NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 31, 2012

VIA E-MAIL [nomfanelo.mpotulo@treasury.gov.za]
Nomfanelo Mpotulo
National Treasury, Private Bag
X115 Pretoria 0001
Republic of South Africa

Re: Draft Taxation Laws Amendment Bill, 2012: Creation of a Unified System of Taxing Real Estate Investment Trusts (REITs) for Property Investment Schemes

Dear Ms. Mpotulo:

The National Association of Real Estate Investment Trusts (NAREIT)® greatly appreciates the opportunity to provide its comments regarding Draft Taxation Laws Amendment Bill, 2012: Creation of a Unified System of Taxing REITs for Property Investment Schemes (Draft REIT Law). NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

NAREIT applauds South Africa for its willingness to consider the introduction of a South African REIT structure by 2014. NAREIT believes that adopting a tax-transparent structure that resembles the current United States REIT vehicle would capitalize on over 50 years of experience with, and evolution of, REITs in the United States, and should promote a number of the South African government's objectives. Given the increasing global recognition of the acronym "REIT," we are pleased that South Africa proposes to adopt this term and hope it will maximize investor awareness of this new structure.

On January 31, 2008, NAREIT provided its comments on a discussion paper posted by the South Africa National Treasury, entitled "Reforming the Listed Property Investment Sector in South Africa" (the Paper) concerning the potential authorization of a South African real estate investment trust (REIT) that would provide a new vehicle for investing in property to meet the South African Government's objectives of developing the South African real estate market while maximizing protection to investors, safeguarding the industry reputation, and allowing for maximum return for investors (the 2008 Comments).

Our comments below are based on the Draft REIT Law and accompanying Explanatory Memorandum dated July 5, 2012 (Explanatory Memorandum), and they refer to the 2008 Comments when appropriate

EXECUTIVE SUMMARY

NAREIT is pleased that South Africa is proposing to combine the property unit trust (PUT) and property loan stock (PLS) regimes into one REIT[1] regime with a 2014 effective date. The Explanatory Memorandum states that the proposed regime would contain the following features: i) the REIT must have a minimum amount of gross property assets (direct interests in immovable property (such as land and buildings), interests in a lease relating to immovable property, interests in a property subsidiary or holdings in another REIT); (ii) the REIT must solely invest in immovable property assets and collateral debt instruments and hedges used to reduce the risk associated with property-related loans; iii) the REIT must distribute most of its profits on a yearly basis; and, iv) the REIT must not have excessive borrowings (*i.e.*, gearing) in relation to the total gross asset value of all immovable property held by that entity.

As further set forth below, NAREIT recommends that South Africa consider the following changes and/or clarifications with respect to its adoption of the REIT structure: 1) allow formation of non-listed REITs; 2) confirm that a REIT may own non-South African properties; 3) allow REITs to own real property through fiscally transparent entities and clarify that REITs may own debt secured by mortgages on real property and other types of real estate assets; 4) clarify that a REIT may undertake development for its own account for purposes of long-term real estate ownership; 5) clarify that REITs must distribute a specific majority of their income, calculated pursuant to tax, not accounting, principles; 6) clarify that REITs may distribute and deduct capital gains; 7) allow the market to set the amount of debt that a REIT may carry, but if there are statutory debt limits, they should be based on interest coverage rather than debt to equity ratios; 8) clarify that REITs may pay a monetary penalty in lieu of loss of REIT status for inadvertent failure to comply with the REIT rules; and, 9) clarify that, to the extent that an entry tax or levy is imposed on a company for converting to or becoming a REIT, such tax or levy should be modest, and/or the rules could parallel the U.S. REIT rules mandating the distribution of pre-REIT earnings coupled with taxation of any pre-REIT asset appreciation within ten years of a REIT's election.

DISCUSSION

I. Permit Non-Listed REITs

The Draft REIT Law contemplates requiring SAREITs to be listed companies. NAREIT suggests that South Africa consider allowing non-listed SAREITs to allow both for the "incubator" REIT the business plan of which includes a potential public listing, as well as for the REIT that is an investment vehicle owned by a wider variety of sophisticated investors.

[1] This letter will refer to a South African REIT as an "SAREIT".

As you may know, U.S. REITs do not need to be listed on an exchange, although many are.[2] In the United States, many REITs have been formed as unlisted "incubator REITs," essentially to develop a track record prior to an eventual public listing. When initially formed, these companies may not own sufficient properties of sufficient size to warrant a public listing. Alternatively, they may begin as private companies to enable their management to develop a track record. However, as these companies increase their portfolios and their expertise, listing may become appropriate, and their prior existence as a REIT may be seen as a benefit to their new public shareholders. [3] Even these non-listed U.S. REITs must satisfy a "five or fewer" individuals rule[4] and be owned by at least 100 shareholders[5] so they remain consistent with the U.S. Congress' vision of making REITs widely held.

In the Paper, it appeared that it was the South African Government's objective to permit non-listed companies to qualify as SAREITs when owned by a single investor or by certain regulated, sophisticated (non-retail) investors. However, the Draft REIT Law appears to require SAREITs to be listed entities. In that regard, we point to the success in the U.S. model of the investment in non-listed REITs by pension plans, foundations, public charities, and other institutional investors that are attracted to the corporate governance benefits of a corporate structure as contrasted with a partnership under which a general partner has more discretion.

Finally, there are dozens of U.S. REITs that, while not listing on a stock exchange, have sufficient numbers of shareholders that they are required to satisfy the same filing requirements as listed companies. Several of these companies have become listed over the years, several more have been acquired by listed REITs, others have been acquired by private equity firms, and still others have sold their assets and liquidated after a long-term period. These "non-traded, SEC-registered REITs" have raised billions of dollars in investments over the years from "accredited" U.S. investors, and their counterparts in South Africa would be denied this type of access to commercial real estate under the Paper and the Draft REIT Law.

NAREIT suggests that you consider allowing non-listed SAREITs to allow both for the "incubator" REIT the business plan of which includes a potential public listing, as well as for the REIT that is an investment vehicle owned by a wide variety of sophisticated investors. We note also that Japan, among other countries with a REIT or REIT-like regime, recently permitted non-listed entities to qualify as REITs.

We recognize the National Treasury's objective of promoting maximum protection to investors, safeguarding the industry reputation, and allowing enough flexibility for the SAREIT industry to provide maximum return for investors. We believe that the U.S. model, which allows for non-

[2] U.S. Internal Revenue Service ("IRS") data indicates the growth of private REITs over the past several years. This data demonstrates that for 1993, there were 354 U.S. REIT tax returns (Form 1120-REIT) filed, compared to 189 listed U.S. REITs. In 2004, there were 1,123 REIT tax returns filed, compared to 193 listed U.S. REITs, while in 2008, there were 1,660 REIT tax returns filed, compared to 136 in 2008.
[3] See Exhibit 1, which provides information about listed U.S. REITs that started as unlisted REITs.

[4] I.R.C. § 856(a)(6) and (h).
[5] I.R.C. § 856(a)(5).

listed companies to qualify as REITs while ensuring that they are widely held, also achieves these objectives. In the U.S., sale of interests in REITs are governed by both state and federal securities rules. As the REIT is larger in size and shareholders, greater oversight is required. For example, REITs with more than $10 million in assets whose securities are held by more than 2,000 (or 500 non-accredited) owners must file annual and other periodic reports with the U.S. Securities and Exchange Commission. These reports provide important financial information to investors so that they make informed choices about their investments.

Furthermore, U.S. federal tax law requires REIT shares to be transferable, thereby affording investors liquidity should they desire to exit their investments. Finally, by allowing REITs to be private entities, U.S. law balances these investor protections with the flexibility to provide maximum return for investors – even if that return is with respect to a company that is not publicly listed.

II. Confirm non-South African Property Permitted

NAREIT's 2008 Comments recommended that South Africa not be the only country to limit investment to primarily domestic markets and instead allow its REITs to make investments throughout the world based on market demands. It appears as though the Draft REIT Law would permit SA REITs to own property outside of South Africa, but it would be helpful to clarify this point.

III. Clarify REIT Income and Asset Tests

A. Fiscally Transparent Entities

It appears that South Africa is still contemplating whether to permit SA REITs to own property through **fiscally transparent entities** (like partnerships), although ownership through certain property subsidiaries would be permitted. If SAREITs cannot invest through fiscally transparent entities, NAREIT believes that this limitation could prevent an SA REIT from entering into valuable joint venture agreements pursuant to which one investor might provide capital while the other investor provides management and operational expertise. The limitation also could prevent other flexible types of property ownership arrangements that could help to maximize shareholder value. NAREIT strongly urges that South Africa consider allowing its REITs to invest indirectly through one or more levels of fiscally transparent entities.

B. Qualifying Income from a Wide Variety of Real Estate-Related Sources

The Draft REIT Law indicates that an SAREIT could invest in collateral debt instruments to immovable property. Presumably, such debt instruments would include debt at least in part secured by a mortgage on real property, but it would be helpful to clarify that point.

Additionally, NAREIT recommends that South Africa consider defining the types of real estate assets a REIT may invest in broadly. The U.S. experience may be instructive. Quarterly, at least 75% of a U.S. REIT's assets must consist of "real estate assets," Government securities, cash and cash items. The term “real estate assets” is defined broadly to include interests in real property (fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon), as well as interests in mortgages on real property, shares of other REITs, and any property that is attributable to the temporary investment of new capital. REITs may invest in U.S. properties or non-U.S. properties. U.S. tax law “looks through” all of the tiers of a REIT’s ownership of fiscally transparent entities (like partnerships) to determine the real estate assets owned by the REIT. On the other hand, REITs cannot own more than 10% of the securities of any corporate entity other than another REIT, a taxable REIT subsidiary, or a “qualified REIT subsidiary” (a wholly owned subsidiary which is completely disregarded for U.S. tax purposes, and the income and assets of which are viewed as owned by the REIT).

The broad definition of “real estate assets” allows for a great amount of flexibility, not just for the newly formed REIT as it looks for investment opportunities, but also for the existing REIT as it considers other types of real estate related investment opportunities. Flexibility has been important to U.S. REITs because it has allowed them to own new types of properties as market conditions change. For example, in 1994, office REITs comprised only 4% of the total U.S. REIT market while in 2004, office REITs comprised about 12% of the total U.S. REIT market. Similarly, retail REITs were 35% of the total REIT market in 1994, and today they are over 26% of this market.

The broad definition of “real estate assets” also has allowed U.S. REITs to invest in all types of loans secured by real property. For example, in recent years, REITs have enhanced their debt portfolios by providing short-term mezzanine financing to borrowers secured by the borrower’s ownership interest in the tax transparent entity that owns the relevant property. Mezzanine financing provides for a higher than average rate of return as well as fairly expedited default procedures in the event of default. A loan secured by a partnership or limited liability interest is treated as a “real estate asset” if most of the partnership or limited liability company’s assets consists of real property equal to or in excess of the amount of the loan, and a number of related conditions are satisfied. Mezzanine financing can serve as the basis for a lender to acquire the property secured by the financing in case the borrower gets into financial difficulty.

IV. Permit Development for REIT’s Own Account

The Draft REIT Law is unclear regarding whether an SAREIT could develop properties for its own account. NAREIT recommends that SA REITs be permitted to develop property for their own account so long as the property is not held primarily for sale in the ordinary course of the REIT’s business, but that a safe harbor be provided for rental property held for at least two years.

U.S. REITs may develop property for their own account that, once developed, they hold for investment. In the U.S. context, the relevant inquiry is whether the property is held as investment (for the long term) or as inventory as a dealer (for the short term). This rule provides the flexibility for those REITs that have property development expertise to benefit their shareholders by undertaking development for their own account, thereby achieving cost efficiency and savings. This rule also helps spur development by REITs with particular development and redevelopment expertise.

Gains attributable to the sale of "dealer property" are taxed to a U.S. REIT at a 100% rate. Thus, the REIT faces strong discouragement, but not loss of REIT status, from directly developing property for third parties. The determination of whether property is "dealer property" is based on the facts and circumstances of the situation, but a safe harbor does apply. A U.S. REIT may develop properties for third parties through its fully taxable subsidiary, which may not be greater than 25% of the U.S. REIT's gross assets.

Specifically, no tax is imposed on a U.S. REIT's property sales if, among other requirements, the REIT has 1) held the property for at least 2 years, 2) not spent more than 30% of the net selling price of the property over the last 2 years, 3) not made more than 7 sales of property within the taxable year or the aggregate fair market value or adjusted bases of property sold during the taxable year does not exceed 10% of the fair market value or aggregate adjusted tax bases of all of the REIT's assets as of the beginning of the taxable year. Further, these objective tests are only a "safe harbor," and a REIT is not assessed the 100% tax if it can demonstrate that it did not act as a dealer based on the surrounding facts and circumstances.

V. Distribution Rules

A. Confirm That SA REITs Should Calculate their Distribution Requirement Using Tax, Rather Than Accounting, Principles

Among other things, the Paper proposed that an SA REIT be required to distribute at least 90% of its accounting profits (with respect to rental income) and that proceeds realized by an SA REIT on the sale of assets must be reinvested within 12 months and may not be distributed to unit holders. The Explanatory Memorandum mentions that an SAREIT must distribute most of its profits on a yearly basis, but the specific percentage of its profits is not clear.

In our 2008 Comments, NAREIT recommended that the distribution requirement be calculated based on taxable income based on realized transactions, rather than accounting profits, so as to avoid distribution of "phantom gains". The Draft REIT Law is unclear whether South African law would require SA REITs to calculate their distribution requirement based on tax or accounting principles. Again, NAREIT recommends the use of tax principles.

B. Confirm That SA REITs May Distribute Capital Gains

The Paper proposed that SAREITs not be permitted to distribute their capital gains, and be exempt from paying tax on their capital gains. The Paper presumes that the value of underlying assets would be reflected in the unit pricing of the SAREIT's interests. As a practical matter, at least from the U.S. perspective, the trading price of interests in a REIT may be higher or lower than the net asset value of the REIT's properties. As a result, this presumption will not always be accurate.

The Draft REIT Law and Explanatory Memorandum are unclear to us on this point, and clarification that capital gains may be distributed would be helpful. NAREIT strongly believes the 2008 Paper's proposal to limit the distribution of capital gains could handcuff SA REITs by discouraging them from selling properties at the most opportune time based on market conditions. NAREIT recommends that, like U.S. REITs, SA REITs be permitted to distribute gains from sales of property. To the extent there is concern about excessive sales, these could be limited as they are in the U.S. by imposing a 100% tax on gains from sales of property held primarily for sale in the ordinary course of the REIT's trade or business. NAREIT again recommends that an SA REIT should have the **option** to not pay tax on asset sales so long as the sales proceeds are reinvested with the 12-month period contemplated in the Paper.

In addition to NAREIT's suggestion above that SAREITs be permitted to distribute their capital gains, NAREIT suggests that South Africa follow the U.S. model and only tax capital gains at the shareholder level if distributed. The U.K REIT regime is similar in ultimate result. As mentioned in our 2008 Comments, NAREIT recommends that no entity tax be imposed on capital gains if the REIT reinvests the sales proceeds within the 12-month period contained in the proposal. Furthermore, in order to avoid double taxation, the U.S. regime permits a U.S. REIT to retain and pay tax on capital gains (without having to reinvest the sales proceeds) while providing its shareholders with a credit for tax paid.

VI. Allow Market Forces to Determine Appropriate Debt Levels

The Paper proposed that an SA REIT be entitled to borrow up to 70% of the value of its real estate property. The Draft REIT Law is unclear regarding the specific limit although it proposes that an SAREIT not have excessive borrowings in relation to the total value of its immovable property. The Draft REIT Law is not clear as to how this debt limit would be measured.

Again, the U.S. experience may be instructive in this context. U.S. law does not provide a limit on the amount of debt that a REIT may incur. NAREIT believes that market forces are the best determinants of the appropriate level of gearing.

The public market (*e.g*., analysts and investors) in the U.S. has encouraged listed REITs to incur a lower level of debt compared with commercial real estate held privately. These market forces, rather than specific legislative requirements, have created this situation. As a result, as of March 31, 2012, the average debt to market capitalization for listed U.S. equity REITs (property-owning REITs, as opposed to REITs that own mortgages or a combination of mortgages and property) was 35.6 %, their coverage ratio of EBITDA divided by interest expense was 2.9 and their fixed charge rate of EBITDA divided by interest expense plus preferred dividends was 2.6.[6]

Additionally, the market may consider different debt amounts appropriate for different property sectors. Rating agencies also provide an outside force to limit gearing. For example, as of June 30, 2012, 46 U.S. equity REITs, or 68% of the industry by market capitalization, had investment grade ratings. For these companies to increase borrowing, they must be prepared to address

[6] *See* http://returns.reit.com/reitwatch/rw1207.pdf (page 2).

credit agency concerns and expectations. Furthermore, as the capital markets have become more comfortable with publicly traded REITs and their use of debt, the level of leverage borne by REITs has fluctuated, sometimes increasing as market conditions warranted.

The lower debt levels associated with REITs compared to privately-owned real estate investment in the U.S. overall have had a positive effect throughout the economy. Average debt levels for U.S. REITs are 30-40% of market capitalization, compared to leverage of 60% and often higher that is used when real estate is privately owned. The higher equity capital cushions REITs from the negative effects of fluctuations in the real estate market that have traditionally occurred. The ability of REITs better to withstand market downturns have had a stabilizing effect on the real estate industry and its lenders, resulting in fewer future bankruptcies and work-outs. Consequently, the general U.S. economy has benefited from reduced real estate losses by federally insured financial institutions.[7]

<u>Proposal:</u>

NAREIT recommends that legislation provide the flexibility to meet different market challenges and not limit the level of gearing for an SA REIT. If the Government believes that there must be some limitation on gearing, then NAREIT suggests that gearing be limited based on reference to a REIT's interest coverage ratio (earnings before interest and taxes for a one year, divided by interest expenses for the same year). This is the type of limitation provided for in the U.K. REIT regime.[8] Specifically, the U.K. provides that the interest cover ratio not be permitted to fall below 1.25, but, to the extent the ratio does fall below 1.25, a tax liability will attach to the amount that causes the ratio to fall below the 1.25 limit. Further, NAREIT recommends that an SA REIT should have the ability to petition the South African government for an exception to any leverage limits to account for unforeseen market conditions.

VII. Implications of Non-Compliance with Regulatory Requirements

The Paper proposes a one-year grace period during which violations of qualifying criteria may take place although a monetary penalty may be payable. NAREIT is concerned that inadvertent violations of qualifying criteria may be discovered long after the one-year period has ended (for example, if the SAREIT did not meet the 75% income test or distribute at least 90% of its net profits for a particular year). NAREIT recommends that South Africa not take an "all or nothing" approach to REIT qualification after a one-year grace period, but, instead, impose appropriate monetary penalties for failures to satisfy the REIT requirements.

VIII. Tax Transition Rules

The Paper had suggested that an entry tax/levy may be considered in connection with conversion to an SA REIT. It is not clear to us from the Draft REIT Law or Explanatory Memorandum whether this idea was retained. If so, NAREIT suggests that any conversion fee be relatively

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[7] *See, e.g.*, http://www.dallasfed.org/assets/documents/research/swe/2002/swe0206c.pdf .
[8] *See* EPRA Global REIT Survey 2010 http://www.epra.com/regulation-and-reporting/taxation/reitsurvey/.

modest in order to encourage the development of the SA REIT market. Alternatively, a low fee could be coupled with a minimum holding period, as in the case of the U.K. or French REIT regimes, to reduce the potential for abuse of a REIT regime.

A few factors in the U.S. tax laws operate to encourage the formation of REITs by deferring (and possibly eliminating) any "toll charge" that could apply to the conversion of an ordinary corporation (a "C corporation") to a REIT. Ordinarily, a C corporation that converts to a REIT is required to pay an entity-level tax on the appreciation inherent in its assets (a "built-in gains tax"). A special provision (I.R.C. § 1374) allows such a C corporation to choose to defer that tax on conversion and instead pay tax only on any built in appreciation to the extent that its former "C corporation assets" are sold in the 10 years following its REIT conversion. Following the close of this 10-year period, the REIT can sell the assets without paying a REIT-level tax.

A corollary to the ability to make a "§ 1374 election" is the "like kind exchange" provisions of § 1031. Under this provision, an entity may exchange one parcel of investment property for another parcel of investment property through a tax-deferred "like kind exchange". By exchanging some of its former C corporation assets for replacement properties during the 10-year testing period, the REIT can carry over its holding period to the replacement properties, thereby enabling it to avoid the toll charge.

Finally, another method for deferring tax in the U.S. is through the "UPREIT" (or "umbrella partnership REIT") structure. In general, U.S. tax law provides that the transfer of appreciated property to a REIT in exchange for stock in the REIT is a taxable transfer. On the other hand, in general, the transfer of appreciated property to a partnership is not a taxable transfer. As a result, investors may transfer their appreciated properties in exchange for partnership units of a partnership (an "operating partnership" or "OP"). in which the REIT is the majority-owned general partner. After approximately one year, investors may exchange their OP units for REIT stock or cash (at the REIT's option) in a taxable transfer.

Many large private property owners typically own U.S. properties through partnerships or other fiscally transparent entities. In general, these owners can convert their property interests into REIT interests (often on a publicly traded basis) on a tax-free basis by transferring their partnership interests to a REIT's OP. Doing so allows these private property owners to benefit from diversifying into a publicly traded REIT's portfolio and to enjoy the increased liquidity that ownership of a publicly traded entity provides. Furthermore, most new REITs are set up in the UPREIT structure to facilitate future tax-free transfers by investors to the OP. Approximately 2/3 of publicly traded equity REITs are organized in an UPREIT structure.

Finally, it should be noted that the U.S. does have a form of an exit tax that cannot be avoided. An ordinary corporation that converts to REIT status must distribute its non-REIT current and accumulated "earnings and profits" to shareholders by the end of its first year as a REIT. Essentially, this distribution forces the converting corporation to distribute a taxable dividend to its shareholders, thus ensuring that income earned by the corporation (and presumably previously taxed at the corporate level) is taxed at the shareholder level.

NAREIT's concern is that an entry fee that is too steep could stifle the SA REIT market. As discussed above, in the U.S., there is no toll charge upon conversion, but if the U.S. REIT sells its pre-REIT property within ten years of its REIT election, gain is subject to entity-level tax. Both the U.K. and French REIT regimes impose low toll charges upon conversion, as well as a minimum holding period, to reduce the potential for abuse of the REIT structure.

Proposal:

NAREIT suggests that any conversion fee be relatively modest in order to encourage the development of the South African REIT market. Alternatively, a low fee could be coupled with a minimum holding period, as in the case of the U.K. or French REIT regimes, to reduce the potential for abuse of the REIT structure or the SA REIT regime could adopt the combination of distribution of pre-REIT earnings and built-in gain rules to mirror the U.S. REIT regime.

Thank you for the opportunity to submit these comments. Please contact me at tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel, at dbernstein@nareit.com if you would like to discuss them in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

Cc: Ms Adele Collins
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Exhibit 1

U.S. Listed REITs That Were Unlisted REITs[1]

Name	Trading Symbol	Equity Market Capitalization As of June 30, 2012 (in millions)
AmREIT	AMRE	$51[2]
American Realty Capital Trust, Inc.	ARCT	$1,731
BioMed Property Trust Inc	BMR	$2,873.5
DCT Industrial Trust	DCT	$1,562.5
Digital Realty Trust	DLR	$ 8,272.0
Healthcare Trust of America, Inc	HTA	$2,200[3]
Inland Real Estate Corporation	IRC	$743.6
Piedmont Office Realty Trust	PDB	$2,971
Prologis	PLD	$15,252.6
Retail Properties of America, Inc.	RPAI	$827
Strategic Hotel Capital, Inc.	SLH	$1,319.6

Source: NAREIT

[1] Aside from the list of companies above, other private REITs have gone public, after which they may have been sold or acquired or de-listed.
[2] As of opening on July 27, 2012, the first day of public trading.
[3] As of July 25, 2012.