National Association of Real Estate Investment Trusts®

REITs: Building Dividends and Diversification®

June 5, 2014

SENT VIA E-MAIL

Marlies de Ruiter
Jacques Sasseville
Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

Re: OECD Discussion Draft on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Treatment of U.S. Real Estate Investment Trusts

Dear Ms. De Ruiter and Mr. Sasseville:

The National Association of Real Estate Investment Trusts (NAREIT[1]) appreciates the opportunity to provide comments on the OECD Discussion Draft on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (Discussion Draft). These comments focus in particular on the need for clarification and specific guidance regarding the manner in which the anti-abuse rules proposed to be included in the OECD Model Tax Convention would apply in the determination of whether a U.S. real estate investment trust (REIT) is entitled to the benefits of a tax treaty with respect to its cross-border investments. Specifically, these comments request that the commentary to the proposed anti-treaty shopping provisions in the Discussion Draft confirm that U.S. REITs (which are U.S. domestic entities and are subject to U.S. corporate income tax) are residents for tax treaty purposes and are eligible for qualification for treaty benefits under the same tests that apply to other non-REIT companies.

Tax treaties serve a critically important role in facilitating cross-border trade and investment by reducing unintended double taxation that would be a barrier to such activity. With the OECD's Model Tax Convention at the center of the global network of double tax treaties, the current work of the OECD under BEPS Action 6 on addressing treaty abuse deserves careful attention, including consideration of the potential implications of this work for U.S. REITs with foreign investments.

[1] NAREIT is the worldwide representative voice for 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.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

We appreciate the OECD's recognition that more work needs to be done to ensure that the proposal to add a two-pronged anti-treaty shopping provision to the OECD Model Tax Convention does not interfere inappropriately with treaty benefits for investments through collective investment vehicles. As part of this work, we urge the OECD to ensure that the proposal also operates appropriately in the case of U.S. REITs making cross-border investments in real estate. Providing clarification and specific guidance with respect to the treatment of U.S. REITs under the proposed anti-treaty shopping provision would build on the OECD's earlier work on tax treaty issues related to REITs as reflected in the OECD's 2007 report on REITs and the 2008 update to the OECD Model Tax Convention.

Background on U.S. REITs, global activity and tax treaties

Recognition of the magnitude and increasing globalization of investments in and through REITs led to the OECD's work on tax treaty issues related to REITs, which culminated in the 2007 report on REITs and the inclusion of REIT-related language in the 2008 update to the OECD Model Tax Convention. The main focus of this earlier work was on the appropriate application of withholding tax reductions provided under a treaty for dividends paid by a REIT that is resident in one of the treaty partner countries to an investor that is resident in the other treaty partner country.

The globalization of real estate and REIT investment has continued since the OECD completed that work in 2008. As of April 30, 2014, the FTSE EPRA/NAREIT Global Real Estate Index, which includes 457 stock exchange listed companies in 37 countries around the globe, had an equity market capitalization of $1.275 trillion. REITs represented 71% of that market capitalization. [2] More than 30 countries have adopted REIT laws, including all of the G-7 and more than half of the OECD.

Additionally, the size of REIT investments continues to be significant. As of May 28, 2014, over 200 U.S. REITs had a market capitalization of almost $800 billion.[3] U.S. REITs are increasingly investing some of their capital outside the United States for a variety of business reasons. In particular, U.S. REITs have multinational businesses as customers and global investment by a REIT allows it to meet these customers' global real estate needs. By expanding outside the United States, a U.S. REIT can provide a multinational customer with a consistent real estate product across the customer's geographic footprint. Additionally, foreign markets offer significant opportunities for real estate development and therefore represent a growth opportunity. Investment in foreign real estate also provides diversification benefits, allowing a U.S. REIT to expand its portfolio to include investments that differ from U.S. real estate investments in their response to economic cycles.

[2] RFTSE EPRA NAREIT Global Real Estate Index http://www.ftse.com/Indices/FTSE_EPRA_NAREIT_Global_Real_Estate_Index_Series/index.jsp and http://www.ftse.com/objects/csv_to_table.jsp?infoCode=encv&theseFilters=&csvAll=&theseColumns=MCwxLDIsNSwxMSwxNywyMg==&theseTitles=&tableTitle=FTSE EPRA/NAREIT Global Indices Values&dl=&p_encoded=1 .

[3] FTSE NAREIT All REIT Index. www.ftse.com.

As was discussed in the 2007 OECD report, a REIT is a widely held company, trust or contractual or fiduciary arrangement that: 1) derives its income primarily from long-term investment in real estate; 2) distributes most of that income annually to its investors; and, 3) does not pay income tax on income related to real estate that is so distributed.[4] As the OECD report further noted, REITs typically are considered to be a resident 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 all the REIT's income, the tax exemption of only 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.[5]

Focusing on U.S. REITs in particular, under U.S. tax law, a U.S. REIT is taxable as a U.S. corporation. U.S. REITs compute their taxable income like other U.S. corporations, but are required to distribute at least 90% of their taxable income. Further, they are entitled to a dividends paid deduction to the extent that they distribute their taxable income. They pay tax on any income that they retain. Many U.S. REITs are registered with the U.S. Securities and Exchange Commission (SEC) and are publicly traded on a stock exchange (Listed REITs). In addition, there are U.S. REITs that are registered with the SEC but are not listed on a stock exchange (Public Non-listed REITs). As provided in the Commentary to the U.S. Model Tax Treaty, U.S. REITs are considered to be residents of the United States for tax treaty purposes.[6]

Although U.S. REITs do not pay tax at the entity level like other corporate entities to the extent that they distribute 100% of their annual taxable income, the mandatory distribution rules mean that U.S. REITs have significant levels of income distribution as compared to other corporate entities. In 2013, SEC-registered U.S. REITs distributed approximately $34 billion. Thus, the amount of U.S. tax collected on a current basis with respect to dividends paid by U.S. REITs through tax on dividend distributions is high. This includes withholding tax on dividends paid to foreign investors in such REITs.

The Discussion Draft's proposed addition of a new two-prong anti-treaty shopping provision to the OECD Model Tax Convention would put new pressure on questions regarding whether U.S. REITs qualify for treaty benefits. In particular, without appropriate clarification, uncertainty

[4] *Tax Treaty Issues Related to REITs*, Public Discussion Draft, Center for Tax Policy and Administration, OECD, October 30, 2007, p. 3.
[5] *Id.*, p. 4.
[6] *U.S. Treasury Technical Explanation to the 2006 US Model Income Tax Convention*, November 15, 2006, Article 4(1).

likely would exist concerning whether payments received by U.S. REITs with respect to their cross-border investments in real estate would be eligible for treaty benefits. Moreover, collateral issues could arise regarding the application of treaty provisions regarding the withholding tax rates on dividends paid by U.S. REITs to its foreign investors.

We urge the OECD to address the treatment of U.S. REITs with appropriate clarification and specific guidance in the commentary to the proposed anti-treaty shopping provisions that these entities are residents for tax treaty purposes and are eligible for qualification for treaty benefits under the same tests that apply to other companies. Making this clarification would reaffirm the OECD's important work on REITs reflected in the 2007 report and the 2008 update to the OECD Model Tax Convention.

Treatment of U.S. REITs under Proposed Limitation on Benefits Provision

The first prong of the proposed anti-treaty shopping provision set forth in the Discussion Draft is a limitation on benefits provision that is modeled on the limitation on benefits articles that typically are included in U.S. tax treaties. It provides a series of mechanical, objective tests that are intended to provide clear and certain results. However, given the particular circumstances of U.S. REITs, these mechanical tests could create uncertainty. Just as the OECD recognized the need for REIT-specific provisions regarding withholding taxes on dividends as provided in the 2008 update to the OECD Model Tax Convention, the application of these mechanical tests to U.S. REITs specifically should be addressed in commentary to the proposed limitation on benefits provision. It is critically important to make clear that U.S. REITs are U.S. resident companies, and, therefore, the limitation on benefits tests that are relevant to non-REIT companies are applicable to U.S. REITs in the same manner as to other corporate entities.

With respect to U.S. Listed REITs, the most relevant test in the proposed limitation on benefits provision is the exchange traded company test (Exchange Traded Test) in paragraph 2(c)(i).

Under the proposed Exchange Traded Test, a resident of a treaty partner country that is a company would be entitled to benefits under the relevant treaty if two tests are met. First, the principal class of the company's shares (including any disproportionate class) must be regularly traded on one or more recognized stock exchanges as provided under the treaty. Second, either the company's principal class of shares must be primarily traded on one or more recognized stock exchanges that are located in its residence country or the company's primary place of management and control must be in its residence country. The Exchange Traded Test also includes a rule that provides for treaty benefits to a subsidiary company if at least 50 percent of its shares by vote and value (and at least 50 percent of any disproportionate class) is owned directly or indirectly by five or fewer companies that themselves are regularly traded on one or more recognized stock exchanges and if each intermediate owner, if any, is a resident of one of the two treaty partner countries.

The Discussion Draft does not provide definitions of all of the technical terms contained in the proposed Exchange Traded Test. However, the test is very similar to a test in the limitation on benefits article included in the 2006 U.S. Model Tax Convention. Therefore, in considering the proposed test, it seems useful to look at the definitions in the 2006 U.S. Model Tax Convention as further elaborated in the Technical Explanation to such model.

Under the 2006 U.S. Model Tax Treaty, a "recognized stock exchange" includes the NASDAQ System and any stock exchange registered with the SEC as a national securities exchange for purposes of the Securities Exchange Act of 1934, as well as exchanges in the treaty partner country and other exchanges agreed upon by the competent authorities.[7] U.S. treaties typically include an agreement that extends the definition of a recognized stock exchange to major exchanges that are located in third countries.

Under the 2006 U.S. Model Tax Convention, a company's "primary place of management and control" is the location in which senior management employees exercise day-to-day responsibility over the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries).[8]

U.S. Listed REITs typically would meet the conditions specified in the Exchange Traded Test:

- Shares of U.S. Listed REITs typically are listed on the New York Stock Exchange (NYSE), the NYSE MKT, or the NASDAQ, each of which would be expected to be a recognized stock exchange under the proposed provision. U.S. Listed REIT shares are traded regularly, with active turnover and with significant liquidity.

- U.S. Listed REITs also primarily are traded on such exchanges, which are located in the United States.

- In addition, U.S. Listed REITs typically have their primary place of management and control, as defined in the 2006 U.S. Model Tax Treaty, in the United States, as the strategic, financial, and operational policy decision making is executed by senior management employees located in the United States.

Of course, in any particular situation, the U.S. Listed REIT at issue would need to determine that it satisfied the specified conditions in order to meet the Exchange Traded Test. This would be a fact-based determination. However, given the special circumstances of REITs, it would be very helpful to have specific guidance included in the commentary to the proposed limitation on benefits provision that makes clear that a U.S. REIT is a company that is a resident of the United States and that is eligible to be tested for qualification for treaty benefits under the Exchange Traded Test.

---

[7] *2006 U.S. Model Tax Convention*, November 15, 2006. Article 22(5)(a).
[8] *Id.*, Article 22(5)(d).

With respect to U.S. Public Non-listed REITs, the most relevant test in the proposed limitation on benefits provision is the test contained in paragraph 2(e) that looks to: 1) an entity's ownership; and, 2) the deductible payments that it makes (Ownership/Base Erosion Test).

To satisfy the Ownership/Base Erosion Test, a resident of a treaty partner country must satisfy two requirements. The ownership portion of the test would be satisfied if, on at least half the days of the taxable year, at least 50% of the entity's shares or beneficial interests measured by vote and value (and at least 50% of any disproportionate class), is owned, directly or indirectly, by persons that are residents of such country and that are entitled to the benefits of the relevant treaty because they are included in one of several specific categories that include individuals, the countries themselves (or agencies or instrumentalities thereof), exchange traded companies (meeting the test described above), and non-profit entities and pension funds, provided that, in the case of indirect ownership, each intermediate owner is a resident of such country. The base erosion requirement would be satisfied if less than 50% of the entity's gross income for the taxable year, as determined in the country of residence, is paid or accrued in the form of deductible payments, directly or indirectly, to persons that are not residents of one of the two treaty partner countries entitled to the benefits of the relevant treaty under one of the categories listed above.

U.S. Public Non-listed REITs typically would meet both of the conditions specified in the Ownership/Base Erosion Test. With regard to the ownership requirement, U.S. Public Non-Listed REITs are owned predominantly by U.S. persons, including individual investors and pension funds. The earnings of U.S. Public Non-Listed REITs are distributed to their owners on a current basis. Such distributions are deductible by the REIT and therefore could be considered to be payments that are taken into account under the base erosion requirement. As noted above, the owners of U.S. Public Non-Listed REITs predominantly are U.S. persons who would be entitled to treaty benefits and, therefore, payments to such persons would not run afoul of the base erosion requirement. However, it would be helpful to have specific guidance included in the commentary clarifying that U.S. Public Non-Listed REITs are residents of the United States that are eligible to be tested for qualification for treaty benefits under the Ownership/Base Erosion Test.

Treatment of U.S. REITs under the Proposed "Main Purpose" Test

The second prong of the proposed anti-treaty shopping provision contained in the Discussion Draft would provide a form of general anti-abuse rule. Under this proposed test, treaty benefits would be denied if obtaining such benefit was "one of the main purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit would be in accordance with the object and purpose of the relevant provisions" of the treaty. The Discussion Draft specifies that this general anti-abuse rule would apply in addition to the limitation on benefits provision. Therefore, this second prong of the test could apply to deny treaty benefits when the requirements of one of the limitation on benefits tests otherwise are satisfied.

Like many others who have submitted comments on the Discussion Draft, we would question the appropriateness of an approach that would deny treaty benefits under a broad general rule when a more specific rule would apply to provide benefits. We, like others, are concerned about the uncertainty that would be created with the application of a “main purpose” test that could potentially deny treaty benefits even though the requirements of the limitation on benefits provision are satisfied.

The concern about uncertainty is particularly acute in the case of U.S. REITs which, unlike other non-REIT U.S. corporations, not only must distribute the vast 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 (thus, they cannot “absorb” any additional foreign tax liability in the same manner as non-REIT U.S. corporations). The risk that an unexpected tax liability could arise subsequently, after the required distribution of current earnings, because of a challenge under a “main purpose” test would have a significant chilling effect on cross-border investment. A U.S. REIT must have a high degree of certainty regarding the tax treatment when deciding whether or not to make a cross-border investment. The uncertainty that would be inherent in a “main purpose” test would be a significant factor in the decision making regarding cross-border investments and thus would impede the free flow of capital.

In this regard, we further have a specific concern about how the “main purpose” test could be applied in the context of the special circumstances of U.S. REITs. In particular, we are concerned that the fact that U.S. REITs have tax treatment that differs from other corporations could give rise to issues in the application of the broad and vague standards reflected in the test. In order to avoid this uncertainty, it would be helpful if specific guidance were included in the commentary to the “main purpose” test to make clear that the fact that an entity at issue is a U.S. REIT that is subject to a special tax regime should not itself be considered a factor that weighs in favor of denying benefits under any application of the main purpose test. Moreover, the REIT status of the entity also should not be considered to be an adverse factor in determining whether treaty benefits should be granted because such benefits would be in accordance with the objective of the treaty under the exception to the “main purpose” test.

*****

We appreciate the OECD’s focus on ensuring that the proposal for the addition of new anti-treaty shopping provisions to the OECD Model Tax Convention will not inadvertently call into question the qualification of different forms of collective investment vehicles for treaty benefits. We welcome this opportunity to provide comments on the need for specific clarification regarding the qualification of U.S. REITs for treaty benefits under the proposed new provisions.

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

Respectfully submitted,

Tony M. Edwards

Tony M. Edwards
Executive Vice President & General Counsel