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Tax and Legal News

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Property Sector Tax Alert - Foreign Exchange

Tax consequences of foreign exchange movements amid the COVID 19 crisis for Real Estate Investment Trust

The outbreak of the COVID-19 pandemic has had a significant impact on the global foreign exchange (**forex**) market, which has been reflected through increased volatility in forex.

In addition to the adverse effect that COVID-19 has had on the South African economy, ratings agency Moody's downgrade of South Africa at the end of March 2020 also adversely impacted the Rand against major other currencies.

The volatility in the forex rates is evident from the recent fluctuations in the Rand/Dollar exchange rate. The strength of the Rand varied from R14.75/$1 at the end of January 2020 to just under R18.00/$1 at the end of March 2020. This is a weakening of the Rand against the Dollar of 22% in only 3 months from January 2020 to March 2020.

What are the tax implications

Section 24I of the Income Tax Act[1], (**the Act**) governs the income tax treatment of forex gains or losses made in respect of both realised and unrealised forex transactions. Simplistically unrealised forex gains and losses are treated as taxable or deductible unless the deferral provisions[2] apply. In the context of deferred unrealised forex differences a cash event will only occur upon settlement of the exchange item.

Assuming the taxpayer is not in an assessed loss position, there is a tangible cash tax impact in instances where the deferral provisions are not applicable to unrealised gains or losses. This impact is magnified in periods of forex volatility.

This is especially relevant where an unrealised forex gain is recognised which does not result in any cash inflow but the same non-cash gain creates taxable income which results in a tax cash outflow. The converse is however also true for an unrealised forex loss which does not result in any cash outflow but the same non-cash loss creates a reduction in taxable income and tax cash payable.

Impact of unrealized forex on a Real Estate Investment Trust (REIT)

There are two key aspects REITs should consider:

1. Cash flow impact on the amount the REIT is able to distribute as a qualifying distribution

In terms of the gross income provisions of the Act, read with section 24I of the Act, a REIT or Controlled Company, (**CC**), must include both realised and unrealised forex gains and losses in the calculation of its taxable income. However, dividends/qualifying distributions (**QDs**) the REIT declares and pays to its investors are generally limited to actual cash the REIT/CC has earned, and therefore would exclude unrealised forex differences.

Accordingly, there may be a mismatch between the timing of the inclusion of the unrealised forex gain in the taxable income and the corresponding inclusion of the forex gain in the QD. This mismatch may result in the REIT or CC not being able to make a large enough QD to reduce its taxable income to zero, applying the REIT provisions of the Act[3]. In the subsequent year when the forex gain is realised, the REIT or CC may have surplus cash from which limited/no benefit will arise by way of a QD deduction, as the deduction is limited to taxable income, which will exclude the prior year unrealised forex gain now realised.

The timing mismatch in respect of an unrealised forex loss may result in the REIT or CC having a surplus amount of cash from which limited/no benefit will arise by way of a QD deduction, as the deduction is limited to taxable income (i.e. may not create an assessed loss). In the subsequent year once the forex loss is realised, the REIT or CC may not be able to make a large enough QD to reduce its taxable income to zero, which will exclude the prior year unrealised forex losses now realised.

2. Impact of forex gains on the 75% qualifying distribution assessment

Given the instability of the Rand, many REITs/CCs entered into hedging instruments which result in forex gains and losses, both realised and unrealised. The recent significant volatility in the Rand may result in REITs/CCs having large forex gains. Forex gains which do not fall within the rental income definition (recently amended in the 2019 Taxation Laws Amendment Act) may have a negative impact on the 75% QD assessment.

The impact is such that both realised and unrealised forex gains are included in gross income but may not form part of the rental income definition. The result is that there may be a risk that the REIT/CC may not meet the 75% rental income to gross income ratio requirement. In turn this may result in the REIT/CC not being able to claim the dividend as a qualifying distribution deduction and ultimately the REIT/CC may be in a taxable income position.

Careful consideration needs to be given as there is a risk that REITs/CCs may fall prey to the potential adverse consequences noted above.

Other considerations

Apart from the matters highlighted above you would also need to consider:

- The VAT implications of the above scenarios (refer to the attached VAT Alert)
- Whether there are any aspects to consider from a Corporate Law perspective
- The treatment and tax consequences of cross currency and interest rate swaps.

How can we help?

We are able to assist you with determining the appropriate tax consequences and preferred approach based on your specific circumstances.

Contact us


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Regards
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FOOTNOTES

1 No 58 of 1962, as amended

2 Section 24I(10A) of the Act

3 Section 25BB of the Act

[1] No 58 of 1962, as amended

[2] Section 24I(10A) of the Act

[3] Section 25BB of the Act