The discussion paper on **REFORMING THE LISTED PROPERTY INVESTMENT SECTOR IN SOUTH AFRICA** is hereby released for public comment.

Comments on the discussion document should be furnished by Thursday**, 31 January 2008** in the Format indicated in *Annexure B* to this document. Due to time constraints, it will not be possible to respond individually to comments received. However, receipt of comments submitted in the correct format before the due date, will be acknowledged and fully considered by the National Treasury.

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National Treasury
REPUBLIC OF SOUTH AFRICA

REFORMING THE LISTED PROPERTY INVESTMENT SECTOR IN SOUTH AFRICA

Discussion paper

3 December 2007

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Part III – The way forward

Introduction

Indirect investment in property can be achieved by investing in property investment vehicles. Different types of property investment vehicles exist but they all have similar objectives including: providing a simple, quick and safe way to invest in property, enhancing liquidity for the investor, providing a fairly predictable income stream to the investor with capital growth on his/her investment.

In 1960 Real Estate Investment Trusts (REITs) were created in the United States of America (USA) to make investments in large-scale, income-producing real estate accessible to a diversified investor base, including institutional and retail investors. The Netherlands subsequently enabled this listed property structure in 1969. Belgium legalised REITs in 1995, as did Turkey, followed by Greece in 1999. The United Kingdom (UK) and Germany implemented REIT structures in 2007.

The Ernst & Young, Global REIT Report 2006 (the Ernst & Young report) estimated the rapidly growing market capitalisation of the global REIT industry at over US$608 billion with most of the capital located in the USA. The USA listed property market is worth in excess of US$300 billion. Other strong markets include Canada, Singapore, France, Australia and the Netherlands.

REITs are currently not specifically catered for in the South African regulatory and tax environment. The two most common types of REIT-like property vehicles currently in existence in South Africa are Property Loan Stock (PLS) companies and Collective Investment Schemes in Property (CISPs). Both are explained in Part I of this document.

National Treasury is reviewing the REIT structure for application in South Africa on two grounds. Firstly, and of paramount importance, is the optimisation of the regulatory framework to cater for the current fragmented property investment landscape which is only partly regulated. Optimising the regulatory framework also entails relaxing or redesigning some of the regulatory requirements that are too restrictive and not internationally competitive. Secondly, there is an inconsistent tax treatment of the two different types of property vehicles, mainly due to the difference in their legal forms and governing regulatory legislation.

The first part of this document will focus on describing the South African property investment landscape and regulatory constraints. These regulatory constraints are identified, compared to international trends as well as National Treasury objectives, and followed by proposed amendments to the regulatory framework. The second part of this document focuses on the South African tax dispensation. The current tax regime applicable to South African property investment vehicles is described, followed by international tax trends and a proposed new tax dispensation for REITs. The final part of this document highlights the next steps to be taken towards a new South African REIT framework, including transitional matters.

The purpose of this discussion document is to highlight National Treasury policy objectives and considerations, and to invite comments from stakeholders on these policy matters. The document also outlines some broad design features and comments on these are also invited. It should be noted that the proposed regulatory amendments will be accommodated within the Collective Investment Schemes Control Act (No. 45 of 2002)(CISCA). The proposed REIT structure will therefore effectively be accommodated in terms of CISCA and supplementary governing rules. Although not the main purpose of this discussion document, other concerns identified by stakeholders (and not addressed in this document) in accommodating REITs under CISCA may also be highlighted as part of the commentary process. A new tax dispensation for REITs is proposed with a separate schedule to the Income Tax Act dealing only with REITS. Comments on the proposed new tax dispensation are also invited.

Part I

1. The local market landscape

The main South African property investment vehicles are PLS companies and CISPs. Currently, there are five CISPs and nineteen PLS companies listed on the main board of the JSE Securities Exchange (the JSE), and at least one other CISP listed on Alt-X. In addition, there are a number of unlisted PLS companies of which two are registered with the Property Loan Stock Association (PLSA).

A CISP is a portfolio of investment grade properties that is typically held in the form of a trust even though CISCA does not prescribe the legal form. Thus, each portfolio's participatory interests are listed on the JSE in the "Real Estate" sector and is administered by a manager responsible both for the day-to-day operation of the properties and leases, and for the investment strategy of the trust or company.[1] A CISP can generate value for the investor through rental income from the underlying portfolio and appreciation in the values of these properties over time.

A PLS company also derives its income from holding a property portfolio, and its legal form differs from that of a [typical] CISP[2] in that it is a company. PLS companies also differ from CISPs in that management activities are normally performed internally i.e. the management activities of CISPs are always performed by an external entity whereas these activities may be performed by PLS companies themselves (internal management). Notably, a listed PLS company generally pays out almost all of its annual income, as opposed to other listed companies that retain up to 80 per cent of their income. In this respect PLS companies and CISPs are very similar.

The main difference between PLS companies and other companies is the method whereby the shareholders capitalise the company. An investor who purchases a linked unit in a PLS company receives one part equity and one part debenture.[3] The debenture portion of the linked unit generates interest at a variable rate for the linked unit holder. The interest is paid out of profits obtained from: rental streams from the properties in which the company is invested; the sale of an

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[1] The affairs of the manager that administers the CISPs are regulated by a deed. This document is similar to a mortgage and conveys title to a trustee for the benefit of some other person named in the document.

[2] The term "typical" is inserted here to reflect the fact that while CISCA does accommodate the company legal form, supplementary governing rules conflict with this flexibility, as discussed more fully below.

[3] The conditions and terms of the debentures, including rate of interest payable and repayment dates, are governed by the debenture trust deed, and independent trustees are appointed to look after the interests of debenture holders.

asset that has appreciated in value since its purchase; the rendering of property management services or other immovable property related activities.

Listed CISPs are subject to regulatory requirements imposed by the JSE for a securities exchange listing i.e. in the form of listings requirements, but more crucially are governed by CISCA under the auspices of the Registrar of Collective Investment Schemes - a Financial Services Board (FSB) function. This act and supplementary governing rules are not specifically tailored to accommodate non-trust entities and this is a key area of concern for PLS companies. One example of problematic supplementary governing rules is the “deed” between “the manager” and “the trustee”. This deed or agreement may be problematic when the manager and the trustee is one and the same entity.

From a governance perspective, listed PLS companies are subject to the Companies Act (No 61 1973) and JSE regulations. PLS companies are typically geared at a debt to equity ratio considerably higher than the gearing allowed for CISPs i.e. 30 per cent.[4]

The listed property industry, both domestically and abroad, has been characterised over recent years by increased consolidation, primarily through merger or buy-out transactions. During 2006 takeovers in South Africa included: Growthpoint Properties Limited (Growthpoint) buying Paramount and Metboard; Redefine taking over Spearhead; and Emira acquiring Freestone.

Over the past decade, the size of the listed property sector held by PLS companies has increased dramatically. In 1998, CISPs had the majority market share of the South African listed property sector with 66 per cent of the total market capitalisation, compared to the 34 per cent market cap held by PLS companies. Since then this position has changed, with PLS companies by mid-2007 holding approximately 74 per cent of the total market cap of the listed property sector compared to the CISPs’ 26 per cent.

[4] The FSB’s model deed has historically limited gearing to 30 per cent of the value of the underlying assets. The FSB has approved in principle the increase of this limit to 60 per cent as a first step towards a more flexible regulatory regime that accommodates more property investment vehicles under CISCA.

The aggregate size of the listed property sector has grown considerably, most notably over the past year. Between June 2006 and June 2007 the market capitalisation of the PLS companies increased from R52,1 billion to R68,8 billion (a 32 per cent increase). Over the same period the market cap of the CISPs increased from a market capitalisation of approximately R16 billion to R24,3 billion (a 52 per cent increase). The relatively higher growth in PLS companies (both in number and size) can, at least in part, be attributed to the greater flexibility afforded to PLS companies. CISPs are subject to an arguably overly strenuous regulatory environment.[5]

Looking at returns generated across the CISP sector in 2006, CISPs competed well with the FTSE/JSE ALSI and ALBI returns during the same period. The accumulated returns comprise of an income return of 11,8 per cent and capital growth of 49,9 per cent, compared to the return of 57 per cent from the FTSE/JSE ALSI. The abnormally strong growth in the stock market over the past three years has resulted in CISPs trading at a significant premium to their net asset values. Indeed by March 2006, CISPs reflected an average net asset value of R2,53 per unit, compared to the average market value of R6,84 per unit.

The growth in market value across the listed property sector has been accompanied by a growth in liquidity, with the value of trades increasing from R1.3 billion in 1998 to R10 billion in 2005.[6]

The growth and success of the listed property sector in South Africa has also supported growth in other sectors, such as the construction industry.

2. A need for change

We have already noted two drivers of the property investment sector regulatory review. Firstly, the current property investment landscape is fragmented, only partly regulated and the regulatory framework is too restrictive and not internationally competitive. Secondly, there is an inconsistent tax treatment of

[5] Examples of an overly strenuous regulatory regime applicable to CISPs are the low leveraging limits (until the FSB's recent communication to the industry to raise this limit to 60 per cent), the implicitly imposed external management structure, as well as certain duties and responsibilities awarded to CISP trustees or custodians.
[6] No trade data after 2005 is available.

the two different types of property investment vehicles. The first issue is addressed in paragraph 2.1 below and the second issue is addressed in paragraph 6.

2.1 A fragmented and unregulated market

As illustrated, the listed property sector is currently dominated by two types of investment vehicles namely the CISPs and PLS companies, but these two vehicles do not operate on a level playing field due mainly to differences in the governing regulatory framework (or absence thereof). The impact of this differential treatment is reflected in the market cap of the [FSB unregulated] PLS companies (R68,8 billion) as opposed to that of the [FSB regulated] CISPs (R24,3 billion).

A uniform tax dispensation for all property investment vehicles will be difficult to implement in the current fragmented environment. Moreover, a fragmented market promotes investor uncertainty, particularly for retail investors.

Foreign investor shareholding in local property investment vehicles is relatively insignificant, comprising a mere 1 per cent of the total shareholding. Domestic companies and collective investment schemes are the major shareholders in PLS companies and hold 48,7 per cent and 21,5 per cent of total shares respectively. This is a surprising fact, as the Ernst & Young report, measuring the performance of the property sector, shows South African CISPs to be the top listed property performer in the world, with an average rate of return over a three year period of 34 per cent. France and the Netherlands followed with average three year returns of 31 per cent and 24 per cent respectively. Furthermore, the South African CISP sector experienced the lowest volatility of all 13 countries evaluated in the report.

Another factor contributing to the favourable investment climate of the South African listed property sector is the weak return produced in developed countries such as the USA e.g. the USA 1 year return to June 2006 was only 6,55 per cent against South Africa's 22,95 per cent.[7] These figures are promising for the South African listed property sector, especially if South Africa could offer an internationally recognised REIT product that USA investors are familiar with.

The evidence suggests that the South African listed property sector is well placed to compete internationally – both in terms of risk and return. Thus from a policy perspective National Treasury deems it necessary to remove possible obstacles for foreign investor investment in the listed property market – namely the fragmented regulatory structure governing the listed property investment vehicles in South Africa.

3. The benefit of a REIT as an investment vehicle

Internationally, REITs are credited with the following advantages:

- *Tax-efficiency:* a REIT is usually treated as a conduit, thereby avoiding the "double taxation" that occurs when investing in normal shares. Income earned is added to the investor's taxable income and taxed at a marginal rate;
- *Diversification:* REITs provide an opportunity for investors to more readily access property as an asset class in a variety of sectors (e.g. residential, commercial, industrial) and geographical regions;
- *Liquidity:* As listed entities REITs can be traded daily, unlike direct investments in property which are highly illiquid;
- *Accessibility:* Investors can more easily gain exposure to the property market for a minimum outlay (the cost of the share) compared to direct investment;
- *Provider of Income:* The requirement that REITs have to pay out most of its income to investors makes it an ideal investment vehicle for pension funds and pensioners; and

[7] Keeping in mind that South Africa is coming off a relatively low base; the USA has by far the largest property market capitalisation in the world, with the Ernst & Young report measuring it at US$608 billion in 2006, and at US$900 billion when accounting for the effect of gearing.

- *Good governance:* REITs are subject to listing rules as well as REIT regulations.

4. A new South African REIT: Regulatory framework

The core characteristics of PLS companies and CISPs are similar to that of most international REIT structures. The following similarities between the anticipated REIT structure and the existing property investment vehicles (i.e. PLS companies and CISPs) should facilitate a relatively smooth transition process:

- Taxing of investment returns in the hands of the investor only (PLS companies and CISPs pay out most of their income to investors and tax is effectively only levied in the hands of the investor);

- Investing in immovable property related business (PLS companies and CISPs invest in property related businesses with a focus on rental income); and

- Listing on a licensed exchange (PLS companies and CISPs are traded on the JSE).

The South African regulatory design structure of REITs should be in line with internationally recognised REIT design features to promote foreign investment in the listed real estate market, as well as further support the local investor base. Both the PLS companies and CISPs have indicated their willingness to reconfigure their respective industries to the internationally recognised REIT structure.

National Treasury envisages a REIT defined to minimise adjustment (and therefore disruption and cost) for the PLS and CISP sectors. The REIT structure should therefore be straightforward, well understood, internationally competitive and easily accessible by local and foreign investors. REITs will be regulated and supervised by the FSB to ensure investor protection. With these principles in mind, the proposed REIT design should have certain design features that are informed by policy considerations and objectives. These design features are described in more detail below.

4.1 Organisational rules

Internationally, the organisational rules pertain to the specific institutional forms allowed, listing requirements, the minimum stated capital, shareholder restrictions and management restrictions. With some exceptions, most countries accommodate both trusts and company structures in their REIT design, and require that the REIT be listed. The regulation of management oversight (in terms of both duties and responsibilities) normally depends on the institutional form of the REIT. Management oversight typically requires some degree of shareholder protection exercised by trustees in the case of a trust or directors in the case of a company. Australian REITs must be managed by a corporate trustee, responsible entity or fund manager. Likewise in the USA, the REIT must be managed by one or more trustees or directors.

Shareholder restrictions vary considerably from country to country. For example, Australian REITs (known as Listed Property Trusts) have no minimum or maximum shareholding requirements. German and UK REITs permit a maximum shareholding of 10 per cent per shareholder (with some exceptions) to ensure that the interests are widely held and to minimise the loss of tax revenue for their respective governments under Double Tax Agreements (DTAs). Germany also requires that the permanent free float[8] be at least 15 per cent, and at the time of the exchange listing, at least 25 per cent. Japan, the USA and Canada place limits on the minimum number of shareholders namely 50, 100 and 150 respectively.

A further policy issue relates to the possible restrictions in respect of foreign participation. Canada for example requires that the Canadian REIT be a unit trust resident in Canada and cannot be established or maintained primarily for the benefit of non-Canadian residents. Korea restricts foreign ownership.

National Treasury objective: Appropriate regulation to promote maximum protection to investors and to safeguard the industry reputation, whilst also allowing enough flexibility for REITs to provide maximum return for investors.

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[8] Free float means the shares of a public company which are freely available to the investing public.

National Treasury proposals: The South African REIT will be housed under CISCA, meaning that its legal seat and place of management must be in South Africa. Consideration is being given to replace the term CISP with the internationally recognised term REIT in CISCA. The JSE already refers to this segment of the listed market (to include both CISPs and PLS companies) as REITs. Investment units in these REITs will be called "property units" consisting of "participatory property interests" in trusts and "property shares" in companies.

It is proposed that a REIT be a public company or a trust, but must be listed on a South African licensed exchange. This is, in the main, to promote a higher level of fund governance through increased transparency, and to ensure daily pricing (and liquidity) for retail investors. An exception to the listing requirement may be considered for REITs with a single investor and/or where direct investment in the REIT is not offered to the retail market and investors constitute certain financial institutions that are regulated by the FSB e.g. long-term insurers. The consideration for such an exception to the rule will be informed based on relevant information provided by the industry.

Irrespective of the institutional form of the REIT, property unit holders in the REIT must be represented by elected trustees or directors. Specific rules requiring oversight and transparency of management decisions and strategy should ensure that where the interests of fund managers and property unit holders diverge, property unit holder rights remain protected (see paragraph 4.5).

No minimum investment requirement or maximum investment limit are proposed but certain investment parameters may be considered to facilitate government policy objectives (e.g. parameters to limit the tax loss to the fiscus). Possible investment parameters will be in line with the international REIT design framework.

Currently CISPs fall under the ambit of CISCA. The result of housing REITs under CISCA will be that CISPs will automatically be converted to REITs. PLS companies will have to apply for REIT status in terms of CISCA. One of the tasks of the FSB in regulating the PLS industry will be to assess PLS compliance with the new requirements imposed upon them as REITs.

4.2 Income and asset rules

All countries impose restrictions on the activities that can be undertaken by REITs. These restrictions normally include imposing limits on income generated from certain activities or certain classes of assets. However, these limits still provide enough flexibility to REITs to operate their business in a fairly unconstrained manner. For example a minimum investment in immovable property (minimum percentage of asset value to be invested in immovable property) or a minimum income derived from immovable property (minimum percentage of income to be derived from immovable property). Investments in assets other than immovable property may also be limited in terms of types of assets (e.g. restricted to cash or cash-like assets like government bonds).

In Australia a REIT must invest in land either inside or outside Australia with the main purpose of deriving rental income from it (specified as a minimum of 50 per cent of income generated) or in real estate companies that derive income primarily from rentals.

The UK requires that at least 75 per cent of income must be rental income from property and 75 per cent of assets must be classified as investment assets. Development activity is permitted as long as it is done for the purpose of letting and the property is retained for at least three years. The company must have at least three properties in its portfolio throughout all accounting periods and the value of a single property must not exceed 40 per cent of the combined value of all the properties.

In the USA, at least 75 per cent of a REIT's gross annual income must be generated from real estate related sources, and at least 95 per cent must come from real estate related sources and passive sources like dividends and interest. Therefore, the USA rules on asset allocation differ from the UK rules, while both countries require a minimum of 75 per cent of income to come from real estate.

Internationally, REIT rules are generally flexible with respect to whether or not REITs can invest in other REITs, although most jurisdictions require that income must primarily be derived from real estate activities. This requirement does not necessarily require direct investment into fixed property. For example, Australia allows a REIT to invest in any other real estate company with its main source of income being rental income. The real estate company does not have to be a REIT, as long as more than 50 per cent of its income is derived from rental sources. The USA has similar asset and income tests with reference to real estate assets including shares of other REITs.

South African CISPs are able to invest directly in immovable property locally and abroad, and Collective Investment Schemes in Securities (CISS) can invest in fixed property companies which own and develop various types of properties. CISPs are also allowed to invest in property shares or to hold participatory interests in CISPs or foreign REITs, provided that the country in which the REIT is situated has a foreign currency sovereign rating provided by a rating agency.

Arguments have been put forward to relax these investment limits to allow all collective investment schemes (both in property and shares) to invest in each other and in PLS companies. At present, nothing prevents a PLS from investing in another PLS, a CISP, property development companies or any other security locally or abroad.

National Treasury objective: To streamline the corporate layering within the industry as well as to promote investment in South African real estate.

National Treasury proposals: In order to streamline the corporate layering within the industry, indirect investment in property will be limited to two REIT layers per indirect investment i.e. a REIT can only invest in another REIT (domestic or abroad) if the investee REIT invests directly in property. This means that all property companies will either have to register as a REIT or liquidate in terms of the transition rules (see paragraph 8). It is further proposed that “bundling” assets together in a corporate entity for financing purposes only (e.g. securitisation) not be recognised as a REIT but merely act as a conduit.

A REIT should be able to invest directly into immovable property situated in South Africa or internationally, although investment in immovable property situated outside South Africa may be limited. This limit will be informed by the policy objective to develop the South African property market and to reduce the complexity of allowing foreign tax credits to flow-through to REIT investors.

International property investment will further be limited to property situated in a foreign country that has a foreign currency sovereign rating provided by a rating agency.

There will be no restrictions on the types of properties allowed i.e. open land, residential, commercial or industrial. Income derived from other property related sources, specifically the provision of asset management and/or administration services, will be permitted.

It is proposed that South African REITs be required to generate at least 75 per cent of total income as rental income from immovable property. This requirement should ensure that the property fund invests in immovable property and generates the majority of its income directly from immovable property. Direct and indirect development activities will be permitted as long as they are for the purpose of letting and retain the property for at least three years. A REIT should invest in immovable property (long-term) rather than trade or speculate with property (short-term), and the activities of the fund should reflect this.

To ensure adequate risk spreading through diversification, a REIT investing directly in property must have at least three properties in its portfolio throughout all accounting periods, with a maximum proportion of any one property being 40 per cent of the total fixed asset value. These requirements will also be applicable to conduits referred to on the previous page.

To increase flexibility a REIT can invest in cash, money market instruments and government securities. These balances will be taken into account when applying the immovable property requirement of 75 per cent. The specified instruments will be permitted to promote the efficient employment of the cash flow in the fund, as well as to facilitate diversification into low risk, liquid instruments in the event of a property market down turn.

4.3 Distribution rules

REITs are typically required to distribute all or most of their net income annually. For example, in Hong Kong and Singapore at least 90 per cent of the REIT's net income must be distributed annually. In Malaysia, income distributed to unit holders is not taxed in the hands of the REIT, while undistributed income is taxed in the REIT.

Germany and the USA require that at least 90 per cent of a REIT's taxable income be distributed annually. The UK requires that a minimum of 90 per cent of rental income be distributed. Germany requires that all income and gains be distributed to investors although they do allow for up to 50 per cent of capital gains to be allocated to a reserve account for a period of up to two years. Amounts allocated to this reserve account are to be used to acquire immovable property.

National Treasury objective: To provide an efficient and regulated savings vehicle for investors whilst limiting the tax-loss to the fiscus.

National Treasury proposals: In line with international trends, REITs will have to distribute most (at least 90 per cent) of their accounting profits on an annual basis. At least some level of regulation of expenses should be catered for in the regulatory framework to ensure that the beneficial tax status of these entities do not subsidise costs of service providers to the REITs and that the full benefit of the beneficial tax status of the REIT is passed on to the property unit holders.

Proceeds realised on the sale of assets (other than upon liquidation of the REIT) have to be reinvested and may not be distributed to unit holders. Reinvestment should happen within a reasonable time of no longer than 12 months from the date the gain is realised. Consideration could be given to extending this period in exceptional circumstances. The reason why capital distributions should be prohibited is that it could be used to artificially inflate the short term investment returns for property unit holders while eroding the fund's longer-term value (at the expense of property unit holders). A further problem with capital distributions is that long-term growth of investments is not facilitated and the capital distribution may not necessarily go to the correct property unit holder (i.e. a timing problem).

4.4 Gearing limits

Gearing is used to increase exposure to market movements on immovable property beyond what the initial equity-like capital investments of property unit holders would allow. Moreover, as a significantly cheaper form of capital raising (which does not dilute ownership), debt can be an efficient means to finance long term growth, thereby optimising returns for property unit holders. On the other hand, excessive “borrowing” can also undermine the financial stability of an entity, as the cash flows may not be adequate to repay interest obligations (i.e. due to a downturn in the economy and/or increased interest rates). The regulatory objective is to appropriately balance the possible increased returns and capital growth on the one hand against capital protection on the other.

The underlying assets of a REIT are primarily land and buildings (immovable property), which are typically less volatile than other asset classes like securities. Also, immovable property has a much higher intrinsic value than certain other asset classes like securities. Banks have a long history of financing immovable property and have, in general, a sound risk assessment framework in place to access the default risk on these mortgages.

In summary, while supply and demand drives the property unit price of the REIT, in turn meaning that its property unit price can be as volatile as any other listed security, REITs have a better “stop-loss” provision (with specific reference to break-up value) by its very nature. This is due to immovable property providing for a higher break-up value of the REIT than other operating companies. These arguments go toward justifying a higher borrowing limit for REITs than currently allowed for CISPs.

The question that now arises is: what should the limit be? Internationally, the percentage of this limit varies (the borrowing limit is generally expressed as a percentage of total asset value). So while the USA and Canada have no gearing limits, Australia and the Netherlands have gearing limits of 75 per cent and 60 per cent respectively. The UK has approached the gearing issue from a different angle, requiring that the ratio of profits (before capital allowances and interest payments) to interest payments be limited to 1.25 i.e. if profits are 100, interest payments are limited to 80.[9]

[9] The imposition of this equation will impose a maximum level of gearing to between 65 to 75 per cent.

Although a CISP's current gearing limit of 30 per cent (of the value of the assets, to be raised to 60 percent by the FSB) competes well with certain developing countries like Malaysia and Singapore (at 35 per cent), National Treasury recognises that South African property vehicles are competing for domestic and global capital investment against both developed and developing countries. In addition, National Treasury acknowledges that South Africa has a systemically stable banking (lending) sector, with strong corporate governance across the listed security environment. These conditions facilitate a more flexible regulatory approach to gearing.

According to the Ernst & Young report, most REITs in countries with gearing limits do not fully optimise their gearing "rights" (i.e. actual gearing remains far off the gearing limits). The Australian REIT market's actual gearing is in line with the international average i.e. 33 per cent. Gearing of REITs globally ranges between 28 and 38 per cent which is deemed conservative in comparison to gearing ratios of other operating companies.

Two North American countries, the USA and Canada have the highest REIT gearing levels in the world at an average of 56,4 per cent. This could be attributed to the different accounting treatment in the North American countries (where assets are valued at cost rather than fair value) and the absence of gearing limits.

In South Africa, CISPs have recorded an average gearing of only 16,7 per cent (and are reported by the Ernst & Young report as exhibiting the lowest gearing across its sample), while still producing excellent returns over a three year period. This indicates that gearing is only one of a number of factors that influence the performance of a country's property investment sector.

National Treasury objective: It is recognised that investors should be protected against a loss of capital invested in the REIT. However, the level of protection should also take into account the objective of encouraging optimal investor returns through higher levels of gearing within the REIT. The proposed gearing limits are therefore informed by these policy considerations and objectives.

National Treasury proposals: There are two distinct aspects of this proposal: The first is the base i.e. on what value do we base the gearing limit, and the second is the value of the gearing limit. It is proposed that the base be the value of the fixed assets (as reflected in the last financial year's published financial statements). One area of concern is that in times of economic down turn and increased interest rates, rental income of the REITs may fall short of covering interest payments. Consideration will be given to identify possible measures to protect investor capital against these risks. A further complexity of these increased gearing limits is that the REIT may lose its REIT status if the value of property decreases from one year to the next. Paragraph 4.7 will deal with this issue. It is further proposed that the value be limited to 70 per cent.[10]

4.5 Investor protection: The role and duties of the trustees/directors

The role and duties of a director in terms of the Companies Act differ from the role and duties of a trustee[11] of a collective investment scheme in terms of CISCA. The interests of an investor in a REIT need to be protected but the "trustee" or "custodian" structure in its current form as contained in CISCA may not be workable for the proposed REIT structure. A new REIT landscape will need to ensure that trustees (in the case of a trust) and directors (in the case of a company) have equal obligations to property unit holders. Ownership and vesting requirements of the assets should also be reviewed.

International trends vary on this aspect. In the UK, REIT rules allow only for a corporate identity and require no trustees. In contrast, in Canada the trustees of a trust are generally personally liable for any liability incurred by them in the course of administering the trust; individuals serve as trustees of most REITs. However, many REITs hold their operating assets in a "sub-trust", the trustees of which are corporations. This is to provide limited liability protection for the trustees of the REIT.

[10] The FSB's accommodation of a rise to 60 per cent is a first step towards this increased flexibility.
[11] Trustee for the purposes of this section also includes a custodian as contemplated in CISCA.

Singapore has proposed increased responsibilities for REIT trustees that include an obligation to ensure the following:

- That the REIT has proper legal title to the properties it owns;
- That the properties have a good marketable title;
- That the contracts (such as rental agreements) entered into on behalf of the REIT by the REIT manager are legal, valid and binding and enforceable by or on behalf of the REIT in accordance with its terms; and
- That the REIT manager arranges adequate property insurance and public insurance coverage in relation to the REIT's properties.

National Treasury objective: To ensure that trustees and directors of REITs protect the interests of property unit holders without imposing an undue burden on trustees of compulsory duties falling outside their core function. Managers must be provided with enough flexibility to carry out their duties without undue hardship or constraints while still being effectively accountable to the trustees and directors.

National Treasury proposals: It is proposed that CISCA and the generic founding document be reviewed for possible amendments giving effect to the National Treasury objectives. The Generic Deed applicable to CISPs should be reviewed and restructured as a Generic Founding Document applicable to REITs irrespective of their legal form. Legislation and the founding document should address and/or clarify the role and duties of trustees/directors to ensure that various legal forms can effectively be accommodated under CISCA.

4.6 Economic Empowerment (BEE)

The Property Charter signed in the early part of 2006 provides for, *inter alia*, the transfer of 25 per cent ownership to previously disadvantaged communities within a period of five years.

To meet this objective, financing has to be facilitated where the manager (acting on behalf of the REIT) extends surety / guarantees as security for the third party funding obtained by the relevant BEE investor; this is to enable the BEE investor to acquire participatory interests in the REIT. The guarantee must be secured by a portion of the REIT's assets, equal to the total funding provided by the third party.

There is currently uncertainty around who should or could provide a guarantee (i.e. the CISP, the portfolio manager or neither) as well as the procedure to be followed with respect to the provision of guarantees.

National Treasury objective: To enable the REIT industry's participation in BEE initiatives whilst ensuring adequate investor protection.

National Treasury proposals: In order to provide an effective balance between the abovementioned objectives, the existing CISP framework (aimed at investor protection) should be reviewed against the backdrop of the Property Charter (aimed at encouraging BEE initiatives). Consultation between the National Treasury and the Property Charter Council will inform this review, to be followed by more detailed proposals in the response document.

4.7 Implications of non-compliance with regulatory requirements

A number of penalties may be imposed in terms of CISCA on non-compliant managers and trustees in the form of (amongst others) withdrawal of its approved status. These may need to be reviewed due to the proposed new REIT structure.

Internationally there are two main models: the first is the "partial REIT" structure and the second is the "all or nothing REIT" structure. The UK follows the first model in terms of which a REIT is allowed to have a "ring-fenced" regime i.e. to the extent certain requirements are not met, the non-compliant part of the business is taxed at normal rates. The USA follows the "all or nothing" REIT structure i.e. the tax dispensation applicable to REITs only applies if all the REIT requirements are met. In order to reduce or accommodate the potential penalty applicable to violations of some of the REIT design features in the "all or nothing" structure, the REIT will retain its status even if it violates some of the qualification criteria as long as the violations were effectively outside the control of the REIT. A monetary penalty may still be payable for each violation.

National Treasury objectives: To allow for a simplified and easy-to-administer tax and regulatory model, without causing undue hardship for the REIT (including managers and trustees) or participatory unit holders (that may result from the REIT violating the qualifying criteria due to reasons outside the control of its stakeholders).

National Treasury proposals: An “all or nothing” tax dispensation is proposed for South African REITs. A grace period of one year will be allowed where violations of qualifying criteria take place although a monetary penalty may still be payable. Thus REITs will effectively be granted one year to rectify the violation after which it will lose its tax exempt status. Regulatory requirements and penalties applicable to managers and trustees/directors will continue to be enforced.

Part II

5. Current tax treatment

5.1 Tax treatment of CISPs

The legal form of a CISP is a vesting trust – this means that all income earned by the trust accrues to the beneficiaries (or participatory interest holders) of the trust. The capital gains realised from the sale of assets by a vesting trust also vests in the participatory interest holder, although paragraph 67A of the 8th Schedule of the Income Tax Actoverrides this general principle. The effect of this paragraph is that no capital gain is realised by the participatory interest holder when immovable property is sold by the CISP and Capital Gains Tax (CGT) is only payable when the unit holder disposes of his unit. The participatory interest holder will pay tax on the gain realised on his participatory interests. Vesting trusts have the same tax status as any other trust i.e. all taxable income of the trust is taxed at a rate of 40 per cent, but due to all income earned and gains realised by the trust vesting in beneficiaries the taxable income of a vesting trust will normally be 0. The income will retain its nature i.e. if the trust receives rental income, the same amount of rental income will vest in the hands of unit holders. CISPs own the underlying assets (property) directly or indirectly through the shares in a fixed property company.

5.1.1 CISPs owning property directly

Income earned by a CISP vests in the participatory interest holders (see clause 32 “Paying over of receipts to trustee and appropriation thereof” of the Generic Deed). The CISP is also obliged to pay all income earned to its participatory interest holders. CISPs that own property directly will have no taxable income, as all the income vests in and is distributed to unit holders. The income earned by the CISP is mainly rental income and is distributed to participatory interest holders. For tax purposes the distribution is regarded as rental income.

The capital gains realised from the sale of assets by a CISP is effectively exempt from tax in the hands of the CISP due to the conduit principle. As previously indicated, no CGT is triggered for the participatory interest holder when the CISP sells immovable property. The gain attributable to the participatory interest holder of a CISP is determined only upon the disposal of that holder’s participatory interest rather than the sale of the underlying property.[12]

5.1.2 CISPs owning property indirectly through shares in a fixed property company

A fixed property company earns taxable rental income from the properties it owns but receives a tax deduction for all dividends (paid from profits of a revenue nature) paid to its shareholders.[13] The fixed property company therefore also acts as a conduit to the extent it pays out all its rental income to its shareholders in the form of dividends.[14] These dividends constitute taxable dividends in the hands of the CISPs[15] but due to CISPs being vesting trusts, the taxable dividends accrue to participatory interest holders. No Secondary Tax on Companies (STC) is payable on these dividends.[16]

Fixed property companies are subject to CGT and will therefore pay CGT on gains realised on the sale of property. Dividends declared from these capital

[12] Paragraph 67A of the 8th schedule to the Income Tax Act.
[13] Section 11(s) of the Income Tax Act.
[14] Should the fixed property company retain some of its income, it will pay income tax at corporate tax rates on this income.
[15] Section 10(1)(k)(i)(aa) of the Income Tax Act.
[16] Section 64B(5)(b).

gains are not tax deductible for the company but the dividends are exempt from income tax in terms of Section 10(1)*(*k*)*(i) as the proviso[17] does not apply to dividends paid from capital gains. STC is payable on these dividends distributed from capital gains.

5.2 Tax treatment of PLS companies

PLS companies are registered as companies in terms of the Companies Act and are regarded as companies for income tax purposes i.e. they are liable to pay tax at a rate of 29 per cent on taxable income. PLS companies issue linked units consisting of a small equity component (reflected on the company's balance sheet as share capital and premium) and a large debenture component (reflected on the company's balance sheet as debentures). The debentures' component is normally repayable after a period of 25 years and subject to a special resolution. Interest is payable on the debenture component at a variable rate. The interest is generally in excess of 95 per cent of operating profits before debenture interest.

Interest incurred by a company is a tax deductible expense provided it is incurred in the production of income.[18] PLS companies pay out most or all of their profits in the form of interest to linked unit holders and are therefore left with very little taxable or no income. Interest received is taxable in the hands of linked unit holders. PLS companies therefore effectively enjoy the same income tax treatment as CISPs – the only difference is that participatory interest holders in CISPs receive rental income whereas linked unit holders in PLS companies receive interest income. The nature of the income earned by PLS companies depends on whether they own property directly or indirectly through subsidiaries.

5.2.1 PLS companies owning property directly

PLS companies owning property directly earn mainly rental income. Income tax payable by the company is calculated on the taxable income (after debenture interest). Dividends may be declared on the equity component of the linked unit. Dividends are not tax deductible for the company and STC is payable at a rate of 10 per cent on net dividends distributed.

[17] Paragraph (aa) of the proviso to Section 10(1)(k)(i) of the Income Tax Act.
[18] Section 11(a) of the Income Tax Act.

PLS companies are subject to CGT and the gain realised on the sale of fixed property will be taxed at an effective rate of 14.5 per cent. Should dividends be distributed from capital gains, these would also be subject to STC. The gain or profit realised by a linked unit holder on the sale of a linked unit is classified either as a capital gain or ordinary income.

5.2.2 PLS companies owning property indirectly through shares in a subsidiary

A PLS company (parent) owning shares in a subsidiary earns mainly interest income because the subsidiary is also a PLS. The capital and income structure will effectively be duplicated due to the dual PLS layer but the end result should be the same as the single layer PLS structure. CGT is payable on disposal of immovable property at subsidiary level and income tax or capital gains is payable by linked unit holders when they dispose of the linked units.

6. Need for change

6.1 <u>Tax charges on re-structuring activities within the sector</u>

Sections 41 to 47 of the Income Tax Act make specific provision for the deferral of tax where reorganization transactions take place within a group of companies. As previously pointed out, CISPs are not regarded as companies for Income Tax purposes. Therefore, any re-organisation transaction involving companies and CISPs, or transactions between two CISPs, will not qualify for tax deferral.

6.2 <u>Tax uncertainty in the PLS sector</u>

It is difficult to have a uniform tax regime for the property sector if the market is fragmented with no uniform regulatory regime applicable to all entities in this sector. As there is no simple uniform tax dispensation for property investment vehicles, legislation follows legal form. Instead there should be a specific tax dispensation for all property investment vehicles, meaning that PLS companies should be able to enjoy the same tax dispensation as CISPs provided they are similarly regulated.

Moreover, SARS has expressed concern that the high level of debenture interest payments to linked unit holders may constitute dividends rather than interest. These interest payments effectively places the PLS companies in the same tax position as CISPs but without the FSB oversight and regulatory legislation designed to protect investors.

7. A new South African REIT: Tax dispensation

The tax treatment of REITs depends, to a large extent, on certain regulatory rules being adhered to. Internationally these regulatory rules are either imposed by regulatory authorities or tax authorities.

It is internationally accepted that REITs should invest mainly in fixed property generating rental income. In order to achieve this, income and asset rules are imposed. The first example of such a rule is the requirement that a minimum percentage of assets should be invested in immovable property from which rental income is derived (refer to paragraph 4.2).

Most countries recognise that for local investors, income generated by a REIT should be taxed in the hands of those investors, thereby giving effect to the tax conduit principle. Income is not automatically attributed to investors; regulatory or tax rules require that most income (expressed as a minimum percentage of income) be distributed to investors. The minimum distribution requirement varies between 80 per cent (e.g. Belgium) and 100 per cent (e.g. the Netherlands). Retained earnings are normally taxed as income in the hands of the REIT. Countries that have income distribution rules include Australia, Belgium, Canada, France, Japan, the Netherlands, the UK and the USA.

The rule described above effectively pushes the tax liability from the REIT entity level up to the investor level. A risk attached to this rule is the risk of not collecting taxes from foreign investors. In order to limit this risk to the fiscus, countries impose a withholding tax on distributions either to all investors or only to foreign investors. Countries that impose a withholding tax on distributions include Belgium, France, Japan, Korea, the Netherlands, Singapore and the USA.

The capital gains realised on the sale of immovable property are generally tax exempt in the hands of the REIT (see Belgium, France, Italy, the Netherlands, and the UK). However, some countries require that a certain percentage of capital gains be distributed to investors (e.g. France requires 50 per cent of gains to be distributed to investors).

Countries that recently introduced REIT legislation (in terms of which REITs are awarded a special tax dispensation) levy an entry charge on entities entering the REIT regime. The entry tax can be a fixed percentage on the value of immovable property held at the date of entry or a reduced CGT levied on the unrealised profit of the immovable property held on the date of entry. Belgium, France, the Netherlands and the UK levy an entry tax. The entry tax rates vary and are not useful for purposes of this document as the entry tax should be compared to the effective tax rate on property levied in that country and the average level of unrealised profit in each entity wanting to enter the REIT regime.

Tax risks: It should be noted that although REITs have been around for many years, their unique structure and tax dispensation were not specifically catered for in DTAs. The OECD is busy looking at a specific clause on REITs to be incorporated in the model OECD tax treaty. Developments in this regard should therefore be carefully monitored.

National Treasury proposals: Before broaching the details of international REIT design, the first question to be asked is what distinguishes a REIT from other operating companies i.e. why should a special tax dispensation be awarded to these entities? In response, consider that a REIT invests in fixed property and generates rental income for distribution to its investors. A REIT can therefore be characterised as a pool of capital contributions by investors to purchase fixed property. The fixed property will generate “passive” rental income. It should therefore be noted that any deviation from this basic principle should be regarded as a special concession from a tax perspective. Special concessions should be considered for a number of reasons i.e. to enable South African REITs to compete internationally and increase returns for investors without significantly increasing the associated risks.

International comparisons are very important but we should be careful to not just follow international REIT design trends without understanding the real estate market of the relevant country i.e. the development stage of the commercial real estate market in that country, the general tax system of that country and the government's objectives when REIT regulatory or tax design was introduced. For example Australia has a well-developed and established REIT market with excess cash to invest, whereas the German commercial real-estate market is mainly in the hands of government or private individuals. The REIT market is therefore underdeveloped and the German government wants to strengthen this market by providing for a reduced CGT rate when commercial property (held for longer than 5 years) is disposed of to REITs.

South African tax legislation currently imposes a dual layer of tax on corporate profits. The first layer of tax is levied on the company when it realises profits i.e. companies are subject to income tax on ordinary income and CGT on the disposal of capital assets. The second layer of tax is levied on distributed profits i.e. if these profits are distributed in the form of dividends, these are taxed again. Shareholders are also taxed on the gains realised from the disposal of shares. Certain investment vehicles are not subject to this dual layer of tax and only investors are taxed on income and capital gains realised by the investment vehicle. These investment vehicles include CISPs. It is proposed that some of the regulatory rules for CISPs be reviewed in light of the international REIT trends and to accommodate other property investment vehicles i.e. PLS companies. The beneficial tax dispensation applicable to these entities should remain and should also be streamlined as proposed below. However, we should be careful that the REIT design features and special tax dispensation do not undermine the general tax principles and tax dispensation applicable to operating companies.

For any listed property vehicle that reflects the preceding REIT characteristics and is registered as a REIT to be supervised by the FSB, the following tax treatment is proposed:

A simple and uniform tax dispensation will be applicable to all REITs. The new tax dispensation should allow for only one level of tax i.e. investors in REITs will pay income tax on income distributed by the REIT and will pay CGT on gains realised from the sale of long-term investments in REITs. No tax should be payable on ordinary income or capital gains realised by the REITs, provided certain regulatory rules are in place i.e. income earned by the REIT has to be distributed to unit holders and capital gains realised by the REIT has to be reinvested. REITs will not have to apply for approval from SARS to access this special tax dispensation as the regulatory design already takes account of special design features needed to facilitate the simple and streamlined tax dispensation. Some regulatory features are aimed at limiting the potential tax-loss or tax-avoidance schemes. It should be noted that a close relationship between the regulatory REIT design and tax dispensation be maintained on a continuous basis after introduction.

7.1 Tax implications of income distribution

Regulations will require that a REIT distributes most of its net income to investors within its financial year. The REIT will have no taxable income and investors will be taxed on these distributions. The benefit of this tax dispensation is that REITs will not have a compliance burden of filing tax returns and paying corporate tax and STC. Consideration will be given to introducing measures to ensure the regulatory foundation on which the tax dispensation is based is adhered to and continues to support the policy behind the tax dispensation. The effective tax rate on these distributions will be the investors' marginal rate of tax (ranging between 0 and 40 per cent).[19] The effective tax rate on similar distributions made by a company is 35,5 per cent (the corporate tax rate of 29 per cent and a STC rate on net dividends paid of 10 per cent).

Income distributed by the REIT has to retain its nature i.e. rental income has to be paid to investors as rental income. This classification of income will simplify the tax treatment and ensure that the income will be treated as income from immovable property for DTA purposes.

[19] Although the effective tax rate could range between 0 and 40%, it is more likely that the effective rate should be 18% and higher as low income earners are unlikely to have significant amounts of savings to invest.

7.2 Tax implications of capital gains

The regulatory framework will prevent REITs from distributing capital gains (or any proceeds from the sale of capital assets) to property unit holders. This will ensure that capital is effectively "locked-in" the company for re-investment. However, the increase in value of the underlying assets (realised or unrealised) should be reflected in the unit pricing. This constitutes a dual layer of gains and should capital gains be payable by the REIT upon disposal of capital assets and by property unit holders on the disposal of property units in the REIT, CGT will effectively be paid twice on the same gain.

REITs will therefore be exempt from paying tax on capital gains and property unit holders will pay tax on the gain realised on the disposal of their property units. This gain will be taxed as either ordinary income or capital gains depending on certain facts and circumstances. The 3-year capital gain rule on shares should also be extended to property units in REITs. In terms of this rule, gains realised from the sale of shares (or property units) held for a period of more than 3 years, will be taxed as capital gains.

The effect of this tax dispensation is that capital gains are only taxed once at investor level. Although the effective CGT rate of corporates are higher than that of individuals, the effect of this is negated by the fact that the capital gains are taxed in the hands of the unit holder before the underlying immovable properties are sold i.e. unit prices take account of market values of immovable properties held by the REIT before these properties are sold. Special capital gains roll-over provisions for property unit holders will also be considered in certain corporate re-organisation transactions e.g. asset for share transactions as contemplated in Section 42 of the Income Tax Act.

A further benefit of this tax dispensation is that corporate restructurings within the REIT environment (at the second REIT layer level) should happen without any tax charges.

The investment units in a REIT are property units. This could limit the tax-loss to the fiscus as international investors will have to pay tax on the gains realised from the sale of these investment units in terms of domestic legislation and DTAs. Consideration will also be given to amend existing sections in the Income Tax Act (i.e. Section 9(2) and paragraph 2(2) of the 8^{th} schedule) to allow for all gains on the sale of investment units in South African REITs by non-residents, to be subject to tax.

Part III – The way forward

8. Process and transition rules

8.1 Process

The document is released for public comment on 3 December 2007. As indicated before, this document focuses on policy considerations rather than design features. Comments on policy considerations are invited but design features proposed in this document may also be commented on. Annexure B contains more detail about the requested comments and the format in which these should be submitted. The comment period will end on 31 January 2008, with a response document containing more detailed design features scheduled for mid or late 2008. Interaction with industry stakeholders will also take place between the end of the comment period and the release of the response document. Draft legislation and a draft Generic Founding Document are scheduled for release in December 2008.

It is proposed that the REIT structure be introduced during the course of 2009.

8.2 Regulatory transition rules

To facilitate PLS companies under the ambit of CISCA as REITs, PLS companies and their managers should be able to register as REITs with the FSB without major organisational restructurings or impact on their businesses. It is therefore important that CISCA provides a framework suitable for both CISPs and PLS companies.

The Generic Deed now applicable to CISPs will be changed to a Generic Founding Document (trust deed for trusts and articles of incorporation for companies) for REITs. Amendments to this founding document will have to be made to give effect to National Treasury's proposals.

In order to provide external managers with more flexibility to manage and control the day-to-day operations of the CISP, consideration is being given to allow external managers more discretion and power over payments and bank accounts.

8.3 Tax transition rules

To facilitate the conversion of existing property holding entities to a new REIT environment, these conversions will be tax-free although an entry tax/levy may be considered. CISPs are already within the tax-free environment so no conversion is required and therefore no tax event will be triggered. PLS companies converting to REITs will also not trigger any CGT on underlying assets. Income earned up to the date of conversion by the PLS may have to be paid out to investors shortly before conversion.

Investors in both CISPs and PLS companies may have to swap their existing participatory interests or linked units (old investment) for property units in the REIT (new investment). This swap will be tax-free, provided the cost of the old investment and original acquisition date is retained and applies to the new investment.

Fixed property companies and PLS subsidiaries should be amalgamated or converted to REITs, although certain conduits (bundling of fixed assets) may be allowed. Income earned up to the date of conversion may have to be distributed shortly before the conversion. Should these entities be amalgamated, assets will be transferred without triggering CGT but an entry tax/levy may be payable. A requirement of the tax-free amalgamation may be that the original cost of the asset and the original acquisition date of the asset by the fixed property company or PLS subsidiary be retained. Should a fixed property company or a PLS subsidiary elect to convert to a REIT, the same principles will apply.

GLOSSARY

Collective Investment Scheme in Property (CISP) - One of the two types of vehicles that retail investors can invest in to get exposure to commercial property. The legal form of a CISP is a vesting trust and the investors hold a participatory interest. A CISP is regulated by the Financial Services Board in terms of the Collective Investment Schemes Control Act. This investment vehicle is also referred to as a property unit trust (PUT).

Debenture - Unsecured debt backed only by the integrity of the borrower, not by collateral, and documented by an agreement called an indenture. One example is an unsecured bond. The debenture portion of a linked unit in a PLS generates interest at a variable rate for the linked unit holder. The interest is paid out of the profits.

Equity – This term refers to an ownership interest in a corporation in the form of shares or preference shares. It also refers to total assets minus total liabilities, in which case it is also referred to as shareholder's equity or net worth or book value. In real estate, it is the difference between what a property is worth and what the owner owes against that property.

Fixed property company – CISPs used to hold shares in a fixed property company as they were prohibited from holding the immovable property directly. The fixed property company was the owner of the immovable property.

Generic Deed - Deed that governs CISPs in South Africa.

Linked unit – An investment unit in a PLS. The linked unit comprises one part equity and one part debenture (also referred to as a stapled unit).

Linked unit holder - This term refers to investors who invest in PLS companies.

Listed property sector – Term used to describe all listed property vehicles; comprises of PLS companies and CISPs.

Market capitalisation – This term refers to the market value of a listed company which is calculated by multiplying its current share price by the number of shares in issue. The total market cap refers to the market cap of all entities in that sector.

Participatory property unit – An investment unit in a South African REIT with a trust legal structure.

Participatory property unit holder - This term refers to investors who invest in a South African REIT with a trust legal structure.

Participatory interest - An investment unit in a CISP (also referred to as a participatory unit).

Participatory interest holder - This term refers to investors who invest in a CISP (also referred to as a participatory property unit holder).

Property Loan Stock company (PLS) - One of the two types of vehicles that retail investors can invest in to get exposure to commercial property. The legal form of a PLS is a company with the investors holding stapled units. PLS companies are not regulated by the FSB.

Property share – An investment unit in a South African REIT with a company legal structure.

Property share holder – This term refers to investors who invest in a South African REIT with a company legal structure.

Property unit - This refers to investments in the Real Estate Investment Trust (REIT) structure. The proposed South African REIT structure will allow companies and trusts to register as REITs. The investment unit in the company will be referred to as a property share and in the trust as a participatory property unit.

Property unit holder – This term refers to investors who invest in a South African REIT.

Real Estate Investment Trust (REIT) – An internationally recognised term and structure used to provide investors with the opportunity to participate directly in the ownership or financing of real estate projects by providing them with a tradable interest in a pool of real estate-related assets. REITs own, and often operate, income-producing real estate.

Secondary Tax on Companies (STC) – A tax levied on South African companies on the net dividends it distributes. The tax is currently levied at a rate of 10 per cent.

Tax conduit principle – In terms of this principle, investors are taxed on the income generated by the entity they invest in i.e. the income earned by an entity is imputed to investors and no tax is levied on the entity.

Vesting trust - All the income earned and capital gains realised from the sale of assets by the trust accrue to the beneficiaries (or participatory interest holders) of the trust.

Annexure A

Reform Category	National Treasury policy objective/s	National Treasury proposal/s	Anticipated legislative and/or regulatory change/s
Organisational rules	Appropriate regulation that: promotes maximum protection to investors, safeguards the industry reputation, and allows enough flexibility for the REIT industry to provide maximum return for investors. Listing requirements, minimum stated capital requirements and management restrictions are aimed at investor protection.	Housed under CISCA. Consideration is being given to replace the term Collective Investment Scheme in Property (CISP) with the term Real Estate Investment Trust (REIT) in CISCA to allow international uniform terminology. Can be a public company or a trust. Must be listed. An exception is considered where investment in the REIT is not offered to the retail market and investors constitute certain financial institutions that are regulated by the FSB e.g. long-term insurers. Investors must be represented by a board of directors or a trustee/s, as appropriate for the adopted institutional structure. No minimum or maximum domestic shareholder restrict-tions will apply. Similarly, at this stage no foreign shareholder restrictions are envisioned, subject to there being a limited potential for tax loss.	
Income and asset rules	To streamline the corporate layering within the industry. To promote investment in the South African real estate market.	Indirect investment will be limited to two corporate layer within the industry. A REIT will continue to be able to invest directly in immovable property locally and internationally, as long as the foreign country has a currency	

		sovereign rating provided by a rating agency. There are no restrictions on the types of properties allowed i.e. open land, residential, commercial or industrial. Income generated by other property related sources, for example through the provision of asset management or administration services, is permitted. At least 75 per cent of income must be rental income from property and at least 75 per cent of assets must be classified as immovable property. Development activity is permitted if done with the intention of letting and is retained for at least three years. A REIT must have at least three properties in its portfolio, with a maximum proportion of one property being 40 per cent of the total fixed asset value. A REIT may invest in cash, the money market and government securities. These balances will be included in the total asset base on which the immovable property requirement of 75 per cent is based.	
Distribution rules	To provide an efficient (and protected) savings vehicle for investors whilst limiting the tax-loss to the fiscus.	Must distribute at least 90 per cent of net income annually. Capital gains realised on the sale of assets must be reinvested, and my not be redistributed to the to unit holders.	

Gearing limits	Investors should be protected against capital loss. The level of protection should be formulated in light of encouraging optimal returns for investors through higher levels of gearing within the REIT.	A REIT can borrow up to a maximum of 70 per cent of the value of its real estate property. A gearing maximum prescribed for the fund must be identified in the REIT's Trust Deed or MoA Only bank sourced debt can be used.	
Role of trustees, directors, and the management company.	To ensure that trustees and directors are not burdened with compulsory duties falling outside their core function as protector of investor interests. Management companies must be provided with enough flexibility to carry out its duties without undue hardship or constraints.	The generic CISCA founding document will be amended to make it more functional and realistic for the manager to operate a REIT (currently a CISP), ensuring that the trustee/ board of directors focuses more on investor protection than the control of the day-to-day operations of the REIT.	
Structural issues that prevent REITs from participating in BEE transactions	To enable the REIT industry's participation in BEE initiatives. The Property Charter commits the industry to have transferred 25 per cent ownership within 5 years.	In order to provide an effective balance between the abovementioned objectives, the existing CISP framework (aimed at investor protection) should be reviewed against the backdrop of the Property Charter (aimed at encouraging BEE initiatives). Consultation between the National Treasury and the Property Charter Council will inform this review followed by more detailed proposals in the response document.	
Tax dispensation		A simple and uniform tax dispensation will be applicable to all REITs. The new tax dispensation should allow for only one level of tax i.e. investors in REITs will pay income tax on income distributed by the REIT and will pay CGT on gains	

		realized from the sale of long-term investments in REITs. No tax should be payable on ordinary income or capital gains realized by the REITs. REITs will not have to apply for approval from SARS to access this special tax dispensation as the regulatory design. Income distribution: The effective tax rate on these distributions will be the investors' marginal rate of tax (ranging between 0 and 40 per cent). Income distributed by the REIT has to retain its nature i.e. rental income has to be paid to investors as rental income. REITs will be exempt from paying capital gains and property unit holders will pay tax on the gain realised on the disposal of their property units. The 3 year rule for capital gains tax treatment on shares, will apply to property units in REITs.	

Annexure B

Format in which comments are to be submitted

In order to deal with all the comments received in an effective manner, we request that comments be submitted in the format indicated below. Comments received in the correct format on or before 31 January 2008, will be acknowledged and considered.

<u>Format of comments submitted:</u>

1. Heading: **Comments on Discussion Paper: Reforming the Listed Property Investment Sector in South Africa**
2. Date comments are submitted
3. Name of Entity on whose behalf comments are submitted (including contact details)
4. Type of stakeholder (e.g. property management company, CISP, PLS company, etc)
5. Summary of comments (number each paragraph). No more than one short paragraph for each comment and paragraphs structured as follows:
   a. Reference to relevant paragraph in the discussion document (e.g. Par 4.1 Organisational rules)
   b. Outline the specific National Treasury proposal to which the comment relates
   c. Outline concern and revised proposal (i.e. commentator's proposal)
6. Detailed description of comments (use same numbering for each comment, than the number used before – see par 5). Detailed description should:
   a. state why the National Treasury proposal is of concern and give a practical example where possible; and
   b. state the commentator's proposal with special emphasis on how the proposal supports National Treasury objectives as stated in the discussion document. (References to international trends (with specific examples of detailed design features as well as why these should be followed by South Africa i.e. do these design features support National Treasury objectives), administrative and/or operational simplification etc. will also add support for a convincing argument).

Comments received will be made public in the response document referred to in Part III of the discussion paper.

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