

Tax treaty issues related to REITs (Real Estate Investment Trust)

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The following observations are made pursuant to the assumptions (para. 3 of *Introduction*) below resumed, which regard the REITs as entities:

- i. widely held by several owners;
- ii. aimed at a medium-long term investment in real estate properties;
- iii. used to distribute the most part of their profits (where the remainder is destined to refurbishment of existing properties and/or acquisition of new properties);
- iv. not subject to an income tax on the realized profits to be distributed.

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Para. 8 – Treaty Entitlement of the REIT – We agree on the conclusions of the WP that in general the REITs should be considered as «*liable to tax for purposes of the Treaty definition of “resident of a Contracting State”*».

However, since the matter appears to be a key matter and it is subject to different approaches among the different countries, we believe that the WP should clearly state which are the requirements to be met for a REIT in order to fall within the definition of «liable to tax».

We in particular refer to the possibility of a REIT to fall (A) within the definition of “*person*” and (B) within the definition of “*resident of a Contracting State*”.

This is particularly a key matter in all instances where the REIT is not organized as a *legal entity*.

(A) As far as the definition of «*person*» is concerned, we are of the opinion that WP should accept the conclusions reached by the General Report of IFA Congress of 1997¹ and then qualify as a «*person*» any REIT if:

- (a) the investment management company intends to operate this pooled and regulated investment scheme as an independent entity;
- (b) the estate of the REIT is separate from the estate of the investment management company;
- (c) accessibility of the REIT to the general public ²;
- (d) ancillary to that, effective tradeability of the units of the REIT and independence of the management.

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(B) As far as the definition of «*resident of a Contracting State*» is concerned, we are of the opinion that WP should accept the conclusions reached by the same OECD Commentary³ and then qualify as a «*resident of a Contracting State*» any REIT if:

- i. includable among the “*other organizations*” as to the definition contained in the OECD Commentary;
- ii. exempt from tax but the State where they are located “*could assert jurisdiction to tax the entity on its worldwide income if the conditions for the exemption are not met*”.

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Para. 6 - Classification of the income of the REIT

Another subject matter which in our view requires additional clarification from WP concerns the consequence of the qualification of the income realized by the REIT, as regards as to the issues set forth below.

The cases under discussion envisage that: REIT is located in State A; immovable property is located in State A; investor in the REIT is resident in State B.

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¹ Ed – Bongaarts, The Taxation of the Investment Funds, *Cahiers de Droit Fiscal International*, 1997, Vol. 82b.

² This requirement to be intended by the authors as “*preventing cases where any third party is using the REIT to conceal its dominating role*” (Ed – Bongaarts, *cit.*).

³ OECD Commentary, paragraph 8.2 on article 4(1).

a. Payments by REIT to foreign investor of taxed income

There are cases in which the exemption granted to a REIT (as defined in the Report) by the State A is not granted to all classes of income; i.e., in Italy, the regime applicable to SIIQ, «*società di investimento immobiliare quotata*» provides for a general exemption to all income deriving from the rent of properties (rental income), but subjects to ordinary taxation at corporate rate (27,5%) the other classes of income (for example, income from capital gain on disposal of properties).

If the REIT is subject to tax on part of its income at ordinary rate, then the investor should not be taxed by the State A on the amount distributed by the REIT, save for a limited withholding tax, regardless of whether such investor is considered a small or a large investor.

Otherwise, a double taxation may arise in the hands of the (large) investor, which is subject to tax by State A as his/her investment was made in an immovable property in State A.

This approach has been accepted, inter alia, by Italian Government with Finance Bill for 2008, whereby the withholding tax exemption based upon the Parent-Subsidiary Directive has been agreed also to SIIQ payments (see paragraph 374 of article 1 of Finance Bill for 2008).

Based upon the above approach, we suggest to add to WP addition at the end of paragraph 2 of article 10 the following sentence:

“The same limitation to the withholding tax rate, provided for under preceding letter b), is applicable to all investors of a company which is a REIT and which does not enjoy a full exemption from income taxation in the Contracting State of which the REIT is resident.”

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b. Payments by REIT to foreign investor of unrealized income

Generally speaking, the REIT distributes income out of profits realized during its relevant fiscal year.

The obligations of timely reporting the NAV («*net asset value*») of the investment to the public, further to the regulatory requirements usually introduced to distribute most part of the profits of the period, may lead to the consequence that a REIT:

- accounts for a profit due to the appreciation of the NAV (“unrealized income”);

- distributes such profit withdrawing the cash proceeds from other sources (i.e. equity capital or loans).

If the REIT had been a company, this behaviour would not probably be allowed (e.g.: *fair value* undistributable reserves provided for under IFRS) and, mostly, taxes would generally not be levied on such profit.

From an investor perspective, in fact, if the REIT is increasing its liabilities for distributing an "unrealized income", the enrichment of the investor (cash receiving) is offset by the reduction in value of the REIT unit (debt increasing or equity capital decreasing).

The authors do not have a solution to the matter, but just remit to the WP the subject for further perusal and analysis.

We note however, that this class of unrealized gain is quite common among the REITs' profits and require specific regime of taxation. Solutions found under OECD Commentary (para. 8 and following under article 13) for appreciation in value of asset of a company seem not proper for the case under discussion.

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c. Payments by REIT to foreign investor of interest income

We agree on the principle stated by WP that all income distributed by a REIT is an income from a security and not from immovable property.

We also agree that the nature of the investment implies that the distribution from a REIT shall be regarded as a dividend rather than as an interest⁴.

At the same time, the interest payments from a REIT shall not give rise to thin capitalization or base erosion arguments in State A, since – as remarked by the WP – most REITs enjoy full (or partial) tax exemption on profits.

In addition, the regulatory restrictions to indebtedness should limit the possibility to have material interest payments by REITs – in respect of the overall REITs distributions.

Such argument leads us to a further point: according to regulatory laws of some countries, REITs are allowed to have a debt to equity ratio higher than the standard one allowable for the "common" REITs (up to 90%), if they are "*Closed-end Funds*", meaning with that definition a REIT (what follow are just two of the most relevant features of a "*Closed-end Funds*"):

⁴ Another option could have been to classify every REIT distribution as "*Other income*" under article 21 of OECD Tax Treaty Model, but this could lead to undesired results for the Residence States of REIT (State A in the examples) allowing not only a general (or partial) exemption on income realized by REIT, but also on the related distributions.

- where only “*specialised or professional investors*” can have access;
- where the scope of the REIT is merely “*speculative*” (i.e. the horizon of the investment is not of a medium-long term).

As it may be argued, the two features outlined determine that such REITs appear to be somehow out of the definition of REIT given in the beginning of the WP Report: such “*Closed-end Funds*” are not “*widely held by several owners*” and generally not “*aimed at a medium-long term investment in real estate properties*”.

Consequently, WP should clarify in the opinion of the authors whether: (i) to exclude such “*Closed-end Funds*” from the scope of the present Report and/or (ii) to state a specific tax treatment for such investment scheme, different from the one applicable to the REITs as defined in the Report.

Generally speaking, we do not believe that the solution proposed by the WP (“*to make reference of the relevant domestic provisions that define REITs for domestic tax purposes*”) is satisfactory to this extent.

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d. Payments by REIT to foreign investor under a fiduciary arrangement

The WP Report has correctly faced the case where a REIT is “*structured as a trust or as a contractual or fiduciary arrangement and does not qualify as a company*”, being a case quite recurrent in the practice.

However, the qualification as a dividend of any distribution by a REIT so structured should be correct on condition that the fiduciary arrangement satisfies the following requirements:

- (i) independence of the investment management company; and
- (ii) effective management of the assets contributed in the REIT; and
- (iii) tradeability of REIT units on the financial market; and
- (iv) no connection between the estate of the management company and the estate of the REIT.

Should one of these requirement not be met, then the fiduciary arrangement would need to be seen as a pure “*pass-through*”, and the income classification should then reflect the nature of the income received by the REIT.

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Para. 32 – Distinction between large and small investor

This distinction between large and small investor is the basic principle underlying the WP Report on REITs.

Such principle does not affect the rule stated by WP that all income distributed by a REIT is an income from a security and not from immovable property.

In other words, a large investor is presumed to realize an income from security (i.e. dividend) even if the State A maintains – from a pure Tax Treaty purpose – the (not exclusive) right to tax such dividend disapplying any limitation provided for under article 10 of OECD Model Tax Treaty.

The authors believe that this approach appears to be partially contradictory with the principle of “*widely held by several owners*”, appearing to be one of the basic requirements for being admitted as a REIT within the definition given in the Report; in other words, if the purpose to “discriminate” the large investors is of “*preventing cases where any third party is using the REIT to conceal its dominating role*”, such purpose should already be ensured by fact that the ownership of the REIT is split among different (independent) parties.

In conclusion, it is opinion of the authors that:

- the class of large investors in a REIT (based upon the definition of the Report) is in practice not so recurrent (since the ownership of the REIT is widely split) to require a separate tax treatment; or
- the existence of the class of large investors in a REIT jeopardizes the nature of this instrument and impede to qualify it as a REIT under the Report;
- the large investors in a REIT can also disguise other entities “*widely held by several owners*”, such as pension funds or other REITs. In this event, WP should probably clarify that this is a class of large investor that should benefit from the same tax treatment of the “small investor”. It appears that this approach is accepted also by WP in para. 45 of the Report, but only for Pension Funds.

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Para. 35 – Taxation of distribution to large investors

It is opinion of the authors that the taxation of the large investor (by way of the domestic withholding, with no Tax Treaty reduction) cannot be left to the REIT State without any limitation.

The distinction (and the consequent discrimination of the large investor) appears to be acceptable if the tax base of the income taxable by the State A is the same of the small investor.

Since the distribution of the REIT should come out of the same amount (NAV of the investment for a given period) both for the small and for the large investors, there is no reason in principle for having a different tax base. Notwithstanding

that, this should be inserted by WP as a requirement to be agreed bilaterally between Contracting States before stating the distinction said above.

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Para. 43 – Relief of double taxation in the State of residence

WP states in the Report that *“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 (...) it would be appropriate to apply the credit method to them”*. On the contrary, *“distributions to large investors in a REIT (...) should be covered by the exemption method if this is the method generally applied by a State”*.

Based upon the general treatment applicable under Italian tax law, any portfolio investment (likewise the one made by a small investor in a REIT, as defined in the Report), being subject to a limited withholding tax, shall not form part of the taxable income of the recipient in his/her residence country, and thus shall not have access to the credit system.

Stating thus it more precisely, a basic requirement (under Italian tax law) for having access to the foreign tax credit and recover the taxes retained by State A on REITs distributions, is that such distributed income is included in the taxable income of the small investor and there subject to tax: this usually does not take place where the income is a portfolio investment and the withholding tax levied (abroad) is final⁵. In addition, most of the treaties stipulated by Italy precise (para. 3 of art.23) that tax credit is not granted on incomes subject to (final) withholding taxes in Italy. The treaties then clarify that this treatment applies if this is required by the beneficiary of the income.

Such tax level is usually acceptable by the small investor, since total taxation is limited to the (foreign) withholding tax and then in line with taxation on capital income usually applicable on capital markets for other classes of investments (eg listed stocks, State bonds, ...).

On the other hand, being a large investor, no limited taxation is ensured under the approach taken by the WP Report and the proposed changes to the Commentary.

In principle, taxation (levied again with a withholding tax by the REIT, but presumably at an higher rate) could also be quite relevant and credit system may allow the deduction of such foreign tax against the domestic tax charges.

However, it is the opinion of the authors that the application of a credit system may involve several problems of coordination, in particular with reference to the

⁵ The reason for that is to mitigate taxation on limited investment of capital made by small investors and not to raise obstacles to the capital freedom of movement.

determination of income (i.e. in case of accrued income, rules for determining income may strongly vary among States) and the fiscal year to which it refers.

Conclusively, we agree then the exemption system as the preferable mechanics to avoid double taxation both for small and for large investors in a REIT.