



Pension Investment  
Association of Canada

Association canadienne des  
gestionnaires de caisses de retraite

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**RE: Withholding tax on Capital Gain Dividends and Liquidating Distributions paid by REITs / Notice 2007-55**

The purpose of this letter is to express our concerns regarding the Internal Revenue Service (“IRS”) Notice 2007-55 (“Notice 2007-55”) and its impact on our members.

The Pension Investment Association of Canada (“PIAC”) is a representative association for pension funds in Canada in pension investment and related matters. Senior investment professionals employed by PIAC’s member funds are responsible for the oversight and management of over C\$940 billion in assets that are invested on behalf of millions of Canadians.

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PIAC members include both Canadian public sector pension funds (“Government Pension Funds”) that generally qualify for governmental exemption contained in section 892 of the Internal Revenue Code<sup>1</sup> and Canadian private sector pension funds (“non-Government Pension Funds”) (collectively the “Canadian Pension Funds”). The Canadian Pension Funds are generally exempt from Canadian income tax under the Income Tax Act (Canada).

Our members have steadily increased their investments in foreign jurisdictions, especially since the elimination of the previous foreign content limit applicable to Canadian Pension Funds. These foreign investments, which include all investments in the United States of America (“US”), enable Canadian Pension Funds to achieve better returns and reduce their risks through a greater diversification of their investment portfolios.

Investment in the US has been an important element of the diversification strategy of our members, largely because the income from most of their US investments qualifies for exemption from US income tax under either the IRC or the Canada-US Income Tax Convention. In particular, our members have been attracted by the generally favourable treatment of passive minority investments by both public and private non-US investors in the stock of real estate investment trusts (“REITs”) that hold interests in US real estate. As a result, our members invest an estimated 8.4% of their assets (or C\$68.7 billion) directly in the US, and, in addition, an estimated half of some \$87.7 billion of member-invested Global equities would also be invested in the US.

In light of this background, we wish to address the impact upon our members of Notice 2007-55. Under Notice 2007-55, Government Pension Funds are denied the benefit of section 892 for capital gain dividends and liquidating distributions attributable to gains from the sale or exchange of US real property interests (“USRPIs”) received from REITs. Furthermore, pursuant to Notice 2007-55, liquidating distributions that would have otherwise been treated as payments in exchange for stocks of domestically-controlled REITs and exempt under the section 865 sourcing rules are subject to tax under section 897.2 These positions differ significantly from the settled expectations of our members, as well as the expectations of other public and private non-US investors and their US tax advisors.

The taxation of capital gains dividends and liquidating distributions translates into an additional tax burden for our members that qualify for tax treaty benefits of approximately 38.25% (35% of withholding tax plus 5% of branch profit tax on the net after-tax amount) of such distributions, thereby resulting in a substantially reduced net return on investments.

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<sup>1</sup> Unless indicated otherwise, all references in this letter are to the *Internal Revenue Code of 1986*, as amended (“IRC”).

<sup>2</sup> Except in cases where, as provided by section 897(h)(1), Canadian Pension Funds, at no time during the 1-year period ending on the date of the distribution, owned more than 5% of the publicly traded REIT.

Although gains realized by a Canadian Pension Fund on the sale of a non-controlling interest in a REIT generally would continue to be exempt from US taxes, it is expected that, as a result of Notice 2007-55, the sale price of such interest will be discounted to reflect the future tax liability associated with the underlying USRPIs held by the REIT. For example, the discount could be expected to reflect the tax imposed under Notice 2007-55 if the REIT liquidates and the shareholders surrender their stock in liquidation, even if the sale of an interest in the REIT otherwise remains exempt. The decline in value caused by such discounts is creating concerns amongst Canadian Pension Funds managers that potential investments in REITs might no longer be able to deliver attractive and competitive returns for Canadian tax exempt pension funds.

In addition to its adverse effect on investment returns, Notice 2007-55 discourages US real estate investment by Canadian Pension Funds in partnership with US taxable investors. For example, Notice 2007-55 makes it far more difficult to develop an exit strategy upon which both US and Canadian partners can agree, in view of the divergent US tax treatment of an asset sale and a share sale.

In summary, the implementation of Notice 2007-55 will result in substantial costs for our members owning minority interest in REITs, rendering this type of investment far less attractive.

In order to prevent a decline in investments in US REITs by Canadian Pension Funds, we urge the Treasury Department and the IRS to consider modifications to Notice 2007-55 and/or clarifications to the current tax regulations to ensure that:

Capital gain dividends attributable to the sale of USRPIs by a REIT be considered as dividends for the purpose of Article XXI of the Canada-US Income Tax Convention and as income from investment in stocks for the purpose of section 892.

Amounts received by a non-US REIT shareholder that qualifies for the section 892 exemption for foreign governments in a section 331 complete liquidation of a REIT be treated as payments in exchange for stocks so that any gain resulting be considered as income from investment in stocks for the purpose of section 892 exemption.

Amounts received by other non-US REIT shareholders in a section 331 complete liquidation of a domestically controlled REIT not be treated as distributions described in section 897(h)(1) and thus qualify for exemption from US taxation under the section 865 sourcing rules.

Should you wish to discuss this matter in further details, please feel free to contact us if we can be of further assistance.

Respectfully submitted on behalf of the members of PIAC.



Roger Robineau  
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