



NATIONAL
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OF
REAL ESTATE
INVESTMENT
TRUSTS*

September 20, 2001

HAND-DELIVERED

Barbara M. Angus, Esq.
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 1000
Washington, D.C. 20220

Re: United States-United Kingdom Income Tax Convention

Dear Barbara:

Congratulations on executing a revised income tax treaty with the United Kingdom that would better facilitate commerce between the two countries. In particular, the provisions in Article 10, paragraph 3(b)(that would provide for no tax withholding on a pension plan's receipt of ordinary dividends from a corporation resident in the other treaty country) recognize the importance of pension plans in both countries and would greatly facilitate cross-border investment.

Unfortunately, it appears that the proposed treaty does not extend this reciprocal respect of both countries' pension plans to dividends U.K. pension plans receive from U.S. REITs. This exclusion is contrary to similar exemption provisions contained in prior U.S. bilateral tax treaties, and we urge the Treasury Department to take the appropriate measures necessary to remedy this exclusion.

As you know, the U.S. tax treaties with Canada, the Netherlands, Switzerland and Venezuela respect the tax-exempt status of pensions plans in each country and therefore do not impose taxes on the income generated by these plans' portfolio investments in the other treaty partner. The zero withholding and tax rate for Dutch pension plans has attracted a significant amount of capital to the REIT industry, and we would expect that a similar policy towards British pension plans would attract more investment dollars into the REIT industry.

The reciprocal exemption of pension plan portfolio investments in bilateral treaties recognizes the increasing interconnection of global businesses, as more and more employees work for companies based outside their home country. Further, the reciprocal exemption encourages cross-border investments that are beneficial to both countries. We believe that REITs should continue to benefit from these cross-border investments.



U.S. pension funds are not taxed on their portfolio investments unless through leverage or some other reasons they are subject to the unrelated business income tax (“UBIT”). Similarly, REIT dividends generally are not subject to tax under the same set of rules. *See* Rev. Rul. 66-106, 1966-1 C.B. 151.¹ Extending the portfolio investment exemption rules to equivalent plans in treaty countries better harmonizes the businesses operating in each country.

Some treaties allow pension fund dividend income to be exempt only if the pension plan and the distributing corporation are not related persons. For example, the Agreed Minutes to the Protocol to the Dutch treaty states that

For the purpose of paragraph 2 of Article 35 [relating to the pension fund exemption from tax from portfolio dividends], a person is considered to be a related person if more than 80% of the vote or value of any class of the shares is owned by the person deriving the income.

Although the treaties’ explanatory materials do not discuss the genesis of the related party rule, it appears to be an attempt to ensure that the exemption is being extended to a true portfolio investment rather than a situation under which the pension plan in effect engages in a trade or business by controlling a corporation conducting such trade or business. We note that similar issues are raised in the case of a foreign government investing in U.S. corporations, in which the normal exemption of dividends does not apply if the foreign government owns (by vote or value) 50% or more of a corporation’s stock or in some other manner has effective control of the corporation. See I.R.C. § 892(a)(2).

In the REIT area, there are several tests that could be viewed as models for a control test. For example, sale of stock of a “domestically-controlled REIT” is not subject to FIRPTA. See I.R.C. § 897(h)(4). The test for control under this section is whether foreign persons held less than 50% during the testing period.

Congress enacted perhaps the most relevant control test in 1993 when it enacted rules on when UBIT is imposed on pension fund investments in REITs. Under this change, the dividend exemption rule applying to pension plans does not apply to any pension plan owning 10% or more of a REIT if the REIT is a “pension-held REIT.”² Although the definition is a bit complicated, essentially a company is a pension-held REIT if either (1) one pension plan owns more than 25% (by value) of a REIT’s stock; or (2) one or more pension plans each owning 10% or more of a REIT’s stock collectively own more than 50% (by value) of a REIT’s stock. See I.R.C. § 856(h)(3)(D).

¹ Further, U.S. pension plans generally are not taxed on the rents they receive unless the UBIT rules apply. See I.R.C. § 512(b)(3).

² Essentially, a 10% or more pension plan shareholder of a pension-held REIT is treated for UBIT purposes as if it directly owned and operated a proportionate amount of the REIT’s assets.

The legislative history states:

The committee believes that relaxation of the five or fewer rule is appropriate to encourage pension fund investment in REITs. Such investment, however, may permit circumvention of the UBTI. Accordingly, in certain circumstances, UBIT is imposed on a pension trust holding shares in a REIT if direct ownership of the REIT assets by the pension trust would have resulted in UBIT.

H.R. Rep. No. 11, 103d Cong., 1st Sess. 183 (1993).

Thus, Congress wanted to enact provisions that encouraged pension plans to invest in REITs, but not if the ownership of REIT shares was being used to circumvent the UBTI rules instead of being made for portfolio investment purposes. The 25% threshold was arrived at as an objective demarcation line above which a pension plan's ownership would be deemed to make the REIT controlled by pension funds.

A 25% test has been used before to test control by a major shareholder. For example, in the pending tax treaty with Italy, the normal withholding rate of 15% on dividends from a corporation to a shareholder in the other country is reduced to 5% if the shareholder owns at least 25% of the distributing corporation's voting stock. Accordingly, to the extent that the Treasury Department concludes that the 80% related party test in the Dutch treaty (or the 50% related party test in I.R.C. § 892) should not be used in the pending U.K. treaty, we recommend that the related party test be measured by a 25% ownership test.

We note that the tax treaty position adopted by the Treasury Department in 1997 (and reflected in the pending U.K. treaty) calls for a 15% withholding rate on REIT dividends to a non-individual shareholder resident in the treaty country only if the shareholder owns (1) 5% or less of a publicly traded REIT; or (2) 10% or less of any REIT with diversified assets. While the 1997 REIT position makes sense in the context of taxable investors, we think a 25% test is better for pension plan investors in REITs.

In 1997, the issue presented was the proper withholding rates on REIT dividends distributed to taxable institutional investors. The 15% rate typically available for dividends from U.S. companies was, among other reasons, premised on the desire to reduce double taxation of a distributing company's earnings. As you may remember, the 1997 tax treaty position for REITs was reached, at least in part, because the much higher dividend pay-out of REITs compared to non-REITs was thought to yield an appropriate level of U.S. taxes on a REIT's earnings, especially combined with the policy of not permitting the 5% rate on "direct investments" to apply to REIT holdings.

Conversely, the relevant comparison with respect to the pension plan exemption issue is between a pension plan's investment in REIT stock versus non-REIT stock. In both cases, the test should be whether a U.K. pension should receive the same tax treatment as a U.S. pension plan. Since a

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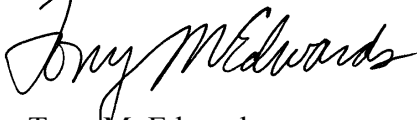
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U.S. pension plan generally is not taxed on REIT dividends, the zero withholding rate should apply to U.K. pension plan investments in REITs. To curb any inappropriate circumvention of U.S. taxes, we suggest that the control test for pension-held REITs is more appropriate analogy than the 1997 treaty position because the both the pension-held REIT test and the related party rule limits in the existing treaties dealing with pension plan investments are designed to provide a "bright line" test for when a pension plan controls a company to the extent that it could be viewed as participating in the company's underlying business.

Thank you for the opportunity to make our views known on this important issue, and I look forward to working with you to find a resolution.

Respectfully submitted,



Tony M. Edwards

Senior Vice President & General Counsel

cc: Patricia Brown, Esq.
Orren S. Penn, Esq.
Jeffrey H. Paravano, Esq.