relief is available (SARS, 1997) & (EPRA, 2022).	- Tax treaty relief can be obtainable if claimed subsequent to the receipts (KPMG, 2013). - A refund of withholding tax may be obtainable under a double tax agreement (HMSO, 2010).	- Dividend withholding tax at 20%, depending on the tax treaty. - Withholding tax is charged on non-resident sellers of immovable property at 7.5% for individuals and 10% for corporations (EPRA, 2022).
Foreign REIT investing in US/UK/SA Property	- Generally, 30% withholding tax (EPRA, 2022).	- Taxed under normal tax rules (EPRA, 2022).	- Taxed on income from SA source or income from SA permanent establishment or immovable property (EPRA, 2022).

Table 1.2: Compiled by author - Main sources: (Internal Revenue Code, 2011:1762); (Corporation tax act, 2010: part 12); (SARS, 2022) & (The Income Tax Act, 2023).

The following analysis can be drawn from the above regimes:

- South Africa adopted the legal form, capital requirements, listing requirements, and leverage requirements partly from the UK REIT regime. Though the UK's leverage is ratio based, the SA regime leverage limit for their REITs is a maximum of 60% of gross asset value equivalent debt, which was meant to protect investors (SAREIT, 2013).
- The income and asset activity test principles were adopted from the UK REIT regime at a 75% rental income requirement which allows the SA REITs a 25% diversification income allowance. SA REIT regime requires that 80% of the company assets be attributable to immovable assets for a property company.
- The distribution requirements were adopted from the US REIT regime with a slightly lower percentage of 75% compared to the 90% requirements in the US and the UK REIT. The US regime allows the REITs to deduct the distributions made to their shareholders, which is similar to what SA REIT has adopted on the SA REIT regime as well, while the UK exempts the rental income from corporate tax.
- The US allows their REITs to deduct a depreciation tax allowance in the determination of their taxable income, while the SA and UK REIT regime does not allow building allowance deductions for their REITs.
- The tax treatment at the REIT and shareholder levels for resident and non-resident shareholders was aligned with the usual tax regulations applicable to each of these jurisdictions.
- The SA REIT regime applied the no conversion fees principle, which is similar to the UK's updated regulations to encourage property companies to convert to the REIT structure and enjoy the special tax dispensations available to the SAREITs.
- SA REITs have up to four months after the year end to make the distributions to a shareholder, which is less time compared to the UK and the US's time period allowed to make distributions to shareholders within twelve months after year end; the twelve months' time period allows the

REITs sufficient time to find cash for distribution to its shareholders compared to the SA REIT's time period.

CHAPTER 4. Tax Challenges with SA REIT Regime

This chapter looks at the tax challenges faced by South African REITs in the implementation of the SA REIT tax laws and regulations. We examine the challenges with the regime itself to understand the challenges that could lead to the regime being less attractive compared to other regimes, instances of exposure to double taxation, instances of uncertainties that could expose the REITs to penalties and other tax leakages, as well as instances where the tax laws make it difficult for the REITs to comply, as a result of the nature of a REIT. We look at challenges arising from the Income Tax Act, the VAT Act, tax administration issues, as well as tax treaty issues affecting REITs and propose amendments to be made to the legislation where possible.

4.1 Introduction

As indicated by de Klerk (2019), there are still more outstanding matters to address in the SA REIT regime. Since 2013, the property industry has advanced, and numerous technical matters have resulted from applying the Income Tax Act, including issues relating to the sector increasing its global presence. Various submissions have been made by the SA REIT association to the National Treasury relating to section 25BB of the Act. Some of the challenges that require attention includes the issues discussed below.

4.2 Challenges relating to the Income Tax Act

4.2.1 *Effects of the Foreign Business Establishment Definition*

Section 25BB of the Act requires that when determining qualifying distributions of a REIT, an amount incorporated in the income of a REIT or controlled company under section 9D(2) of the Act must not be considered for the purpose of applying the 75% of gross income requirement (SARS, 2022).

Section 9D of the Act provides for the inclusion of the net income of controlled foreign companies to a South African shareholder with a minimum level of voting or participation rights in the controlled foreign company unless that controlled foreign company meets the definition of a foreign business establishment (FBE).

Section 9D of the Act sets out the following requirements for FBE:

> ''Foreign business establishment, in relation to a controlled foreign company, means –
> *(a)* a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where –
>
> (i) that business is conducted through one or more offices, shops, factories, warehouses, or other structures;
>
> (ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct primary operations of that business;
>
> (iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;
>
> (iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and
>
> (v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:
>
> Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in sub-paragraph (i), employees as contemplated in sub-paragraph (ii), equipment as contemplated in sub-paragraph (iii), and facilities as contemplated in sub-paragraph (iv) of any other company –
> *(aa)* if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management, or other criteria of a similar nature;
> *(bb)* if that other company forms part of the same group of companies as the controlled foreign company; and
>
> *(cc)* to the extent that the structures, employees, equipment, and facilities are located in the same country as the fixed place of business of the controlled foreign company''.

The definition of FBE has been in place since 2000 when section 9D of the Act was introduced (Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd (1269/2021), 2023). As seen in the Coronation case, the definition fails to consider modern ways of doing business. The FBE requirements set out above in relation to property investments were based on an in-house asset management model, which has since changed as the majority of REITs and other property-owning companies outsource the asset management activities to third parties, which results in the property-owning company not having any employees but only the property owned. Most of these properties would be owned by special purpose vehicle companies, which would then be subsidiaries of the REIT or any property company (Modise, 2018).

Para (a)(ii) of the FBE definition is an issue in that most of the REITs controlled foreign companies will not meet the FBE definition if they are externally managed regardless of those entities having active rental operations (the material substance in the form of an actual property structure) which results in unintended implications for the REIT.

Most of these CFCs are located in a non-tax haven state which shows that the intention of the establishment was not to avoid tax liability. If the foreign property investment company does not meet the definition of FBE, it will result in attribution and inclusion of the rental income generated by the foreign property company in the REIT's gross income, which is excluded from the rental income definition for qualifying distributions purposes, which might expose the REIT to a failure in meeting the 75% rental income test (SAREIT, 2017).

This results in the imputation of the rental income being taxed in the hands of the SA REIT or controlled company, which is not in line with the intended flow-through of income intended for REITs (section 9D of the Act). This way, the SA REITs are not able to compete with the UK and US REIT investments.

Proposed solution:

The definition of FBE should preferably be expanded to include the position for immovable properties held by CFCs of a REIT, just as those entities that have been catered for in para (e), (f), and (g) of the FBE definition. As required by the Act, REITs will distribute their profits annually through their chain of companies to their investors, which will then be taxed in the investor's hands, which proves to the authorities that the requested amendment to section 9D will not result in abuse of the Act (SAREIT, 2017).

4.2.2 *Impact of building insurance claims and payouts on rental income requirement for REITs.*

During the month of July 2021, the South African real estate sector experienced severe property damages due to protests and vandalism in Kwa-ZuluNatal and Gauteng after the former president handed himself in to start his 15 months jail term for contempt of court. The estimated cost of property damage and loss of income was R558 million, and claims were submitted to SASRIA and approved accordingly for both the loss of income as well as the replacement of the damaged property (Staff, 2021).

The REITs that claimed for the destruction of properties and the loss of income would have to classify the received income accordingly, of which the amounts received for compensation for the destruction of property would be used to repair or replace the damaged property. However, the amounts received as compensation for loss of income are an issue in that they do not meet the definition of rental income, as stated in section 25BB of the Act. Rental income includes amounts stated in para (b)(i) as "*amounts received or accrued with respect to the use of immovable property, including a penalty or interest on late payment of such amount*."

If the compensation for loss of income is not regarded as rental income, the most affected REITs may have struggled to pay a tax-deductible qualifying distribution as this compensation might have resulted in the 75% rental income test not being met which will mean the REIT would not enjoy the REIT tax dispensation and possible loss of REIT status might have been a concern as a result.

Proposed solution:

Amounts received as compensation for the destruction of immovable property should fall within the exclusions listed in section 25BB(5)(a), which includes the capital gains resulting from the sale of immovable property.

With regards to the compensation for loss of income, the rental income definition, specifically para (b)(i), should be expanded to include amounts received as compensation for loss of income to cater to REITs. South Africa is always experiencing strikes and riot issues; therefore, it is necessary to outline these changes for future purposes as well.

4.2.3 *Consequences of taxable income position*

A REIT and a controlled company are allowed a deduction, subject to several limitations, for distributions made to its shareholders in terms of section 25BB of the Act. South African resident investors are taxed normal tax on the distributions received from a REIT or controlled company since proviso (aa) of section 10(1)(k)(i) excludes a dividend received from a REIT from the dividend exemption on income tax. If a REIT is in a taxable income position and it incurs a tax liability, the income will be double taxed on any subsequent distribution from the REIT to its investors, which clogs the flow-through principle of REIT taxation (Ungerer, 2013). Gogineni et al. (2021) added that the corporate tax on the remaining undistributed income of a REIT results in the transfer of wealth from shareholders to the government, twice in the scenario described above. Currently, the way the Act reads, regardless of whether the amount received by the shareholder has been subject to tax in the hands of the REIT, the recipient will still be subject to tax as well.

Proposed solution:

Proviso *(aa)* to dividend exemption in section 10(1)(k)(i) should be amended to exclude dividends paid from amounts that were already subject to tax. In this way, shareholders will receive exemption from income tax on dividends received from a REIT that was previously subject to income tax initially in the REIT’s hands (Ungerer, 2013).

4.2.4 *Capital gains are distributed by a controlled company.*

Section 25BB(5)(a) of the Act excludes from the determination of capital gains or losses of a REIT any capital gains or loss relating to the disposal of immovable property of a REIT or controlled company (SARS, 2022). An issue arises when a controlled company sells a property that is capital gains tax exempt in line with section 25BB(5)(a), then distributes the proceeds to the parent company with the purpose of settling debt or making new investments in property in the parent's own name. That distribution will be taxed at the hands of the receiving company because the parent company would not have distributed the amount as it is aimed at debt repayment or re-investment, despite the source of the dividend being an amount exempt from taxation. It should be noted that this amount would have been part of rental income and deductible had it been distributed to shareholders by the parent company.

Proposed solution:

The Act should be amended (proviso (aa) to section 10(1)(k)(i)) to provide an exemption from tax of amounts that have been previously taxed with source from disregarded capital gains resulting from the disposal of immovable property.

4.2.5 *Unbundling and liquidation distributions on REIT group structures.*

Inconstancies regarding the application of the SA REIT regime and the corporate restructure rules in the Act were highlighted in Annexure C of the 2019 Budget Speech (National Treasury, 2019). These have been found to be exposing SA REITs to double taxation, according to CDH (2019a). REITs are generally precluded from claiming capital allowances on the immovable property, which used to cause an issue when a REIT engaged in a corporate restructure since their assets were not eligible to be classified as an allowance asset. This meant that the corporate restructuring rules were not applicable to REITs (National Treasury, 2019). To ensure that rollover relief is available to REITs and controlled companies, the requirement to acquire allowance assets was relaxed for REITs and controlled companies, which means now they are able to purchase an allowance asset as a capital asset or allowance asset (SARS, 2022).

Despite these welcomed amendments, the problem is with regard to tax consequences relating to amalgamations, unbundling, and liquidation transactions (sections 46 and 47 of the Act) (CDH, 2019a).

It is usual practice for a REIT to hold a multi-level group structure as a result of the various properties companies they acquire. Both internationally and locally, REITs have been characterised by increased consolidation through merger or buyout transactions (National Treasury, 2007). REITs find it difficult to simplify a complex group structure as they do not benefit from the rollover relief provided in the above sections of the Act (SAREIT, 2017).

A normal scenario is where a REIT bought a property company that has been subject to tax before, with non-distributable reserves or retained earnings. Normally the REIT would want to transfer the properties into a single company for ease of administration which would then leave that property company with only loans or equity reserves. To liquidate this company, the REIT would have to declare a dividend from those equity reserves which have already been subject to tax. This cannot be done without attracting other income tax consequences (CDH, 2019a).

Unbundling transactions:

Any dividend *in specie* received from a REIT or controlled company is subject to tax as a result of section 46(6A), specifically excluding REITs or controlled companies from obtaining the rollover relief under section 46 of the Act (SAREIT, 2017).

Liquidation transactions:

Liquidation distributions made by a REIT or controlled company will constitute a dividend which must be included in the shareholder's gross income and will be subject to tax as the dividend exemption is not applicable on distributions made by a REIT or controlled company in terms of proviso (aa) of section 10(1)(k)(i)

(CDH, 2019a). The other issue is that liquidation dividends received by a REIT from its property companies will not qualify as rental income, which might affect the 75% rental income test (Ungerer, 2013).

The above issues also result in REIT or controlled company shareholders being taxed on a dividend received from profits that were already subject to tax at 27%, which clogs the flow through principles of a REIT (CDH, 2019a).

Proposed solutions

The tax authorities should consider amending section 10(1)(k)(i) proviso (aa) to exclude distributions made pursuant to the application of sections 46 and 47 of the Act. This will eliminate the double taxation issue as shareholders will not be taxed on amounts that were previously subject to tax, as currently is the case. In addition, it will assist REITs in restructuring their corporate affairs for commercial purposes without triggering unintended negative tax consequences (SAREIT, 2017).

4.2.6 *Unrealised gains on foreign currency hedges (section 24I)*

South Africa's stagnating economy and the understanding of investment diversification benefits have led many South African REITs to invest in real estate in other countries, which results in the need to enter into foreign exchange contracts to hedge against fluctuations of the South African Rand (CDH, 2019a). Foreign exchange rate movements have an impact on the REITs industry. Due to the uncertainty regarding the impact of government policies on the value of the currency relative to the trading partners, it makes sense that REITs and the currency markets will have high exposure, hence the need to hedge against foreign exchange movements (Raheem et al., 2022).

The definition of rental income per section 25BB of the Act initially excluded unrealised gains or losses for foreign exchange derivative contracts of a REIT even though those were incurred for hedging against currency exchange fluctuations on rental income (National Treasury, 2019). The 2019 tax law amendment bill resulted to the amendment of the rental income definition to include unrealised foreign exchange gains only and disregarded the unrealised foreign losses as those would reduce the qualifying distributions target of at least 75% of gross earnings to be from rental income (National Treasury, 2019).

The above change resulted in the unrealised foreign gain being taken into account on the REIT's taxable income in the year of assessment in which it arose, which assisted companies in meeting the 75% rental income requirement, especially REITs with significant amounts of foreign exchange gains (SARS, 2022).

The outbreak of the Covid-19 pandemic had a noteworthy impact on the foreign exchange market worldwide. Apart from the impact of the Covid-19 pandemic, the South African economy also suffered a Moody's credit rating downgrade of South Africa in 2020, which affected the Rand significantly which highlights the need for foreign exchange hedging for South African REITs with investments in other countries (KPMG, 2020b).

The issue therefore is, though the inclusion of unrealised foreign gains on rental income was helpful in meeting the 75% rental income test, an issue arises in that a REIT must include the unrealised gains in the determination of its taxable income while the cash event will only occur in future upon settlement. It is unlikely that the REIT will be able to make large qualifying distributions to reduce its taxable income to zero as qualifying distributions are generally limited to actual cash that the REIT has earned, which excludes the unrealised forex differences (KPMG, 2020b ; SAREIT, 2017). This creates a mismatch between the time at which the REIT must include the unrealised gains in its taxable income and the inclusion of the gains in qualifying distributions on settlement of the foreign exchange contract (SAREIT, 2017). When the foreign exchange contract is realised in the following year, the REIT may have surplus cash to distribute to its shareholders; however, that is not beneficial either, as the REIT cannot make qualifying distributions in excess of its taxable income as the qualifying distribution deduction must be limited to the taxable income of the REIT (SAREIT, 2017). This issue was highlighted as one of the issues for consideration in the

2019 Budget Review; however, no changes have been made to the legislation as yet (CDH, 2019a).

Refer to the diagram below for an illustration of the unrealised foreign exchange gains' timing difference:

Assuming that a REIT has 31 December, year-end, and enters into a forward exchange contract on 1 December FY1 to sell $100 at R/$ = 10. On 31 December, the exchange rate was R/$ = 9. The REIT settles the FEC in FY2 when the rate is R/$=8. The timeline is as follows:

FY1		**FY2**	
20X0	**20X1**	**20X2**	**End of FEC**
Sells for $100 @ R/$10	100 fx gain	100 fx gain	200 cash settlement of FEC

Tax implications are as follows:

REIT Tax computation	**FY1**	**FY2**
Taxable income	200	200
Foreign exchange difference (s24I)	100	100
Less: S25BB(2) qualifying distribution	(160)*	(300)**
Taxable income	140	0
Tax @27%	37.8	0

Table 1.3: compiled by the author – Source: SAREIT (2017).

*The REIT cannot distribute 300 in year one as the 100 from foreign exchange contracts has not been realised yet, and also, it cannot distribute the whole 200 as it needs some cash to pay for the tax liability arising from the 100 included in its taxable income.

**REIT would distribute 400 to its shareholders; however, it will not be beneficial as section 25BB of the Act limits the qualifying distributions deduction to the REIT's taxable income.

Proposed solution:

The definition of rental income should be amended to include foreign exchange gains on a REIT’s exchange item only when it is realised to allow the REIT to make the distributions to its shareholder in the same year of assessment as the year that those gains were included in its taxable income (SAREIT, 2017).

4.2.7 *Income from derivatives utilised by REITs.*

Section 25BB of the Act has been amended for the rental income definition and formula to include foreign exchange gains arising from the hedging of amounts included on the rental income formula in terms of section 24I. There are other derivatives employed by REITs in the process of diversifying their portfolio from other countries, such as cross currency interest rate swaps (CCIRS), which are important to the operations of REITs but are not catered for in the rental income definition section 25BB of the Act. Financial derivatives, including forward and future contracts, swaps, etc., are one of the most important tools to hedge against currency-associated risks for real estate investments (Bejol & Livingstone, 2018). REITs frequently enter into derivatives contracts to shield themselves from raising borrowing costs due to currency fluctuation, and it has been demonstrated that firm value increases with the usage of interest rate swaps which indicates the importance of REITs making use of CCIRS in their operations (Hu & Smith, 2018).

Cross-currency swaps take place where two parties simultaneously lend and borrow an equal amount of money in two different currencies for a particular period of time (Brophy et al., 2019). Interest received as part of these transactions would constitute gross income as defined by the Act; however, where the interest received exceeds 25% of the REIT's gross income, the risk arises that the REIT might not be able to make qualifying distributions in line with section 25BB(2)(a) of the Act exposing the REIT status to possibly being revoked as well, should the 75% rental income test not be met. As mentioned above, one of the requirements for being a REIT is that the company must not enter into derivative instruments that are not in the ordinary course of business; however, the CCIRS are part of the REIT's hedging strategy, which lies at the heart of any REITs that have offshore investments risk management policy which makes these derivatives part of the REIT's ordinary course of business (SAREIT, 2013; JSE Limited, 2013).

Proposed solution:

The rental income definition in section 25BB of the Act should be extended to include gross income arising from financial instruments entered in the normal course of business of a REIT, such as the CCIRS. This will help with preventing unintended outcomes which have the potential to threaten the REIT's status and the REIT's ability to utilise the special tax dispensation available to South African REITs.

4.2.8 *Definition of property company*

Section 25BB of the Act defines a property company as “a company:

> (a) in which 20 percent 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 percent or more of the value of the assets, reflected in the annual financial statements prepared in accordance with the Companies Act or IFRS, is directly or indirectly attributable to immovable property".

REITs are usually held within a group of companies which may pose a difficulty as they end up having to assess at each company whether 80% or more of the value of assets is attributable to the immovable property regardless of each entity being economically exposed to an investee company that holds the property. As indicated by the National Treasury (2007), REITs are characterised by increased consolidation from merger or buyout transactions, both locally and internationally, which explains the multi-level company structure.

According to SARS (2022), the test to confirm if 80% of the company assets are attributable to immovable property should be done at each company level, not consolidated financial statement level. The challenge, therefore, is that the 80% of assets attributable to the immovable property test might not be met at each company's financial statement level as each company's assets might include intercompany loans for companies with debt financing within the group. This issue would have been eliminated had the test been done at the consolidated financial statement level. The UK REIT regime allows for such tests to be done at consolidated financial statements level with adjustments for unusual transactions to avoid distortion of the company’s position (PWC, 2021).

Where the total value of a company's holding in its subsidiary is more than 20% attributable to debt instead of equity, that subsidiary will not meet the definition of a property company regardless of its indirect exposure to immovable property. Therefore, any dividend income from such a subsidiary will not qualify for inclusion as part of rental income defined in section 25BB, which might affect the REIT's 75% rental income test, threatening the REIT's status and the deductibility of qualifying distributions made to shareholders.

Proposed solution:

Section 25BB of the Act, together with Interpretation Note 97, should be amended to allow the property company test (80% of assets must be attributable to immovable property) to be done at the consolidated financial statement level to eliminate unintended consequences of intercompany debt finance.

4.2.9 *Unlisted vs. listed property companies.*

The South African REIT regime requires companies to be listed on an exchange to qualify for the special tax dispensation available to REITs which is also similar to REIT regimes of other jurisdictions, such as the UK, China, and Canada (EPRA, 2022). While the listing requirement is appropriate as the compliance requirements, it also serves as a strategy to ensure investor protection. The listing requirements can be very narrow, costly, and burdensome administratively, which discourages other companies from listing, and as a result, they cannot enjoy the tax benefits available to REITs (Ungerer, 2013). The 2019 budget review indicated that unlisted property companies should also qualify for the same tax dispensation available to listed REITs; however, the concern is whether this will not discourage listed REITs from listing if other companies can still enjoy the REIT tax benefits without being listed (CDH, 2019a). According to de Klerk (2019), the SA REIT has also been promoting to the National Treasury the need to extend the SA REIT tax benefits to unlisted property companies; however, there has been slow development in this regard.

When the REIT regime was introduced in South Africa in 2013, the requirement was that the property company must be listed with the JSE, which required compliance with the JSE listing requirements to remain a REIT (Ungerer, 2013; CDH, 2019a). New exchanges were introduced to South Africa in 2016, which eliminated the JSE monopoly, including A2X Markets (Pty) Ltd, Cape Town Stock Exchange, and Equity Express Securities Exchange (Pty) Ltd (EESE) (SARS, 2022). This has led to the amendment of the Act to allow entities to receive REIT status through these other exchanges instead of the JSE only. This amendment was intended to encourage other property companies wishing to list as a REIT but were previously unable to as they could not meet the JSE listing requirements and the listing fees. With more than one exchange available, companies now have flexibility when deciding on the exchange that best meets their needs and budget, and positively more companies can be listed as REITs and enjoy the special tax dispensation available to REITs (CDH, 2019a).

Even though the above amendment was made to boost growth in the REIT industry, not much movement has been seen on the number of property companies that are listed as REITs as a result which indicates that unlisted property companies will have to be accommodated through other means if South Africa wishes to see a growth in the country's REIT industry.

The UK REIT grants three years grace period after granting the REIT status to a company for it to be listed on a stock exchange, if after three years the company or group has not listed, it is considered to have left the REIT regime, which SA REIT regime should also consider to ensure growth of the REIT industry (PWC, 2021).

Proposed solution:

The Act should possibly be amended to allow property companies to select the application of a REIT status on submission of the annual returns, the same as the US REIT regime, instead of listing being the main requirement for being a REIT. This means the country could have both listed and unlisted REITs. Breetzke (2014) also recommended that the South African regime should learn from the Australian REITs model in this regard, where both listed and unlisted REITs benefit from tax dispensations available for REITs; in this way, the South African REIT industry would grow faster. The UK government is currently in consultation for potential relaxation of certain requirements and restriction on the UK REIT regime including the listing requirement, which the SA REIT should also consider (PWC, 2021).

Another option is to lower the capital requirement for the listing of REITs which will ensure that the majority of property companies meet the criteria and are listed on an exchange and enjoy the REIT tax benefits.

As indicated by the Minister of Finance, the FSCA regulations should be extended to include the regulation of the unlisted property companies that will take advantage of the REIT tax dispensation if the listing requirements are waived to ensure investor protection remains a priority (CDH, 2019a).

4.2.10 *Consequences of a company ceasing to be a REIT or controlled company*

When a company ceases to be a REIT or controlled company, its year end is considered to have ended the day preceding the date the company ceases to be a REIT or controlled company, and the following year of assessment commences on the day that the company ceases to be a REIT or controlled company. The company can still make deductible qualifying distributions to its shareholders provided that the declaration is made before the company ceases to be a REIT or controlled company (SARS, 2022).

Based on practical events that take place leading to the loss of a REIT status, it is almost impossible for the company to prepare its accounts until the end of that period as well as make the necessary provisional tax payments and then declare and pay a dividend from the profits earned during the REIT regime. Even if the company has the intention to make the declaration before ceasing to be a REIT, the administrative burden around losing the REIT status does not allow the company enough time to make such qualifying distributions.

For example, Fortress Real Estate Investment Trust Limited's REIT status was revoked by the JSE on 20 January 2023 after losing an appeal against the JSE's decision as a result of battling for months to win its shareholder's approval to collapse its dual-share structure and the last day of their REIT regime was 31 January 2023. Even if this company wanted to make qualifying distributions before 31 January 2023, it would have had to prepare accounts from the beginning of its year of assessment, which is 01 July 2022 until 31 January 2023, make the provisional tax payments, and then declare the dividends to its shareholders if they had the intention to make deductible qualifying distributions before ceasing to be a REIT. This would have been almost impossible to complete due to the timing, the solvency and liquidity tests they would have had to perform, obtaining board approval, finalising accounts, etc., before making the dividend declaration. A thorough assessment would have been necessary as the company lost its REIT status due to the non-payment of qualifying distributions to shareholders within four months after the 2022 year of assessment to begin with; hence time would have been appropriate to allow them to make such a decision (Java Capital Banking, 2023).

Proposed solution:

The SA REIT laws and regulations should be amended to allow a company ceasing to be a REIT or controlled company to declare deductible qualifying distributions to its shareholders within 12 months after its last year of assessment as a REIT. The distributions can still be declared and paid even if it has already ceased being a REIT as long as those distributions relate to gross income made during the REIT regime.

4.2.11 *Interest limitation impact on REITs*

Rules for interest deduction limits were introduced to the Act in section 23M in 2013 with the aim of ensuring that base erosion and profit shifting (BEPS) from South Africa is prevented. The main purpose of the section is to limit excessive interest deductions with regard to debts owed to a person not subject to South African tax if both the lender and the debtor have a controlling relationship (National Treasury, 2021).

A controlling relationship exists in a scenario where the lender/creditor owns more than 50% of the equity shares in the debtor. If section 23M applies, then interest deductions incurred on a loan from the creditor will be limited to 30% of the adjusted taxable income (CDH, 2021a). Under these amendments, interest deductions that were previously not subject to interest deduction limitation will probably be subject to the limitation rules, and REITs with multinational group companies will be impacted if there are intergroup loans with tax exempt creditors who have controlling relations with the South African debtor, the debtor's interest deduction will be limited accordingly. This could further require that the REIT distributes more cash to keep tax neutral if the interest deduction has been limited (KPMG, 2020).

It is more likely than not that the REIT's adjusted taxable income may be zero if it made sufficient qualifying distributions. The REIT's interest deduction will be limited to the interest it receives, if any, which will usually not be much as a REIT's main income comprises rental income, dividend income, and qualifying distributions from its controlled companies, which might result in no deduction at all for interest incurred by a REIT where section 23M is applicable. This might discourage the REIT from making use of intergroup borrowings that trigger the section 23M limitation (CDH, 2021a). Refer to the below example for the impact of section 23M on REITs.

The REIT made sufficient qualifying distributions which reduced the adjusted taxable income to R0; interest received for the year is R100; interest incurred on a section 23M affected loan is R200.

Under section 23M, interest deductions will be limited to R100 even though R200 was incurred. The R100 interest received will be taxed in the REIT's hands unless it is part of qualifying distributions made, where it will be subject to tax in the shareholder's hands (CDH, 2021a).

Proposed solution:

REITs should keep in mind the consequences of section 23M on their funding strategies and avoid making use of a debt from a creditor that is exempt from South African tax and has a controlling relationship with the South African debtor to avoid the negative consequences of the interest limitations imposed by section 23M (CDH, 2021a).

4.2.12 *Impact of change in the corporate tax rate for REITs*

The corporate income tax rate has been reduced from 28% to 27% for companies commencing in years of assessment beginning on or after 1 April 2022 (National Treasury, 2021). The change is aimed at benefiting all companies responsible for tax payments in South Africa together with their investors; however, this change may not be as beneficial for investors in REIT companies compared to investors in non-REIT companies. Gogineni et al. (2021) argues that dividends from REITs are generally taxed at a higher rate compared to dividends from a non-REIT. The initial intention of the introduction of the REIT regime was to ensure that REITs operate as a conduit whereby the net rental income flows to the ultimate investor, who will be responsible for the tax, not the REIT. Currently, there is a possibility that the change in the tax rate might negatively affect REIT investors, especially individuals taxed at marginal rates, compared to an instance where the dividend is the same as a non-REIT (KPMG, 2022). According to proviso (aa) of section 10(1)(k)(i) of the Act, individuals do not receive an exemption on a dividend received from a REIT; therefore, the full dividend received from a REIT is taxable in the individual's hands at marginal rates compared to a dividend received from a non-REIT which is taxed at 27% (income tax) in the company's hands and 20% dividend withholding tax on the investor's hands (KPMG, 2022).

Refer below for an illustration of how REIT investors get affected by the rate change.

	REIT	**Non-REIT (28%)**	**Non-REIT (27%)**
Taxable income before deduction	R100 000	R100 000	R100 000
Less qualifying distribution	(R100 000)	R0	R0
Taxable income	R0	R100 000	R100 000
Tax payable by the entity	R0	R28 000	R27 000
Dividends tax withheld at 20%	R0	R14 400	R14 600
Distribution to Investors	R100 000	R57 600	R58 400
Tax on investor's taxable income	R45 000	R0	R0
Net return for the individual investors	R55 000	R57 600	R58 400

Table 1.4 – Source: KPMG (2022)

The above illustration shows that non-REIT investors will benefit more from the corporate tax rate reduction as they will have more income remaining after the taxes have been paid, while REIT investors will have less net return available, assuming they are taxed on the highest tax bracket (KPMG, 2022).

Proposed solution

Tax authorities should look at other ways that can encourage individual investors to invest in a REIT, as the above illustration might discourage investors due to the level of tax paid by individual investors as a result. The corporate tax rate reduction appears to only benefit non-REIT investors (KPMG, 2022).

4.3 Tax challenges relating to Value Added Tax

VAT on the temporary letting of residential property by developers.

Property developers in the residential property space, including REITs and controlled companies who are VAT registered, are allowed to deduct input tax on VAT incurred on the property development costs, and they are required to levy VAT at the standard rate on the sale of the developed property (Core Tax, 2022).

The supply by a REIT or controlled company of a dwelling under the arrangement of letting and hiring is an exempt supply in terms of section 12(c) of the VAT Act (SARS, 2022). It occasionally happens as a result of adverse economic conditions that developers struggle to find a buyer for the developed property for sale at the required selling price and therefor the developer opts to temporarily rent out the property to generate some cashflow until the suitable buyer is found (CDH, 2022).

The temporary letting of a property that was initially intended for sale triggers a change in use adjustment from a taxable supply to an exempt supply in terms of section 18(1) of the VAT Act. VAT becomes due and payable at the tax fraction of the open market value of the property on the date that the property is let out, which creates a cashflow issue for the developer as the amount of VAT due is disproportionate to the rental income received from the temporary letting of the property. This position results in the vendor being even more out of pocket, while the decision to let the property was intended to alleviate cashflow problems relating to unfavourable economic conditions (CDH, 2022).

Section 18B of the VAT Act was introduced in January 2012 and ceased to apply on 1 January 2018, which granted temporary relief to developers who temporarily rented out residential units for a period of up to 36 months without triggering the change in use adjustment, which was almost sufficient time to find the suitable buyer or even use the rental income earned from the letting out of the property for 36 months to pay up the VAT output due after the 36 months period expired (Core Tax, 2022). When section 18B ceased to apply, developers were again faced with cashflow difficulties as a result of the disproportionate adjustment.

Section 18D, as well as sections 9(13) and 10(29), have been added to the VAT Act as a means to relieve developers when temporarily letting units that were developed with the intention to sell.

Section 18(2) states that “a property is deemed to be supplied for consideration equal to the adjusted cost of construction, extension, or improvement of the property if the residential property initially built for sale is temporarily applied”. Output VAT equivalent to the tax fraction of the adjusted cost of construction must be paid over to SARS on the first day that the property is let out (CDH, 2022).

Temporarily applied is defined as

> “the application of fixed property or a portion of a fixed property in supplying accommodation in a dwelling under an agreement, or more than one agreement for letting and hiring thereof, which agreement or agreements, relate to a combined total period not exceeding 12 months”.

The "temporarily applied" definition does not apply to rental arrangements exceeding 12 months; if the arrangement is more than 12 months, section 18D will not apply, but section 18(1) will apply.

Section 18(3) and 18(4) provide that where the property is subsequently sold within 12 months, the sale is deemed to be a taxable supply, and VAT must be levied on the consideration charged for the property. Section 18(5) provides for the input tax deduction when the property is subsequently sold or when it is no longer used to supply accommodation after the 12 months expires, which is the amount equivalent to the tax fraction of the adjusted cost initially paid as output VAT when the property was first let out (CDH, 2022).

Below is an example to illustrate the above:

The property has a market value of R2 500 000 and an adjusted cost of R1 840 000 and is temporarily let for R20 000 a month for 12 months.

If section 18D is applicable, VAT output of R240 000 (R1 840 000 X 15/115) will be accounted for, which still puts the developer out of pocket as the VAT output becomes due when the property is first let out.

If section 18D is not applicable due to the lease period being more than 12 months, the VAT output of R326 087 (R2 500 000 X 15/115) should be accounted for in terms of section 18(1) of the VAT Act.

It is not clear what the tax implications are if the VAT was initially paid in terms of section 18(2), but the lease then extends beyond the 12 months period due to unforeseen circumstances. This amendment seems to only allow developers 12 months to find a suitable buyer, and looking at the current economic conditions in South Africa, it is taking more than 12 months to sell the property, which means developers will be exposed to section 18(1) change in use adjustment at the tax fraction of the open market value of the property, or not renting out the property at all and losing out on the cashflow relief that would have been brought by temporarily renting the property (CDH, 2022).

Proposed solution

The Act should be amended to clarify the tax implication if there is a change in circumstances where the lease extends beyond 12 months after the VAT output has been paid in terms of section 18D(2). SARS should consider how long it takes to sell residential property in the current economic conditions of South Africa and allow developers such time before a change in use adjustment can be triggered on the letting of residential property developed with an initial intention to sell to alleviate the cashflow pressure currently encountered by developers when such circumstances arise (CDH, 2022).

4.4 Tax challenges relating Tax Administration Act on REITs

4.4.1 *Provisional tax payment and submissions*

REITs always need to consider whether they will be in a taxable income position, i.e., if they will have sufficient tax-deductible qualifying distributions to make dividend distributions to their shareholders and the amount to distribute in order to be in a nil taxable income position in line with section 25BB of the Act. Uncertainties regarding distributions became a major problem during the Covid-19 pandemic affecting both the 2020 and 2021 years of assessments. One of the REITs, Fortress Real Estate Investment Trust Limited, even lost its REIT status due to the inability to make distributions to their shareholders within four months after their 2022 financial year end (Java Capital Banking, 2023).

Given the above issues, it is almost difficult for a REIT to confirm before finalising its financial results if it is in a taxable income position or not, which creates uncertainty regarding the second provisional tax payment. If a REIT does not make such a payment when it ought to have made one, it is exposed to provisional tax underestimation penalties in line with the Fourth Schedule to the Act (Britz & Jayes, 2019).

Proposed solution:

The National Treasury should provide REITs with an option to make an adjustment or top up to the second provisional tax estimate within four months after year end as at that point, the REIT would be certain of their tax position, which will help REITs avoid any provisional tax penalties which could have resulted.

4.4.2 *Carbon tax registration delays*

Technology will help REITs to design more sustainable buildings, with efficient use of water and energy resources which will result in reduced operational costs and carbon emissions (Ho et al., 2013). The Carbon Tax Act has been amended with effect from 1 January 2023 to give extension to the section 12L of the Act, energy efficiency savings tax incentive up to 31 December 2025. This change aims to encourage taxpayers to invest in energy efficiency, for companies to reduce greenhouse gas emissions, and stimulate energy-efficient practices. If this allowance ceases in 2025, it is not clear what will motivate SA REITs to enhance their building designs with energy solutions that will reduce carbon emissions and compete with other REIT markets (National Treasury, 2023).

Currently, the carbon tax administration at SARS is still under development. As a result, it takes time to get registration for carbon tax finalised to enable submission of the relevant carbon tax returns and payments.

Proposed solution

SARS should dedicate a team to look into speeding up the carbon tax registration processes for REITs as these deductions affect the taxable income from which the qualifying distributions are calculated to encourage REITs to incorporate green energy efficiency measures on their properties and thus reduce carbon emissions in South Africa.

Furthermore, carbon tax incentives should be kept indefinitely to encourage property development companies and other affected companies to invest more in projects that will reduce carbon emissions.

4.4.3 *Delays on payments of VAT refunds*

A registered VAT vendor is required to levy VAT at 15% on taxable supplies and claim input VAT on the tax paid by the vendor when acquiring goods and services from other suppliers. VAT liability arises where the output VAT due is more than the input VAT claimed, and a VAT refund becomes due from SARS if the VAT input claimed is more than the VAT output for that period. VAT audits are performed by SARS usually, where a VAT refund is due to the vendor and usually takes longer to finalise, which results in delays with VAT refunds (Joubert, 2021).

REITs involved in the construction and development of new commercial properties and residential properties are mostly entitled to large sums of VAT refunds on the cost incurred for the construction. According to the Tax Administration Act, SARS has to pay any refund due to vendors within 21 days. Frequently SARS takes longer to refund developers any of the input tax amounts claimed due to prolonged audits, which results in cash flow problems for the developers as the VAT refunds usually form part of their financing and budgeting for the construction. This causes delays in property developments and puts the developers out of pocket to a point where construction could be stopped until SARS releases the funds (Joubert, 2021).

Proposed solution:

SARS should comply with the Tax Administration Act and pay out refunds to vendors within the specified timeframe. Suppose a company is selected for an audit. In that case, those audits should be finalised within the prescribed 21 days, and refunds made timeously to reduce any negative impact associated with the delayed refunds (Nieuwenhuizen, 2019).

4.5 Tax treaty issues affecting REITs.

Cross–border investments in REITs and cross-border investments made by REITs trigger potential international double taxation, which requires the analysis of tax treaty issues affecting income and gains derived by the REIT investors and the REIT itself (Simontacchi & Stoschek, 2019). South Africa is not a member of the OECD, but, the South African courts have made it clear that the OECD Model Tax Convention Commentary can be used to interpret South African tax treaties (Ungerer, 2013). The OECD model served as a basis for many double tax treaties concluded by South Africa and its trading partners (AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Services (13276), 2015). South Africa has also developed a working relationship with the OECD since 2010, where they collaborate on policy issues. South Africa is also party to numerous

OECD instruments, making the OECD model important for interpreting the South African tax treaties (OECD, 2018). Howard and Pancak (2019) stated that domestic taxes play a vital role in shaping foreign real estate investments; hence, this study must also cover tax treaty issues affecting REITs. The tax treaty issues include understanding which taxpayer is entitled to the tax treaty between the REIT and the shareholder, who is the taxpayer for treaty purposes, and how should distributions from REITs to foreign investors be treated (OECD, 2017).

For the purposes of this section, a REIT is defined as

> "a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property (real estate) distributes most of that income annually and does not pay income tax on income related to immovable property that is so distributed. The fact that the REIT vehicle does not pay tax on that income is the result of tax rules that provide for a single level of taxation in the hands of the investors in the REIT" (OECD, 2017).

The tax treaty issues affecting REITs will be considered based on the following elements of a REIT's income:

- Income from immovable property – rental income on Article 6.
- Business profits from business carried through the immovable property in Article 7.
- Capital gains from the immovable property on Article 13.
- Dividend income on Article 10; and
- Interest in Article 11

The OECD model gives rights to the primary taxation of income from immovable property, any gains derived from the sale of immovable property, and income from business profits derived from a business carried on in respect of immovable property if it is a permanent establishment to the source country (Simontacchi & Stoschek, 2019). The residence country would exempt such income or provide a credit for any of the foreign taxes levied on the income (OECD, 2017).

<u>Treaty entitlement of the REIT</u>

The first issue relates to the difficulty with determining if the REIT is entitled to the tax treaty relief not only with regard to the treaty provisions on the REIT's income but also with regard to the distributions made by the REIT. This can be seen, for example, in dividends, where Article 10 of the OECD model is applicable to dividends paid by a company that is a resident of a contracting state. This raises issues on the application of the tax treaty to REITs that trust, not companies as required by article 10, which raises a concern whether trust REITs are eligible for the tax treaty benefit as they might not meet the definition of a person based on the laws of the treaty parties (OECD, 2008).

A REIT will only be entitled to treaty relief if it qualifies as a person and it qualifies as a resident of a contracting state (Simontacchi & Stoschek, 2019). The tax treaty between South Africa and the United States also defines persons to include trusts and partnerships, which eliminates the above issue (SARS, 1997).

The tax treaty between South Africa and the UK does not explicitly include trusts in their definition of persons; however, this is included in the other body of persons part of the definition, which also entitles trust REITs to the tax treaty relief (HMSO, 2010). A REIT that qualifies as a treaty person is considered liable to tax for treaty purposes (Simontacchi & Stoschek, 2019).

<u>Who is the taxpayer for tax treaty purposes?</u>

In the absence of certain provisions, determining whether the tax treaty should be applied at the investor level or REIT level can be an issue as it might differ from one country to another. The REIT might be structured such that it is a contractual arrangement where the income derived would legally be the investors for tax treaty purposes. Although in other cases, a REIT might be considered the legal owner of the income, it might not be the economic owner of the income as this would be the investor for tax purposes (OECD, 2017).

The OECD (2017) proposed a general rule for countries to allow the REIT relief for double taxation for any source tax levied on the REIT even though the country of residence levies the tax on income derived by the REIT on investors. The SA REIT regime taxes the distributed income of a REIT in the investor's hands;

however, any taxes paid by the REIT in another jurisdiction where the property is situated is deducted on the determination of the REIT's taxable income in terms of section 25BB(2A)(a) (SARS, 2022).

<u>How should REIT distributions to foreign investors be treated under tax treaties?</u>

A company REIT's distribution to foreign investors will constitute a dividend covered by Article 10 of the OECD model; however, this might not be the case where the REIT is a trust or contractual arrangement treated as a flow-through vehicle under domestic laws. The other issue relating to the distributions is whether the distributions should be considered income from immovable property or income from investing in security (OECD, 2017). The USA and SA DTA (SARS, 1997) contain special tax dispensation for distributions made by REITs to foreign investors, which some countries do not have.

There are two ways in which this could be looked at, the first being to consider that the distribution of the income by the REIT is merely the allocation of a share of that income and treat the income as income from immovable property as if the investor directly earns it. This approach subjects the income to a high tax rate, and the investor would be subject to filing requirements in the source country. The second view would consider the investor's initial intention to invest in an income distributing security similar to traded shares, where they will be entitled to the same tax treaty treatment given to the other kinds of shares covered under Article 10 (Ungerer, 2013).

There is, however, a significant difference between a REIT distribution and other dividends in that the other dividends have already been taxed in the country of residence of the company, while REIT distributions are not subject to tax at the company level since they are taxed in the investor's hands which results in a complication with the lower rate of withholding tax applied even though there was no tax charged at the entity level for the REIT (OECD, 2017).

Foreign investors investing in South African REITs are subject to a dividend withholding tax of 20%. In contrast, a lower rate will be levied if a declaration has been submitted by the recipient before the dividend is paid that the dividend is subject to a reduced rate as a result of a double tax agreement in terms of section 64G(3) of the Act (SARS, 2022). The tax charged in respect of the dividends paid to a resident of another contracting state, will be limited to:

- "5% of the gross amount of the dividend if the beneficial owner is a company directly holding at least 10% of the voting stock of the company paying the dividends"; and
- “15% of the gross amount of the dividends in all other cases” (OECD, 2017).

The OECD (2017) concluded that it is better to treat REIT distributions to a small investor the same as a portfolio equity investor in line with Article 10 and that limiting the rate of source taxation to the one applicable to portfolio dividends would not be appropriate in the case of investors holding a large percentage of investment in a REIT.

Tax levied on distributions to large investors should be proportionate to the tax levied on income from direct investment in immovable property (OECD, 2017). The UK and SA tax treaty agreement provides for a 15% withholding tax on the gross dividend from qualifying dividends paid by a property investment company that is a resident of a contracting state.

In the SA and the US tax treaty, the tax charges above do not apply in case of dividends paid by a US REIT but instead apply 15% of the gross amount of the dividend if the beneficial owner is an individual holding less than 10% in a REIT otherwise domestic withholding tax rate applies (SARS, 1997).

Distribution of capital gains

Distributions from capital gains are better off treated as if they were distributions from the rental income generated by a REIT in line with Article 6, where the income is subject to tax in the source country which is where the immovable property is situated (OECD, 2017).

Treatment of capital gains on the sale of shares in a REIT

Although it was agreed that applying paragraph 4, allowing the source taxation of gains resulting from the sale of large investors' interests in a REIT, would be appropriate, different opinions were expressed as to whether this would also be appropriate for a small investor in a REIT. Paragraph 4 was meant to apply to any gains on the sale of shares in a company that generates value from immovable property, and therefore there is no reason to differentiate between a REIT and a publicly held company in this regard as long as the tax treaty does not provide an exception to a sale of shares by a listed company, there should not be an exception for the sale of shares in a REIT either. Others argued that small investors' interests should rather be treated as security instead of an indirect holding in immovable property since it would be difficult to administer source tax of gains on small interest in a widely held REIT (OECD, 2008).

<u>Distributions made to tax exempt entities such as pension funds.</u>

Generally, distributions are subject to withholding tax at a reduced rate where a tax treaty applies, however; according to PWC (2021), distributions made to institutional investors that are exempt from tax, such as government entities and pension funds, will not be subject to any withholding tax.

It was concluded that distributions from investments in a REIT by pension funds should be treated like other investment income of a pension fund (OECD, 2008).

The most important factor with regard to tax treaty issues affecting REITs is that the contracting states should clearly define all the affected terms to align local legislation with the tax treaty impact. In some instances, amendments to the treaty become necessary, especially if the treaty agreement was drafted before the introduction of the REIT regime. The US and SA double tax agreement was finalised before the introduction of the SA REIT regime but it already included special provisions for REITs which are not present in other tax treaty agreements (SARS, 1997). Similar provisions should be considered for treaty agreements that are yet to be signed with other countries to eliminate the above tax treaty issues affecting REITs.

CHAPTER 5. CONCLUSIONS & RECOMMENDATIONS

5.1 Introduction

This chapter provides conclusion to the identified challenges faced by SA REITs when applying the current tax laws and regulations governing the SA REITs and the proposes amendments to address the identified challenges. In addition, this chapter provides recommendations for future studies relating to the taxation of SA REITs.

5.2 Conclusions of the Study

The study explored the tax challenges faced by the SA REITs on the application of the SA REIT tax laws and regulations and recommended amendments that should be made to address the identified challenges. The study identified challenges that exposes the SA REITs to double taxation, instances where the REIT conduit principle is clogged because of distributions being made out of income that has already been taxed in the REIT's hands, bearing in mind that dividends received from a REIT are excluded from the dividend exemption in section 10(1)(k)(i) of the Act. Furthermore, issues have been identified that threaten the REIT's chances of meeting the 75% rental income requirement, thus, exposing the REITs to possible fines and penalties and possible loss of the REIT status due to significant amount of income from sources other than rental income in terms of section 25BB of the Act being included in the REIT's gross income. There are other administration issues that results in frustrations in the REITs' tax administration process which have a potential to expose the REIT to fines and penalties, such as the requirement to pay second provisional taxes when the REIT is not yet certain whether it will be in a taxable income position after making its qualifying distributions. Tax treaty issues that affect the taxation of REITs have also been identified, ranging from understanding the taxpayer for the treaty purposes, who is entitled to the tax treaty between the investor and REIT and understanding how distributions to foreign investors are to be treated under the tax treaty. Clarity is required, especially on the double tax agreements between the different countries to ensure that the REITs and their investors are not exposed to double taxation and the conduit principle does not clog up as a result.

Since the enactment of the South African REIT framework in 2013, amendments have been made to the legislation to iron out technical issues identified along the way; however, some of the issues identified and brought forth to the National Treasury through commentary and submissions by institutions, such as the SAREIT association and other scholars, have not yet been amended in the legislation (de Klerk, 2019).

Ungerer (2013) identified practical issues with the SA REITs regime, including the need to extend the regime to unlisted REITs, and made recommendations for studies to be done on how the regime could be extended to cover the unlisted REITs of which the SA REIT legislation has not yet been amended. De Klerk (2019) indicated that there needed to be faster progress in this area; however, the SA REIT association is already working together with the National Treasury to achieve this. Countries, such as the US and Australia, do not have listing requirements for their REITs and it is believed that this has contributed significantly to the growth of these countries REIT industry (Parker, 2018). The UK government is undergoing a consultation process to relax some of their REIT regime requirements and restrictions, including the listing requirement according to PWC (2021). The South African government should consider fast tracking the process of granting unlisted REITs the same tax dispensations enjoyed by listed REITs to encourage foreign investments and growth of the SA REIT industry.

The impact of the imputation of net income from controlled foreign companies unless the controlled foreign company is a foreign business establishment was initially raised by the SA REIT association in 2017, however no changes have been made to the act on this regard. The majority of the REIT controlled companies fail to meet the definition of foreign business establishment because of external management. This issue exposes the REITs failure to meet the 75% gross income test especially when the section 9D imputation from controlled foreign company is significant, which threatens the REIT's ability to make tax deductible qualifying distributions and the loss of REIT status (SAREIT, 2017). The Act should be amended to make an exception for controlled foreign companies held by REITs similar to the type of companies given exception on the definition of foreign business establishment.

South Africans are frequently undergoing strikes for many reasons, including poverty, inequality, unemployment, etc, which is unfortunately always demonstrated through vandalism and damage of amenities (Murwirapachena & Sibanda, 2014). REITs experienced significant damage to their properties as well as loss of income in July 2021 as a result of the riots that took place (Staff, 2021). It is therefore necessary for the authorities to consider adjustments to the act to cater for the impact that insurance pay-outs will have on the REIT's 75% rental income test, thus avoiding any unintended consequence of strikes on the REIT's tax benefits and status.

The initial objective of introducing the REIT regime includes the elimination of double taxation which property vehicles were exposed to before the REIT framework, which is based on the conduit principle, was introduced. The REIT regime allows for the income of the REIT to be taxed only in the investor's hands and not on both the REIT and the investor (National Treasury, 2007). There are still instances of exposure to double taxation where the REIT's income is initially subject to tax on the REIT's hands and later, in the investors hands, since the dividend exemption from income tax does not apply to dividends received from a REIT (SAREIT, 2017). These issues, including double tax exposure from unbundling and liquidation transactions, affect sections 46 and 47 of the Act (CDH, 2019a); instances where the REIT paid dividend from income that was previously taxed as a result of being in a taxable income position after making the 75% qualifying distributions (Ungerer, 2013). This also includes cases where a controlled company makes distributions to the parent company out of capital gains for possible debt repayment of the disposed property or re-investment through the parent's own name. Such distributions get taxed in the parent's hands since the parent will not distribute them as they are planned for a certain purpose though they emanate from amounts that were exempt from tax based on section 25BB(5) of the Act. Proviso (aa) to section 10(1)(k)(i) should be amended to exclude distributions made by a REIT from amounts that were already subject to taxation. This amendment will assist with avoiding the unintended consequences of a double taxation issue arising on the above-mentioned scenarios.

Section 25BB has been amended a few times since the introduction of the SA REIT regime, some of the amendments of which include the updating of the rental income definition to include the unrealised foreign gains emanating from the hedge of the amounts listed as part of rental income for qualifying distribution purposes. The inclusion of unrealised gains on rental income to be distributed to shareholders result to cashflow issue due to the time difference from when the distributions must be made from unrealised foreign gains and the cash event which is when the unrealised gains are settled (SAREIT, 2017) and (KPMG, 2020b). The act should be amended to allow REITs to include unrealised gains in determination of the taxable income only when the cash event has occurred to avoid the above cashflow crises (SAREIT, 2017).

The Act should also be amended to include in the rental income definition other derivatives used by REITs on their operations such as the CCIRS to avoid any unintended outcome which could threaten the REITs 75% income test, resulting to non-deductible qualifying distributions if the 75% income test is not met and possible loss of the REIT status.

The REIT regulation should be amended to have the property company test to confirm if a company meets the requirements to be a property company (from which any dividends received by the REITs from a property company form part of the rental income for the 75% income test and qualifying distributions) to be done at the consolidated financial statement level to avoid consequences of intergroup transaction on the 80% of assets attributable to immovable assets requirement. The UK REIT regime also requires this test to confirm property rich company requirements to be performed at consolidated financial statement level adjusted for non-recurring transactions to avoid distortion of the financial position (PWC, 2021).

The Act should be amended to give leniency to companies ceasing to be a REIT as currently when a company ceases to be a REIT, it has to make a declaration for qualifying distributions before the last day of being a REIT and because of the administrative burden associated with losing a REIT status, stakeholder management and crisis management, it is almost impossible for the REIT to have updated accurate financial information to be able to make qualifying distributions before ceasing to be a REIT. The Act should allow such qualifying distributions to be made within 12 months after ceasing to be a REIT as long as the qualifying distributions are made out of income that was earned before ceasing to be a REIT.

The South African corporate tax rate change from 28% to 27%, aimed at benefiting both companies and investors (National Treasury, 2021), appears to be unfavourable to REIT investors because they now have less money from dividend distributions compared to non-REIT investors. The government should find other means to keep investments in REIT attractive, especially for individual investors (KPMG, 2022).

Other changes made to the Act includes the amendments in section 23M of the Act. Consequences of this amendment require the REITs to keep in mind the consequences of section 23M on their funding strategies and avoid making use of a debt from a creditor that is exempt from South African tax and has a controlling relationship with the South African debtor that can expose the REIT to non-deductible interest expenses (CDH, 2021a).

The Act should further be amended to cater for the VAT consequences on REITs that develop properties to sell. Properties developed for sale are a taxable supply and the vendors developing those are allowed to claim input tax on the development costs and they must levy VAT at the standard rate of 15% of the sale of the developed property. Where unfavourable economic conditions prevail and the developer struggles to sell the property, sometimes the developer will opt to rent it out until a suitable buyer is found which triggers change in use adjustment. Change in use adjustment leads to cashflow issues on the developer’s side due to the output tax that must be paid based on the market value of the property compared to the rental income generated from the temporarily renting of the property (Core Tax, 2022). Section 18D of the VAT Act allows for VAT output to be paid based on the adjusted cost of constructing the property if it is only being let out for period not exceeding 12 months (CDH, 2022).

The Act should be amended to clarify the tax implication if there is a change in circumstances where the lease extends beyond 12 months after the VAT output has been paid in terms of section 18D(2). SARS should consider how long it takes to sell residential property in the current economic conditions in South Africa and allow developers such time before a change in use adjustment can be triggered on the letting of residential property developed with an initial intention to sell to alleviate the cashflow pressure currently encountered by developers when such circumstances arise (CDH, 2022)

The REIT regulations should be amended to cater for REIT's time sensitive administration processes, such as providing an extension for REITs on the second provisional tax payment, ensuring that REITs request for registrations for all forms of taxes are prioritised including carbon tax registration, timeous VAT refund payments to avoid cashflow issues as a result of unnecessary delays on VAT refund payments.

It should be noted that SARS has already made efforts to ensure smooth tax administration for REITs through making available to the SA REITs a public relations manager to whom tax administration queries and escalations can be made if any delays are encountered in tax administration processes.

Regarding the tax treaty issues affecting REITs, tax authorities should consider the amendment of double tax agreements where the issues listed above were not catered for on the treaty agreements especially because the SA REIT regime is still new, provisions regarding the taxation of REITs would most likely not be part of treaty agreements. Amendments to the treaty agreements should be made to ensure that it is clear who is entitled to the tax treaty between the REIT and the investor; who is the taxpayer for tax purposes which would also cater for the inclusion of trust REITs, where necessary, as the taxpayer, because some of the tax treaty agreements have excluded trusts from the definition of taxpayer (OECD, 2017). Amendments should be made to include specific provisions relating to the taxation of REITs between the contracting parties similar to the provisions included in the US and SA treaty agreement (SARS, 1997).

Based on the above-identified issues, it is apparent that the SA REIT regime still has room for development and growth to address the challenges identified and ensure that the regime is more attractive to foreign investors. It was stated in the 2019 Budget Speech that amendments are still required to the SA REIT regime most importantly, to cater for unlisted REITs and to resolve some of the double tax issues mentioned above (National Treasury, 2019:23). It is with the hope that once the above challenges have been dealt with, some of the property companies will adopt the REIT structure and push the SA REIT industry to even greater lengths on the global REIT markets.

5.3 Suggestions for further research

- A research study is required to develop a model which can be used to extend the REIT tax dispensations to unlisted property companies, especially the way these companies can be regulated to ensure compliance with applicable laws and regulations and investor protection.
- An analysis is required to understand the cost vs. benefit of remaining listed as a REIT, considering that Chapter 4 has shown that the reduction in corporate tax rates disadvantages individual investors of a REIT. Also, regarding companies that lose their REIT status, it would be interesting to understand whether they become better off after losing the REIT status.
- A detailed analysis of a South African REIT company's taxable income determination compared to a US company's taxable income calculation excluding the exchange rate difference to understand if US companies are better off compared to SA companies, considering they are still allowed depreciation allowances while SA REITs are not, and also whether the distribution percentage differences have a significant impact on the company.

REFERENCES

Books

Block, R.L., 2011. Investing in REITs: real estate investment trusts. John Wiley & Sons.

Botha, M., Rossini, L., Du Preez, L., Geach, W.D., Goodall, B.B., 2017. The South African financial planning handbook 2014. LexisNexis (Pty) Limited.

Parker, D., 2018. The Routledge REITs Research Handbook. Routledge Abingdon.

Simontacchi, S., Stoschek, U., 2019. Guide to global real estate investment trusts. Kluwer Law International BV.

Journal articles

Baum, A., Devaney, S., 2008. Depreciation, income distribution and the UK REIT. Journal of Property Investment & Finance 26, 195–209.

Bejol, P., Livingstone, N., 2018. Revisiting currency swaps: hedging real estate investments in global city markets. Journal of Property Investment & Finance.

Beracha, E., Feng, Z., Hardin, W.G., 2019. REIT operational efficiency: Performance, risk, and return. The Journal of Real Estate Finance and Economics 58, 408–437.

Bredell, E., Boshoff, D., 2013. Introduction of REITs in South Africa Transformation of the Listed Property Sector 6, 38–46.

Brophy, T., Herrala, N., Jurado, R., Katsalirou, I., Le Quéau, L., O'Donnell, S., 2019. Role of cross currency swap markets in funding and investment decisions. Seamus, Role of Cross Currency Swap Markets in Funding and Investment Decisions (August, 2019).

Brounen, D., De Koning, S., 2012. 50 years of real estate investment trusts: An international examination of the rise and performance of REITs. Journal of Real Estate Literature 20, 197–223.

Carstens, R., Freybote, J., 2018. The impact of introducing REITs on foreign investments and liquidity in South Africa. Journal of Real Estate Literature 26, 103–128.

Carstens, R., Freybote, J., 2018. The impact of introducing REITs on foreign investments and liquidity in South Africa. Journal of Real Estate Literature 26, 103–128.

de Klerk, E., 2019. Real estate investment trusts. TAXtalk 2019, 14–17.

Ghosh, C., Petrova, M., 2021. The effect of legal environment and regulatory structure on performance: cross-country evidence from REITs. The journal of real estate finance and economics 63, 40–81.

Gogineni, S., Jain, P., Upadhyay, A., 2021. REIT Regulations and Valuation: A Global Perspective. Available at SSRN 4310581.

Ho, K., Rengarajan, S., Lum, Y., 2013. “Green” buildings and Real Estate Investment Trust’s (REIT) performance. Journal of Property Investment & Finance 31, 545–574. https://doi.org/10.1108/JPIF-03-2013-0019

Howard, M., Pancak, K.A., 2019. Do Taxes Matter to Foreign Real Estate Investors? Evidence from FIRPTA Reform. Journal of Portfolio Management 45, 160–171.

Hu, Y., Smith, G., 2018. Interest Rate Swaps and Nonfinancial Real Estate Firm Market Value in the US.

Ijasan, K., Junior, P.O., Tweneboah, G., Adam, A.M., 2021. How does South Africa’s real estate investment trusts integrate with major global REITs markets? A time-frequency approach. Scientific African 14, e00993.

Joubert, P., 2021. VAT Audits and Refunds: Is it Really a Nightmare? Tax Professional 2021, 21–23.

Kruger-Levy, N., Dauskardt, R., Bomani, H., Anti, N.A., Gam-Ikon, E.O., 2017. residential reits and their potential to increase investment in and access to affordable housing finance in Africa.

Mazurczak, A., 2011. Development of real estate investment trust (REIT) regimes in Europe. Journal of International Studies 4.

Murwirapachena, G., Sibanda, K., 2014. Exploring the incidents of strikes in post-apartheid South Africa. International Business & Economics Research Journal (IBER) 13, 553–560.

Nieuwenhuizen, C., 2019. The effect of regulations and legislation on small, micro and medium enterprises in South Africa. Development Southern Africa 36, 666–677.

Ntuli, M., Akinsomi, O., 2017. An overview of the initial performance of the South African REIT market. Journal of Real Estate Literature 25, 365–388.

Oh, J., Verstein, A., 2023. A Theory of the REIT.

Peters, M.D., Marnie, C., Tricco, A.C., Pollock, D., Munn, Z., Alexander, L., McInerney, P., Godfrey, C.M., Khalil, H., 2020. Updated methodological guidance for the conduct of scoping reviews. JBI evidence synthesis 18, 2119–2126.

Raheem, I.D., Fasanya, I.O., Yusuf, A.H., 2022. Economic policy uncertainty and the co-movement between REITs and exchange rate. Review of Economic Analysis 14, 121–141.

Wesson, N., Carstens, R., 2019. The impact of South African real estate investment trust legislation on firm growth and firm value. South African Journal of Economic and Management Sciences 22, 1–8.

White, B.S., Howell, M.T., 2020. The REIT Industry's First 55 Years: Keys to Longevity. International Journal of Business 25, 215–229.

Wong, W.W., Reddy, W., 2018. Evaluation of Australian REIT performance and the impact of interest rates and leverage. International Real Estate Review 21, 41–70.

Xu, Y., Yiu, E.C.Y., 2010. The effects of tax reforms on REITs: an international empirical study. Available at SSRN 1878505.**Government Publications**

Corporation tax act, E., 2010. Corporation Tax Act 201. Accessible on https://www.legislation.gov.uk/ukpga/2010/4/section/1184. (accessed 6.8.23).

HMSO, 2010. UK/South Africa Double Taxation Convention - UK/South Africa Double Taxation Agreement – 2003 (accessed 5.25.23).

Internal Revenue Code, 2011. 26 U.S. Code § 857 - Taxation of real estate investment trusts and their beneficiaries. LII / Legal Information Institute. Accessible on https://www.law.cornell.edu/uscode/text/26/857.(accessed 6.8.23).

National Treasury, 2023. Explanatory Memorandum on the taxation laws amendment bill.

National Treasury, 2021. Taxation Laws Amendment Act 20 of 2021 (English / Afrikaans) | South African Government. - Taxation Laws Amendment Act 20 of 2021 (accessed 5.27.23).

National Treasury, 2019. Reviewing the Real Estate Investment Trust (REIT) tax regime.

National Treasury, 2007. Reforming The Listed Property Investment Sector in South Africa.

SARS, 2022. Interpretation Note 97, Income Tax Act 58 OF 1962, Sections 1(1) – Definition of "REIT" and 25BB, Taxation of REITS and Controlled Companies.

SARS, 1997. Convention Between The Republic of South Africa and The United States of America for The Avoidance of Double Taxation and The Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains – Accessible on https://www.irs.gov/businesses/international-businesses/south-africa-tax-treaty-documents. (accessed 5.25.23).

The Income Tax Act, 2023. Income Tax Act 58 of 1962 | South African Government. Accessible on https://www.gov.za/documents/income-tax-act-29-may-1962-0000. (accessed 6.8.23).

Academic research (Thesis)

Breetzke, M., 2014. The Taxation of Real Estate Investment Trusts (REIT) in South Africa (PhD Thesis). Nelson Mandela Metropolitan University.

Coetzee, J.H., 2019. Real estate investment trust tax regime: Analysing the implications of building allowances (PhD Thesis). North-West University.

Kantilal, H., 2016. An analysis of the real estate investment trust tax regime on the South African property sector (PhD Thesis). North-West University (South Africa), Potchefstroom Campus.

Makatsane, N.P., 2018. A performance comparison of specialised (industrial) and non-specialised real estate investment trusts in South Africa (Master's Thesis). Faculty of Engineering and the Built Environment.

Modise, T.P., 2018. An exploration of corporate real estate management outsourcing practices in South Africa (Master's Thesis). Faculty of Engineering and the Built Environment.

Naidoo, H., 2014. The introduction of REITs to the South African property market: Opportunities for fund managers (PhD Thesis). University of the Witwatersrand, Faculty of Commerce, Law and Management.

Rampersad, P.R., 2010. The possible impact of the proposed South African REIT Structure on the listed property sector (PhD Thesis). University of the Witwatersrand.

Strauss, W.J.P., 2018. Real estate investment trusts: the current state of tax research (PhD Thesis). University of Pretoria.

Ungerer, M., 2013. Practical issues relating to the taxation of Real Estate Investment Trusts (“ REITs”) in South Africa. (Master’s Thesis). University of Cape Town.

Case law

Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd (1269/2021), 2023. Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd (1269/2021) [2023] ZASCA 10; [2023] 2 All SA 44 (SCA) . Accessible on http://www.saflii.org/za/cases/ZASCA/2023/10.html (accessed 5.27.23).AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Services (13276), 2015. AB LLC and BD Holdings LLC v Commissioner of the South African Revenue Services (13276) [2015] ZATC 2. Accessible on http://www.saflii.org/za/cases/ZATC/2015/2.html. (accessed 5.27.23).

Web page

Barrus, R., Munuhe, J., 2018. Tax reform impact on real estate investment trusts Accessible on https://www.bakertilly.com/insights/tax-reform-impact-on-real-estate-investment-trusts. (accessed 6.12.23).

Britz, D., Jayes, K., 2019. Provisional Tax : Penalties and Interest Risks Accessible on https://www.thesait.org.za/news/460317/Provisional-Tax--Penalties-and-Interest-Risks.htm. (accessed 5.25.23).

Cassanos, R., Roman, C., Cosby, C., Zhang, L., 2020. A Tax Issue Checklist For REITs Grappling With The Pandemic - Law360 Tax Authority. Accessible on https://www.law360.com/tax-authority/articles/1263609/a-tax-issue-checklist-for-reits-grappling-with-the-pandemic. (accessed 5.25.23).

CDH, 2022. Cliffe Dekker Hofmeyr - VAT on temporary letting of residential property by developers: The new rules. Accessible on https://www.cliffedekkerhofmeyr.com/en/news/publications/2022/Practice/Tax/tax-and-exchange-control-alert. (accessed 5.25.23).

CDH, 2019a. Reviewing the Real Estate Investment Trust tax regime.

CDH, 2021a. Cliffe Dekker Hofmeyr - 2021 Draft Tax Laws Amendment Bill: Welcome relief for REITs? Accessible on https://www.cliffedekkerhofmeyr.com/en/news/publications/2021/Tax/Tax-Alert-19-August-2021-2021-Draft-Tax-Laws-Amendment-Bill-Welcome-relief-for-REITs-.html. (accessed 1.25.23).

Core Tax, 2022. VAT on temporary letting of residential property by developers: what you need to know – Property Wheel. Accessible on https://propertywheel.co.za/2022/08/vat-on-temporary-letting-of-residential-property-by-property-developers-what-you-need-to-know. (accessed 5.25.23).

Deloitte, 2022. uk reits a summary of the regime Deloitte. Accessible on https://www2.deloitte.com/uk/en/pages/real-estate/articles/reit-taxation.html. (accessed 5.27.23).

EPRA, 2022. Global REIT Survey. EPRA - European Public Real Estate, Accessible on https://www.epra.com/public-affairs/global-reit-survey. (accessed 5.25.23).

Ernst & Young, 2018. Global REIT Markets.

Java Capital Banking, 2023. Removal of REIT status - Fortress REIT Limited - A (JSE:FFA). Accessible on https://www.listcorp.com/jse/ffa/fortress-reit-limited-a/news/removal-of-reit-status-2826224.html. (accessed 5.25.23).

JSE Limited, 2020. JSE announces relief measures | Johannesburg Stock Exchange. Accessible on https://www.jse.co.za/news/press-releases/johannesburg-stock-exchange-announces-relief-measures-market-participants. (accessed 5.27.23).

JSE Limited, 2013. jse listing requirements. Accessible on https://www.jse.co.za/sites/default/files/media/documents/2019/4/JSE%20Listings%20Requirements.pdf. (accessed 5.27.23).

KPMG, 2022. REITs - the reduced corporate income tax rate.

KPMG, 2020. Important changes to the interest limitation provisions.

KPMG, 2013. Taxation of real estate investment trusts.

KPMG, 2020b. Tax consequences of foreign exchange movements amid the COVID 19 crisis for Real Estate Investment Trust.

Macfarlanes, 2022. guide to uk reits macfarlane. Accessible on https://www.macfarlanes.com/media/bx1ntr5g/guide-to-uk-reits-june-2022-v6.pdf. (accessed 6.8.23).

Mazars, 2018. What to do if SARS does not pay out your refund - Mazars - South Africa. Accessible on https://www.mazars.co.za/Home/About-us/News-and-publications/Our-publications/Mazars-Messenger/Mazars-Messenger-September-2018. (accessed 5.25.23).

NAREIT, 2022. Global REIT to real estate investing - Google Search. Accessible on https://www.reit.com/investing/global-real-estate-investment. (accessed 5.25.23).

OECD, 2018. South Africa and the OECD. Accessible on https://www.oecd.org/southafrica/south-africa-and-oecd.htm. (accessed 5.27.23).

OECD, 2017. Tax treaty Issues Related to REITs | READ online. Accessible on oecd-ilibrary.org. https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_f84c5775-en. (accessed 5.25.23).

OECD, 2008. R(23). Tax treaty issues related to REITs | READ online. oecd-ilibrary.org. Accessible on https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2014-full-version/r-23-tax-treaty-issues-related-to-reits_9789264239081-116-en. (accessed 5.27.23).

Pinsent Masons, 2023. UK tax treatment of REITs. Pinsent Masons. Accessible on https://www.pinsentmasons.com/en-gb/out-law/guides/tax-treatment-of-reits. (accessed 6.8.23).

PWC, 2022. UK REITs - An attractive vehicle for UK property investment. PwC. Accessible on https://www.pwc.co.uk/services/tax/insights/uk-reits-attractive-vehicle-uk-property-investment.html. (accessed 5.25.23).

PWC, 2021. Worldwide Real Estate Investment Trust (REIT) Regimes - Compare and contrast. Accessible on https://www.pwc.com/gx/en/industries/financial-services/asset-management/publications/compare-and-contrast-worldwide-real-estate-investment-trust-reit-regimes-2021.html. (accessed 5.25.23).

PWC, 2022a. Key tax issues at year end for REIT investors 2022/23.

SAREIT, 2023. What is a REIT? SA REIT. Accessible on https://sareit.co.za/what-is-a-reit. (accessed 5.27.23).

SAREIT, 2017. SA REIT comments on REIT tax issues.

SAREIT, 2013. overview of Real Estate Investment Trusts SAREIT association - Google Search. Accessible on https://sareit.co.za. (accessed 5.27.23).

Simply Wall St, 2022. South African (JSE) REITS Industry Analysis. Simply Wall St. Accessible on https://simplywall.st/markets/za/real-estate/reits. (accessed 5.27.23).

Staff, R., 2021. Riots cost South Africa's SA Corporate Real Estate $38 mln. Reuters.

Statista, 2023. U.S. REITs market cap 1975-2022. Statista. Accessible on https://www.statista.com/statistics/916665/market-cap-reits-usa. (accessed 5.27.23).