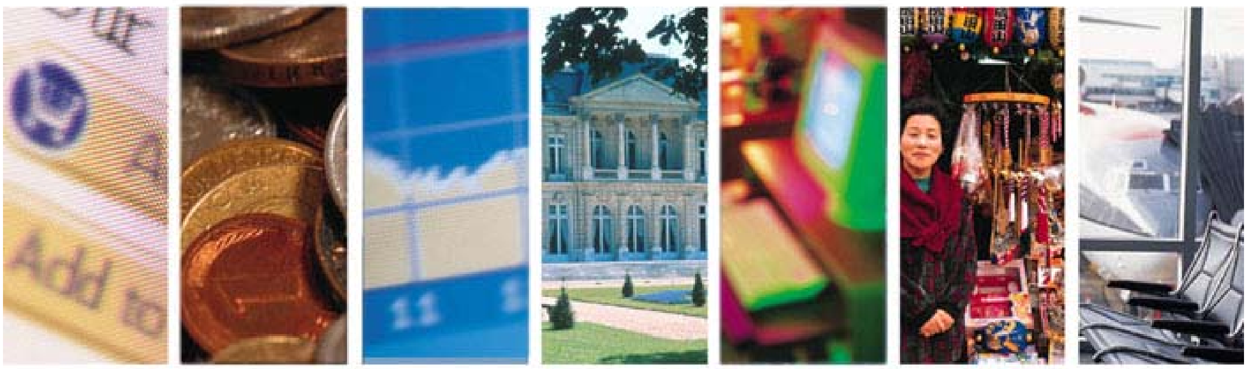
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



TAX TREATY ISSUES RELATED TO REITS

Public discussion draft
30 October 2007

CENTRE FOR TAX POLICY AND ADMINISTRATION

30 October 2007

TAX TREATY ISSUES RELATED TO REITS

Public discussion draft

The use of Real Estate Investment Trusts ("REITs") has significantly expanded worldwide and more and more countries are introducing rules to facilitate the use of these vehicles. This has led the OECD to examine the cross-border tax treaty issues arising from this form of investment.

The first draft of this report was prepared by an informal technical group of tax officials and experts from the REIT sector which was mandated by the OECD Committee on Fiscal Affairs to prepare an analysis of the issues related to the application of tax treaties to REITs and to present suggestions for additions to the Commentary of the OECD Model Tax Convention, including possible alternative provisions dealing with REITs that States wishing to do so could include in their bilateral treaties. The report of that technical group was presented to Working Party No. 1 on Tax Conventions and Related Questions, which is the sub-group of the OECD Committee on Fiscal Affairs that is responsible for updating the OECD Model Tax Convention. After discussion of that report, which led to a few minor changes, the Working Party approved its public release as a discussion draft.

The Working Party invites interested parties to send their comments on this discussion draft **before 15 January 2008** so that they may be examined at the next meeting of the Working Party. Comments should be sent to:

Jeffrey Owens
Director, CTPA
OECD
2, rue André Pascal
75775 Paris
FRANCE
e-mail: jeffrey.owens@oecd.org

Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation may be posted on the OECD website. Comments should be sent in electronic form, preferably in Word format, to facilitate their posting on the OECD website and their reproduction in OECD documents.

TAX TREATY ISSUES RELATED TO REITS

Introduction

1. Real Estate Investment Trusts ("REITs") first appeared in the United States in the 1960s and are now found throughout the world. The use of that investment vehicle has significantly expanded worldwide and more and more countries are introducing rules to facilitate the use of REITs. It has been estimated that, as of June 2006, REITs listed on stock-exchanges had a market capitalisation of US$ 608 billion and property assets worth in excess of US$ 890 billion.[1] The importance and the globalisation of investments in and through REITs have led the OECD to examine the cross-border tax issues that such investments raise for tax treaties.

2. The first draft of this report was prepared by an informal technical group of tax officials and experts from the REIT sector which was mandated by the OECD Committee on Fiscal Affairs to prepare an analysis of the issues related to the application of tax treaties to REITs and to present suggestions for additions to the Commentary of the OECD Model Tax Convention, including possible alternative provisions dealing with REITs that States wishing to do so could include in their bilateral treaties. The report of that technical group was presented to Working Party No. 1 on Tax Conventions and Related Questions, which is the sub-group of the OECD Committee on Fiscal Affairs that is responsible for updating the OECD Model Tax Convention. After discussion of that report, which led to a few minor changes, the Working Party approved its public release as a discussion draft.

3. For the purposes of this report, a REIT is a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property (real estate), distributes most of that income annually and does not pay income tax on income related to immovable property that is so distributed. The fact that the REIT vehicle does not pay tax on that income is the result of tax rules that provide for a single-level of taxation in the hands of the investors in the REIT (with corresponding withholding tax obligations imposed on the REIT with respect to its distributions to foreign investors).

4. Despite these common features, there may be significant differences between countries as regards how REITs are structured and how the tax exemption of the income is provided. In some countries, REITs were developed using the tax rules generally applicable to trusts and companies; in others, a specific REIT tax regime has been adopted.

---

1 Ernst & Young, Global REIT Report 2006, Australia, October 2006, available at http://www.ey.com/Global/download.nsf/International/Real_Estate_-_Global_REIT_Survey_2006/$file/EY_REHC_GlobalREITSurvey2006.pdf. Since this report was issued, Germany, Italy and the United Kingdom have enacted REIT laws.

Application of tax treaties to REIT investments

5. The following sections of the report discuss the application of the provisions of the OECD Model Tax Convention to income from investments in and through REITs. In some cases, the report puts forward suggestions for changes intended to allow countries wishing to do so to address in a bilateral treaty some of the issues examined in the report. It is acknowledged, however, that some of the issues and suggestions discussed in this report may raise particular issues for countries that are members of the European Union. Whilst the report describes some of these issues, it would have been beyond the mandate of the Working Party to try to deal with those. It was noted, however, that these issues were the subject of on-going work by the European Commission and Member States of the Community.

Classification of the income of a REIT

6. Rental income constitutes by far the largest part of the income of REITs. It is therefore assumed that most of the cross-border income derived by REITs would be covered by the provisions of bilateral tax treaties that are similar to Article 6 (Income from Immovable Property) of the OECD Model Tax Convention. Since REITs may also derive income from businesses carried on through immovable property without directly deriving income from such property, income of a REIT may also fall under Article 7 (Business Profits). REITs also derive capital gains from immovable property or securities that would be covered by Article 13 (Capital Gains) of the OECD Model, dividends covered by Article 10 (Dividends), interest from debt instruments (mostly mortgages) covered by Article 11 (Interest) and a small proportion of other types of income.

7. Since provisions of tax treaties that are based on Articles 6, 7 and 13 of the OECD Model grant to the State where immovable property is located an unlimited right to tax the income and capital gains derived from that immovable property or its alienation, as well as the business profits and gains attributable to a business carried on in that immovable property if it constitutes a permanent establishment, the typical income of a REIT that invests abroad would, under these provisions, be taxable in the *situs* country, with the country of residence exempting such income or providing a credit for the foreign tax levied on such income. This summary analysis, however, raises a number of issues.

Treaty entitlement of the REIT

8. A first difficulty relates to the determination of the REIT's own treaty entitlement. This is relevant not only as regards the application of the treaty provisions to the income of the REIT but also as regards the application of tax treaties to the distributions of a REIT since, for example, Article 10 (Dividends) of the OECD Model applies to dividends "paid by a company which is a resident of a Contracting State".

9. 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 the income 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.

Treaty entitlement of the REIT investor

10. In most cases, the investors in a REIT will be clearly entitled to the benefits of tax treaties concluded by their country of residence. It should be noted, however, that a part of investments in REITs come from pension funds and that some countries consider that pension funds are not entitled to treaty benefits absent specific treaty provisions.[2]

Who is the relevant taxpayer for purposes of tax treaties?

11. The determination of who is the relevant taxpayer for purposes of the application of tax treaties to the income derived by the REIT raises treaty interpretation issues.

12. It seems clear that absent specific provisions, the determination of whether the tax treaty provisions should be applied at the level of the REIT or at that of its investors will not be uniform between countries.

13. First, differences in REIT structures produce different results. For instance, a REIT may be structured as a contractual or fiduciary arrangement so that the income derived by the REIT is legally that of the investors for purposes of tax treaties and the REIT itself is merely the manager of the funds invested.

14. Second, domestic tax rules may allocate the REIT income to a taxpayer who is different from the one who is the legal owner of the income. Under such rules, whilst the REIT might be the legal owner of the income, it may be considered not to be the economic owner of the income for purposes of taxation. Also, the REIT might be considered to be simply a pass-through entity for purposes of taxation. Conversely, it may be considered that whilst the income of a REIT is simply passed-through to the investors in the form of a distribution, that distribution does not retain the tax character of the underlying income so that the REIT remains the relevant taxpayer for purposes of the application of tax treaties.

15. The principles developed in the OECD Partnership Report are relevant to deal with cases where REITs are treated as pass-through entities. However, in many cases, the REIT will not constitute a transparent entity as described in the Partnership Report and will be the relevant taxpayer for purposes of the application of the provisions of tax treaties to the income that it derives from other countries.

16. Since, however, the REIT will not pay residence State tax on that income to the extent that it is distributed, this will create difficulties with respect to the application of domestic and treaty provisions for the relief of double taxation. The Working Party considered that, as a general rule, it would be appropriate, as a policy matter, for a State to allow relief of double taxation for any source tax that has been levied on the REIT even if the residence State imposes tax on the investors rather than on the REIT itself. Where the domestic law of a country does not provide for the flow-through of relief, the Working Party considers that that country should try to find a way to provide such relief.

17. The Working Party also concluded that the question of the application of tax treaties to REIT income was intertwined with that of the treaty treatment of REIT distributions to foreign investors so that these two questions had to be examined together.

2 This issue is discussed in paragraphs 8.1 to 8.3 of the Commentary on Article 4 of the OECD Model Tax Convention.

How should REIT distributions to foreign investors be treated under tax treaties?

18. The application of tax treaties to REIT distributions to foreign investors involves significant tax policy and treaty interpretation issues.

19. As a matter of treaty interpretation, it seems clear that where the REIT is a company that qualifies as a treaty resident to whom the underlying income is allocated for treaty purposes, its distributions to foreign investors constitute dividends covered by Article 10 of the OECD Model. This, however, will often not be the case as the REIT may be structured as a trust or as a contractual or fiduciary arrangement or may be treated as a pass-through vehicle under domestic tax law.

20. The Working Party therefore went beyond a strict legal analysis based on existing provisions of tax treaties to try to articulate a tax treaty policy that would be generally applicable to REITs.

21. The starting point of that policy analysis was that the State in which the immovable property is located should have the primary, unlimited, right to tax that income. This has been a fundamental and consistent feature of provisions based on the OECD Model Tax Convention for a long time and whilst alternative views were briefly discussed, it was quickly concluded that this approach should not be challenged.

22. The real policy question, however, is whether a distribution from a REIT should be considered to be income from immovable property or income from investing in a security.

23. On the one hand, one could look at the underlying income of the REIT and consider that the distribution of that income is nothing more than the allocation of a share of that income. Under that view, it would be appropriate to treat that income as income from immovable property in the hands of each investor and require each of them to be taxed as if he/she had directly earned that income. That, however, would mean that the income would be typically subject to a high rate of tax and that the investors could be subject to filing requirements in the country where the immovable property is located.

24. On the other hand, one could consider that the investor is merely looking for an income distributing security that is, or is similar to, any publicly-traded share and should obtain the same treaty treatment as is normally given to the return on shares, which is covered by Article 10 (Dividends). A small investor in a REIT has no control over the immovable property acquired by the REIT and no connection to the particular property held by the REIT. Such a small investor cannot be viewed as having made an investment in the underlying immovable property held by the REIT any more than a shareholder of a multinational company can be viewed as having made an investment in the particular assets held by the company. Rather, the small investor invested in the REIT as an entity. The small investor is looking to the distributions from the REIT and the appreciation in its REIT interest for its investment returns just as a shareholder in a multinational company is looking to corporate dividends and share appreciation for its investment return.

25. It was noted, however, that there is a fundamental difference between a REIT distribution and other dividends since other dividends represent the after-tax distribution of income that has already been taxed in the country of residence of the company and/or in the country where the profits of that company arose. REIT distributions, on the other hand, represent income that has not been subjected to residence-based taxation at the entity level. To the extent that the treaty treatment of dividends takes account of the corporate level taxation, which seems clear in the case of the lower rate applicable to substantial inter-corporate shareholdings, it could therefore be argued that a different treatment is warranted for REIT distributions. There are, however, other circumstances in which a reduced rate of withholding tax is applied notwithstanding that there is no underlying corporate tax. This would be the case

with respect to interest on bonds, which is another type of security where there is no underlying corporate level tax (since interest is deductible) and in respect of which tax treaties generally provide for an even lower rate of tax than that applicable to dividends. REIT distributions are, of course, more of the nature of a return on equity than on debt. Even in the case of dividends, however, the treaty rules applicable to the income from portfolio investment usually provide for lower source taxation than on income from direct investment in immovable property, probably because the most practical, and usual, way of collecting tax from portfolio investment is through a withholding tax on the gross return that does not take account of the investment expenses of the investor (e.g. leverage costs).

26. The Working Party noted that immovable property is increasingly viewed by capital markets as a separate asset class with mixed attributes of both equity and debt investment. Industry participants in the Group that prepared the first draft of this report have stressed that the yields on such an investment reflect a combination of attributes of both stocks and bonds.[3] Moreover, the very high distribution rates for REITs' income mean that the source tax levied in accordance with Article 10 will be substantial even though the rate of such a tax is at the rate provided for portfolio dividends. This is in contrast to other corporate vehicles, where the taxes generated by taxing dividends paid to foreign shareholders is much less substantial because of the low level of dividend distribution. By way of illustration, for the period from 1972 to 2006, distributed income represented an average of 57.1% of the total return for U.S. REITs in the FTSE NAREIT Equity REIT Index, while distributed income represented an average of just 28.2% of the total return for the securities in the Standard and Poor's 500 Index and just 26.4% of the total return for the securities in the Dow Jones Wilshire 5000.

27. For these reasons, it was concluded that an appropriate treaty policy would be to treat a REIT distribution to a small investor in the same way as a portfolio equity investment. It also concluded, however, that limiting the rate of source taxation to that applicable to portfolio dividends would not be appropriate in the case of an investor holding a large investment in a REIT. For such a large investor, the investment in the REIT may be a substitute for a direct investment in the underlying property of the REIT. In this situation, limiting the source State tax on distributions from the REIT to the reduced rate applicable to portfolio dividends or the even lower rate applicable to direct dividends would seem inappropriate; such distributions should be subjected to the full tax rate provided by domestic law.

28. That policy could be implemented by providing that a distribution from a domestic REIT to a non-resident investor who owns an interest of less than 10% in the REIT would be subject to tax in the source-country at a rate not exceeding the portfolio dividend rate (i.e. 15%) provided in subparagraph 10(2)(b) of the OECD Model Tax Convention. Conversely, a distribution from a REIT to an investor who owns an interest of 10% or more in the REIT would not be eligible to any rate limitation under Article 10. That approach should apply regardless of the legal form of the REIT so that distributions from a REIT that are not covered by Article 10 would be treated in the same way.

29. The implementation of such a policy would require alternative treaty provisions that could be adopted by States wishing to do so. The Working Party concluded that such alternative treaty provisions should be included in the Commentary on Article 10 of the OECD Model Tax Convention and it is therefore proposed to include the following new paragraphs in that Commentary (cross-references to that new section of the Commentary could also be added in the Commentary on Articles 6, 13 and 23).

3 See Ibbotson Associates, "Commercial Real Estate: The Role of Global Listed Real Estate Equities in a Strategic Asset Allocation" (November 2006), found at http://corporate.morningstar.com/ib/documents/MethodologyDocuments/IBBAssociates/GlobalRealEstateWhitePaper.pdf.

Add the following heading and new paragraphs 67.1 to 67.7 to the Commentary on Article 10

IV. Distributions by Real Estate Investment Trusts

67.1 In many States, a large part of portfolio investment in immovable property is done through Real Estate Investment Trusts (REITs). A REIT may be loosely described as a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property, distributes most of that income annually and does not pay income tax on the income related to immovable property that is so distributed. The fact that the REIT vehicle does not pay tax on that income is the result of tax rules that provide for a single-level of taxation in the hands of the investors in the REIT.

67.2 The importance and the globalisation of investments in and through REITs have led the Committee on Fiscal Affairs to examine the tax treaty issues that arise from such investments. The results of that work appear in a report entitled "Tax Treaty Issues Related to REITS".[4]

67.3 One issue discussed in the report is the tax treaty treatment of cross-border distributions by a REIT. In the case of a small investor in a REIT, the investor has no control over the immovable property acquired by the REIT and no connection to that property. Notwithstanding the fact that the REIT itself will not pay tax on its distributed income, it may therefore be appropriate to consider that such an investor has not invested in immovable property but, rather, has simply invested in a company and should be treated as receiving a portfolio dividend. Such a treatment would also reflect the blended attributes of a REIT investment, which combines the attributes of both shares and bonds. In contrast, a larger investor in a REIT would have a more particular interest in the immovable property acquired by the REIT; for that investor, the investment in the REIT may be seen as a substitute for an investment in the underlying property of the REIT. In this situation, it would not seem appropriate to restrict the source taxation of the distribution from the REIT since the REIT itself will not pay tax on its income.

67. 4 States that wish to achieve that result may agree bilaterally to replace paragraph 2 of the Article by the following:

> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State (other than a beneficial owner of dividends paid by a company which is a REIT in which such person holds, directly or indirectly, capital that represents at least 10 per cent of the value of all the capital in that company), the tax so charged shall not exceed:
>
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends (other than a paying company that is a REIT);
>
> b) 15 per cent of the gross amount of the dividends in all other cases.

According to this provision, a large investor in a REIT is an investor holding, directly or indirectly, capital that represents at least 10% of the value of all the REIT's capital. Countries may, however, agree bilaterally to use a different threshold. Also, the provision applies to all distributions by a REIT; in the case of distributions of capital gains, however, the domestic law of some countries provides for a different threshold to differentiate between a large investor and a small investor entitled to taxation at the rate applicable to portfolio dividends and these

4 OECD, Paris, 2008. Reproduced in volume II of the loose-leaf version of the Model at R-….

countries may wish to amend the provision to preserve that distinction in their treaties. Finally, because it would be inappropriate to restrict the source taxation of a REIT distribution to a large investor, the drafting of subparagraph *a*) excludes dividends paid by a REIT from its application; thus, the subparagraph can never apply to such dividends, even if a company that did not hold capital representing 10% or more of the value of the capital of a REIT held at least 25% of its capital as computed in accordance with paragraph 15 above.

67.5 Where, however, the REITs established in one of the Contracting States do not qualify as companies that are residents of that Contracting State, the provision will need to be amended to ensure that it applies to distributions by such REITs.

67.6 For example, if the REIT is a company that does not qualify as a resident of the State, paragraphs 1 and 2 of the Article will need to be amended as follows to achieve that result:

> 1. Dividends paid by a company which is a resident, or a REIT organized under the laws, of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
>
> 2. However, such dividends may also be taxed in, and according to the laws of, the Contracting State of which the company paying the dividends is a resident or, in the case of a REIT, under the laws of which it has been organized, but if the beneficial owner of the dividends is a resident of the other Contracting State (other than a beneficial owner of dividends paid by a company which is a REIT in which such person holds, directly or indirectly, capital that represents at least 10 per cent of the value of all the capital in that company), the tax so charged shall not exceed:
>
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends (other than a paying company that is a REIT);
>
> b) 15 per cent of the gross amount of the dividends in all other cases.

67.7 Similarly, in order to achieve that result where the REIT is structured as a trust or as a contractual or fiduciary arrangement and does not qualify as a company, States may agree bilaterally to add to the alternative version of paragraph 2 set forth in paragraph 67.4 above an additional provision drafted along the following lines:

> For the purposes of this Convention, where a REIT organized under the laws of a Contracting State makes a distribution of income to a resident of the other Contracting State who is the beneficial owner of that distribution, the distribution of that income shall be treated as a dividend paid by a company resident of the first-mentioned State.

Under this additional provision, the relevant distribution would be treated as a dividend and not, therefore, as another type of income (e.g. income from immovable property or capital gain) for the purposes of applying Article 10 and the other Articles of the Convention. Clearly, however, that would not change the characterisation of that distribution for purposes of domestic law so that domestic law treatment would not be affected except for the purposes of applying the limitations imposed by the relevant provisions of the Convention.

Issues arising from this approach

30. The Working Party also examined various technical issues related to this approach as well as its possible extension to situations where a foreign REIT invests in a domestic REIT or invests directly in

domestic immovable property. The following reflects the conclusion of the Working Party on these various issues.

Definition of REIT

31. A first design issue is how to define a REIT for purposes of the above rules. The Working Party concluded that given the differences in domestic law concerning the structure and features of REITs, this should be dealt with bilaterally. For the purpose of the above provisions, countries would therefore be expected to include in their bilateral conventions specific definitions of REITs that would allow the application of these provisions to their own REITs. Such definitions may, for example, make reference to the relevant domestic provisions that define REITs for domestic tax purposes.

Distinction between large and small investor

32. A first issue related to a possible distinction between large and small investors is to what extent it would be possible to provide for different treatment of distributions, or different treatment of a REIT entity, based on the size of the shareholding. It was suggested that this involved some domestic and EU law principles. For example, it was noted that disclosure rules imposed by market regulators would typically require the disclosure of any investor owning more than a certain percentage (e.g. 5%) of a listed entity.

33. Clearly, a large investor should not be allowed to get the benefit of the lower rate applicable to portfolio interests in a REIT by simply dividing its investment in the REIT among a number of associated entities. This is why the provision put forward does not grant the lower rate to an investor who holds "directly or indirectly" capital that represents at least 10% of the value of the overall capital of a REIT. Also, the lower rate should not be granted in cases of abuse of the provision, for example, where a company with a holding of 10% or more has, shortly before the payment of a distribution, transferred its interests in a REIT to a number of small investors for the purpose of securing the benefits of the lower rate, with a commitment to re-acquire these interests after the distribution. States that do not believe that they can prevent such arrangements through their domestic anti-abuse rules may find it appropriate to supplement the proposed provision by a paragraph subjecting the application of the lower rate to the condition that the interests in a REIT were not acquired primarily for the purpose of taking advantage of that lower rate.

34. A second issue is the determination of the level of capital ownership that would trigger the application of the "large investor" treatment. The approach put forward in this report suggests a threshold of 10% of the value of the capital of the REIT. Countries may, however, agree bilaterally to use a different threshold.

Taxation of distributions to large investors

35. It was accepted that, ideally, the tax levied on distributions to large investors should be commensurate with the tax levied on a return from a direct investment in immovable property. While the above provisions do not limit the tax that may be charged in the State in which the immovable property is situated, some States may provide an option to file on a net basis.

Distribution of capital gains

36. The Working Party generally agreed that it would be appropriate to provide the same treatment for distributions from capital gains and distributions from rental income derived by the REIT. For that reason, the above proposal treats distributions of both types of income in the same way. The same conclusion has generally been reached with respect to all other types of income that could be derived by a

REIT. It was noted, however, that in the case of distributions of capital gains, some countries use a different threshold to differentiate between a large investor that is subject to source country tax without limitation under the Convention and a small investor entitled to taxation at the rate applicable to portfolio dividend; these countries may wish to preserve that distinction in their bilateral treaties.

Treatment of capital gains on interests in a REIT

37. The Working Party examined the possible application of paragraph 4 of Article 13 to gains realized on the alienation of an interest in a REIT. Given that the purpose of a REIT is primarily to hold immovable property, the conditions for the application of that paragraph would be met when shares in a REIT are alienated (in the case of REITs that are set up in a non-corporate form, the same result would follow from either paragraph 1 of Article 13, which could apply to some REITs set up as contractual arrangements, or the modified version of paragraph 4 that appears in paragraph 28.5 of the Commentary on Article 13).

38. Whilst it was agreed that applying paragraph 4 to allow the source taxation of gains resulting from the alienation of a large investor's interests in a REIT would be appropriate, different views were expressed as to whether that would also be an appropriate result for gains realized by small investors in a REIT.

39. For some members of the Working Party, paragraph 4 was intended to apply to any gain on the alienation of shares in a company that derives its value primarily from immovable property and there would be no reason to distinguish between a REIT and a publicly held company with respect to the application of that paragraph, especially since a REIT is not taxed on its income. These members considered that as long as a treaty does not provide an exception for the alienation of shares of companies listed on a stock exchange (as suggested in paragraph 28.7 of the Commentary on Article 13), there should not be a special exception for interests in a REIT.

40. Other members of the Working Party, however, disagreed. For them, a small investor's interest in a REIT should be treated as a security rather than as an indirect holding in immovable property. They considered that this treatment of the small investor's interest in a REIT as a security was consistent with this report's conclusion regarding the appropriate treatment of such interest for purposes of the taxation of distributions. These members also indicated that, in practice, it would be very difficult to administer the application of source taxation of gains on small interests in a widely held REIT. Some of them added that since REITs, unlike other entities deriving their value primarily from immovable property, are required to distribute most of their profits, it is unlikely that there would be significant residual profits to which the capital gain tax would apply (as compared to other companies).

41. It was also noted that allowing source taxation of such gains could result in a double exemption if the State of source did not exercise this taxing right and the State of residence of the investor was an exemption country (that problem, which is inherent to paragraph 4 of Article 13, is described in paragraph 28.9 of the Commentary on that Article).

42. The Working Party concluded that the Commentary on Article 13, which already discusses possible exceptions to paragraph 4, should be supplemented to address a possible additional exception for gains on small interests in a REIT. It therefore proposes the inclusion of the following new paragraphs in that Commentary.

*Renumber paragraph 28.9 of the Commentary on Article 13 as paragraph 28.*12 *and add the following new paragraphs 28.9 to 28.11*

> 28.9 Finally, a further possible exception relates to shares and similar interests in a Real Estate Investment Trust (see paragraphs 67.1 to 67.7 of the Commentary on Article 10 for background information on REITs). Whilst it would not seem appropriate to make an exception to paragraph 4 in the case of the alienation of a large investor's interests in a REIT, which could be considered to be the alienation of a substitute for a direct investment in immovable property, an exception to paragraph 4 for the alienation of a small investor's interest in a REIT may be considered to be appropriate.
>
> 28.10 As discussed in paragraph 67.3 of the Commentary on Article 10, it may be appropriate to consider a small investor's interest in a REIT as a security rather than as an indirect holding in immovable property. In this regard, in practice it would be very difficult to administer the application of source taxation of gains on small interests in a widely held REIT. Moreover, since REITs, unlike other entities deriving their value primarily from immovable property, are required to distribute most of their profits, it is unlikely that there would be significant residual profits to which the capital gain tax would apply (as compared to other companies). States that share this view may agree bilaterally to add, before the phrase "may be taxed in that other State", words such as "except shares held by a person who holds, directly or indirectly, interests representing less than 10 per cent of all the interests in a company if that company is a REIT". (If paragraph 4 is amended along the lines of paragraph 28.5 above to cover interests similar to shares, these words should be amended accordingly.)
>
> 28.11 Some States, however, consider that paragraph 4 was intended to apply to any gain on the alienation of shares in a company that derives its value primarily from immovable property and that there would be no reason to distinguish between a REIT and a publicly held company with respect to the application of that paragraph, especially since a REIT is not taxed on its income. These States consider that as long as there is no exception for the alienation of shares in companies quoted on a stock exchange (see paragraph 28.7 above), there should not be a special exception for interests in a REIT.

Relief of double taxation in the State of residence

43. The approach put forward in this note could require appropriate adjustments to the Article on relief of double taxation. It would be necessary, for instance, to avoid the application of the exemption method in the case of distributions to small investors in a REIT. Since these distributions would be subject to limited source taxation, it would be appropriate to apply the credit method to them. Conversely, distributions to large investors in a REIT, which would be subjected to source taxation without any treaty limit, should be covered by the exemption method if this is the method generally applied by a State (see also paragraph 41 above as regards the risks of double exemption of capital gains).

Application of the participation exemption / EU parent-subsidiary directive

44. Another issue is to what extent domestic rules on participation exemption and, more generally, the EU parent-subsidiary directive, would allow a State to tax a distribution to a large investor at a rate commensurate with the rate applicable to income from immovable property rather than at the rate applicable to a dividend to a large corporate shareholder. To some extent, the answer to that question could depend on the legal structure of the REIT and on whether or not the REIT and the investor could be considered to be tax-exempt.

Distributions to tax-exempts (pension funds)

45. Paragraph 69 of the Commentary on Article 18 (Pensions) includes an alternative provision that States may use to extend the domestic exemption of income derived by domestic pension funds to income derived by pension funds established in another State. That provision allows States to achieve greater neutrality with respect to the location of capital.

46. The Working Party concluded that, as a matter of policy, distributions from a portfolio investment in a REIT should be treated like other investment income of a pension fund and noted that, as drafted, the alternative provision would appropriately cover that type of income. States contemplating the inclusion of such a provision should, however, consider the policy issue of whether the provision should apply to distributions to a pension fund that holds more than a portfolio investment in a domestic REIT (i.e. 10% or more).

Potential for base erosion and access to interest treatment

47. The OECD Model Convention provides that source taxation on interest payments may not exceed 10% but tax treaties often provide that interest payments will not be taxable in the source country. Many countries have enacted thin capitalisation rules to prevent the erosion of their tax base through interest payments that would be deductible from the tax base without being subject to source taxation.

48. The Working Party examined whether the tax treatment of REITs could give rise to a similar base erosion concern. One example that was discussed was that of a REIT that would offer foreign investors the possibility to invest in a combined equity and debt instrument, with the debt component representing almost all the value of the investment. In such a case, a very large part of the REIT profits could effectively be distributed to the investors as interest payments subject to no source taxation.

49. It could be argued that the interest payments would be subject to residence taxation in the hands of the investors, although this may not provide a satisfactory response to the source country concern, particularly in the case of tax-exempt or low-tax foreign investors. Also, various design features of a REIT regime may prevent or reduce this risk of base erosion. For example, the REIT regulatory framework or market preferences may make it difficult to highly leverage the REIT and the REIT may be prevented from issuing participating debt instruments.

50. Whilst it was noted that at least one country had introduced a thin-capitalization rule in its REIT regime to address the base-erosion concern, the Working Party concluded that this issue was not specific to REITs and that no REIT-specific recommendation should be made to deal with it.

Investment by a foreign REIT

51. The Working Party finally examined whether and how the above proposal on the tax treaty treatment of distributions to foreign investors in a domestic REIT should be extended to a foreign REIT deriving income from domestic immovable property and to a foreign REIT investing in a domestic REIT.

52. The industry participants in the Group that prepared the first draft of this report stressed that in order to achieve a more efficient market for portfolio investment in immovable property, REITs established in one country need to be able to invest in foreign countries' immovable property and in REITs established in other countries. Therefore, the tax obstacles that hinder such cross-border investments should be addressed. They also indicated that the adoption of solutions that would avoid the need for the arrangements that are currently used to avoid multiple taxation of such cross-border REIT investments would be beneficial for both REITs and tax administrations.

53. It was suggested that EU law may require a country to extend its domestic REIT regime to REITs established in other EU States. This is obviously an important question for EU Member States and it is hoped that it will be addressed as part of the on-going work on taxation and REITs that a Working Group of the European Commission and Member States of the Community is carrying on.

54. This led the Working Party to examine whether treaty provisions based on paragraph 3 of Article 24 of the OECD Model Tax Convention could be interpreted to require a country to extend its domestic REIT regime to a foreign REIT holding domestic immovable property through a permanent establishment. The Working Party concluded that such an interpretation should be rejected and noted that extending the benefit of an exemption granted to a domestic REIT (the distributions from which would be taxed) to such a permanent establishment would result in an undue advantage for the foreign REIT since the distributions of that REIT could not similarly be taxed, in particular because of paragraph 5 of Article 10, by the State where the permanent establishment is located. As explained in paragraph 20 of the Commentary on Article 24:

> …the wording of the first sentence of paragraph 3 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied.

55. As a matter of tax policy, and putting aside practical considerations regarding tax administration and tax collection, the majority of the members of the Group that produced the first draft of this report considered that if an equivalent tax regime could be applied to a foreign REIT, there would be no reason for a country to treat foreign REITs differently from domestic REITs with respect to investment in domestic property. This, however, would require that country to be able to levy and collect an equivalent amount of tax on distributions of domestic income by a foreign REIT as it would levy and collect on distributions of such income by a domestic REIT that would have a similar investor base and similar levels of distributions made at similar intervals, considering that the policy rationale underlying the tax exemption for domestic REITs is that tax will be collected on the income of the REIT at the investor's level rather than at the entity's level.

56. A State wishing to extend the tax benefits of its domestic REIT regime to foreign REITs would, however, face various legal, administrative and compliance issues. These would primarily include:

- the difficulty of identifying which part of the distribution by a foreign REIT would correspond to domestic income;
- the general tax treaty prohibition, found in provisions similar to paragraph 5 of Article 10 of the OECD Model, against taxing distributions by a company resident in another State;
- the practical difficulty of identifying a foreign REIT's large investors and investors who are not entitled to treaty benefits; particularly where the foreign REIT's investors include other REITs;
- difficulties related to the extension of double tax relief on a distribution received by an investor in one REIT to take account of the tax levied on a previous distribution received by that REIT.

57. The extension of a domestic REIT regime to foreign REITs would therefore require a trade-off between the basic policy objective of ensuring an equivalent tax treatment and the need to take account of

the above issues. The Working Party examined various approaches that could be considered for that purpose, including

- levying source tax at the time that the foreign REIT that has invested domestically makes a distribution,
- deeming the foreign REIT to be a domestic REIT for treaty purposes, and
- deeming the foreign REIT to have a permanent establishment.

These possible approaches and some issues that they raise are discussed in more detail in the Annex.

ANNEX

TECHNICAL ANALYSIS OF VARIOUS APPROACHES PUT FORWARD FOR EXTENDING DOMESTIC REIT REGIMES TO FOREIGN REITS

1. As indicated in paragraph 57 of the note, the Working Party examined various approaches that could be considered for the purposes of extending a domestic REIT regime to foreign REITS. The following describes some of these approaches and presents some of the issues that were identified with respect to them.

Subsequent withholding tax

2. One approach would be for a State to exempt from domestic tax the income from domestic immovable property derived by a foreign REIT recognized as similar to a domestic REIT, or a distribution from a domestic REIT to such a foreign REIT, but to impose a withholding tax on the subsequent distributions by the foreign REIT to its own interest-holders.

3. Under that approach, the tax on such subsequent distributions by the foreign REIT would include both the tax of the State in which the foreign REIT has been established and that of the State in which the foreign REIT invested (either directly in domestic immovable property or in a domestic REIT).

4. Whilst that approach would primarily be implemented through domestic law changes, it may also require a change to tax treaties in order to avoid the prohibition, found in paragraph 5 of Article 10, against taxing distributions by foreign companies (see below).

Deeming the foreign REIT to be a domestic REIT for tax treaty purposes

5. Another approach would be to design treaty rules that would have the effect of deeming immovable property income derived from a State by a foreign REIT recognized as similar to a domestic REIT, as well as a distribution from a domestic REIT to such a foreign REIT, to be the income of a distinct company resident of that State that qualifies as a REIT in that State. That income, or a percentage thereof, would also be deemed to be distributed at regular intervals (such as annually) so as to trigger the application of source taxation rights under Article 10.

Deeming the foreign REIT to have a permanent establishment

6. A third approach would be to design treaty rules that would deem a foreign REIT that holds immovable property in a State, or that holds an interest in a domestic REIT in such State, to have a permanent establishment in that State to which the income from such immovable property or distributions from such domestic REIT would be attributable. These rules would also deem a distribution of the income of that permanent establishment to its head office and would allow the source State to tax this deemed distribution.

Application of these approaches to foreign REITs investing directly in domestic immovable property

7. As regards the income from a direct investment by a foreign REIT in immovable property of a given State, the three approaches described above would ensure that, as would be the case for income derived by a domestic REIT, the distributed domestic income of the foreign REIT is not taxed by that State at the time of its realisation by the foreign REIT.

8. A first issue that would arise under all these approaches is the determination of the rate of tax at which an actual distribution by the foreign REIT (under the first approach) or a deemed distribution (under the second and third approaches) would be taxable by the source State. The foreign REIT might have large and small investors; also, these investors might be residents of the State where the REIT is established, of the State where the immovable property is located or of third States. In order to apply to the investors in the foreign REIT an approach equivalent to the one put forward in this note as regards investors in a domestic REIT, one possibility would be to adjust the tax rate by looking through the investor REIT to determine the indirect ownership percentages of investors in that REIT. Thus, if all the investors in the foreign REIT were small investors that are residents of the State where the REIT is established, the withholding tax on the distribution to the investor REIT would be imposed at the lower portfolio dividend rate applicable to small investors. If the foreign REIT had other investors not entitled to that lower rate, the withholding tax on the distribution to the investor REIT would be imposed at a blended rate based on the proportionate interests held indirectly by the various categories of investors. For this purpose, it was suggested that the determination of whether the foreign REIT has large investors could be based on filings under rules requiring public disclosure of ownership by large investors. Such a look-through approach, however, would raise considerable administrative and compliance difficulties. The Working Party noted that some of these difficulties are currently being examined by the Informal Consultative Group on Collective Investment Vehicles with a view to addressing these issues in a broader context.

9. The fact that the distributions by the foreign REIT will not come exclusively from the income derived from immovable property in the source State creates an additional issue with respect to the first approach. Since, under that approach, tax would be imposed on the actual distribution by the foreign REIT, it would be necessary to identify which part of that distribution can reasonably be attributed to the income derived from the source State. Also, since losses realised outside the source State could reduce or eliminate actual distributions by the foreign REIT in a case where substantial income is derived from the source State, States would have to decide either to accept that result or to introduce rules deeming a distribution of the source-State income to have been made in such a case.

10. The second and third approaches would avoid these issues by taxing deemed distributions of the income arising from the source State instead of actual distributions by the foreign REIT. By doing so, however, these approaches could be seen as maintaining a significant difference between the tax treatment of domestic REITs and foreign REITs. Also, these approaches could create difficulties as regards the elimination of double taxation in the State of residence of the investor, which would tax the actual distributions. Additional rules might therefore be needed to ensure that relief of double taxation is granted under these approaches.

11. Under paragraph 5 of Article 10 of the OECD Model Tax Convention, a State is prevented from taxing distributions by a company resident in the other Contracting State. Since the first approach would have the practical effect of taxing the distributions by a foreign REIT, an exception to that treaty rule would seem to be required. A similar exception may also be required for the third approach because that approach might be considered to result in the taxation of the undistributed profits of the foreign REIT to the extent that it deems a distribution of income by the deemed permanent establishment to the head office of the foreign REIT. Since the second approach would deem a distribution to be made by a resident company, however, it would not require such an exception.

12. A related issue that could arise under the first approach, but which would probably be avoided under the second and third approaches, would be the practical implementation of the taxation of the distributions by the foreign REIT. If the State of residence of the foreign REIT were required to administer the tax levied by the State of source, it may be put in the difficult position of having to apply a withholding tax agreed to between the State of source and a third State where some of the foreign REIT's investors might be residing.

13 In order for any of these three approaches to be effective, the treaty rules that would be designed to implement them would need to be associated with corresponding domestic law provisions. Whilst treaty rules would seem sufficient to ensure that taxation is not levied by the source State upon the realisation of income from domestic investment by a foreign REIT, in most countries changes to domestic rules would be required in order to impose tax on the actual or deemed distributions by the foreign REIT.

Application of these approaches to foreign REITs investing in domestic REITs

14 The application of the approach put forward in this note for the tax treaty treatment of foreign investors in a domestic REIT to a foreign REIT that invests in a domestic REIT raises similar issues as those examined above as regards direct investment by a foreign REIT in domestic immovable property.

15. One difference, however, concerns the determination of the rate applicable to the actual distribution by the foreign REIT (under the first approach) or the deemed distribution (under the second and third approaches). Since the foreign REIT may itself qualify as a small investor in the domestic REIT, the determination of the treaty rate that should apply to such distributions requires a different analysis:

- If the foreign REIT qualifies as a small investor in the domestic REIT, one could consider that the foreign REIT should be entitled to the reduced rate of dividend withholding tax applicable to small investors. Some countries, however, might be reluctant to follow that approach where the foreign REIT is not considered to be a resident entitled to treaty benefits, where there are third-country investors in the foreign REIT or where it would be possible for foreign investors to divide a large investment in a domestic REIT through a number of foreign REITs each qualifying as a small investor in the domestic REIT (if it is not possible to prevent this through the approaches discussed in paragraph 33 of the note).

- If the foreign REIT is a large investor in the domestic REIT, the reduced rate of dividend withholding tax applicable to small investors nevertheless could be applied if the State considers that administrative and compliance difficulties do not justify trying to collect the extra tax that would be payable by large investors or third-country small investors in the foreign REIT and furthermore considers that REITs typically are not a vehicle that would lend itself to investors seeking inappropriately to obtain treaty benefits.

- A country, however, may be reluctant to apply the reduced rate applicable to small investors if the foreign REIT itself had large investors. The look-through approach discussed in paragraph 8 above could be used to overcome that difficulty by looking through the investor base of the foreign REIT in order to determine the proportion of large investors (and, possibly, of third country investors).