Reforming the Listed Property Investment Sector in South Africa

Response to National Treasury
Republic of South Africa
Discussion Paper

By the

National Association of Real Estate Investment Trusts®

January 31, 2008

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

January 31, 2008

Ms. Attalia Otto
National Treasury, Private Bag
X115 Pretoria 0001
Republic of South Africa

Re: Reforming the Listed Property Investment Sector in South Africa

Dear Ms. Otto:

The National Association of Real Estate Investment Trusts (NAREIT)® greatly appreciates the opportunity to provide its comments on the discussion paper (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.

NAREIT is the representative voice for United States REITs and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

NAREIT's responses to relevant headings in the Paper are set forth below under headings marked in bold face. As an initial point, NAREIT applauds South Africa for its willingness to consider the introduction of a South African REIT structure by 2009. NAREIT believes that adopting a tax-transparent structure that resembles the current United States REIT vehicle would capitalize on 48 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 believe that South Africa's adoption of this term will maximize investor awareness of this new structure.

Respectfully submitted,

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EXECUTIVE SUMMARY

<u>Part I – Regulatory Environment</u>

4.1 Organizational rules

The Paper contemplates requiring REITs to be listed companies. An exception is considered when investment in the REIT is not offered to the retail market and investors constitute certain financial institutions that are regulated by the Financial Services Board (FSB) such as long-term insurers. NAREIT suggests that South Africa consider allowing non-listed REITs to allow both for the "incubator" REIT whose business plan includes a potential public listing, as well as for the REIT that is an investment vehicle owned by a wider variety of sophisticated investors.

4.2 Income and asset rules

The Paper proposes that a REIT could invest directly in immovable property locally and internationally, although investment outside South Africa would be limited. The Paper also proposes that, in order to "streamline the corporate layering within the industry as well as to promote investment in South African real estate, indirect investment in property will be limited to two REIT layers per indirect investment, *i.e.*, a REIT can only invest in another REIT if the investee REIT invests directly in property". Further, the Paper provides that qualifying income would be derived from rents as well as asset management and administrative services. Moreover, the Paper would permit development for a REIT's own account but only if the property is held for at least three years.

First, NAREIT recommends 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.

Second, it is not clear from the provision concerning indirect investment whether the Paper intends to limit indirect property investment through **corporate** entities (like other REITs) or also through **fiscally transparent entities** (like partnerships). If the latter, NAREIT believes that this limitation could prevent a South African REIT from entering into valuable joint venture agreements pursuant to which one investor might provide capital while the other investor provides "know how." 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 South African REITs to invest indirectly through one or more levels of fiscally transparent entities.

Third, NAREIT recommends that South Africa provide REITs flexibility to maximize shareholder value by allowing them to earn qualifying income from a wide variety of real estate-related sources.

Fourth, NAREIT recommends that South Africa also consider allowing South African REITs to invest in loans secured by mortgages on real property, again as another type of real-estate related investment that can improve shareholder return.

Finally, NAREIT recommends that South African REITs be permitted to develop for their own account as 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.

4.3 Distribution Rules

Among other things, the Paper proposes that a South African REIT be required to distribute at least 90% of its accounting profits and that proceeds realized by a South African REIT on the sale of assets must be reinvested within 12 months and may not be distributed to unit holders.

On the first point, NAREIT is concerned about the calculation of the 90% requirement under accounting, rather than tax rules. Under International Financial Reporting Standards (specifically IAS 40), companies are required to report the "fair value" of investment property either in their financial statements or in a footnote to such statements. If a company chose to use fair value reporting of its investment property in its financial statement, the Paper apparently would require the REIT to distribute unrealized appreciation of the investment property without having the capital to do so, resulting in the need to borrow or sell properties (possibly at inopportune times) in order to raise capital. Thus, NAREIT recommends 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".

Regarding capital gains, NAREIT strongly believes that such a recommendation could handcuff South African REITs by discouraging them from selling properties at the most opportune time based on market conditions. NAREIT recommends that, like U.S. REITs, South African 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 recommends that a South African 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.

4.4 Gearing Limits

The Paper proposes that a South African REIT's debt level be limited to 70% of total asset value. NAREIT suggests that gearing be limited only market forces as is the case in the U.S, or, at the very least, that gearing be limited based on reference to the REIT's interest coverage ratio (earnings before interest and taxes for a one year, divided by interest expenses for the same year) as is the case in the U.K.

4.7 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 REIT 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.

Part II – Tax Dispensation

7.2 Tax Implications of Capital Gains

The Paper proposes that REITs 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 REIT'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.

In addition to NAREIT's suggestion above that REITs 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 above, 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.

8.3 Tax Transition Rules

The Paper suggests that an entry tax/levy may be considered in connection with conversion to a South African REIT. 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.

DETAILED COMMENTS

4.1 Organizational rule

The Paper contemplates requiring REITs to be listed companies. An exception is considered when investment in the REIT is not offered to the retail market and investors constitute certain financial institutions that are regulated by the FSB such as long-term insurers.

As you may know, U.S. REITs do not need to be listed on an exchange, although many are.[1] 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. [2]

In addition, in light of the South African Government's objective to permit non-listed companies to qualify as REITs when owned by a single investor or by certain regulated, sophisticated (non-retail) investors, 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.

<u>Proposal</u>:

NAREIT suggests that you consider allowing non-listed REITs to allow both for the "incubator" REIT whose business plan 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 recognize the National Treasury's objective of promoting maximum protection to investors, safeguarding the industry reputation, and allowing enough flexibility for the REIT industry to provide maximum return for investors. We believe that the U.S. model, which allows for non-listed companies to qualify as REITs, 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

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[1] 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.

[2] See Exhibit 1, which provides information about listed U.S. REITs that started as unlisted REITs. In addition, UBS Investment Bank has published data demonstrating the tremendous increase in capital raised by public, nonlisted REITs (REITs with over 500 shareholders or $10 million in assets that are required to file financial information publicly, but whose shares are not publicly traded) over the last four years. For example, in 2000, public, nonlisted REITs raised $717 million, while in the 1st quarter alone of 2003, such companies raised approximately $1.5 billion.

assets whose securities are held by more than 500 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, 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.

4.2 Income and asset rules

The Paper proposes that, in order to "streamline the corporate layering within the industry as well as to promote investment in South African real estate, indirect investment in property will be limited to two REIT layers per indirect investment, *i.e.*, a REIT can only invest in another REIT if the investee REIT invests directly in property". Additionally, the Paper proposes that a REIT could invest directly in immovable property locally and internationally, although investment outside South Africa would be limited based on 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. Outside investment further would be limited to properties in those countries with a currency sovereign rating provided by a rating agency. Income generated by other property related sources, for example through the provision of asset management or administration services, is proposed to be permitted. Development would be permitted for the REIT's own account and only if the property is held for at least three years.

By way of background, the U.S. experience may be instructive. In order to remain real estate-focused, U.S. REITs must satisfy an annual income test and a quarterly asset test. Annually, at least 75% of a REIT's income must be from real estate sources such as "rents from real property" and interest on loans secured by mortgages on real property, gain from the sale of real property held for investment, dividends from REITs and gain attributable to the sale of REIT shares, abatements and refunds of taxes on real property, and other related income. Furthermore, at least 95% of a REIT's income must be derived from passive sources, such as those sources included in the 75% test, as well as dividends and non-real estate interest.

In connection with the types of permissible assets, U.S. tax law requires that at the end of each calendar quarter, at least 75% of the value of a REIT's total assets be represented by "real estate assets," cash and cash items (including receivables) and Government securities. These requirements are discussed in more detail below.

A. Income

U.S. REITs must satisfy a two-part income test. At least 75% of their annual gross income must be derived from real estate related sources, including rents from real property; interest on debt secured by mortgages on real property; and gains from the sale of real property. Additionally, at least 95% of their annual gross income must be derived from those real estate related sources, as well as other passive sources, such as dividends and bank deposit interest.

For most equity (*i.e.*, property owning) REITs, the majority of their income is derived from "rents from real property" as this term is specifically defined under U.S. tax law. In general, this term is defined as all rents from interests in real property, charges for services customarily rendered in connection with the rental of real property (described below), and rent attributable to personal property which is leased under, or in connection with, a least of real property, but only if the rent attributable to the personal property is not greater than 15% of the total rent for the taxable year attributable to the total rent for the taxable year for both real and personal property.

1. Income from Services

Since 1986, REITs have provided a wide variety of services that are considered customary, as part of their rental of real property, such as: furnishing electricity (including sub-metering of electricity), water, heat, light, and air conditioning, elevator services, telephone answering services; performing general property maintenance and related services such as routine engineering and janitorial services, general cleaning services (including cleaning of windows, public entrances, exits and lobbies as well as the cleaning of a tenant's interior space); establishing rental terms, selecting tenants, entering into, negotiating and renewing leases, arranging for payment of taxes with respect to the property; maintaining exercise rooms, leasing space for vending machines (provided by independent third parties); and providing telecommunications services (by negotiating cable lease and easement agreements with internet service providers, broadcasters, long distance operators, and other service providers that provide telephone and other communications, cable, e-mail, video communications, electronic research, internet access, networking, safety and security systems, and environmental control systems and similar types of systems and services or in some cases setting up cable service at a property).

To the extent that a REIT derives under 1% of the income from a specific property as a result of providing "noncustomary" services, the income from the property may continue to qualify as "rents from real property". If the income attributable to noncustomary services were in excess of this 1% threshold, the REIT should use a fully taxable corporate subsidiary (taxable REIT subsidiary or TRS) or independent third party to provide the service; otherwise the entire amount of rental income from the property would consist of nonqualifying income. To the extent that more than 5% of a REIT's income is comprised of nonqualifying income, the REIT could face a loss of REIT status.

Although TRSs may provide virtually any service to a REIT tenant or third party, constraints were placed on the TRS vehicle in order to ensure that the REIT remain a real-estate focused business. Specifically, no more than 20% of a REIT's assets may consist of all of its securities in TRSs. Furthermore, if payments between a REIT and its affiliated TRS do not satisfy an "arm's length" standard, they are subject to a 100% excise tax.

Furthermore, despite the amount of services that are typically provided at lodging and/or health care facilities, a U.S. REIT may own such facilities if it leases the facilities to a tenant who either operates the properties itself or hires an independent contractor to operate the properties. Allowing REITs to own health care facilities and loan money to operators of those health care facilities helps to increase the number and quality of these facilities, which can be especially useful as the aging "baby boomer" generation begins to need such facilities.

Hotel REITs, but not health care REITs, may own up to 100% of TRS to which they lease their properties if the TRSs hire independent operators to operate the hotels. Health care REITs may own no more than 10% of any tenant who rents one of their facilities; ownership of any more than this amount would disqualify all rent from such facility from constituting qualifying rental income.

2. Income from Development

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 expertise in blighted areas and redevelopment in all areas. These REITs choose not to develop for their own account.

Gains attributable to the sale of "dealer property" are taxed to the 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.

Specifically, no tax is imposed on a REIT's property sales if, among other requirements, the REIT has 1) held the property for at least 4 years, 2) not spent more than 30% of the net selling price of the property over the last 4 years, 3) not made more than 7 sales of property within the taxable year or the aggregate adjusted bases of property sold during the taxable year does not exceed 10% of the aggregate adjusted tax bases of all of the REIT's assets as of the beginning of the taxable year (10% rule). 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. Proposed federal legislation, S. 2002 and H.R. 1147, would reduce the safe harbor holding period from 4 years to 2 years, and would permit the REIT to calculate the 10% rule based on either aggregate tax bases or fair market value.[3]

Many REITs have established a core expertise in developing properties, and therefore develop properties for third parties through a TRS. Profits of the TRS are taxable at the entity level, but the after-tax income of the TRS could be distributed to the REIT in the form of dividends, which are qualifying income under the 95% gross income test. Thus, REIT shareholders benefit from

[3] *See* NAREIT's website for more information about this legislation: http://www.nareit.com/policy/government/ridea.cfm. Note in particular, that the legislation's lead sponsor, Senator Orrin Hatch (R-UT) stated in his introductory remarks concerning the legislation that a 4-year holding period is "simply too long a time in today's marketplace." http://www.nareit.com/policy/government/Hatch%20Introductory%20Statement%20s2002%20(8-3-02).pdf

the TRS activities and a normal corporate tax is imposed on activities not suitable under the REIT umbrella.

Additionally, in recent years, many REITs have expanded their investment portfolios through the use of joint ventures. A property owner may contribute property to a joint venture entity while the REIT contributes capital and/or manages and develops the property. By acquiring interests in properties through joint ventures, REITs greatly expand their property investment opportunities without having to secure additional capital from the public markets.

B. Assets

For U.S. REITs, 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 whose income and assets are viewed as owned by the REIT).

Under U.S. law, REITs may not pass through foreign tax credits to shareholders, although that issue has not been thoroughly examined because U.S. REITs have only recently begun to operate abroad. 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 25% of this market.

The broad definition of "real estate assets" also has allowed 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 consist 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.

Proposals:

Indirect Property Investment

It is not clear from the proposal concerning indirect investment whether the Paper intends to limit indirect property investment through **corporate** entities (like other REITs) or also through **fiscally transparent entities** (like partnerships). If the latter, NAREIT believes that this limitation could prevent a South African REIT from entering into valuable joint venture arrangements that would maximize flexibility in the investment structure, leading to increased shareholder return. NAREIT strongly urges that South Africa consider allowing South African REITs to invest indirectly through one or more levels of fiscally transparent entities.

Property Investment Outside of South Africa

NAREIT is pleased that South Africa is considering allowing investment in properties outside of South Africa. With that said, NAREIT is concerned about potential limitations requiring a South African REIT to invest only in South African properties. In order to allow South African REITs the greatest flexibility in investing to maximize return for investors, NAREIT recommends that South Africa not be the only country[4] to limit investment to primarily South African properties and instead allow its REITs to make investments throughout the world based on market demands.

One potential objection raised by the National Treasury is the complexity of passing through foreign tax credits. As noted above, this pass-through is not permitted in the U.S. although the issue has not been thoroughly examined. South Africa may wish to consider allowing for foreign tax credits could be passed through to REIT investors in a manner similar to the method used for Australian shareholders of Listed Australian Property Trusts with respect to their investments in the U.S. Specifically, these shareholders are entitled to a foreign tax credit in Australia with respect to U.S. withholding tax on dividends.

Services

The Paper proposes that income generated by other property related sources, for example through the provision of asset management or administration services, will be permitted.

NAREIT applauds the National Treasury for proposing to treat services related to asset management and administration as qualified REIT income. With that said, NAREIT recommends that South African REITs be provided adequate flexibility to provide the same type of wide array of services as U.S. REITs are permitted to provide. NAREIT also suggests that, to

[4] The rules governing Japanese REITs currently prevent J-REITs from investing outside of Japan. However, we understand that regulations likely will be adopted this year to remove this restriction.

the extent there is concern that the South African REIT may provide services that are not sufficiently property-related, South Africa consider a TRS-like construct.

Development

The Paper contemplates that development would be permitted for the REIT's own account but only if the property is held for at least three years.

NAREIT's concern is that the National Treasury proposal requiring a REIT to hold a property for at least three years may inappropriately restrict a South African REIT from maximizing return for investors by preventing it from selling property at the best time. Accordingly, NAREIT recommends that South African REITs be permitted to develop for their own account as 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 property held for at least two years (the current four year rule under U.S. law has proved to be too restrictive). To the extent that there is concern about excessive property sales, NAREIT recommends that South Africa consider rules similar to those used in the U.S. that would impose a 100% tax on sales of properties that are held "primarily for sale in the ordinary course of business" of the REIT.

Immovable Property and Debt Secured by Mortgages on Such Property

Also, NAREIT recommends that South Africa also consider allowing South African REITs to invest in loans secured by mortgages on real property. As noted above, in the U.S., the broad definition of "real estate assets" also has allowed REITs to invest in all types of loans secured by real property including the mezzanine financing described above

4.3 Distribution Rules

Among other things, the Paper proposes that a REIT distribute at least 90% of its accounting profits and that that proceeds realized by a South African REIT on the sale of assets must be reinvested within 12 months and may not be distributed to unit holders. NAREIT believes that the tax treatment of REITs in the U.S. has been one of several components leading to the success of REITs in the U.S. Consequently, NAREIT recommends a similar tax-transparent system for South Africa.

In the U.S., REITs are required to distribute 90% of their taxable income (other than net capital gains). The distribution requirement is keyed off of the calculation of taxable income, rather than book income (based on financial statements). It is important that the calculation of the 90% requirement is based on taxable income, rather than book income.

Under International Financial Reporting Standards (specifically IAS 40), companies must report investment property at "fair value" either directly in their financial statements, or as a footnote to such statements. We understand that over one-half of European companies with investment properties and the vast majority of U.K. REITs report the fair value of their investment properties on their financial statements. If a company chose to use fair value reporting of its investment property in its financial statement, the Paper apparently would require the REIT to distribute unrealized appreciation of the investment property without having the capital to do so, resulting in the need to borrow or sell properties (possibly at inopportune times) in order to raise capital.

If U.S. REITs meet the distribution requirement, and meet various other qualification requirements, they are entitled to deduct their distributions from taxable income. To the extent that U.S. REITs have remaining taxable income after the deduction for dividends paid, they pay a corporate level tax on this income. REITs can distribute capital gains and receive a deduction for such distributions, but they are not required to do so. Again, to the extent they retain capital gains, they are subject to tax.

If the U.S. REIT elects to pay a corporate level tax on retained capital gains, its shareholders: 1) include in income their proportionate share of the undistributed capital gains; 2) receive a tax credit for their proportionate share of the tax paid by the REIT; and 3) increase their adjusted tax basis in the REIT's stock by the difference between the amount of their capital gain and their share of the tax paid by the REIT. Essentially, a REIT's capital gain income is subject to only one level of tax, regardless of whether distributed. Shareholders also are subject to tax on the gain realized from the sale of REIT stock (typically at the lower, capital gains rates as long as the shares were held as a capital asset).

In NAREIT's view, the most appropriate system of taxation would include these choices, at the option of a South African REIT: 1) a corporate level tax if the REIT retains sales proceeds but does not reinvest in a short time frame, 2) no entity-level tax on distributed amounts through the mechanism of a dividends paid deduction; or, 3) rules that would allow for the tax free treatment of realized capital gains if the gains are reinvested within a specific time period.

The third option is similar to the "like kind exchange" rules of section 1031 that are part of the U.S. tax system. Under section 1031, if a taxpayer exchanges property held for investment with like kind property held for investment, tax on the gain from the exchanged property may be deferred if the exchange is made within specified time periods. This rule can be useful for those companies that are seeking to change or upgrade their class of properties, but would be prevented from doing so by the cost of the tax on capital gains, or for those companies that desire to change their investment focus from a specific geographic area to another area. Because the companies have not changed their core focus and have not received cash in the exchange, the U.S. Congress has decided to defer imposing a tax on like kind exchanges.

While the Paper's proposal does contemplate the tax-free treatment of capital gains if they are reinvested within one year, the Paper does not contemplate allowing the REIT to distribute capital gains to shareholders or merely to elect to pay tax on the gains and allow the shareholders to receive a credit for the tax paid by the REIT.

Proposal

First, NAREIT recommends that the 90% distribution test be based on taxable, rather than book, income in order that the South African REIT should have the capital (based on realized gains) to meet the distribution requirement. Otherwise, the South African REIT would be required borrow or sell properties at potentially inopportune times in order raise the capital to distribute “phantom gains”.

Second, NAREIT respectfully disagrees with the proposal that the REIT be prohibited from distributing capital gains and the requirement that the REIT must reinvest the proceeds within one year to achieve tax-free treatment of those gains. First, NAREIT believes that the real estate market develops best when companies are free to make decisions based on market forces. For example, there may be a situation in which it would be appropriate to sell a property but the market may indicate that it is not appropriate to buy any property for 18 months. In such a case, the REIT would face a disincentive in selling a property because its management may realize that it would not be profitable to acquire a new property within the appropriate time frame. Thus, NAREIT recommends that South African REITs be permitted to distribute capital gains (which would be taxable to the REIT’s shareholders, thereby limiting the loss to the fisc).

4.4 Gearing Limits

The Paper proposes that a South African REIT be entitled to borrow up to 70% of the value of its real estate property.

Again, the U.S. experience may be instructive in this context. As you know, 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. These market forces, rather than specific legislative requirements, have created this situation. As a result, in the third quarter of 2007, the average debt to market capitalization for equity REITs (property-owning REITs, as opposed to REITs that own mortgages or a combination of mortgages and property) was 39.6%.[5]

Additionally, the market may consider different debt amounts appropriate for different property sectors.[6] Rating agencies also provide an outside force to limit gearing. For example, as of December 31, 2007, 29 U.S. equity REITs, or 57% of the industry by market capitalization, had investment grade ratings on their outstanding debt issues. For these companies to increase borrowing, they must be prepared to address 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.

[5] *See* Exhibit 2.
[6] *See* Exhibit 3.

The lower debt levels associated with REITs compared to real estate investment in the U.S. overall have had a positive effect throughout the economy. Average debt levels for U.S. REITs are 40-50% of market capitalization, compared to leverage of 75% 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 should have 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.

Proposal:

NAREIT recommends that legislation provide the flexibility to meet different market challenges and not limit the level of gearing for a South African 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.[7] 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 a South African REIT should have the ability to petition the South African government for an exception to any leverage limits to account for unforeseen market conditions.

4.7 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. Under the proposal, REITs will be granted one year to rectify violations after which they will lose tax-exempt status.

By way of background, U.S. tax law in general used to take an "all or nothing" approach with respect to REIT test requirements. That is, failure of any REIT test could lead to automatic disqualification (and no re-election of REIT status for four years without permission of the Internal Revenue Service) regardless of how insignificant or inadvertent the violation. In 2004, certain "REIT Savings" provisions were made to the Internal Revenue Code of 1986, as amended (the Code) through the enactment of the "REIT Improvement Act" (RIA or the Act) as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, that modified this "all or nothing" approach.

In general terms, the REIT Savings provisions allow a REIT to remedy one or more failures to satisfy the REIT asset test failures, income test failures; and/or "other" REIT test failures by remedying the failure and/or paying a monetary penalty. One requirement in order to remedy

[7] *See* EPRA Global REIT Survey 2007 http://www.epra.com/media/EPRA_REIT_Survey_2007.pdf .

some of the REIT test failures is that the failure be due to "reasonable cause and not willful neglect."

Because the determination of this issue is so factual, it has proven difficult for both taxpayers and/or the IRS to conclude that any REIT test failure is due to reasonable cause and not willful neglect. As a result, many REITs have been forced to seek "closing agreements" with the government permitting them to retain REIT status following the payment of a penalty. The time spent both by the government and taxpayers on closing agreements to resolve these issues is significant and inefficient.

NAREIT's concern with the Paper's proposal of the "all or nothing" approach after a one-year grace period is that South African REITs may also experience similar uncertainty. For example, a discovery of an error years after it occurred with no possibility of remedying the violation would result in loss of REIT status even if the violation were fairly insignificant (for example, if only 74.99% of a REIT's gross income were from qualifying sources, the REIT would fail the income test, and if the discovery of a calculation error were made years after the particular year in question, it would be impossible to rectify).

Proposal: 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.

Part II – Tax Dispensation

7.2 Tax Implications of Capital Gains

As discussed above under Section 4.3, the Paper proposes that REITs not be permitted to distribute their capital gains, and be exempt from paying tax on their capital gains.

NAREIT's concern is that the Paper presumes that the value of underlying assets would be reflected in the unit pricing of the REIT'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.

Proposal:

In addition to NAREIT's suggestion under Section 4.3 above that REITs be permitted to distribute their capital gains, NAREIT also suggests that South Africa follow the U.S. model and tax capital gains at the shareholder level if distributed and tax the shareholder upon disposition of the REIT stock. The U.K REIT regime is similar. Furthermore, in order to avoid double taxation, while at the same providing for the retention of cash during a period when raising of capital may be difficult, the U.S. regime permits a U.S. REIT to retain and pay tax on capital gains while providing its shareholders with a credit for tax paid.

8.3 Tax Transition Rules

The Paper suggests that and entry tax/levy may be considered in connection with conversion to a South African REIT.

NAREIT's concern is that an entry fee that is too steep, as is the case with the Israeli REIT regime, could stifle the South African REIT market. 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.

Exhibit 1

U.S. Listed REITs That Were Unlisted REITs

Name	Trading Symbol	Equity Market Capitalization As of Dec. 31, 2007 (in millions)
AMB Property Corporation	AMB	$5,692.9
American Financial Realty Trust	APRO	$1,045.6
AmREIT	AMY	$45.3
BioMed Property Trust Inc	BMR	$1,517.5
DCT Industrial Trust	DCT	$ 1,555.2
Inland Real Estate Corporation	IRC	$921.8
ProLogis	PLD	$16,240.3
Strategic Hotel Capital, Inc.	SLH	1,243.9

Source: NAREIT

Exhibit 2

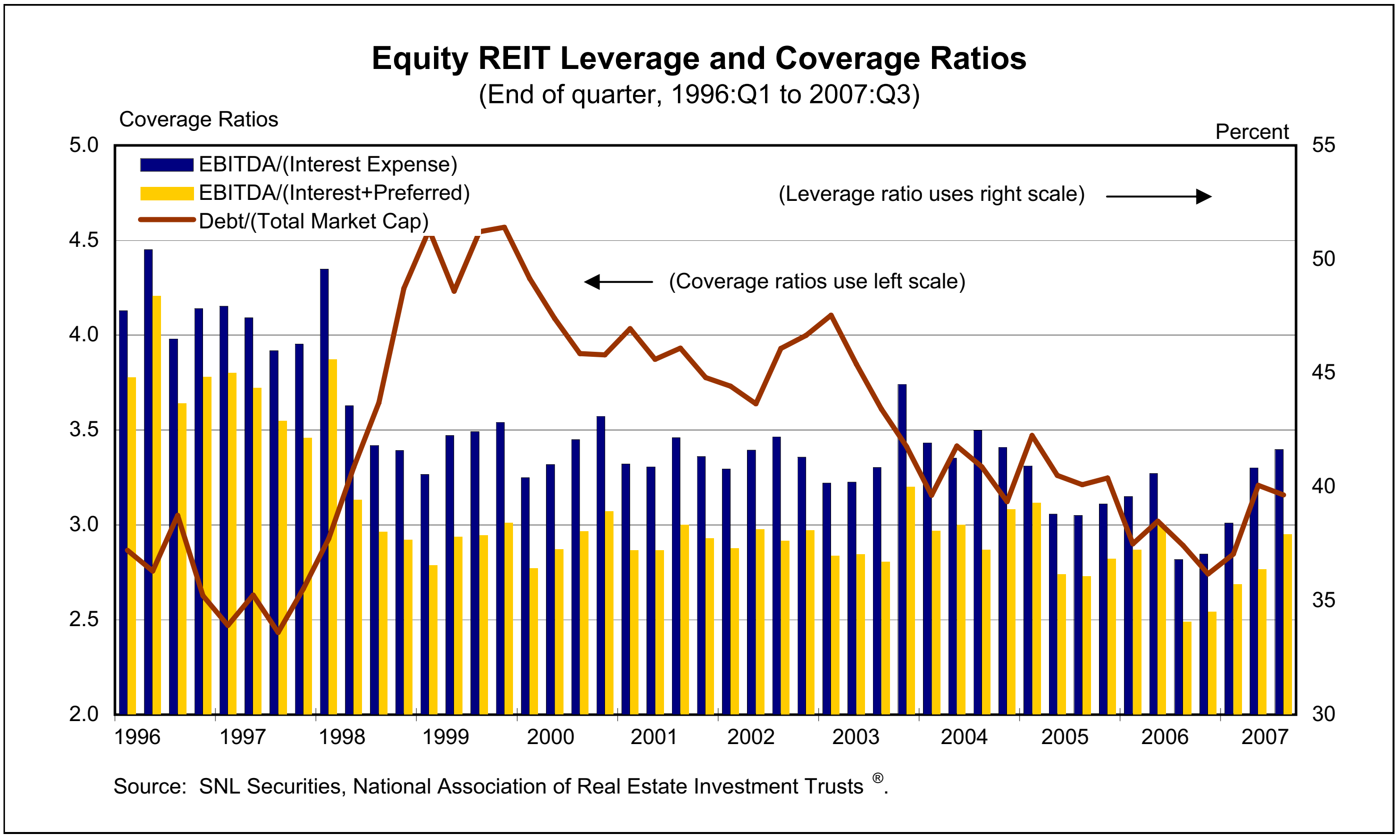
Equity REIT Leverage and Coverage Ratios
(End of quarter, 1996:Q1 to 2007:Q3)
Coverage Ratios
Percent
EBITDA/(Interest Expense)
EBITDA/(Interest+Preferred)
Debt/(Total Market Cap)
(Leverage ratio uses right scale)
(Coverage ratios use left scale)
5.0
4.5
4.0
3.5
3.0
2.5
2.0
55
50
45
40
35
30
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
Source: SNL Securities, National Association of Real Estate Investment Trusts ®.

Exhibit 3

Summary of Financial Leverage by Property Sector : Third Quarter 2007

(Publicly Traded Real Estate Investment Trusts)

Sector	Number of Companies	Implied Market Capitalization (Sep 2007)[1]	Debt Ratio[2]	Interest Coverage[2]	Fixed Charge Coverage[2]
By Property Sector					
Industrial/Office	26	88,798,687	38.6	4.86	3.79
Office	15	47,705,292	40.5	3.79	3.56
Industrial	6	29,212,913	36.6	4.43	4.12
Mixed Industrial/Office	5	11,880,482	36.2	10.17	3.94
Retail	27	111,457,186	40.7	2.79	2.56
Shopping Centers	15	41,668,050	33.9	3.09	2.78
Regional Malls	7	62,469,854	46.0	2.46	2.32
Free Standing	5	7,319,282	33.3	3.95	3.42
Residential	21	52,062,460	42.3	2.80	2.60
Apartments	17	49,531,635	41.7	2.85	2.64
Manufactured Homes	4	2,530,825	54.3	1.90	1.87
Diversified	7	24,709,039	42.7	2.61	2.30
Lodging/Resorts	11	25,745,670	39.5	3.46	3.10
Health Care	9	23,845,904	39.8	3.06	2.88
Self Storage	3	2,888,534	48.1	2.54	2.46
Specialty	5	17,308,561	24.5	3.24	3.05
Equity Totals by Property Sector	109	346,816,041	39.6	3.40	2.95
Commercial Property Financing	13	5,788,291	85.4	0.86	0.83
Home Property Financing	13	8,165,020	89.7	0.70	0.69
Mortgage Totals	26	13,953,311	87.9	0.77	0.75
Hybrid Totals	4	5,366,681	60.2	15.12	15.04
Industry Totals	139	366,136,033	41.8	3.47	3.04

Notes:

[1] Equity market capitalization in thousands of dollars, including operating partnership units.

[2] Weighted averages using end-of-period equity market capitalizations, including operating partnership units.

Source: SNL Securities, National Association of Real Estate Investment Trusts ®.