SOUTH AFRICAN REVENUE SERVICES

Per email :
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cc: Johan de la Ray- jdelarey@sars.gov.za

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Dear Sirs

SA REIT ASSOCIATION COMMENTS ON THE SARS DRAFT INTERPRETATION NOTE WITH SUBJECT: TAXATION OF REIT'S AND CONTROLLED COMPANIES

We refer to SARS Draft Interpretation Note to which we have been afforded the opportunity to review prior to finalisation.

We set out hereunder our submissions for your kind consideration:

1. **Paragraph 2 of the background**

   The draft Interpretation Note ("draft IN") states that REITs are subject to other specific tax provisions such as Dividends Tax, Transfer Duty and Securities Transfer Tax. This statement is confusing as it suggests that REITs are subject to these taxes which is not the case. If the intention is to remind the reader that specific rules apply regarding these taxes and REITs we feel that it should be rephrased as this is not apparent from the wording.

   The statement should be rephrased to read that a REIT or controlled company is also subject to other specific tax provisions in relation to Dividends Tax, Transfer Duty and Security Transfer Tax.

2. **Para 4.2 of page 10 – General requirement of "controlled company"**

   The above paragraph states that "a "controlled company" is defined in section 25BB(1) and means a company that is a subsidiary, as defined in IFRS, of a REIT.

   However confusion is created here as trusts are treated as subsidiaries in terms of IFRS, whereas the above statement refers solely to "a *company"* which is a subsidiary as defined in IFRS, of a REIT. We also note that the 2012 explanatory memorandum specifically states that:

   > "For this purpose, subsidiary status is an IFRS definition, not a tax definition. Hence, a subsidiary can include a controlled trust."

   We accordingly propose Trusts should be included in accordance with the IFRS reference (by way of interpretation or at least by way of legislation). Many REITs have controlling interests in technical "discretionary trusts." Beneficial ownership in these trusts is fixed (unlike family discretionary trusts) with the distribution element being discretionary based on net rental profits to match the former property loan stock structure. Some of these trusts include former property unit trusts sanctioned under the Income Tax Act before the creation of section 25BB.

Alternatively, consider using the definition of "controlled person" as opposed to a controlled company – as the definition of 'person' includes a trust in terms of section 1 of the ITA.

3. **Para 4.4.1 of Page 11**

The second paragraph is incorrect. It states that*: "A company that is not a REIT or a controlled company that is a resident on the last day of the relevant year of assessment will not qualify for the deduction of a qualifying distribution for that year of assessment, even if the company was a REIT or a controlled company that is a resident for the part of the year of assessment".*

This is incorrect because it is contrary to what is envisaged in 25BB(7) which states that the year of assessment for a REIT ends when it **ceases to be** a REIT. Therefore the interpretation is incorrect as the REIT can still deduct a qualifying distribution as the REIT's year of assessment is deemed to end on the day that the company ceases to be a REIT or controlled company.

In addition the Interpretation Note does not address the situation where the company was a REIT for a part of the year of assessment *and* on the last day of that year of assessment. For example if it had REIT-status for the last 6 months of the financial year.

We submit that this should be clarified by means of an example.

4. **Page 12 – last bullet**

The last bullet requires potential redrafting.

4.1 Clarification is required as to how the local shareholders can determine if residents directly or indirectly hold more than 50% in the controlled foreign company. The directly or indirectly concept presumably has the same meaning as the section 9D terminology used for the CFC definition.

4.2 Exemptions as envisaged in s9D should similarly apply in the context of a REIT or controlled "company" The rationale behind excluding section 9D(2) is unclear.

"Gross income (as defined)" less "Exempt income" (as defined) = "Income" (as defined) in section 1 of the ITA. Section 9D(2) include CFC net income **into income** – not gross income.

Rental income per its definition does not included s9D(2) amounts.

4.3 We also question the exactness of the subsequent final paragraph of Page 12, which states that a "company may lose its REIT status on the JSE if a distribution does not meet the requirements of the definition of "qualifying distribution" in section 25BB(1)." The distribution requirements associated with the JSE should be directly linked to the rules of the JSE (as opposed to an indirect tax linkage).

4.4 No guidance is provided as to the Income Tax sanctions in the event that REIT status is lost. Maybe an example of the consequences would be useful.

5. **Page 13 – meaning of "property company"**

Second bullet should be amended to read: "*At the end of the previous **or current** year of assessment."*

In addition the statement made that "it is unlikely that such a company would distribute a dividend until after the end of its first year of assessment" is confusing as it is not necessarily the case in

particular if the company was formed at the beginning of the year and generated profits during the year. Therefore this statement is incorrect and may cause confusion.

Reference to any dividend is wider than only qualifying distributions as is referred to in bullet 3. Is it therefore possible for a REIT to distribute a dividend that is not a qualifying distribution?

6. Page 14 – Meaning of "group of companies" in the definition of "property company"

Clarification is required with respect to the word "hold" in the explanation. Our submission is that this should be "beneficially hold" and a proper definition be provided therefor.

7. Page 14 - Meaning of the words "directly or indirectly"

The 80% requirement should be further clarified. The test should presumably match the 80 % rule for immovable property companies in paragraph 2 of the Eighth Schedule. First, the test is based solely on assets as opposed to income. In terms of direct, one makes a comparison of immovable property versus other assets held by the company at issue. The indirect test would "only" require a look-through approach for "shares" held by the company (not merely an example of the look-through approach).

We think that some examples should be added here given the importance of this issue. The examples should cover multiple layers of companies. We also would require a *de mininis* exclusion. It is impractical to have a look-through approach where the company has only a small percentage of shares lacking any practical control.

8. Page 18 - Clause 4.5

The last paragraph is incorrect as the deductions do not have to be made in the order specified. It is only specified that (c) is last – (a) and (b) can be deducted in any order.

9. Page 19 – 4.5.1

Currently the interpretation is not in line with the law in particular with reference to the interpretation of the limitations imposed on the deductions of tax. In terms of section 25BB(2A)(a) there is only a requirement that the trust must be *"liable for or subject to tax on income"* and no other limitations.

The terms "proved to be payable" should be clarified. The term is presumably linked to the terminology of section 6*quat*. We would also request some examples (e.g. withholding taxes imposed in terms of offshore trust structures, such as A-REITs used in Australia, and other common offshore structures).

10. Page 23 – Example 4

The methodology is flawed in that it purports that the qualifying distribution creates the loss instead of an actual loss carried forward. As such the answer is correct but the disclosure of the deduction, the qualifying distribution limitation, the assessed loss and the addition of the capital gain will cause confusion.

11. Paragraph 4.9 Cessation of a REIT or a controlled company [section 25BB(7)]

The draft IN emphasizes that when a company ceases to be a REIT, the year of the assessment for the REIT ends on that day and a new year of assessment begins on the next day. While the provisions of the ITA provide that on the cessation of the REIT, the taxpayer will have a new year of assessment, practically this could be an issue, as SARS eFiling does not allow for two tax returns to

be filled during the same year of assessment. It may be necessary for companies that cease to be a REIT to file manual tax returns for that year of assessment.

The Interpretation Note should set out the method to allow a company to file two tax returns.

12. Page 30 – paragraph 5.2

It is our submission that section 8F (and section 8FA) should not apply to REITS because artificial debt is not required to trigger a deduction for a REIT distribution in respect of a share. However, if the hybrid debts rules are going to be applied, the hybrid debt should be treated like any other equity share, meaning that payments should be deductible. Therefore section 25BB should override section 8F (and section 8FA)) from an interpretation point of view. This aspect should be clarified in the Interpretation Note.

13. 5.4 – Page 33 (linkage to section 10(1)(k)(i)))

Further clarification is required as to how the deductible "qualifying distribution" rules of section 25BB interact with the "receipt or accrual" concepts of dividends at the shareholder level under section 10(1)(k)(i). The timing of the deductions for the payor and the inclusion for the payee do not seem to be directly linked, thereby creating confusion.

At issue is the typical circumstance in which the REIT (or controlled company) makes payments at the beginning of a year based on a prior year profits calculation. If a REIT is paying listed shareholders, the deduction for the REIT and the receipt / accrual for the listed shareholders are preferable not the same. For instance, assume a REIT makes a January 2017 distribution based on a 2016 financial profit calculation, The deduction for the REIT needs to occur for the 2017 period while the listed shareholders would prefer an inclusion based on an independent 2017 receipt / accrual calculation. However, assume a REIT owns all the shares of a controlled (property) company, both of which have a calendar year basis of taxation. Further assume that the controlled property company makes a distribution in 2017 based on a 2016 financial profit calculation, along with a further distribution by the REIT at roughly the same time on the same basis. Under these circumstances, both entities need to have the timing of the distribution deductions and income to occur within the same year for an orderly process of passing distributions through the REIT chain. We would accordingly request some examples be added in this regard.

14. Page 35 – Para 5.7

We request that an interpretation of the law and examples are provided. We also request that section 45 and 47 in the context of a REIT be addressed.

15. Page 37 – Para 5.8

We request that an interpretation of the law and examples are provided.

16. Page 41 – VAT

We request clarification with respect to the apportionment of VAT claims by the REIT/controlled company with respect to distributions received from subsidiaries who are VAT vendors. We are concerned that a series of intra-group distributions will throw-off the VAT apportionment calculation. For instance, assume a REIT owns all the shares of a controlled (property) company. Further assume that the controlled (property) company makes a qualifying distribution to the REIT, followed by an immediate distribution of the same amount to the REIT's listed shareholders. These distributions should have no impact on VAT apportionment given the required linkage for annual REIT distributions.

17. **New point (urgent REIT investor issue**)

Many REIT investors borrow funds from a bank to acquire REIT shares. The REIT distributions are used to fund the interest and capital payments owed to the bank. It has long been assumed that bank interest is deducible under section 11(a) as an offset against the ordinary income arising from the REIT distributions. However, the section 11(a) deduction is seemingly now being challenged on audit, meaning that the REIT investor is fully taxable on a gross basis. This result is patently unfair because the income tax should theoretically apply only on the basis of net economic profits.

The argument allegedly being made against the investor claims of an interest deduction is that the investor lacks a "trade" as required by section 11(a). However, this view is in direct opposition to the essence of the REIT regime. REIT distributions were set to mimic "rental income" as if the investor held the underlying rental property directly. Rental expenses (including bank interest) are viewed as falling within the section 1 "trade" definition *per se* and REIT income should be interpreted as equivalent to the same. This was a core assumption for the negotiations that led to the creation of section 25BB.

We trust the above to be in order.

Yours faithfully,

ESTIENNE DE KLERK
CHAIRMAN

This submission has been reviewed by SAIT