

LEGAL STRUCTURES FOR PROPERTY FUNDS IN THE REPUBLIC OF SOUTH AFRICA

This article is written against a background of increased foreign interest in real estate in the Republic.

Although there are probably any number of permissible legal structures for the establishment of a property fund for listing on The JSE Securities Exchange South Africa ("**JSE**"), three of these structures immediately come to mind. I deal with these in no specific order of merit or popularity.

Public Companies

The first and simplest legal structure is the establishment of a public company in accordance with the provisions of the Companies Act 1973 ("**Companies Act**"). Shares in the capital of the company are listed on the JSE. Such listing requires the issue of a prospectus or pre-listing statement.

The taxable income of a company is subject to the payment of Income Tax. In addition, when profits are distributed to shareholders by way of dividends, Secondary Tax on Companies (STC) becomes payable on the dividend paid.

Save for the Companies Act and the listings requirements of the JSE, there is no specific legislation which regulates the affairs of a property owning company. Accordingly, by way of example, there is no regulatory limitation on the gearing of a listed property company.

This structure is, because of its negative (in comparison to a variable loan stock company or collective investment scheme) taxation consequences, not commonly used for listed funds. Public companies are however a popular vehicle for unlisted property syndication schemes.

Variable Loan Stock Companies

A variable loan stock company (also known as a "linked unit company") is one where the share capital of the company is divided into "linked units" (which are listed on the JSE) each

comprising a share which is linked to a variable rate debenture. The interest or coupon payable on the debenture varies according to the distributable profits earned by the company during the relevant period.

Distributions therefor constitute a relatively small dividend with the bulk of the profit being distributed as interest on the debenture. Such interest is tax deductible in the hands of the company, thus reducing the taxation liability of the company. On the other hand the interest is taxable in the hands of the unit holder. Consequently each unit holder pays taxation according to it's own applicable regime and the taxation rate applicable to it.

A potential difficulty of this structure is that over time and as the company becomes more and more profitable, the interest component of the distribution becomes disproportionate to the face value of the debentures. Put another way, the coupon on the debenture becomes excessively high. There is a real risk that the South African Revenue authorities will disallow the deduction of interest by the company and will nevertheless tax the full amount in the recipient's hands. This will negate the benefit of this currently popular structure.

As in the case of public companies there is, save for the Companies Act and the listings requirements of the JSE (both of which require the issue of a prospectus or pre-listing statement) no specific legislation which regulates the activities of variable loan stock companies.

Collective Investment Schemes

A collective investment scheme is, by definition in terms of the Collective Investment Schemes Control Act 2003 ("**CIS Act**"), any scheme, in whatever form, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio and in terms of which investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest and the investors share the risk and the benefit of investment in proportion to the participatory interests in a portfolio of a scheme or on any other specified basis. A collective investment scheme does however not include a company which is authorised by the Companies Act.

Although a collective investment scheme may, by definition, take a number of forms the most common form of a collective investment scheme utilises an investment trust. Fundamentally a trust is created for the benefit of holders of "participatory interests". Only public companies, long term insurers and a limited number of other entities qualify in terms of the CIS Act to be trustees of collective investment schemes. Furthermore no trustee may act as trustee of a collective investment scheme before being registered as such by the Registrar of collective investment schemes.

The trustee has a number of statutory duties and obligations. Significantly the trustee must indemnify the manager of the scheme (see hereunder) and investors against any loss or damage suffered in respect of money or other assets in the custody of the trustee and which loss or damage is caused by wilful or negligent act or omission by the trustee.

A collective investment scheme must also be administered by a manager authorised to act as such in terms of the CIS Act. Stringent requirements are specified for registration as a manager.

A portfolio in a collective investment scheme in property managed or carried on by a company is not regarded as a company for tax purposes. It is subject to tax as if it were a trust on the income not distributed to the holders of participatory interests. Dividends distributed by a fixed property company carrying on a collective investment scheme are not exempt from tax in the shareholder's hands, but the fixed property company can deduct such dividends (other than dividends distributed out of capital profits) from its gross income. In effect, the fixed property collective investment scheme is taxed on the difference between its income and dividends distributed.

Collective investment schemes are in fact very similar to what is commonly referred to in other jurisdictions as Real Estate Investment Trusts ("**REITs**").

Collective investment schemes are subject to significant regulation by the Financial Services Board in terms of the CIS Act. Although not provided for in the CIS Act and/or in any regulation thereunder, the Financial Services Board has, in terms of the form model deed approved by it

for purposes of the registration of collective investment schemes, imposed a limit on borrowings that may be incurred by such schemes. Effectively gearing is limited to 30% of the value of the underlying property portfolio.

Foreign Companies

Another alternative (but which is not really intended to form part of the subject matter of this article) is the formation and listing of a public company in a foreign jurisdiction, the object of which is to invest in real estate in the Republic. There are currently no restrictions against land ownership by foreign companies in the Republic.

Comment

Ordinary public companies are, because of negative taxation consequences, not a favoured vehicle for the creation of a property fund in the Republic.

Variable loan stock companies are not subject to the same degree of regulation as are collective investment schemes in property. They have hitherto been a popular form of investment vehicle, but the uncertain future taxation treatment of excess interest causes concern.

Collective investment schemes have advantageous taxation consequences and are, because of their stringent regulation, considered to be conservative "grannies and orphans" investment vehicles. The restriction against gearing does, to some extent, limit profitability.

There is currently, in certain quarters within the real estate industry in the Republic, a strong contingent of property managers, owners and practitioners who are promoting the relaxation of the degree of regulation to which collective investment schemes in property are subject in order to align these schemes with REITs in other major jurisdictions around world.