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SENT VIA E-MAIL TO [TAXTREATIES@OECD.ORG](mailto:TAXTREATIES@OECD.ORG)

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France

**Re: Comments on the OECD Discussion Draft on Follow Up Work on BEPS Action 6**

Dear Ms. De Ruiter:

The National Association of Real Estate Investment Trusts (NAREIT<sup>1</sup>) appreciates the opportunity to provide comments on the OECD's [21 November 2014 Discussion Draft](#) on Follow Up Work on BEPS Action 6 Preventing Treaty Abuse (Discussion Draft). The Discussion Draft invites comments on a variety of issues with respect to changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 of the BEPS Action Plan with the objective of preventing the granting of treaty benefits in inappropriate circumstances.

The Discussion Draft identifies issues to be addressed with respect to the proposed limitation on benefits (LOB) provision and with respect to the proposed principal purpose test (PPT) provision. The Discussion Draft highlights in particular issues related to the treaty entitlement of collective investment vehicles (CIVs) and certain other investment entities.

**EXECUTIVE SUMMARY**

This submission focuses on the treaty entitlement issues with respect to U.S. REITs. Our comments build on work already done by the OECD with respect to REITs as reflected in its 2007 Report [Tax Treaty Issues Related to REITs](#). As discussed in more detail below, U.S. REITs are different from both CIVs and non-CIV funds in ways that are directly relevant to treaty qualification.

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<sup>1</sup> [NAREIT](#) is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.



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Consistent with the OECD's prior work, the eligibility of U.S. REITs for treaty benefits should be determined under the rules applicable to companies. Given that resident status is a threshold question for treaty qualification, we urge the OECD to explicitly reference its prior work on REITs and their residence status in the current work on Action 6. Moreover, in light of the special circumstances of REITs as recognized by the OECD in its prior work, we urge the OECD to provide greater clarity regarding the application of both the proposed LOB provision and the proposed PPT provision to U.S. REITs.

## DISCUSSION

### I. Differences between U.S. REITs and CIVs and Non-CIV Funds

The first two issues identified in the Discussion Draft are the application of the LOB provision, and treaty entitlement more generally, in the case of CIVs and non-CIV funds. With respect to CIVs, the Discussion Draft references the work done in connection with the 2010 OECD Report [\*The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles\*](#).

The Discussion Draft specifically refers to REITs, stating that "REITs are covered by the 2010 Report on CIVs to the extent that they are widely-held and regulated." In this regard, the CIV Report defines the term "CIV" to mean "funds that are widely-held, hold a diversified portfolio of securities and are subject to investor protection regulation in the country in which they are established."

U.S. REITs do not fall within this definition of a CIV. Unlike U.S. regulated investment companies (RICs), U.S. REITs are not generally within the scope of the Investment Company Act of 1940, which regulates the organization and disclosure of financial information of entities, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. Importantly, [Section 3\(c\)\(5\)C of the 1940 Act](#) specifically excludes from the 1940 Act any person who is primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Given the asset and income tests applicable to U.S. REITs, virtually all U.S. REITs fall outside of 1940 Act governance. Thus, U.S. REITs are not subject to the type of investor protection regime contemplated in the OECD definition of a CIV.

Many U.S. REITs are registered with the U.S. Securities and Exchange Commission (SEC) and are publicly traded on a stock exchange. Other U.S. REITs that are not listed on a stock exchange are widely-held and therefore also are registered with the SEC. These U.S. REITs are subject to provisions in the Securities Exchange Acts of 1933 and 1934 that contain rigorous disclosure obligations. However, this disclosure regime applies to any public-traded U.S. corporation. We do not believe that rules that generally are applicable to listed companies are what motivated the investor protection regulation requirement in the OECD definition of a CIV.

Moreover, the assets of U.S. REITs generally would not be characterized as a "diversified portfolio of securities." U.S. REITs own, operate, and finance income-producing real estate, such as apartments, shopping centers, office buildings, health care facilities, hotels, and warehouses. Under U.S. tax law requirements, i) at least 75% of the value of a U.S. REIT's total assets must be represented by real estate assets (including mortgages), cash and cash items, and



government securities; and, ii) not more than 25% of its total assets may be represented by securities that are not qualifying assets for purposes of i). In addition, U.S. tax law requires that at least 75% of a U.S. REIT's gross income must be in the form of real estate rents, interest on real estate mortgages, gains from real estate sales, and other real estate related income. The types of assets required to be held by U.S. REITs is in contrast to the definition of "securities" contained in the Investment Company Act of 1940.<sup>2</sup>

Consequently, while U.S. REITs share some characteristics in common with CIVs, they cannot be considered CIVs for purposes of the Discussion Draft because they do not meet the regulatory regime or asset ownership requirements that are central to the OECD definition of a CIV.

The Discussion Draft briefly refers to REITs that do not qualify as CIVs as potentially facing treaty issues similar to issues faced by alternative funds and private equity funds. In this regard, it is important to recognize that U.S. REITs are not "funds." U.S. REITs are not passive investment holding entities. Rather, U.S. REITs are active businesses that engage in a full range of corporate activities. U.S. "equity" REITs acquire, develop and hold properties in order to generate rental income, and they primarily operate such properties (as opposed to developing and selling properties similar to a merchant builder). U.S. "mortgage" REITs actively finance both residential and commercial real estate assets.

The U.S. Internal Revenue Service has affirmed that a U.S. REIT functions as an operating company, as distinguished from a passive manager similar to an investment fund, because a U.S. REIT "is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property."<sup>3</sup> Moreover, as discussed further below, U.S. REITs must be taxable as U.S. corporations.

U.S. REITs also are characterized as operating companies rather than investment vehicles in a variety of other contexts in the United States:

- The North American Industry Classification System ([NAICS](#)) lists U.S. REITs in the "Lessors of Real Estate" category, which is where active real estate operators are classified, as opposed to the "Other Financial Vehicles" category, where passive investment entities are classified.

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<sup>2</sup> The Investment Company Act of 1940 defines "security" as: "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." (15 U.S.C. § 80-2(a)(36).)

<sup>3</sup> [Rev. Rul. 2001-29](#), 2001-26 I.R.B. 1348.



- The U.S. Commodity Futures Trading Commission (CFTC), in a [2012 Interpretive Letter](#) issued to NAREIT, concluded that U.S. REITs are not commodity pools because they are operating companies rather than pooled investment vehicles.
- Standard & Poor's (S&P) classifies U.S. REITs as operating companies in all of its broad equity indices. As of 31 December 2014, the S&P 100 includes one U.S. REIT, the S&P 500 includes 21 U.S. REITs, the S&P 400 includes 31 U.S. REITs and the S&P 600 includes 34 U.S. REITs.

Finally, in this regard, we note that the Discussion Draft states that treaty qualification issues affecting non-CIV funds can arise because their investor base typically is not restricted to a single country and because they may not meet the active business requirement. Contrary to the suggestion in the Discussion Draft, U.S. REITs do not share these issues. The vast majority of investors in U.S. REITs are U.S. persons and, as discussed above, U.S. REITs conduct active businesses in the United States.

Although U.S. REITs do not constitute CIVs or non-CIV funds, as discussed further below, clarification regarding the treaty status of REITs would be valuable in light of the proposed changes to the OECD Model Tax Convention and related Commentary.

## **II. Treatment of U.S. REITs as Residents for Treaty Purposes**

The starting point in applying both the proposed LOB provision and the proposed PPT provision is a determination of resident status. The Discussion Draft underscores the connection between residence and qualification under the proposed provisions in its discussion of issues with respect to CIVs and non-CIV funds. The status of REITs as residents for treaty purposes was considered and addressed in the OECD's 2007 REIT Report. Given its relevance and importance, the OECD should explicitly incorporate this prior work into the current work on treaty qualification under Action 6.

The primary focus of the 2007 REIT Report was the tax treaty treatment of REIT distributions to foreign shareholders. The Report included proposed treaty provisions regarding the withholding tax treatment of such distributions that could be included by countries in their bilateral treaties. These provisions subsequently were incorporated in the Commentary to the OECD Model Tax Convention with the 2008 update.

Consideration of the question of the tax treaty treatment of distributions by REITs to foreign shareholders first requires a determination of the tax treaty entitlement of the REIT itself. As the 2007 REIT Report noted, this is because Article 10 of the OECD Model applies to dividends paid by a company that is a "resident" of a treaty country. Thus, the resident status of a REIT is relevant to the application of tax treaties, both with respect to the income earned and to distributions made by a REIT

The 2007 REIT Report concluded that REITs generally should be considered to be "residents" for treaty purposes:



Since the income of a REIT is typically distributed, the REIT is not, in a purely domestic context, taxed on that distributed income. As already mentioned, the tax mechanisms that ensure that result vary from country to country and can include, for example, rules that allow the deduction of REIT dividends or distributions, the tax exemption of a REIT that meets certain conditions, the tax exemption of all the REIT's income, the tax exemption of only the part of the REIT's income that is distributed within a specified period of time or rules that allocate the income to the investors rather than to the REIT itself. It seems, however, that in most cases, the REIT would meet the condition of being liable to tax for purposes of the treaty definition of "resident of a Contracting State", subject to the particular problems arising from the application of tax treaties to trusts. There are a few countries, however, where this may not be the case and this is a question that would need to be clarified on a country-by-country basis during treaty negotiations.

Under this analysis, U.S. REITs are residents of the United States. Under U.S. tax law, a U.S. REIT is taxable as a U.S. corporation (and, in fact, must be taxable as a U.S. corporation in order to qualify as a U.S. REIT). The taxable income of a U.S. REIT is computed in a manner similar to the manner in which taxable income is computed for non-REIT corporations. A U.S. REIT is required to distribute at least 90% of its taxable income on a current basis in order to qualify as a REIT and is entitled to a "dividends paid deduction" to the extent that it distributes its taxable income and any realized capital gains. To the extent that a U.S. REIT does not distribute its net capital gain, it still qualifies as a REIT, and it pays corporate tax on such net capital gain.

It should be noted that, although a U.S. REIT does not pay income tax at the entity level to the extent that it distributes its annual taxable income, the mandatory distribution rules mean that U.S. REITs pay significant amounts of taxable dividends relative to other corporate entities. Further, shareholders pay tax on the REIT dividends they receive at the ordinary income tax rate rather than the lower rates generally applicable to corporate dividends. In 2013, SEC-registered U.S. REITs distributed approximately \$34 billion. Thus, the amount of U.S. federal and state taxes collected on a current basis with respect to income distributed by U.S. REITs is high.

The OECD's analysis and conclusion regarding the qualification of REITs as residents for treaty purposes formed the basis for the provisions on the withholding tax treatment of distributions by REITs that were set forth in the 2007 REIT Report and incorporated in the Commentary to the OECD Model Tax Convention. This same matter of the qualification of REITs as residents for treaty purposes is a threshold question in applying both the proposed LOB provision and the proposed PPT provision. Application of these proposed measures to REITs necessarily requires a clear understanding of the threshold question of resident status. The OECD should provide the needed clarity by explicitly referencing its prior work on the resident status of REITs in the Commentary with respect to the proposed provisions.



### III. Treatment of U.S. REITs under LOB Provisions

The [September 2014 Report](#) under Action 6 *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* describes the proposed LOB provision and its various tests as “based on objective criteria that provide more certainty than the PPT rule.” However, that certainty exists for a taxpayer only if it is clear that the tests under the LOB provision are available to be applied to the taxpayer. We believe that many U.S. REITs clearly would satisfy the requirements of one or more of the entity-based tests in the LOB provision if it is made clear that such tests are available to be applied to U.S. REITs.

With respect to U.S. REITs that are registered with the SEC and are publicly-traded on a stock exchange (U.S. Listed REITs), the primary test in the proposed LOB provision is the test under paragraph 2(c) (Exchange Traded Test).

Under the proposed Exchange Traded Test, a resident of a Contracting State would be entitled to benefits under the relevant treaty if such resident is a company or other entity and two requirements are met. First, the principal class of its shares (and any disproportionate class) must be regularly traded on one or more recognized stock exchanges. Second, either: i) its principal class of shares must be primarily traded on one or more recognized stock exchanges located in the Contracting State of which it is a resident; or, ii) its primary place of management and control must be in the Contracting State of which it is a resident.

U.S. Listed REITs typically are listed on the New York Stock Exchange, the NYSE MKT, or the NASDAQ. The shares of U.S. Listed REITs regularly are traded on such market, with active turnover and significant liquidity. In addition, the shares of U.S. Listed REITs primarily are traded on the U.S. market where listed. Moreover, U.S. Listed REITs have their primary place of management and control in the United States, where the day-to-day responsibility for the management of the REIT is exercised.

While the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT provided that it meets the specified conditions with respect to exchange trading and management.

With respect to U.S. REITs that are widely-held but not listed on a stock exchange (U.S. Public Non-listed REITs), the primary test in the proposed LOB provision would be the test under paragraph 2(e) (Ownership and Base Erosion Test).

To satisfy the proposed Ownership and Base Erosion Test, a resident of the Contracting State must satisfy both an ownership requirement and a base erosion requirement.

The ownership requirement would be satisfied if, on at least half the days of the taxable period, persons who are residents of that State and who are entitled to the benefits of the relevant treaty (generally as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) own, directly or indirectly, shares representing at least 50% of the aggregate voting power and value (and at least 50% of any disproportionate class of shares) of the U.S. Public Non-listed REIT. This rule may be subject to a further requirement



that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State.

In addition, to satisfy the base erosion requirement, less than 50% of the gross income, as determined in its Contracting State of residence of the U.S. Public Non-listed REIT, for the taxable period could be paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of the relevant treaty (also as individuals, Contracting States, exchange traded companies or other entities, or non-profit entities or pension funds) in the form of payments that are deductible for purposes of the taxes covered by the relevant treaty in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

U.S. Public Non-listed REITs typically would satisfy both prongs of this test. They are predominantly owned by U.S. persons, including U.S. mutual funds, individual investors and pension funds. Moreover, the income of U.S. REITs is distributed to their owners on a current basis, and the owners are subject to tax on such income. Because such distributions are deductible by U.S. REITs, they could be considered to be payments that are taken into account under the base erosion requirement. As noted above, the owners of U.S. REITs are predominantly U.S. persons who would themselves qualify for treaty benefits under one of the specified categories, and the distributions to such persons would not run afoul of the base erosion requirement.

As with respect to the Exchange Traded Test discussed above, while the entitlement to treaty benefits under this test would be based on the particular facts and circumstances, it would be helpful for the Commentary to specifically state that this test is available for application to a U.S. REIT that meets the specified conditions with respect to ownership and base erosion.

#### **IV. Treatment of U.S. REITs under PPT Provision**

The September 2014 Report on Action 6 acknowledges that the proposed PPT provision involves relatively less certainty and “requires a case-by-case analysis based on what can reasonably be considered to be one of the principal purposes of transactions or arrangements.” The subjectivity of the proposed PPT provision has been subject to significant criticism as involving a level of uncertainty that is unacceptable with respect to a matter as fundamental as the qualification of a company for treaty benefits. The concern about uncertainty is particularly acute in the case of U.S. REITs which, unlike other non-REIT corporations, not only must distribute the majority of their earnings to their investors on a current basis, but also cannot make effective use of foreign tax credits in the United States (and therefore cannot “absorb” any additional foreign tax liability in the same manner as non-REIT U.S. corporations). The risk of having an unexpected tax liability arise after the full distribution of current earnings because of a challenge with respect to potential withholding tax liability under a PPT provision would have a significant chilling effect on cross-border investments. The distribution requirement applicable to U.S. REITs means that a U.S. REIT must have a high degree of certainty regarding the tax treatment of its structure when deciding to make a cross-border investment. The uncertainty inherent in the proposed PPT provision would be a significant negative factor to U.S. REITs when deciding whether to make a cross-border investment. This uncertainty could impede the free flow of capital.



The fact that U.S. REITs are accorded tax treatment that is different than that of other corporations should not be a factor in applying the proposed PPT provision. Guidance should be included in the Commentary to make clear that the fact that a U.S. REIT is subject to a special tax regime (a deduction for dividends paid) should not be considered a factor that weighs in favor of denying benefits under any application of the proposed PPT provision.

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We appreciate the OECD's focus on ensuring that the changes to the OECD Model Tax Convention and related Commentary that have been proposed under Action 6 in order to prevent the granting of treaty benefits in inappropriate circumstances do not operate to inappropriately deny treaty benefits to investment vehicles that have become such an important part of the global economy. NAREIT welcomes this opportunity to provide comments on the need for specific clarification regarding the treaty qualification of U.S. REITs under the proposed provisions. With the focus on clarifying the treatment of other investment vehicles such as CIVs and non-CIV funds, the need is all the greater for these clarifications regarding the entitlement of U.S. REITs to treaty benefits under the proposed LOB provision and the proposed PPT provision.

We would be happy to discuss the matters addressed in this letter or to respond to questions or to provide additional information. I can be reached at (202) 739-9408 or [tedwards@nareit.com](mailto:tedwards@nareit.com).

Respectfully submitted,



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