Real Estate Sector

TAX STIMULUS FOR COMPETITIVE EDGE

by Dr. Jeyapalan Kasipillai and Nor Shaipah Abdul Wahab

Background

The Government has introduced new fiscal measures to stimulate the growth of real estate investment trusts (REITs) in Malaysia. A REIT is a vehicle that mobilises funds from unit holders comprising individuals and companies for investments in real estate. By providing generous tax incentives, the liquidity of the real estate sector will increase thereby boosting its contribution to the national economy. Malaysia has recorded spectacular growth of 4.9 and 6.5 per cent in the real estate sector for the years 2003 and 2004 (National Product and Expenditure Accounts 2003/2004). With the country abandoning its seven-year currency peg to the dollar for a managed float, the splendid growth is expected to rise further in 2005. A flexible currency regime is good for the real estate segment as it creates a clearer investment atmosphere for both local and foreign investors.

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Real Estate Investments Trusts (REITs) and Property Trust Funds (PTFs) were first created five decades ago in the US. Although REITs only made their debut in Singapore three years ago, it already accounts for two to three per cent of Singapore's stock market capitalisation today. In Australia, it has reached nearly nine per cent (*The Star*, 2005). These investment trusts would of course be able to contribute significantly to Bursa Malaysia's market capitalisation once this new asset class bodes well with the investing community. They are particularly popular now as REITs and PTFs in developing countries have financially outperformed other economic sectors in recent years. In this article REITS are meant to include Property Trust Funds.

Guidelines

The Guidelines on REITs issued by the Securities Commission on 3 January 2005 interpret them as investment vehicles that invest or propose to invest at least 50 per cent of their total assets in real estate. An investment in real estate may be by way of direct ownership or a shareholding in a single purpose company whose principal assets comprise of real estate. The guidelines set out the rules that are to be adhered to by the REITs in order to protect the interests of the investing public and facilitate their orderly development. These REITs must be approved by the Securities Commission in order for them to be eligible for the favourable treatment including tax treatment. Failure to comply with the rules and regulations may result in the delay or cancellation of the approval.

Recent Budget Announcement

In the 2005 Budget, the Government announced new tax incentives to promote the growth of REITs and Property Trust Funds (PTFs) in Malaysia. Prior to the announcement, a PTF was taxed as a unit trust but with special deductions in the form of capital allowance deductions (see Section 63A ITA) and a deduction for specified permitted expenses (Section 63B ITA). These two sections (63A and 63B) do not apply to a REIT. The amendments to the ITA on the tax incentives for REIT are covered in the Finance Act 2004 (Act 639).

In recent months, several public-listed companies such as AXIS-REIT, Landmarks Bhd, Naim Cendera Holdings Bhd, Sunway City Bhd and YTL Corporation Bhd launched their real estate investment trust funds and are seeking listing of their REITs on the Bursa Malaysia. There are indications to suggest the REITs, once listed, will receive good response from institutional investors due to their attractive yields.

Tax Treatment of the REIT/PTF

The new amendment to the taxation of a REIT is a 'tax flow through' treatment whereby the REIT will not have to pay any tax on distributed income but instead the unit holder will be subject to tax on the distribution from REIT (Kasipillai J., 2005). This new incentive leaves the REIT in a relatively better position with more income for distribution to unit holders. This makes the REIT more attractive as an investment option as compared to other unit trusts, which invest mainly in equities.

■ Distribution to unit holders

The new Section 61A ITA exempts the REIT from the payment of tax on the amount distributed to the unit holders in the basis period for a year of assessment.

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The balance of the total income that is not distributed will be taxed at 28 per cent on the REIT. This means the REIT effectively pays less tax when it distributes its income.

In June 2005, the executive director of AXIS-REIT, Stewart LaBrooy, announced that the company expects to distribute at least 95 per cent of the company's taxable income every year to its shareholders (The Star, 2005). The company floated the first real estate investment trust on the main board of Bursa Malaysia. He was quoted to have mentioned the following: *"We were looking within the range of 90 per cent to 100 per cent dividend payout for investors*

to feel comfortable. There is no point for us to keep the money as it will be taxed and shareholders also want dividends."

■ Prior to year of assessment 2005

When a REIT receives dividend income, the tax credit from tax at source is given to the REIT. Capital gains and certain interest income will continue to be exempt at the unit holder level. Prior to year of assessment 2005, rental income received by a REIT was treated either as a business or non-business source based on Section 4(a) or 4(d) of the Income Tax Act 1967. Section 4(a) relates to income in respect of gains or profits from a business while Section 4(d) is income in respect of rents, royalties or premiums. The former is regarded as 'active income' eligible for capital allowances while the latter is regarded as 'passive income' and hence not eligible for capital allowance deductions.

■ From year of assessment 2005

The new Section 63C ITA provides that income of a REIT from the letting of real property will be treated as a business source and hence taxable under Section 4(a) and not 4(d) ITA. This new section is also effective from year of assessment 2005.

As mentioned earlier, rental income from letting of real property of a REIT receives special treatment from year of assessment 2005. There will be limitations imposed under the new treatment. Normally, Section 43(2) ITA allows unutilised business losses to be carried forward to the following year or years. Such losses can be offset from other business profits. However, with regard to the new provisions that are applicable to REITs, any excess deductions allowed in arriving at the adjusted income and any unabsorbed allowances under Schedule 3 ITA would be disregarded. Losses from letting of properties cannot be deducted against income from other sources of the REIT in the same basis period. Neither can the rental losses and unabsorbed capital allowances be carried forward to the following year of assessment and used to offset against that year's rental income.

Income from all properties of the REIT will be aggregated and treated as a single source of income. Expenses wholly and exclusively incurred in the production of income will be deductible against the rental income under subsection 33(1) ITA. The remuneration of REIT managers will now be deductible since the rental income is treated as a business source but the trustee's fee will not be allowed as it does not come within the ambit of subsection 33(1) ITA.

■ Real property gains tax exemption

In the case of a taxpayer who disposes of a property to a REIT and makes a chargeable gain, the gain is exempted from real property gains tax with effect from 13 September 2003.

■ Stamp duty exemption

The stamp duty on such transactions was also exempted from 13 September 2003. Real Estate Investment Trusts were eligible for these exemptions prior to year of assessment 2005 and will continue to be exempted hereafter.

Tax Treatment of Unit Holders

If the undistributed profits is eventually distributed to the unit holders any tax paid earlier by the REIT will be available as a tax credit under Section 110 of the Income Tax Act 1967 in the year of assessment the income is brought to tax.

Individual holders who are resident in Malaysia will be taxed at their respective scale rates on the income distributed. The scale rates vary from zero to 28 per cent but the unit holders will be eligible for set-offs under Section 110 ITA. Corporate unit holders receiving income distributed by REITs will be taxed at 28 per cent.

Non-resident unit holders who are receiving income distributed by REITs will be taxed at 28 per cent. With reference to Section 109D ITA, REITs have to deduct the withholding tax upon distributing the income to non-resident unit holders. The

tax deducted shall be remitted to IRB within one month after distributing such income to non-resident unit holders. If the withholding tax is not complied with, the tax arising will be increased by an amount equal to 10 per cent and will become a debt due to the Government of Malaysia.

An illustration on the income tax computation of a real estate investment trust is given in the Table.

Concluding remarks

REITs offer a good business-restructuring alternative to property developers who face funding constraints. They are stimuli that could boost the real estate sector by way of increasing the competitive edge as compared to the other major financial sectors. The relaxation of the tax treatment on the income distributed by REITs or PTFs would provide a great opportunity for the REITs or PTFs to increase the market capitalisation. In Singapore, tax incentives for unit holders have proven to be very effective for the REIT's rapid growth.

The amendment of tax provision on the distribution of total income by the REITs encourages the investor to invest more in this industry. Hence, the exemption of the distribution of the total income in the hand of the REITs would indirectly increase its share of market capitalisation. In future, it is anticipated that the tax incentives could be an effective means to ensure the growth of REITs. AT

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Table Income Tax Computation of a Real Estate Investment Trust

ABC REIT receives the following income: rental, interest and dividends, for the following two years, namely 2005 and 2006.

Income	Year 2005 (RM)	Year 2006 (RM)
Rental	15,000	13,000
Interest	6,000	3,000
Dividend (gross)	7,200	1,200

The company distributes RM22,560 and RM20,000 of the total income to the unit holders in 2005 and 2006 respectively.

ABC REIT — Computation of Income Tax Payable

The computation of the tax payable at the REIT level would appear as follows:

Details	Notes	2005 (RM)	2006 (RM)
Section 4(a) Business income (rental)		15,000	13,000
Section 4(c) Interest		6,000	3,000
Dividend (gross)		7,200	1,200
Total income		28,200	17,200
Less: Distribution	1	(22,560)	(17,200)
Chargeable income		5,640	Nil
Tax payable (28%)		1,579.20	Nil
Section 110 set-off	2	2,016.00	336
Tax refund		**436.80**	**336**

The distribution by the REIT comprises of:

Details	Notes	2005 (RM)	2006 (RM)
Income not subject to tax		22,560	17,200
Income subject to tax	3	Nil	2,800
Total distribution		**22,560**	**20,000**

Computation of income tax by unit holders

The computation of the tax payable at the unit holder level is as follows:

Details	Notes	2005 (RM)	2006 (RM)
Distribution from REIT:			
■ Not subject to tax at REIT level		22,560	17,200
■ Subject to tax at REIT level		Nil	2,800
Section 110 set-off	4	Nil	784

Notes:

1. The exemption on the distribution of the total income in year 2006 is limited to the total income of that year (i.e. RM17,200).
2. Dividend income forms part of the total income of the REIT in both years. The REIT is, therefore, eligible for Section 110 set-off.
3. In year 2006, the total distribution by REIT is RM20,000 and it includes RM17,200 exempt income of that year. The remainder RM2,800 (RM20,000 – RM17,200) is from the taxable income in 2005.
4. The IRB Guidelines stipulate that the undistributed income of a REIT for any year of assessment, which is subsequently distributed to the unit holders, will be taxed on the unit holders in the year of assessment that the income is distributed. Moreover, the guidelines specify that Section 110 set-off for the tax suffered by the REIT would be eligible for unit holders.

Reference

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