THE TAXATION OF UNIT TRUSTS AND REITS

RELEVANT TO ACCA QUALIFICATION PAPER P6 (MYS)

Specific provisions applicable to real estate investment trusts (REITs) and property trusts were included in the Income Tax Act 1967 ('the Act') with effect from the year of assessment 2005. As the two are very similar, we shall refer to both as REITs. In some countries a REIT is constituted as a company but in Malaysia it takes the form of a unit trust so, for the sake of clarity, the expression 'unit trust' will only be used to refer to a conventional unit trust. Candidates will probably remember that a unit trust is in fact just a special kind of trust and that it is covered by the law relating to trusts.

Trusts and settlements fall within Part A1(b)(vi) of the *Study Guide*. This topic was dealt with in an article published in *student accountant* in October 2005. Unit trusts and REITs are treated as a specific topic under Part A2(b)(ii). The article on unit trusts and REITs published in the March 2006 of *student accountant* is now being updated to incorporate recent changes in the law.

TERMINOLOGY
Candidates should bear in mind that unit trusts and REITs are still trusts. In spite of some differences, they all come under the general tax provisions relating to trusts, which are contained mainly in Sections 61 to 62 of the Act.

A trust is not a legal entity but an arrangement which comes into existence when the legal control of a property, or properties, is given to a trustee, who will look after the property on behalf of someone else for a time. Normally the trustee will have no right to take or use the property. The trust may be in the private domain (as in the case of a conventional trust) or in the public domain, as in the case of a unit trust or REIT.

By using the general trust concept, unit trusts become vehicles for investors to pool their funds for investment purposes. Each investor purchases a number of units in the trust, or 'fund'. The return to the investor comprises regular distributions based on the number of units owned. The distribution usually comprises income only, but it may include capital gains.

Because such trusts, or funds, are taking monies from the public for investment, they are highly regulated by the authorities, in particular the Securities Commission and Bank Negara. A unit trust is established by a trust deed. An approved custodian trustee is appointed to hold the investments on behalf of investors, and an approved management company is appointed to manage the funds in accordance with the aims and parameters set for the fund. Units in the fund can be bought and sold at the prices determined and published by the managers.

A property trust (or REIT) is, in fact, a specialised unit trust set up and approved by the Securities Commission in order to own and actively manage income-generating real estate. The taxation of unit trusts is based on the general tax provisions for trusts with modifications. In the case of a REIT, these modified provisions are modified yet again. However, if no particular provisions apply to the REIT, general trust provisions (as applicable to unit trusts) are still relevant.

METHOD OF TAXING A UNIT TRUST OR REIT
Under the general rules for taxing the income of trusts, any income from a source belonging to the trust is to be taxed, in the first instance, as income of the trust body.

Beneficiaries are assessed and charged to tax separately. All trusts, including unit trusts and REITs, have to comply with the self-assessment system in the same way that companies have to. The basis period will be the period covered by any accounts made up by the unit trust or REIT, otherwise the year to 31 December. A return of income must be submitted within seven months of the end of the basis period. Any tax due must be paid without further demand within seven months of the end of the basis period. The unit trust or REIT must provide an estimate of tax payable within one month before the commencement of its basis period, and make instalment payments.

The responsibility for tax compliance rests with the manager, but the trustee is assessable and chargeable to tax. A trustee in office has joint and several liability for the tax liabilities of the unit trust or REIT, to the extent of any accessible monies.

TAXING THE INCOME OF A UNIT TRUST
The normal rules for computation of income, including the source rules, continue to apply. Income of the unit trust consists of income from any source comprising property of the trust, except for exempt income. Exempt income may consist of exempt dividends paid by Malaysian companies, foreign-source income received in Malaysia, or income which is specifically exempt such as interest on certain securities or bonds.

A unit trust enjoys a specific exemption for gains arising from the realisation of investments, and these are not treated as income of the trust body. This avoids the possibility that the trustee might be regarded as dealing in investments.

Where a unit trust (which is not a REIT) has income from the renting of real estate, it must be treated as a source of income under Section 4(d) of the Act. Section 63D of the Act does not allow a unit trust to treat such income as Section 4(a) (business) income. Although capital allowances cannot normally be claimed in respect of a Section 4(d) source, a unit trust which is not a REIT is entitled to a special deduction for qualifying capital expenditure (see **Example 1**).

Deductions can be made from the gross income to ascertain the adjusted income from each source, but this must follow the normal rules of deduction under Section 33 etc, of the Act. Deductions can include interest on monies borrowed by the unit trust to finance the purchase of investments. Any expenses would have to qualify in relation to a particular source of income. Except for the special deduction for permitted expenses, which is referred to below, there is no general deduction for administration expenses. Cash and other gifts specified under Section 44 of the Act can be deducted in ascertaining the total income of the trust.

EXAMPLE 1

For the year ended 31 December 2007, the Fastrich Unit Trust produced the following results:

	RM
Gross income	
Malaysian taxed dividends – gross	320,000
Dividends received from Labuan offshore companies	20,000
Dividends received from overseas companies	5,000
Interest (non-exempt)	10,000
Rent	70,000
Gains on realisation of investments	75,000
	500,000
Less:	
Interest on loan to buy shares	(50,000)
Maintenance and management expenses for rental property	(30,000)
Unit trust manager's remuneration	(35,000)
Secretarial, audit and accounting fees	(15,000)
Cash gift to an approved body	(5,000)
Net income before tax	365,000

The Fastrich Unit Trust had incurred qualifying capital expenditure of RM200,000 on one of its rental properties, and was entitled to a special deduction of RM20,000 each year, being 1/10 of the expenditure. The aggregate income for the year of assessment 2007 is:

	RM	RM
Dividends – non-exempt	320,000	
Interest expenses	(50,000)	270,000
Interest		10,000
Rent	70,000	
Maintenance and management expenses	(30,000)	
Adjusted income from renting	40,000	
Special deduction	(20,000)	
Statutory income from renting		20,000
Aggregate income		300,000

THE UNIT TRUST SPECIAL DEDUCTION FOR QUALIFYING CAPITAL EXPENDITURE

The special deduction for qualifying capital expenditure of a unit trust is given in ascertaining statutory income from the rental source. It is not a capital allowance in the usual sense, and there is no carry forward if the adjusted income is insufficient. Neither is there any balancing charge or balancing allowance. The allowance is 1/10 of the amount of the qualifying capital expenditure. It is given when the asset is in use at the end of a basis period. Allowances cease when the asset is no longer owned or in use, or when the value is reduced to zero.

Qualifying capital expenditure refers to machinery or plant used for the purposes of deriving rent from the letting of real estate, including the alteration of an existing building to install machinery (not to exceed 75% of the total of itself and any other qualifying capital expenditure). It also includes the cutting, tunnelling and levelling of land to receive machinery (not to exceed 10% of the total of itself and any other qualifying capital expenditure). Note that this special deduction is not given to a unit trust which is a REIT.

THE UNIT TRUST SPECIAL DEDUCTION FOR PERMITTED EXPENSES
A special deduction is given in respect of the following 'permitted expenses' provided they are not expenses which could be deducted directly from any gross income:

- manager's remuneration
- maintenance of register of unit holders
- share registration expenses
- secretarial, audit and accounting fees, telephone charges, printing, stationery costs, and postage.

The special deduction follows the familiar $\frac{A \times B}{4C}$ formula where:

A= total permitted expenses
B= gross income consisting of dividend, interest and rent
C= gross income consisting of dividend (whether exempt or not), interest and rent, and gains made from the realisation of investments (whether chargeable to tax or not).

The deduction is not allowed to fall below 10% of the permitted expenses.

EXAMPLE 2
We can now continue from **Example 1** with the Fastrich Unit Trust.

	RM
Aggregate income	300,000
Cash gift to an approved body	(5,000)
Deduction for permitted expenses	(10,000)
Total income and chargeable income	285,000

Subject to any set-off for tax paid by instalments, the Fastrich Unit Trust will have the following entitlement to a tax repayment for the year of assessment 2007:

	RM
Tax on RM285,000 at 27% (the rate applicable to trusts)	76,950
Less Section 110 set off re dividends RM320,000 at 27%	(86,400)
	9,450

The special deduction for permitted expenses is calculated as follows:

Manager's remuneration	35,000
Secretarial, audit and accounting fees	15,000
Permitted expenses (A)	50,000
Gross taxable dividends	320,000
Gross interest	10,000
Gross rent	70,000
(B)	400,000
Exempt dividends RM20,000 + RM5,000	25,000
Gains on realisation of investments	75,000
(C)	500,000
50,000 x 400,000 ÷ (500,000 x 4) =	10,000
(greater than 10% of RM50,000)	

Note that the Section 110 credit for dividend income is given to the unit trust and not to the beneficiaries. Any Section 110 credit for the beneficiaries will be based on the tax charged on the unit trust (RM76,950), and each beneficiary's proportionate entitlement is based on the number of units held.

The example is set in the year ended 31 December 2007. Candidates should note that unit trusts may still receive taxable dividends in the period of transition to the single-tier system. Such dividends will continue to be dealt with as in this example. However, single-tier dividends will be tax-exempt income of the unit trust.

TAXING THE INCOME OF A REIT
The statutory definition of a REIT makes it clear that it is nothing more than an ordinary unit trust with special features. It is defined as a unit trust which is approved by the Securities Commission as a REIT or property trust fund (Section 61A(2) of the Act).

The main ways in which the taxation of a REIT differs from that of an ordinary unit trust are:

- Rent from the letting of real estate is treated as business income.
- There are no special deductions.
- With effect from the year of assessment 2007, the full amount of income for a year of assessment is exempted from tax for the REIT provided that at least 90% of such income is distributed to the unit holders within the time allowed (up to two months after the end of the basis period). For the two previous years of assessment, a REIT was only exempt on the amount of income actually distributed to unit holders within the time allowed.
- When current income is distributed to any unit holder, other than a resident company, tax must be deducted at source. For the two years prior to 1 January 2007 only non-resident unit holders were subjected to deduction of tax at source.

RENTAL INCOME OF A REIT
Income by way of rent from the letting of real estate is treated as income from a business source. As well as rent, this includes any sum paid for the use of premises, such as service charges and car parking fees. Business income treatment is granted automatically by law (Section 63C of the Act).

The income is computed in the same way as for any other business source under Section 4(a). This means that the income from all of the rental properties of the REIT constitutes a single source, and that all expenses wholly and exclusively incurred in connection with lettings are deductible without the need to identify them with specific properties. It also implies that rental income is recognised when it accrues and not when it is received.

Capital allowances can be claimed in respect of qualifying assets, including machinery and plant and industrial buildings, owned and in use for the purpose of the business of the letting. This would include assets located on rented properties as well as assets used for the purposes of maintenance and management.

Note, however, that the treatment of the letting income of a REIT as a business source is more restrictive than for normal business income. There are specific restrictions to be borne in mind:

- There is no special deduction for qualifying capital expenditure, as in the case of an ordinary unit trust.
- A deficit of income does not give rise to an adjusted loss. Consequently, there is no relief by set off against other income of the same year, or by way of carry forward.
- Capital allowances can only be used in the year in which they are given and to the extent that there is statutory income for that year. There is no carry forward.

OTHER INCOME OF A REIT

It is expected that a REIT will have other sources of income in addition to property rentals, such as interest income. This income is still dealt with as investment income and attracts no special treatment. To be allowable, any expenses have to qualify in relation to a particular source of income. There is no special deduction for permitted expenses as there is for a unit trust.

EXAMPLE 3

Brightstar has been approved by the Securities Commission as a REIT. For the year ended 31 March 2007 it produced the following results:

	RM
Gross receipts	
Rents and other property income received and receivable	1,210,000
Bad debts: specific provision	(15,000)
general provision	(27,000)
Net revenue	1,168,000
Property operating expenses	
Property manager's fee	(65,000)
Maintenance costs	(31,000)
Insurance, assessment and quit rent	(12,000)
Total property operating expenses	(108,000)
Net property income	1,060,000
Interest on bonds issued by the Government	100,000
Trust expenses	
Trustee's fee	(20,000)
REIT manager's fee	(45,000)
Administration expenses	(10,000)
Depreciation of office equipment	(5,000)
Finance charges – loan interest	(150,000)
Total trust expenses	(230,000)
Net income before tax	930,000

Computation of total income:

Net income before tax	930,000
Add: bad debts general provision	27,000
restricted interest	40,000
depreciation of office equipment	5,000
trustee's fee	20,000
	1,022,000
Less: interest on bonds issued by the Government	(100,000)
Adjusted income from business	922,000
Capital allowances	(25,000)
Statutory income from business	897,000
Interest on bonds issued by the Government – exempt	–
Total income	897,000

Notes:

i Capital allowances for the year of assessment 2007, based on assets placed in rented properties as well as Brightstar's office equipment, amount to RM25,000.

ii Interest on borrowed money is assumed to be allowable for the reason that the borrowings have been used for the purposes of the (property renting) business, or to acquire assets for the business. However, this is a business source and Section 33(2) interest restriction must be applied. It is ascertained that RM40,000 of the interest expense incurred can be attributed to the investment in Government bonds, and it must be added back. As the bonds do not produce any taxable income, there is no relief.

iii The manager's fee, and all administration expenses, have to be fully allowable, because the primary purpose of Brightstar is to invest for rental income and that is deemed to be a business source. Although the writer takes the view that the same could be said for the trustee's fee, the Inland Revenue view is that this is not a deductible item and it seems best to go along with that for exam purposes.

In a unit trust computation, candidates may start with the gross income from each source. However, the income of a REIT is primarily from a business source and therefore it is more appropriate to start with the net income before tax.

TAXING THE INCOME OF A REIT

The chargeable income of a REIT, after taking into account any tax exemptions, bears tax at the rate applicable to trusts (27% for the year of assessment 2007, 26% for the year of assessment 2008 and 25% thereafter). However, the total income for a year of assessment attracts a special exemption from tax under Section 61A, when at least 90% of the income of the REIT has been distributed to unit holders during the basis period for that year, or within two months of the end of it. Therefore, the actual distributions made by the REIT must be ascertained before the chargeable income can be determined.

EXAMPLE 4

Brightstar REIT (as in **Example 3**) made the following distributions for the basis period for the year of assessment 2007:

		RM
31 March 2007	REIT income	260,000
	Exempt Government bond interest	40,000
15 April 2007	REIT income	550,000
	Exempt Government bond interest	60,000

Computation of tax payable

	RM
Total income as above	897,000
Income exempt (RM810,000 distributed = >90%)	897,000
Chargeable income	Nil
Tax at 27%	Nil

TAXING THE INCOME OF A UNIT HOLDER

A beneficiary entitled to income from a unit trust or REIT is deemed to have a source of income in relation to that unit trust or REIT. As there will be many unit holders, the unit trust manager will determine the share of each unit holder at the time of each distribution, and will provide a tax voucher.

EXAMPLE 5

Details of a typical voucher in the case of a unit trust:

		RM
Payment date	31 December 2007	
Accounting period	Year to 31 December 2007	
Number of units held	10,000	
Gross income		421.54
Malaysian tax		113.82
Non-allowable expenses		185.50
Non-taxable income		321.46
Equalisation payment		92.44
Net amount payable		367.00

The trust manager works out these details based on the principles which apply in taxing a unit trust. Exam candidates are not required to know how this is done – only that, for the unit holder, the amount of gross income of RM421.54 forms part of the unit holder's taxable income for the basis year 2007, and that the unit holder can claim a tax credit of RM113.82. None of the other items have tax consequences.

The present tax regime for REITs started from the year of assessment 2005 but, from the year of assessment 2007, there is a significant change in the way that unit holders are taxed. The position for the year of assessment 2007, as well as for the earlier years, is summarised below:

	2007 and onwards	**2005 and 2006**
Companies		
Resident	Taxed at corporate rate(s), not taxed at source	Taxed at corporate rate(s), not taxed at source
Non-resident	Taxed at source at 27% for the year of assessment 2007, 26% for the year of assessment 2008 and 25% thereafter	Taxed at source at 28%
Individuals		
Resident	Taxed at source at 15%	Taxed at individual scale rates, not taxed at source
Non-resident	Taxed at source at 15%	Taxed at source at 28%
Foreign institutional investors (pension fund, collective investment scheme or other such person approved by the Minister of Finance)	Taxed at source at 20%	Taxed at source at 28% if non-resident
All others		
Resident	Taxed at source at 15%	Taxed at appropriate rate, not taxed at source
Non-resident	Taxed at source at 15%	Taxed at source at 28%

Under the 2009 Budget announcement made in August 2008, the rates for foreign institutional investors and for all residents other than companies are to be reduced to 10% with effect from 1 January 2009. These, and the other rates which are unchanged, are effective until the year of assessment 2011. Candidates should remember that changes in the law are not examinable until six months after they are gazetted.

Tax deducted at the rates shown above is a final tax. As the REIT is distributing tax-exempt income, the tax withholding rates represent the only Malaysian tax burden to be borne by unit holders. Tax deduction at source only applies to the current-year income which is distributed within the time permitted. The amount exempted from tax in the hands of the REIT (RM897,000 in **Example 4** above) is used as the basis for calculating the chargeable income of a unit holder who is a resident company.

The tax withheld must be paid to the Inland Revenue within one month of making the distribution. Failure to pay in time results in the tax being increased by 10% of the amount of tax unpaid.

For a REIT, the distribution certificate will give details of two kinds of exempt income, and these are treated quite differently. Income which is exempt in the hands of the trustees, such as the interest on Government bonds in **Example 3**, is also exempt in the hands of the unit holder. However, income of the REIT which has been specially exempted, because it was distributed to unit holders, is taxable as income of the unit holder. There is no tax credit because no tax is paid by the REIT.

It is possible that a distribution certificate issued by a REIT will also contain details of another kind of income distribution. This would apply when income which has been taxed in the hands of the REIT (because an insufficient amount of income was distributed to unit holders) is subsequently distributed. Where that happens, the beneficiary is still liable to tax on the income but with the benefit of a tax credit, just as in the case of a conventional unit trust.

EXAMPLE 6

A Malaysian resident company owned units in a REIT and was provided with the following details relating to a distribution for the year 2007 made on 15 January 2008:

		RM
1	REIT current year income	874.00
2	Non-taxable income	100.00
3	REIT past year income – gross	50.00
4	Malaysian tax attributable to past year income	14.00
5	Net amount payable	1,010.00

The income shown at 1 and 3 is taxable for the basis period in which it is received. The income shown at 2 is not taxable. A tax credit of RM14.00 can be claimed. ■

Richard Thornton is examiner for Paper P6 (MYS)