



September 15, 2015

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OF
REAL ESTATE
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REITs:
BUILDING
DIVIDENDS
AND
DIVERSIFICATION®

Henry Louie
Quyên Huynh
Office of International Tax Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

Re: **Comments on Proposed Update to U.S. Model Income Tax Treaty**

Dear Messrs. Louie and Huynh:

The National Association of Real Estate Investment Trusts (NAREIT)¹ appreciated the opportunity to meet with you regarding the particular provision related to REITs that is included in the proposed update to the U.S. Model Income Tax Treaty. As we discussed, we very much support Treasury’s provision of a specific REIT regime exception from the new “special tax regime” concept that Treasury is proposing to add to the Model Treaty. However, we are concerned that the draft language for this exception could inadvertently raise technical issues and create unintended ambiguity regarding the application of this exception to U.S. REITs upon the inclusion of the proposed special tax regime provision in future U.S. bilateral tax treaties.

We believe any potential ambiguity could be avoided, and Treasury’s objective in providing a REIT exception could be accomplished, through modifications to the draft language. This letter is intended to build on the productive discussion we had with you regarding this important issue by laying out our technical concerns regarding the draft language and proposing modifications to eliminate the potential for ambiguity regarding the exception for U.S. REITs from the definition of a special tax regime.

¹ 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.

EXECUTIVE SUMMARY

The proposed update to the U.S. Model Income Tax Treaty includes the introduction of a new “special tax regime” concept under which certain treaty benefits would be denied in the case of persons that are subject to a special tax regime. Draft language in the treaty text and the technical explanation would exclude the U.S. REIT regime from the definition of special tax regime.

We agree that the U.S. REIT regime should not be considered to be a special tax regime for this purpose and we very much appreciate Treasury’s inclusion of a specific REIT exception. As discussed below, we are concerned that the technical details of this exception as currently drafted could create unintended ambiguity that could undermine the intended result. In order to provide clarity regarding the intended exception, we urge Treasury to modify the draft language for the exception to incorporate an explicit reference to the U.S. REIT regime in the treaty text.

DISCUSSION

I. Background on REITs

A. *U.S. REITs*

The U.S. REIT industry today includes a vibrant range of companies engaged in real estate ownership or financing that support nearly all sectors of the economy. While there is great diversity within the industry, the REIT rules remain true to their original purpose: a REIT must primarily invest in and derive income from real estate; it must be widely held; and each year it must distribute all of its income to its shareholders in order to not be subject to a corporate-level tax.

A REIT may be a public company with its shares registered with the Securities and Exchange Commission (SEC), or it may be a private company. A public REIT’s shares may be either listed on an established stock exchange, or its shares may be unlisted and sold directly to investors through a broker-dealer or directly to institutional investors.

At the end of June 2015, 327 REITs were registered in the United States with the SEC, and 229 of these REITs were listed on established U.S. stock exchanges (predominantly on the NYSE). Private REITs are not registered with the SEC; nevertheless, each of them still must comply with the REIT rules, and each must file with the IRS every year.

Today’s REITs generally specialize in either owning or financing real estate. “Equity REITs” primarily own, and in most cases operate, income-producing properties, including apartments, data centers, hospitals, hotels, industrial facilities, life science buildings, nursing homes, offices, shopping malls, storage centers, senior housing, student housing, telecommunications towers and timberlands. Equity REITs are estimated to currently own more than \$1.3 trillion of real estate in the United States, including more than 80,000 properties in all 50 states and accounting for an estimated 15-20% of the total commercial real estate market.

“Mortgage REITs” primarily invest in mortgages and mortgage-backed securities, providing financing for residential and commercial properties. More than 2 million single-family homes are estimated to be currently financed by mortgages owned by mortgage REITs. Most of these mortgages would otherwise be funded on the balance sheets of commercial banks or one of the government-sponsored enterprises.

On the basis of total stock exchange-listed REIT equity market capitalization, 93% of today’s stock exchange-listed REITs are equity REITs, and 7% are mortgage REITs.

B. *REITs around the world*

Over the course of the past five decades, the U.S. REIT industry has both grown substantially and performed well. Not surprisingly, other nations have taken notice. In an effort to provide their citizens and economies with the benefits of REIT-based real estate investment, [32 countries so far have adopted various versions of the U.S. REIT model.](#)

For example, every G-7 nation has adopted a regime for REIT-based real estate investment. Additionally, a majority of countries that are members of the Organisation for Economic Co-operation and Development (OECD) have adopted their own regimes for REIT-based real estate investment. Finally, both of our nation’s neighbors, Canada and Mexico, have REIT regimes in place. All of these countries have chosen to follow, more or less, the pioneering experience set forth by the United States.

The FTSE EPRA/NAREIT Global Real Estate Index is the leading investment benchmark worldwide for stock exchange-listed equity real estate investments. The equity market capitalization of the Index today is approximately \$1.4 trillion worldwide, nearly three-fourths of which represents stock exchange-listed equity REITs. Notably, the largest listed real estate company in the world is a U.S. REIT, and U.S. REITs represent 12 of the top 20 listed real estate companies worldwide. However, with REIT models now adopted by many nations around the world, an additional 4 of the top 20 constituents of the Index are REITs organized and headquartered outside the United States (representing, in these cases, REITs from Australia, the Netherlands and the United Kingdom).

C. *Key requirements of the U.S. REIT regime*

The U.S. REIT regime provisions of Internal Revenue Code sections 856-859 contain detailed requirements for qualification as a REIT, including in particular requirements with respect to ownership, assets, income and distributions.

With respect to ownership, a U.S. REIT must have at least 100 shareholders. In addition, five or fewer individuals cannot own more than 50 percent of the value of the stock of a REIT. These requirements are applied on a look-through basis in the case of a REIT that is a subsidiary of another REIT.

With respect to assets, at the close of each quarter of the taxable year, at least 75% of the total value of a REIT's assets must be represented by real estate assets, cash and cash items, and government securities. For this purpose, real estate assets are real property, interests in real property, mortgages secured by real property, and shares in other U.S. REITs.

With respect to income, at least 75% of a REIT's income each taxable year must be in the form of real property rents, interest on real property mortgages, gains on sale of real property and mortgage loans, and dividends and gains from other U.S. REITs.

With respect to distributions, a REIT is required to distribute at least 90% of its taxable income each taxable year. In addition, a REIT is entitled to a dividends paid deduction to the extent that it distributes its taxable income and any realized capital gains. A REIT will be subject to corporate income tax on any income or net capital gains that it does not distribute on a current basis.

II. Proposed special tax regime provision and REIT regime exception

The proposed update to the U.S. Model Treaty would introduce a new special tax regime concept and would limit treaty benefits with respect to income that benefits from such a regime. Under the proposed provision, the source country would retain its right to tax certain income that is paid to a resident of the other country if the resident is subject to a special tax regime with respect to such income. These special tax regime rules would apply to deny the benefit of the elimination of withholding tax on interest and royalty income under Articles 11 and 12 and to deny the exemption from source-country tax on other income under Article 21. The special tax regime concept would also apply to further tighten the ownership-based tests under the limitation on benefits provision of Article 22.

A special tax regime generally would mean any legislation, regulation or administrative practice that provides a preferential effective tax rate to an item of income or profit, including through reductions in the tax base or the tax rate. However, several exceptions would be provided with respect to the special tax regime definition. In particular, special tax regime would not include any legislation, regulation or administrative practice:

that facilitates investment in entities that are marketed primarily to retail investors, are widely-held, that hold real property (immovable property), a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established.

The proposed Technical Explanation would further explain this exception:

The exception from the definition of special tax regime in clause (vi) also applies, in the case of the United States, to real estate investment trusts (REITs) that satisfy the requirements of Code sections 856 through 859. Although REITs are not required to

hold a diversified portfolio of real estate investments, they are designed to facilitate collective investment and are subject to investor-protection regulation.

III. Technical issues with respect to exception language

In considering the language of this REIT regime exception from the definition of special tax regime, we are concerned that the requirement that the entity be subject to investor-protection regulation could as a technical matter create a basis for a treaty partner country to attempt to argue that U.S. REITs do not fall within the parameters of the exception and that the U.S. REIT regime therefore could constitute a special tax regime.

Unlike U.S. regulated investment companies, 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. Thus, U.S. REITs are not subject to the primary investor-protection regime applicable in the United States to other investment-type entities.

As noted above, many U.S. REITs are registered with the 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. Like stock-exchange listed REITs, these U.S. REITs (called Public Non-listed 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 are concerned that treaty partner countries could argue that these rules, which are generally applicable to listed companies, should not be considered to be the type of investor-protection regulation that would be required under the proposed exception from special tax regime status.

We also see some potential ambiguity in the requirement that the entity be marketed primarily to retail investors. The REIT vehicle does serve to provide access to real estate investment opportunities to retail investors. However, in today's security markets, retail investors hold a significant percentage of their investments through mutual funds and exchange traded funds organized as RICs rather than holding the investment directly. For many U.S. REITs, the bulk of their shares are held by RICs. We are concerned that treaty party countries could attempt to argue as a technical matter that because U.S. REITs frequently have significant shareholdings by RICs or in "street name" through other intermediaries, the REIT entity should not be considered to be marketed primarily to retail investors.

IV. Proposal for clarifying the REIT regime exception from special tax regime

We believe that these potential ambiguities regarding the application of the REIT regime exception to the U.S. REIT regime can best be eliminated, and Treasury's objective of providing a clear exception from the definition of special tax regime for U.S. REITs can best be accomplished, by referring explicitly to U.S. REITs in the treaty text. This is the approach used

in the U.S. Model Treaty for the special rules in Article 10 regarding the limitation on withholding taxes with respect to REIT dividends. Article 10(3) specifically refers to “dividends paid by . . . a U.S. Real Estate Investment Trust (REIT)”.

Crafting the REIT regime exception from the definition of special tax regime as an explicit reference to the U.S. REIT regime would eliminate the need to describe a REIT regime. That would avoid any ambiguity regarding whether the U.S. REIT regime meets all the elements of such a description as a technical matter. We believe this is the most straight-forward way to accomplish Treasury’s intent that the U.S. REIT regime is not a special tax regime for purposes of the new limitations on treaty benefits proposed to be added to the U.S. Model Treaty. In this regard, we would note that the interests of lessening the potential for disagreements with treaty partners are best served by making the treatment of U.S. REITs clear in the treaty text itself, so that reference to the Treasury technical explanation is not required to establish such treatment.

If the REIT regime exception were instead to be crafted using a description of a REIT regime, we believe two modifications to the draft language would be required to clarify the treatment of U.S. REITs. First, the requirement that the entities be marketed primarily to retail investors should be adjusted to reference “direct or indirect” retail investors. Second, the investor-protection regulation requirement should be eliminated. Under this approach, additional language could be added to further narrow the potential scope of the exception by focusing on a key characteristic of REITs. For example, the requirement that the entities hold real property could be modified to specify that the entities “are required to hold real property (immovable property)”. Alternatively, an additional requirement could be added that captures the U.S. REIT rules that require distribution of at least 90% of taxable income on a current basis and that subject REITs to corporate income tax to the extent they do not distribute any taxable income and net capital gains on a current basis. Indeed, it should be noted that these features of the U.S. REIT regime effectively serve as a robust investor-protection mechanism.

NAREIT very much appreciates Treasury’s focus on providing a REIT regime exception from the definition of special tax regime in the new provisions proposed for inclusion in the U.S. Model Treaty. We welcome the opportunity to provide these suggestions for modifying the language with respect to this exception to avoid any potential ambiguity regarding its technical application to the U.S. REIT regime.

Henry Louie
Quyen Huynh
September 15, 2015
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We would be pleased to discuss these comments in more detail if you believe it would be helpful. Please feel free to please contact me at (202) 739-9408 or tedwards@nareit.com, Cathy Barre, NAREIT's Senior Vice President, Policy & Politics at (202) 739-9422 or cbarre@nareit.com, or Dara Bernstein, NAREIT's Vice President & Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

A handwritten signature in black ink that reads "Tony M. Edwards". The signature is written in a cursive, flowing style.

Tony M. Edwards
Executive Vice President and General Counsel