Tax Incentives for Real Estate Investment Trusts (REITs) as an Investment Alternative

Introduction

In a bid to help achieve one of the government's Big Four Agenda i.e. Housing, where the government aims to bridge the housing gap by delivering 500,000 units by 2023, innovation in capital raising for both development and end user financing is paramount. One of the key ways that the capital can be raised is through the capital markets. Following the enactment of the Tax Laws (Amendment) Act, 2020 on 25th April 2020, and the proposed changes to the Income Tax (REIT) rules, we revisit the discussion of REITs as an Investment Alternative. In this note we shall cover;

I. Tax Benefits for Investing in REITs,
II. Proposed Changes to the Income Tax (REITs) Rules,2020, and,
III. Conclusion.

What are REITS?

REITs are regulated investment vehicles that enable collective investment in real estate, where investors pool their funds and invest in a trust with the intention of earning profits or income from real estate, as beneficiaries of the trust. REITs source funds to build or acquire real estate assets, which they sell or rent to generate income. The income generated is then distributed to the shareholders at the end of a financial year. In Kenya, the first REIT, Fahari I-REIT by Stanlib, was approved by the Capital Markets Authority in October 2015, and has been the only operational REIT to date.

I. Tax Benefits for Investing in REITs

REITs in Kenya have a number of tax benefits, among them being;

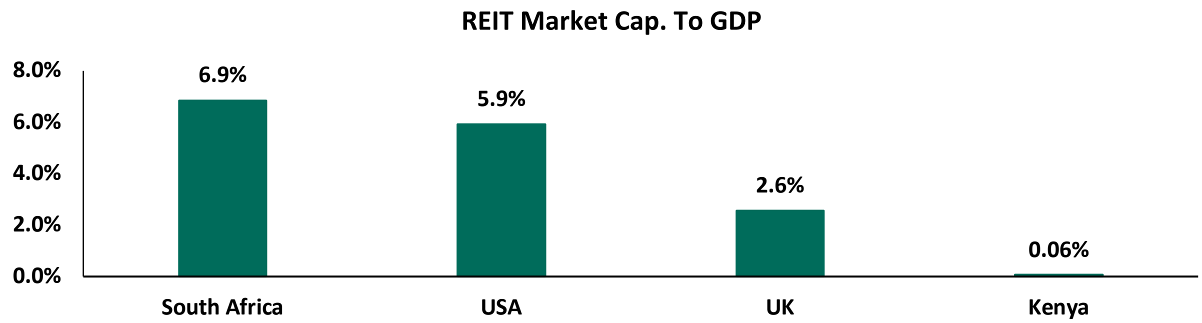
a) A listed REIT and REIT Investee companies enjoy corporate tax exemption, currently at 25% per annum. The only taxation is on distribution of profits to the unit-holders, which would be subject to withholding tax ("WHT") at the rate of 5% for resident and 10% for non-resident unit-holders. The Tax (Amendment) Act, 2020 saw REITS and REITs' investee companies maintain their income tax exemption status after the amendment of Section 20 of the Income Tax Act as per Finance Bill 2019 saw the inclusion of REITs' investee companies in the income tax exemption thus allowing REITs to invest more in companies that develop real estate, rather than going through the process of transferring properties to the REIT,
b) Transfer of properties to a REIT also attracts a stamp duty exemption, as per Section 96A (1) (b) of the Stamp Duty Act.

II. Proposed Changes to the Income Tax (REITS) Rules, 2020

According to the draft Income Tax (Real Estate Investment Trusts) rules, 2020, REITS and REITs' investee companies will now be required to apply to the Commissioner (KRA) for exemption of income tax at the time of registration. Previously REITs were only obliged to get approval from the Capital Markets Authority (CMA). The move is aimed at involving the KRA in order to seal any possible loopholes in tax collection. The draft rules come just after enactment of the Tax Laws (Amendment) Act, 2020 on 25th April 2020, which rejected the proposal in the Tax (Amendment) Bill, 2020 that sought to remove the exemption from tax status of income from pooled funds. In our view, the draft REIT rules that seeks to add the approval of KRA, prolongs the process for setting up REITS and goes against the one stop approval, which is a key factor in the ease of doing business.

III. Conclusion

In Kenya, there is a lot of potential for growth in the REIT market, as evidenced by the low REIT Market Cap to GDP, at less than 0.1%, with only Fahari i-REIT being listed, compared to more developed markets such as South Africa, at 6.9% as highlighted below.



The government in a bid to encourage investments in real estate has put in place tax incentives that favors REITs aimed at boosting the REIT market and in turn lead to deepening of our capital markets. However, the approval by the Capital Markets Authority should be sufficient since the addition of KRA approval goes against a one-stop approval, which is key for ease of doing business. In addition, there is still more that can be done in spurring its growth, through continuous development of supportive framework. In our view, the following measures can be implemented to revitalize the REIT market;

I. Teaming Up of the Market Players and the Regulators to Offer Constant Training to the Investing Public- This training should include training the real estate developers on how they can harness the capital markets as a source of capital for development,
II. Broaden the Pool of Trustees - Currently, Kenya has only three institutions certified as REIT trustees. In order to make the REIT market more vibrant, we need to widen our pool of investment fund trustees to include capable professionals or corporates. For example, in the UK a Chartered Accountant can register with the Financial Conduct Authority to be a trustee, and in South Africa, an insurance company can also be a trustee,
III. Reduce the Minimum Investment to a Reasonable Level - In order to attract capital into capital market vehicles such as Real Estate Investment Trusts (REITs) for real estate development, the minimum investment amount needs to be amended. The current regulations define the minimum subscription amount per investor at Kshs 5.0 mn for a Development REIT (D-REIT), which is too high to attract significant interest from investors. An amount of Kshs 1.0 mn ensures the investor is sophisticated while also allowing a larger pool of investors to participate,
IV. Development of Institutional Grade Real Estate Assets – Currently, inadequate urban planning has given rise to a defined gap in the real estate market for real estate that is more than just a provision of housing, and that can give returns to investors. In this regard, development of institutional grade real estate assets would provide strong underlying assets for REITs, which can support the returns to investors, and,
V. Collaboration of Key Players in the Real Estate and Investment Sectors will play a Major Role in Harnessing Broad Support with regards to Issuance of REITs in the Country. Promotion of club deals at an early stage in the structuring of REIT offerings could go a long way to attract institutional support for successful REIT offerings.